Background Material on GST

(Popularly known as VAT globally)

The Institute of Chartered Accountants of India

(Set up by an Act of Parliament)

New Delhi

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Edition	:	October, 2014
Updated Edition	:	June, 2015
Committee/Department	:	Indirect Taxes Committee
E-mail	:	idtc@icai.in
Website	:	www.icai.org
Price	:	₹ 275/-
ISBN No.	:	978-81-8441-726-5
Published by	:	The Publication Department on behalf of the Institute of Chartered Accountants of India, ICAI Bhawan, Post Box No. 7100, Indraprastha Marg, New Delhi - 110 002.
Printed by	:	Sahitya Bhawan Publications, Hospital Road, Agra-282 003
		June/2015/P1760(Updated)

Dy. No. 187997 FM/FMP/2014

अरुण जेटली
वित्त, कार्पोरेट कार्य
एवं रक्षा मंत्री
भारत

सत्यमेव जयते

Arun Jaitley
Minister of Finance, Corporate Affairs
and Defence
India

September 30, 2014

MESSAGE

It gives me immense pleasure to know that Institute of Chartered Accountants of India is coming up with a publication titled *'Background Material on GST'*.

The Institute of Chartered Accountants of India has been proactively supporting the endeavours of the Government as a part of its role in aiding better governance.

I hope the publication being brought out by the Institute would help in disseminating information about the usefulness of GST among the participants as well as other Government agencies. I wish all success for this publication.

(Arun Jaitley)

K. M. MANI
MINISTER FOR FINANCE, LAW & HOUSING
GOVERNMENT OF KERALA
AND
CHAIRMAN, EMPOWERED COMMITTEE OF
STATE FINANCE MINISTERS

THIRUVANANTHAPURAM

DATED 4th June, 2015

Message

It gives me immense pleasure to know that the Indirect Taxes Committee of the Institute of Chartered Accountants of India (ICAI) is bringing out "Background Material on Goods & Services Tax (GST)". This publication explains the concept of GST, its features and advantages with illustrations, its impact on Indian economy and GST regime in other countries. I commend the efforts gone in for developing this material. I am sure that the readers will find the publication useful and it will help in understanding the Goods and Services Tax, which is likely to be implemented in the country shortly.

I am happy that the Institute of Chartered Accountant of India is living upto its motto of being a partner in nation building. I wish them all the success for this educative publication.

(K.M. Mani)

सत्यमेव जयते
Kaushal Srivastava
Special Secretary & Chairman

भारत सरकार
GOVERNMENT OF INDIA
वित्त मंत्रालय / राजस्व विभाग
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Message

I am happy to learn that Institute of Chartered Accountant of India (ICAI), through its Indirect Taxes Committee, has developed a "Background Material on Goods & Services Tax (GST)" which provides basic understanding of the proposed GST regime in India and its advantages.

The Institute of Chartered Accountant of India has been proactively supporting the Government's initiatives for better governance.

I appreciate ICAI for developing this background material and hope that this publication would help in disseminating information about the usefulness of GST among the members and other stakeholders.

I wish all success to ICAI for this publication as well as for its various endeavours.

K Srivastava
(**Kaushal Srivastava**)

PRESIDENT'S MESSAGE

A growing economy like India needs adequate resources to finance developmental activities that are inclusive and reaches all strata. Our country is continuously evolving its tax system to streamline its administration and generate more revenue for infrastructure, social welfare and a number of other activities.

Way back in the year 2004, Dr. Kelkar Task Force recommended the need of Goods and Services Tax (GST) in India. The Government came out with a First Discussion Paper on GST in November, 2009 and introduced the 115th Constitution Amendment (GST) Bill in the year 2011.

GST is a tax on goods and services, which is leviable at each point of sale or provision of service, in which at the time of sale of goods or providing the services the seller or service provider may claim the input credit of tax which he has paid while purchasing the goods or procuring the services. It is designed to simplify present indirect tax system by integrating the union excise duties, customs duties (CVD/SAD), service tax and state VAT into a single structure.

In order to meet upcoming changes and challenges that introduction of GST is set to bring, the Institute of Chartered Accountants of India is working in a proactive manner. The ICAI is committed to work with Central Board of Excise and Customs (CBEC) and other stakeholdersto facilitate the implementation of GST in India.

It is really heartening that the Indirect Taxes Committee of ICAI has brought out a "Background Material on Goods & Service Tax" which is duly updated with the changes brought in by 122nd Constitution Amendment Bill, 2014 and also contains the Standardized PPT on GST launched by Indirect Taxes Committee. I wholeheartedly compliment the efforts of CA. Atul Gupta, Chairman, CA. Shyamlal Agarwal, Vice- Chairman, other members and secretariat of the Indirect Taxes Committee for bringing out this comprehensive material directed to create awareness about GST.

I am sure this background material would be highly useful to the readers.

Date: 26.02.2015 CA. Manoj Fadnis

Place: New Delhi President

VICE- PRESIDENT'S MESSAGE

Introduction of GST would be second major reform in India in the area of Indirect Taxes after Value Added Tax in the State in 2005.GST is a single comprehensive tax levied on goods and services consumed in an economy. It would mainly subsume union excise duties, customs duties (CVD/SAD), service tax and state VAT into a single levy. It would require a lot of planning to ensure a smooth transition from existing structure to the new one.

Hon'ble Finance Minister Shri Arun Jaitley, in his budget speech on 10th July 2014, asserted working towards approval of legislative scheme to enable introduction of Goods and Services Tax in India. Also 122nd Constitution Amendment (GST) Bill, 2014was introduced on 19th December 2014, which marks another step towards the upcoming GST regime in India.The Institute of Chartered Accountants of India also,living to its motto of being a partner in nation building, has committed itself to be pivotal in introduction of Goods and Services Tax in India.

The ICAIhas been organising various educative programmes to spread awareness about GST among its members and other stakeholders. Till date, the committee has organised over 10 programmes in the year 2015 and more are yet to come. The Indirect Taxes Committee of ICAI has come up with this "Background Material on Goods & Services Tax" for distribution among the participants of the programme, seminar and conferences organised on GST. This material briefly elucidates the existing indirect tax structure of India, the existing GST structure across various countries, the proposed model of GST in India etc. and covers changes made by 122nd Constitution Amendment Bill, 2014. Standardized PPT on GST launched by Indirect Taxes Committee is also covered in this material.

I sincerely appreciate CA. Atul Gupta, CA. Shyamlal Agarwal and other members of the Indirect Taxes Committee for their efforts in bringing out this background material. I trust you all to benefit the most from the same.

Wish you a great learning experience.

Date: 19.02.2015 CA. Devaraja Reddy
Place: New Delhi Vice-President

CHAIRMAN'S MESSAGE

GST is a broad based and a single comprehensive tax levied on goods and services consumed in an economy. It is levied at every stage of the production - distribution chain till retail level with applicable setoffs in respect of the tax remitted at previous stages.It is a destination based tax and levied at single point at the time of final consumption of goods or services by ultimate consumer.

More than 100 countries across the world have introduced GST or Federal VAT in one form or the other. The GST rate in various countries ranges from as low as 5% in Taiwan to as high as 25% in Denmark. India is expecting to have a dual GST model. It will comprise of a Central GST and a State GST. The Centre and the States will each legislate, levy and administer the Central GST and State GST, respectively. There are indications that the Revenue Neutral Rate (RNR) could be in the range of 16% to 20%.

The Institute of Chartered Accountants of India, with a view to update the members and other stakeholder at large by way organising programme, seminar, and conferences, has brought out this Background Material GST.The material covers various topics like concept of GST, its pros and cons, its feasibility & impact in India, challenges for Indian economy, GST in other countries etc. It is an all-inclusive material, which would provide an insight to the basic concepts of GST and also covers the changes brought in by 122nd Constitution Amendment Bill, 2014 and the Standardized PPT on GST launched by Indirect Taxes Committee.

At this juncture, I would also like to express my sincere gratitude and thanks to CA. Manoj Fadnis, President, ICAI, CA. Devaraja Reddy, Vice-President, ICAI, CA. Shyamlal Agarwal, Vice-Chairman, Indirect Taxes Committee as well as other members of the committee for their guidance and support in this initiative. I genuinely appreciate CA. Rakesh Garg for providing basic material and CA. Vijay Gupta and other members of the VAT & GST Study Group for reviewing and bringing this material to its being. I wish you all a wonderful and a knowledgeable stride with this material.

I trust this material would prove to be useful in your endeavours.

Date: 19.02.2015
Place: New Delhi

CA. Atul Gupta
Chairman
Indirect Taxes Committee

VICE-CHAIRMAN MESSAGE

One of the biggest taxation reforms in India -- the Goods and Services Tax (GST) -- is all set to integrate State economies and boost overall growth. GST will create a single, unified Indian market to make the economy stronger. The implementation of GST will lead to the abolition of existing taxes such as excise duty, service tax, Central Sales Tax, State-level sales tax, octroi, turnover tax, etc. thus avoiding multiple layers of taxation that currently exist in India.

Another reason to go the GST way is to facilitate seamless credit across the entire supply chain and across all States under a common tax base. Introduction of GST would also rationalize tax content in product price, enhance the ability of companies to compete globally, and possibly trickle down to benefit the ultimate consumer.

The Institute of Chartered Accountant of India (ICAI) plays a key role in disseminating information regarding upcoming reforms in the economy. This is done with the help of various programmes, seminars, webcasts, background material, manuals etc. In order to get well versed with the Goods and Services Tax (GST), the Indirect Taxes Committee of ICAI has come up with a "Background Material on GST". The material covers various nitigrities connected with Goods and Services and addresses many questions, apprehensions of members and otherwise with its self-explanatory compilations. Topics like concept of GST, benefits arising of GST, its feasibility & impact in India, challenges for Indian economy, GST in other countries etc. are covered herein. The standardized PPT launched by Indirect Taxes Committee and the changes brought in by 122nd Constitution Amendment Bill, 2014 are also a part of this material.

A lot of efforts and hardwork is undergone in preparing this material and efforts of the contributors are commendable. I hope this material benefits you in the best possible manner. I wish you a great learning spree.

Date: 19.02.2015
Place: New Delhi

CA. Shyamlal Agarwal
Vice-Chairman
Indirect Taxes Committee

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AS INTRODUCED IN LOK SABHA

BILL NO. 192 OF 2014*

THE CONSTITUTION (ONE HUNDRED AND TWENTY-SECOND AMENDMENT) BILL, 2014

A

BILL

further to amend the Constitution of India.

BE it enacted by Parliament in the Sixty-fifth Year of the Republic of India as follows:—

Short title and commencement.

1. (1) This Act may be called the Constitution (One Hundred and Twenty-second Amendment) Act, 2014.

(2) It shall come into force on such date as the Central Government may, by notification in the Official Gazette, appoint, and different dates may be appointed for different provisions of this Act and any reference in any such provision to the commencement of this Act shall be construed as a reference to the commencement of that provision.

Insertion of new article 246A.

2. After article 246 of the Constitution, the following article shall be inserted, namely:—

Special provision with respect to goods and services tax.

"246A. (1) Notwithstanding anything contained in articles 246 and 254, Parliament, and, subject to clause (2), the Legislature of every State, have power to make laws with respect to goods and services tax imposed by the Union or by such State.

* ***Source*** **:** http://www.egazette.nic.in/

(2) Parliament has exclusive power to make laws with respect to goods and services tax where the supply of goods, or of services, or both takes place in the course of inter-State trade or commerce.

Explanation.—The provisions of this article, shall, in respect of goods and services tax referred to in clause (5), of article 279A, take effect from the date recommended by the Goods and Services Tax Council.''.

Amendment of article 248.

3. In article 248 of the Constitution, in clause (1), for the word "Parliament", the words, figures and letter "Subject to article 246A, Parliament" shall be substituted.

Amendment of article 249.

4. In article 249 of the Constitution, in clause (1), after the words "with respect to", the words, figures and letter"goods and services tax provided under article 246A or" shall be inserted.

Amendment of article 250.

5. In article 250 of the Constitution, in clause (1), after the words "with respect to", the words, figures and letter "goods and services tax provided under article 246A or" shall be inserted.

Amendment of article 268.

6. In article 268 of the Constitution, in clause (1), the words "and such duties of excise on medicinal and toilet preparations" shall be omitted.

Omission of article 268A.

7. Article 268A of the Constitution, as inserted by section 2 of the Constitution (Eighty-eighth Amendment) Act, 2003 shall be omitted.

Amendment of article 269.

8. In article 269 of the Constitution, in clause (1), after the words "consignment of goods", the words, figures and letter "except as provided in article 269A" shall be inserted.

Insertion of new article 269A.

9. After article 269 of the Constitution, the following article shall be inserted, namely:—

Levy and collection of goods and services tax in course of inter-State trade or commerce.

''269A. (1) Goods and services tax on supplies in the course of inter-State trade or commerce shall be levied and collected by the Government of India and such tax shall be apportioned between the Union and the States in the manner as may be provided by Parliament by law on the recommendations of the Goods and Services Tax Council.

Explanation.—For the purposes of this clause, supply of goods, or of services, or both in the course of import into the territory of India shall be deemed to be supply of goods, or of services, or both in the course of inter-State trade or commerce.

(2) Parliament may, by law, formulate the principles for determining the place of supply, and when a supply of goods, or of services, or both takes place in the course of inter-State trade or commerce.''.

Amendment of article 270.

10. In article 270 of the Contitution,—

(i) in clause (1), for the words, figures and letter "articles 268, 268A and article 269", the words, figures and letter "articles 268, 269 and article 269A" shall be substituted;

(ii) after clause (1), the following clause shall be inserted, namely:—

> ''(1A) The goods and services tax levied and collected by the Government of India, except the tax apportioned with the States under clause (1) of article 269A, shall also be distributed between the Union and the States in the manner provided in clause (2).''.

Amendment of article 271.

11. In article 271 of the Constitution, after the words ''in those articles'', the words, figures and letter ''except the goods and services tax under article 246A,'' shall be inserted.

Insertion of new article 279A.

12. After article 279 of the Constitution, the following article shall be inserted, namely:—

Goods and Services Tax Council.

"279A. (1)The President shall, within sixty days from the date of commencement of the Constitution (One Hundred and Twenty-second Amendment) Act, 2014, by order, constitute a Council to be called the Goods and Services Tax Council.

(2) The Goods and Services Tax Council shall consist of the following members, namely:—

(a) the Union Finance Minister........................ Chairperso;

(b) the Union Minister of State in charge of Revenue or Finance................ Member;

(c) the Minister in charge of Finance or Taxation or any other Minister nominated by each State Government................... Members.

(3) The Members of the Goods and Services Tax Council referred to in sub-clause (c) of clause (2) shall, as soon as may be, choose one amongst themselves to be the Vice-Chairperson of the Council for such period as they may decide.

(4) The Goods and Services Tax Council shall make recommendations to the Union and the States on—

(a) the taxes, cesses and surcharges levied by the Union, the States and the local bodies which may be subsumed in the goods and services tax;

(b) the goods and services that may be subjected to, or exempted from the goods and services tax;

(c) model Goods and Services Tax Laws, principles of levy, apportionment of Integrated Goods and Services Tax and the principles that govern the place of supply;

(d) the threshold limit of turnover below which goods and services may be exempted from goods and services tax;

(e) the rates including floor rates with bands of goods and services tax;

(f) any special rate or rates for a specified period, to raise additional resources during any natural calamity or disaster;

(g) special provision with respect to the States of Arunachal Pradesh, Assam, Jammu and Kashmir, Manipur, Meghalaya, Mizoram, Nagaland, Sikkim, Tripura, Himachal Pradesh and Uttarakhand; and

(h) any other matter relating to the goods and services tax, as the Council may decide.

(5) The Goods and Services Tax Council shall recommend the date on which the goods and services tax be levied on petroleum crude, high speed diesel, motor spirit (commonly known as petrol), natural gas and aviation turbine fuel.

(6) While discharging the functions conferred by this article, the Goods and Services Tax Council shall be guided by the need for a harmonised structure of goods and services tax and for the development of a harmonised national market for goods and services.

(7) One half of the total number of Members of the Goods and Services Tax Council shall constitute the quorum at its meetings.

(8) The Goods and Services Tax Council shall determine the procedure in the performance of its functions.

(9) Every decision of the Goods and Services Tax Council shall be taken at a meeting, by a majority of not less than three-fourths of the weighted votes of the members present and voting, in accordance with the following principles, namely:—

(a) the vote of the Central Government shall have a weightage of one-third of the total votes cast, and

(b) the votes of all the State Governments taken together shall have a weightage of two-thirds of the total votes cast, in that meeting.

(10) No act or proceedings of the Goods and Services Tax Council shall be invalid merely by reason of—

(a) any vacancy in, or any defect in, the constitution of the Council; or

(b)any defect in the appointment of a person as a member of the Council; or

(c) any procedural irregularity of the Council not affecting the merits of the case.

(11) The Goods and Services Tax Council may decide about the modalities to resolve disputes arising out of its recommendation.”.

Amendment of article 286.

13. In article 286 of the Constitution,—

(i) in clause (1),—

(A) for the words "the sale or purchase of goods where such sale or purchase takes place", the words "the supply of goods or of services or both, where such supply takes place" shall be substituted;

(B) in sub-clause (b), for the word “goods”, at both the places where it occurs the words “goods or services or both” shall be substituted;

(ii) in clause (2), for the words "sale or purchase of goods takes place", the words "supply of goods or of services or both" shall be substituted;

(iii) clause (3) shall be omitted.

Amendment of article 366.

14. In article 366 of the Constitution,—

(i) after clause (12), the following clause shall be inserted, namely:—

‘(12A) “goods and services tax” means any tax on supply of goods, or services or both except taxes on the supply of the alcoholic liquor for human consumption;’;

(ii) after clause (26), the following clauses shall be inserted, namely:—

‘(26A) “Services” means anything other than goods;

(26B) “State” with reference to articles 246A, 268, 269, 269A and article

279A includes a Union territory with Legislature;’.

Amendment of article 368.

15. In article 368 of the Constitution, in clause (2), in the proviso, in clause (a), for the words and figures “article 162 or article 241”, the words, figures and letter “article 162, article 241 or article 279A” shall be substituted.

Amendment of Sixth Schedule

16. In the Sixth Schedule to the Constitution, in paragraph 8, in sub-paragraph (3),—

(i) in clause (c), the word "and" occurring at the end shall be omitted;

(ii) in clause (d), the word "and" shall be inserted at the end;

(iii) after clause (d), the following clause shall be inserted, namely:—

"(e) taxes on entertainment and amusements.".

Amendment of Seventh Schedule.

17. In the Seventh Schedule to the Constitution,—

(a) in List I — Union List,—

(i) for entry 84, the following entry shall be substituted, namely:—

"84. Duties of excise on the following goods manufactured or produced in India, namely:—

(a) petroleum crude;

(b) high speed diesel;

(c) motor spirit (commonly known as petrol);

(d) natural gas;

(e) aviation turbine fuel; and

(f) tobacco and tobacco products.";

(ii) entries 92 and 92C shall be omitted;

(b) in List II — State List,—

(i) entry 52 shall be omitted;

(ii) for entry 54, the following entry shall be substituted, namely:—

"54. Taxes on the sale of petroleum crude, high speed diesel, motor spirit (commonly known as petrol), natural gas, aviation turbine fuel and alcoholic liquor for human consumption, but not including sale in the course of inter-State trade or commerce or sale in the course of international trade or commerce of such goods.";

(iii) entry 55 shall be omitted;

(iv) for entry 62, the following entry shall be substituted, namely:—

"62. Taxes on entertainments and amusements to the extent levied and collected by a Panchayat or a Municipality or a Regional Council or a District Council.".

Arrangement for assignment of additional tax on supply of goods to States for two years or such other period recommended by the Council.

18. (1) An additional tax on supply of goods, not exceeding one per cent. in the course of inter-State trade or commerce shall, notwithstanding anything contained in clause (1) of article 269A, be levied and collected by the Government of India for a period of two years or such other period as the Goods and Services Tax Council may recommend, and such tax shall be assigned to the States in the manner provided in clause (2).

(2) The net proceeds of additional tax on supply of goods in any financial year, except the proceeds attributable to the Union territories, shall not form part of the Consolidated Fund of India and be deemed to have been assigned to the States from where the supply originates.

(3) The Government of India may, where it considers necessary in the public interest, exempt such goods from the levy of tax under clause (1).

(4) Parliament may, by law, formulate the principles for determining the place of origin from where supply of goods take place in the course of inter-State trade or commerce.

Compensation to States for loss of revenue on account of introduction of goods and services tax.

19. Parliament may, by law, on the recommendation of the Goods and Services Tax Council, provide for compensation to the States for loss of revenue arising on account of implementation of the goods and services tax for such period which may extend to five years.

Transitional provisions.

20. Notwithstanding anything in this Act, any provision of any law relating to tax on goods or services or on both in force in any State immediately before the commencement of this Act, which is inconsistent with the provisions of the Constitution as amended by this Act shall continue to be inforce until amended or repealed by a competent Legislature or other competent authority or until expiration of one year from such commencement, whichever is earlier. Power of President to remove difficulties.

21. (1) If any difficulty arises in giving effect to the provisions of the Constitution as amended by this Act (including any difficulty in relation to the transition from the provisions of the Constitution as they stood immediately before the date of assent of the President to this Act to the provisions of the Constitution as amended by this Act), the President may, by order, make such provisions, including any adaptation or modification of any provision of the Constitution as amended by this Act or law, as appear to the President to be necessary or expedient for the purpose of removing the difficulty:

Provided that no such order shall be made after the expiry of three years from the date of such assent.

(2) Every order made under sub-section (1) shall, as soon as may be after it is made, be laid before each House of Parliament.

STATEMENT OF OBJECTS AND REASONS

The Constitution is proposed to be amended to introduce the goods and services tax for conferring concurrent taxing powers on the Union as well as the States including Union territory with Legislature to make laws for levying goods and services tax on every transaction of supply of goods or services or both. The goods and services tax shall replace a number of indirect taxes being levied by the Union and the State Governments and is intended to remove cascading effect of taxes and provide for a common national market for goods and services. The proposed Central and State goods and services tax will be levied on all transactions involving supply of goods and services, except those which are kept out of the purview of the goods and services tax.

2. The proposed Bill, which seeks further to amend the Constitution, *inter alia*, provides for—

(a) subsuming of various Central indirect taxes and levies such as Central Excise Duty, Additional Excise Duties, Excise Duty levied under the Medicinal and Toilet Preparations (Excise Duties) Act, 1955, Service Tax, Additional Customs Duty commonly known as Countervailing Duty, Special Additional Duty of Customs, and Central Surcharges and Cesses so far as they relate to the supply of goods and services;

(b) subsuming of State Value Added Tax/Sales Tax, Entertainment Tax (other than the tax levied by the local bodies), Central Sales Tax (levied by the Centre and collected by the States), Octroi and Entry tax, Purchase Tax, Luxury tax, Taxes on lottery, betting and gambling; and State cesses and surcharges in so far as they relate to supply of goods and services;

(c) dispensing with the concept of 'declared goods of special importance' under the Constitution;

(d) levy of Integrated Goods and Services Tax on inter-State transactions of goods and services;

(e) levy of an additional tax on supply of goods, not exceeding one per cent. In the course of inter-State trade or commerce to be collected by the Government of India for a period of two years, and assigned to the States from where the supply originates;

(f) conferring concurrent power upon Parliament and the State Legislatures to make laws governing goods and services tax;

(g) coverage of all goods and services, except alcoholic liquor for human consumption, for the levy of goods and services tax. In case of petroleum and petroleum products, it has been provided that these goods shall not be subject to the levy of Goods and Services Tax till a date notified on the recommendation of the Goods and Services Tax Council.

(h) compensation to the States for loss of revenue arising on account of implementation of the Goods and Services Tax for a period which may extend to five years;

(i) creation of Goods and Services Tax Council to examine issues relating to goods and services tax and make recommendations to the Union and the States on parameters like rates, exemption list and threshold limits. The Council shall function under the Chairmanship of the Union Finance Minister and will have the Union Minister of State in charge of Revenue or Finance as member, along with the Minister in-charge of Finance or Taxation or any other Minister nominated by each State Government. It is further provided that every decision of the Council shall be taken by a majority of not less than three-fourths of the weighted votes of the members present and voting in accordance with the following principles:—

(A) the vote of the Central Government shall have a weightage of one-third of the total votes cast, and

(B) the votes of all the State Governments taken together shall have a weightage of two-thirds of the total votes cast in that meeting.

Illustration:

In terms of clause (9) of the proposed article 279A, the "weighted votes of the members present and voting" in favour of a proposal in the Goods and Services Tax Council shall be determined as under:—

$$WT = WC + WS$$

Where,

$$WT = WC + WS \left(\frac{WST}{SP}\right) \times SF$$

Wherein—

WT = Total weighted votes of all members in favour of a proposal.

WC = Weighted vote of the Union = $\frac{1}{3}$ *i.e.,* 33.33% if the Union is in favour of the proposal and be taken as "0" if, Union is not in favour of a proposal.

WS = Weighted votes of the States in favour of a proposal.

SP = Number of States present and voting.

WST = Weighted votes of all States present and voting *i.e.* $\frac{1}{3}$ *i.e.,* 66.67%

SF = Number of States voting in favour of a proposal.

(j) Clause 20 of the proposed Bill makes transitional provisions to take care of any inconsistency which may arise with respect to any law relating to tax on goods or services or on both in force in any State on the commencement of the provisions of the Constitution as amended by this Act within a period of one year.

3. the Bill seeks to achieve the above objects.

NEW DELHI; ARUN JAITLEY

The 18*th December*, 2014

PRESIDENT'S RECOMMENDATION UNDER ARTICLE 117 OF THE CONSTITUTION OF INDIA

[Copy of letter No. S-31011/07/2014-SO(ST), dated the 18th December, 2014 from Shri Arun Jaitley, Minister of Finance to the Secretary-General, Lok Sabha.]

The President, having been informed of the subject matter of the proposed Bill, recommends under clauses (1) and (3) of article 117, read with clause (1) of article 274, of the Constitution of India, the introduction of the Constitution (One Hundred and Twenty-second Amendment) Bill, 2014 in Lok Sabha and also the consideration of the Bill.

FINANCIAL MEMORANDUM

Clause 12 of the Bill seeks to insert a new article 279A in the Constitution relating to

Constitution of Goods and Services Tax Council. The Council shall function under the Chairmanship of the Union Finance Minister and will have the Union Minister of State incharge of Revenue or Finance as member, along with the Minister in-charge of Finance or Taxation or any other Minister nominated by each State Government.

2. The creation of Goods and Services Tax Council will involve expenditure on office expenses, salaries and allowances of the officers and staff. The objective that the introduction of goods and services tax will make the Indian trade and industry more competitive, domestically as well as internationally and contribute significantly to the growth of the economy, such additional expenditure on the Council will not be significant.

3. At this stage, it will be difficult to make an estimate of the expenditure, both recurring and non-recurring on account of the Constitution of the Council.

4. Further, it is provided for compensation to the States for loss of revenue arising on account of implementation of the Goods and Services Tax for such period which may extend to five years. The exact compensation can be worked out only when the provisions of the Bill are implemented.

MEMORANDUM REGARDING DELEGATED LEGISLATION

Clause 12 of the Bill seeks to insert a new article 279A relating to the constitution of a

Council to be called the Goods and Services Tax Council. Clause (1) of the proposed new article 279A provides that the President, shall within sixty days from the date of the commencement of the Constitution (One Hundred and Twenty-second Amendment) Act, 2014, by order, constitute a Council to be called the Goods and Services Tax Council. Clause (8) of the said article provides that the Council shall determine the procedure in the performance of its functions.

2. The procedures, as may be laid down by the Goods and Services Tax Council in the performance of its functions, are matters of procedure and details. The delegation of legislative power is, therefore, of a normal character.

ANNEXURE

EXTRACTS FROM THE CONSTITUTION OF INDIA

*   *   *   *   *

Residuary powers of legislation.

248. (1) Parliament has exclusive power to make any law with respect to any matter not enumerated in the Concurrent List or State List.

*   *   *   *   *

Power of Parliament to legislate with respect to a matter in the State List in the national interest.

249. (1) Notwithstanding anything in the foregoing provisions of this Chapter, if the Council of States has declared by resolution supported by not less than two-thirds of the members present and voting that it is necessary or expedient in the national interest that Parliament should make laws with respect to any matter enumerated in the State List specified in the resolution, it shall be lawful for Parliament to make laws for the whole or any part of the territory of India with respect to that matter while the resolution remains in force.

*   *   *   *   *

Power of Parliament to legislate with respect to any matter in the State List if a Proclamation of Emergency is in operation.

250. (1) Notwithstanding anything in this Chapter, Parliament shall, while a Proclamation of Emergency is in operation, have power to make laws for the whole or any part of the territory of India with respect to any of the matters enumerated in the State List.

*   *   *   *   *

Distribution of Revenues between the Union and the States

Duties levied by the Union but collected and appropriated by the States.

268. (1) Such stamp duties and such duties of excise on medicinal and toilet preparations as are mentioned in the Union List shall be levied by the Government of India but shall be collected—

(a) in the case where such duties are leviable within any Union territory, by the Government of India, and

(b) in other cases, by the States within which such duties are respectively leviable.

* * * * *

Service tax levied by Union and collected and appropriated by the Union and the States

268A. (1) Taxes on services shall be levied by the Government of India and such tax shall be collected and appropriated by the Government of India and the States, in the manner provided in clause (2).

(2) The proceeds in any financial year of any such tax levied in accordance with the provisions of clause (1) shall be—

(a) collected by the Government of India and the States;

(b) appropriated by the Government of India and the States,

in accordance with such principles of collection and appropriation as may be formulated by Parliament by law.

Taxes levied and collected by the Union but assigned to the States

269. (1) Taxes on the sale or purchase of goods and taxes on the consignment of goods shall be levied and collected by the Government of India but shall be assigned and shall be deemed to have been assigned to the States on or after the 1st day of April, 1996 in the manner provided in clause (2).

Explanation.—For the purposes of this clause,—

(a) the expression "taxes on the sale or purchase of goods" shall mean taxes on sale or purchase of goods other than newspapers, where such sale or purchase takes place in the course of inter-State trade or commerce;

(b) the expression "taxes on the consignment of goods" shall mean taxes on the consignment of goods (whether the consignment is to the person making it or to any other person), where such consignment takes place in the course of inter-State trade or commerce.

* * * * *

Taxes levied and distributed between the Union and the States

270. (1) All taxes and duties referred to in the Union List, except the duties and taxes referred to in articles 268, 268A and 269, respectively, surcharge on taxes and duties referred to in article 271 and any cess levied for specific purposes under any law made by Parliament shall be levied and collected by the Government of India and shall be distributed between the Union and the States in the manner provided in clause (2).

* * * * *

Surcharge on certain duties and taxes for purposes of the Union

271. Notwithstanding anything in articles 269 and 270, Parliament may at any time increase any of the duties or taxes referred to in those articles by a surcharge for purposes of the Union and the whole proceeds of any such surcharge shall form part of the Consolidated Fund of India.

* * * * *

Restrictions as to imposition of tax on the sale or purchase of goods.

286. (1) No law of a State shall impose, or authorise the imposition of, a tax on the sale or purchase of goods where such sale or purchase takes place—

(a) outside the State; or

(b) in the course of the import of the goods into, or export of the goods out of the territory of India.

(2) Parliament may by law formulate principles for determining when a sale or purchase of goods takes place in any of the ways mentioned in clause (1).

(3) Any law of a State shall, in so far as it imposes, or authorises the imposition of,—

(a) a tax on the sale or purchase of goods declared by Parliament by law to be of special importance in inter-State trade or commerce; or

(b) a tax on the sale or purchase of goods, being a tax of the nature referred to in sub-clause (b), sub-clause (c) or sub-clause (d) of clause (29A) of article 366, be subject to such restrictions and conditions in regard to the system of levy, rates and other incidents of the tax as Parliament may by law specify.

* * * * *

PART XX

AMENDMENT OF THE CONSTITUTION

Power of Parliament to amend the Constitution and procedure therefore.

368. (1)

* * * * *

(2) An amendment of this Constitution may be initiated only by the introduction of a

Bill for the purpose in either House of Parliament, and when the Bill is passed in each House by a majority of the total membership of that House and by a majority of not less than two-thirds of the members of that House present and voting, it shall be presented to the President who shall give his assent to the Bill and thereupon the Constitution shall stand amended in accordance with the terms of the Bill:

Provided that if such amendment seeks to make any change in—

(a) article 54, article 55, article 73, article 162 or article 241, or

(b) Chapter IV of Part V, Chapter V of Part VI, or Chapter I of Part XI, or

(c) any of the Lists in the Seventh Schedule, or

(d) the representation of States in Parliament, or

(e) the provisions of this article,

the amendment shall also require to be ratified by the Legislatures of not less than one-half of the States by resolutions to that effect passed by those Legislatures before theBill making provision for such amendment is presented to the President for assent.

* * * * *

SIXTH SCHEDULE

[Articles 244(2) and 275(1)]

Provisions as to the Administration of Tribal Areas in the States of Assam, Meghalaya, Tripura and Mizoram

* * * * *

Powers to assess and collect land revenue and to impose taxes.

8. (1) * * * * *

(3) The District Council for an autonomous district shall have the power to levy and collect all or any of the following taxes within such district, that is to say—

* * * * *

(c) taxes on the entry of goods into a market for sale therein, and tolls on passengers and goods carried in ferries; and

(d) taxes for the maintenance of schools, dispensaries or roads.

* * * * *

SEVENTH SCHEDULE

(Article 246)

List I- Union List

* * * * *

84. Duties of excise on tobacco and other goods manufactured or produced in India except—

(a) alcoholic liquors for human consumption;

(b) opium, Indian hemp and other narcotic drugs and narcotics, but including medicinal and toilet preparations containing alcohol or any substance included in sub-paragraph (b) of this entry.

* * * * *

92. Taxes on the sale or purchase of newspapers and on advertisements published therein.

*   *   *   *   *

92C. Taxes on services.

*   *   *   *   *

List II-State List

*   *   *   *   *

52. Taxes on the entry of goods into a local area for consumption, use or sale therein.

*   *   *   *   *

54. Taxes on the sale or purchase of goods other than newspapers, subject to the provisions of entry 92A of List I.

55. Taxes on advertisements other than advertisements published in the newspapers and advertisements broadcast by radio or television.

*   *   *   *   *

62. Taxes on luxuries, including taxes on entertainments, amusements, betting and gambling.

*   *   *   *   *

Press Information Bureau*

Government of India

Ministry of Finance

19-December-2014 19:46 IST

Union Finance Minister Shri Arun Jaitley Intoduces the Constitution Amendment Bill on Goods and Services Tax (GST) in Lok Sabha; New Article 246a Proposed to Confer Simultaneous Power to Union and State Legislatures to Legislate on GST ;

Centre To Compensate States for Loss of Revenue Arising on Account of Implementation of the GST for a period up to Five Years

The Union Cabinet approved on 17th December,2014 the proposal for introduction of a Bill in the Parliament for amending the Constitution of India to facilitate the introduction of Goods and Services Tax (GST) in the country. The Union Finance Minister Shri Arun Jaitley introduced the said Bill in the Lok Sabha today.

The proposed amendments in the Constitution will confer powers both to the Parliament and State legislatures to make laws for levying GST on the supply of goods and services in the same transaction.

GST will simplify and harmonise the indirect tax regime in the country. GST will broaden the tax base, and result in better tax compliance due to a robust IT infrastructure. Due to the seamless transfer of input tax credit from one state to another in the chain of value addition, there is an in-built mechanism in the design of GST that would incentivize tax compliance by traders. It is thus, expected that introduction of GST will foster a common and seamless Indian market and contribute significantly to the growth of the economy.

Following are the salient features of this Bill:

- A new Article 246A is proposed which will confer simultaneous power to Union and State legislatures to legislate on GST.
- A new Article 279A is proposed for the creation of a Goods & Services Tax Council which will be a joint forum of the Centre and the States. This Council would function under the Chairmanship of the Union Finance Minister and

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* ***Source*** **:** www.pib.gov.in

will have Ministers in charge of Finance/Taxation or Minister nominated by each of the States & UTs with Legislatures, as members. The Council will make recommendations to the Union and the States on important issues like tax rates, exemptions, threshold limits, dispute resolution modalities etc.

- It is proposed to do away with the concept of 'declared goods of special importance' under the Constitution.
- Centre will compensate States for loss of revenue arising on account of implementation of the GST for a period up to five years. A provision in this regard has been made in the Amendment Bill (The compensation will be on a tapering basis, i.e., 100% for first three years, 75% in the fourth year and 50% in the fifth year).

The proposed GST has been designed keeping in mind the federal structure enshrined in the Constitution and will have the following important features:

- Central taxes like Central Excise Duty, Additional Excise Duties, Service Tax, Additional Customs Duty (CVD) and Special Additional Duty of Customs (SAD), etc. will be subsumed in GST.
- At the State level, taxes like VAT/Sales Tax, Central Sales Tax, Entertainment Tax, Octroi and Entry Tax, Purchase Tax and Luxury Tax, etc. would be subsumed in GST.
- All goods and services, except alcoholic liquor for human consumption, will be brought under the purview of GST. Petroleum and petroleum products have also been Constitutionally brought under GST. However, it has also been provided that petroleum and petroleum products shall not be subject to the levy of GST till notified at a future date on the recommendation of the GST Council. The present taxes levied by the States and the Centre on petroleum and petroleum products, i.e., Sales Tax/VAT, CST and Excise duty only, will continue to be levied in the interim period.
- Both Centre and States will simultaneously levy GST across the value chain. Centre would levy and collect Central Goods and Services Tax (CGST), and States would levy and collect the State Goods and Services Tax (SGST) on all transactions within a State.
- The Centre would levy and collect the Integrated Goods and Services Tax (IGST) on all inter-State supply of goods and services. There will be seamless

flow of input tax credit from one State to another. Proceeds of IGST will be apportioned among the States.

- GST is a destination-based tax. All SGST on the final product will ordinarily accrue to the consuming State.
- GST rates will be uniform across the country. However, to give some fiscal autonomy to the States and Centre, there will a provision of a narrow tax band over and above the floor rates of CGST and SGST.
- It is proposed to levy a non-vatable additional tax of not more than 1% on supply of goods in the course of inter-State trade or commerce. This tax will be for a period not exceeding 2 years, or further such period as recommended by the GST Council. This additional tax on supply of goods shall be assigned to the States from where such supplies originate.

Goods and Service Tax (GST)

Globally Known As VAT

Standardised PPT by

Indirect Taxes Committee

Institute of Chartered Accountants of India

Indirect Taxes Committee of ICAI

Major Initiative in 2014-15

- Organized More than 119 Program in One Council Year.
- E Learning Course on Excise, Custom, Service tax and CST Launched- to learn any where, any time.
- 12 Web Cast with recorded Lecture for free download.
- More than 6 Research based Publication launched, 9 more into release by end of January 2015.
- Organized more than 25 program for CBEC officials for capacity building in Department.
- Pursuing Service Tax Audit in line with 44AB Audit in Income Tax to give bird eye view on compliance by assesses.
- Online Portal Launched for better services and various updates for Members.

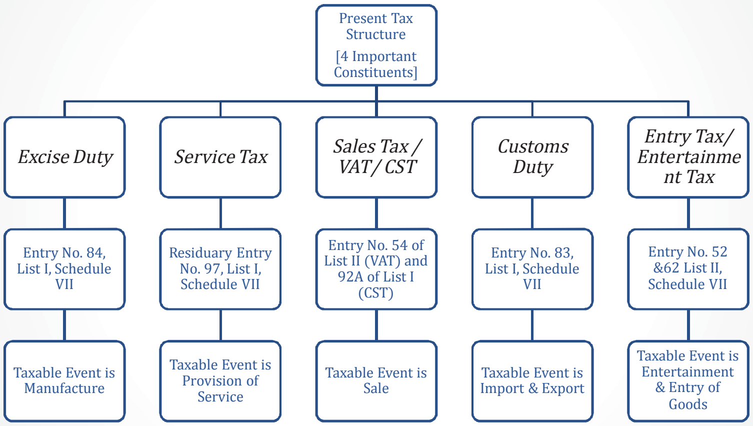
Journey Continues in 2015-16

- Organized More than 50 Programmes since Feb 2015.
- Organized more than 10 programs for CBEC officials for capacity building in Department till date.

Presentation Plan

- Present and Proposed Scheme of Indirect Taxation
- GST –Benefits and Challenges
- Challenges in GST – Lesson from Present System
- Road to GST - Milestones
- Industry' Expectations from GST
- Features of Proposed GST
- Illustration to Showcase Tax Benefit under GST
- Features of Constitution Amendment Bill
- IGST Model
- Features of Place of Supply Rules
- International Perspective in GST
- GST Planning

Present Indirect Tax Structure of India



Proposed Indirect Tax Structure

Intra State Taxable Supply	Excise and Service Tax will be known as CGST	Local VAT & Other taxes will be known as SGST
Inter State Taxable Supply	CST will be known as Integrated GST (IGST)	Approx. Sum Total of CGST and SGST
Import From Outside India	Custom Duty	In Place of CVD and SAD, IGST will be charged

Benefits to Assessee

- Reduction in multiplicity of taxes.
- Mitigation of cascading/ double taxation.
- More efficient neutralization of taxes especially for exports.
- Development of common national market.
- Simpler tax regime -
    - Fewer rates and exemptions.
    - Conceptual clarity (Goods vs. Services).

Benefits to Exchequer/Govt.

- Simpler Tax system.
- Broadening of Tax base.
- Improved compliance & revenue collections (tax booster).
- Efficient use of resources.

Challenges in GST- Lesson from Present System

- Legacy issues which will use resources
- Non Harmonization of Tax rates
- Lack of automation
- Lack of Procedural Manuals
- Lack of Skilled officials
- Double Registration- Handling old Registration
- Poor Quality of tax Returns
- No System for 100% Scrutiny of Tax Returns and Tax Audit
- Lack of Cross Verifications with other tax administrations
- Lack of mechanism to control Evasion
- Impact on Prices

Industry' Expectations from GST

- Low compliance cost
- Simple business processes
- Less requirement of automation initially
- Minimal ITC refund cases
- Exemptions instead of exclusions from GST
- Seamless flow of input credit
- Seamless flow of information between, supplier, buyer and tax administration
- Need for IT portal or agency like TINXSYS, NSDL

Industry' Expectations from GST

- Automation of process by way of e-registrations, e-returns, e-payment
- No requirement of verifications during inter state movement of Goods
- Zero rating of supplies to exporters
- Administrative efficiency in case of assessment and adjudication
- Ease of compliance
- Self-policing

FEATURES OF PROPOSED GST MODEL

Features of Proposed GST

- Destination based Taxation
- Apply to all stages of the value chain
- Apply to all taxable supplies of goods or services (as against manufacture, sale or provision of service) made for a consideration except –
  - Exempted goods or services – common list for CGST & SGST
  - Goods or services outside the purview of GST
  - Transactions below threshold limits
- Dual GST having two concurrent components –
  - Central GST levied and collected by the Centre
  - State GST levied and collected by the States

Features of Proposed GST contd.

- CGST and SGST on intra-State supplies of goods or services in India.
- IGST (Integrated GST) on inter-State supplies of goods or services in India – levied and collected by the Centre.
- IGST applicable to
  - Import of goods and services
  - Inter-state stock transfers of goods and services
- Export of goods and services – Zero rated.
- Additional Tax of 1% on Inter State Taxable supply of Goods by State of Origin and non CENVATABLE

Features of Proposed GST contd.

- All goods or services likely to be covered under GST except :
  - Alcohol for human consumption - State Excise plus VAT
  - Electricity - Electricity Duty
  - Real Estate - Stamp Duty plus Property Taxes
  - Petroleum Products (to be brought under GST from date to be notified on recommendation of GST Council)
- Tobacco Products under GST with Central Excise duty.

Features of Proposed GST contd.

Taxes to be subsumed

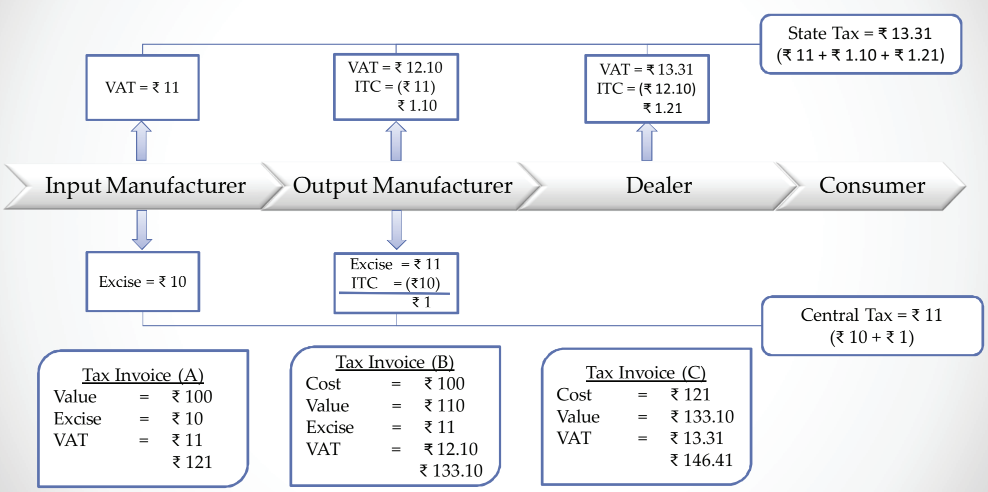
Central Taxes to Subsumed	State Taxes to subsumed
▪ Central Excise duty (CENVAT) ▪ Additional duties of excise ▪ Excise duty levied under Medicinal & Toiletries Preparation Act ▪ Additional duties of customs (CVD & SAD) ▪ Service Tax ▪ Surcharges & Cess	▪ State VAT / Sales Tax ▪ Central Sales Tax ▪ Purchase Tax ▪ Entertainment Tax (not levied by the local bodies) ▪ Luxury Tax ▪ Entry Tax (All forms) ▪ Taxes on lottery, betting & gambling ▪ Surcharges & Cess

Features of Proposed GST contd.

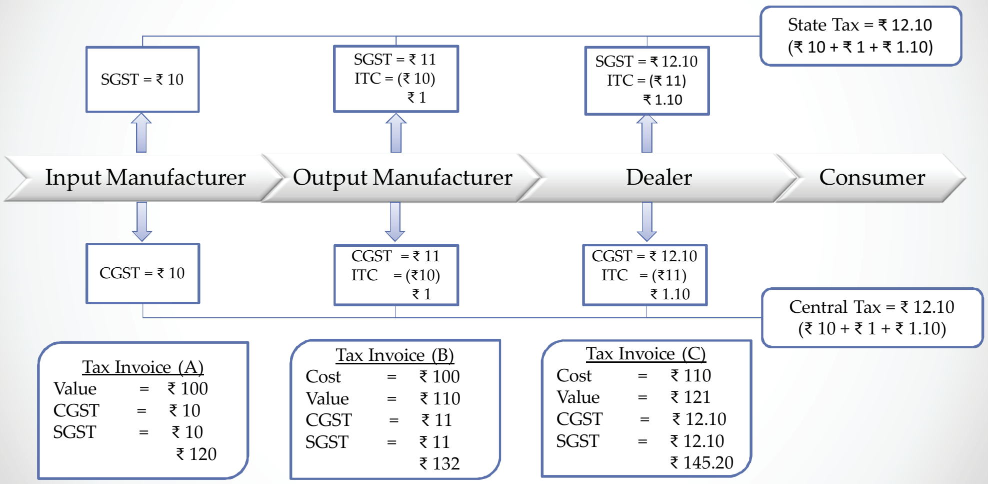
- GST Rates – to be based on RNR – Four rates
  - Merit rate for essential goods and services
  - Standard rate for goods and services in general
  - Special rate for precious metals
  - NIL rate
- Floor rate with a small band of rates for standard rated goods or services for SGST
  - This is similar to mandatory guidelines which will be issued by GST Council in line with European Directive 12/2006
- Optional Threshold exemption in both components of GST.
- Optional Compounding scheme for taxpayers having taxable turnover up to a certain threshold above the exemption.
- HSN Code likely to be used for classification of goods.
- Present Accounting codes likely to be used for Services.

Illustration to Showcase Tax Benefit under GST

Present Scenario (Intra-State Trade of Goods)



GST Scenario (Intra-State Trade of Goods)



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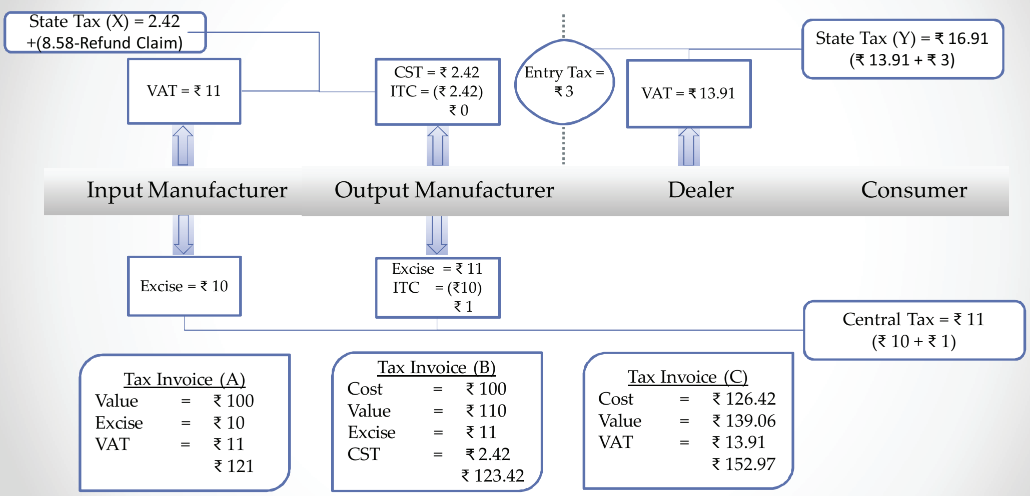
Present Scenario (Inter-State Trade of Goods)



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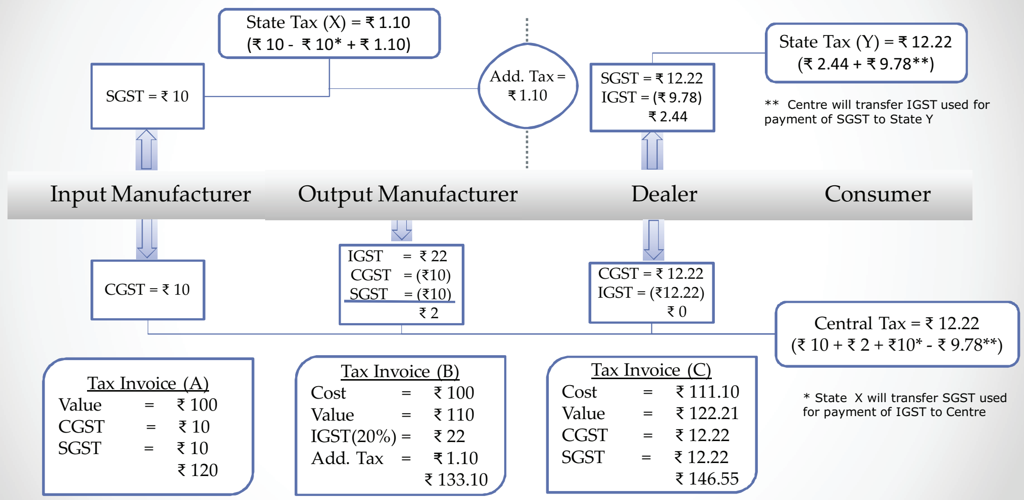
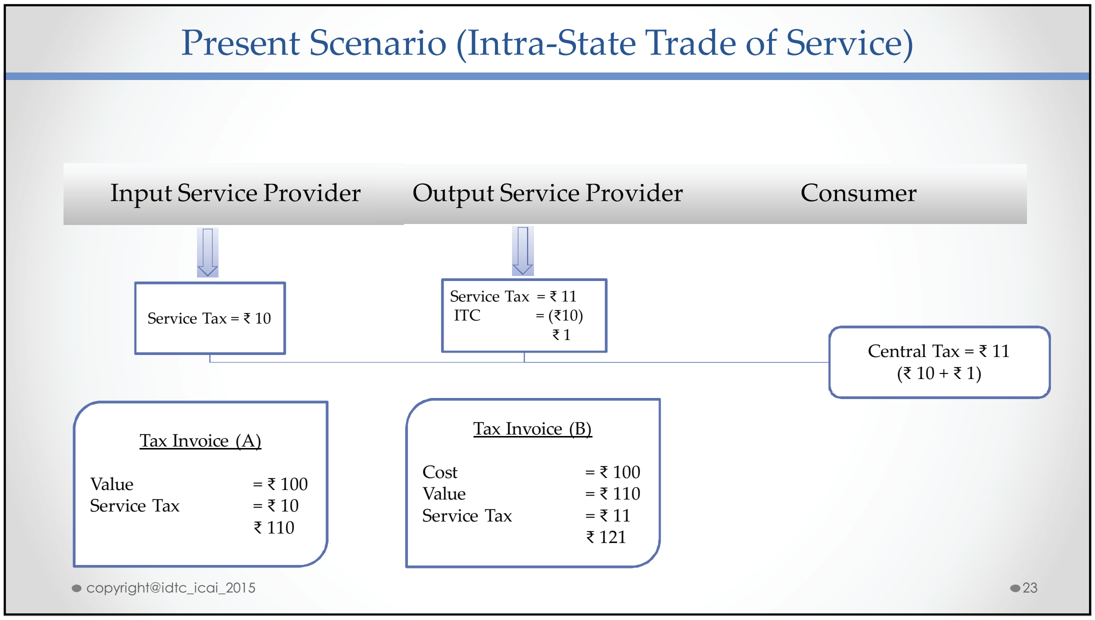
GST Scenario (Inter-State Trade of Goods)

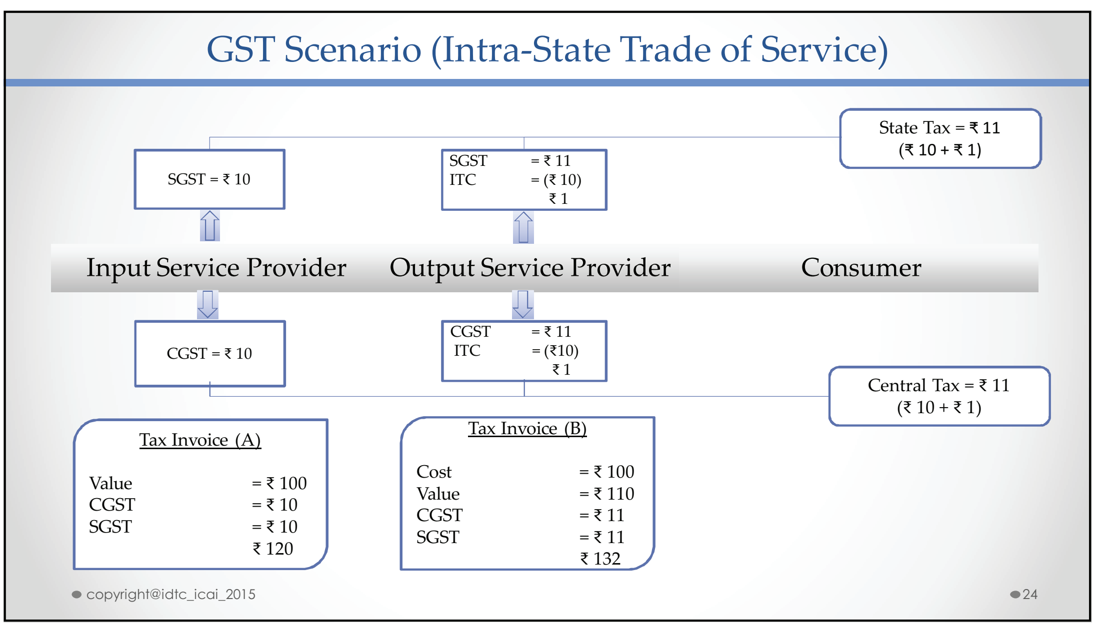


Comparison (Trade of Goods)

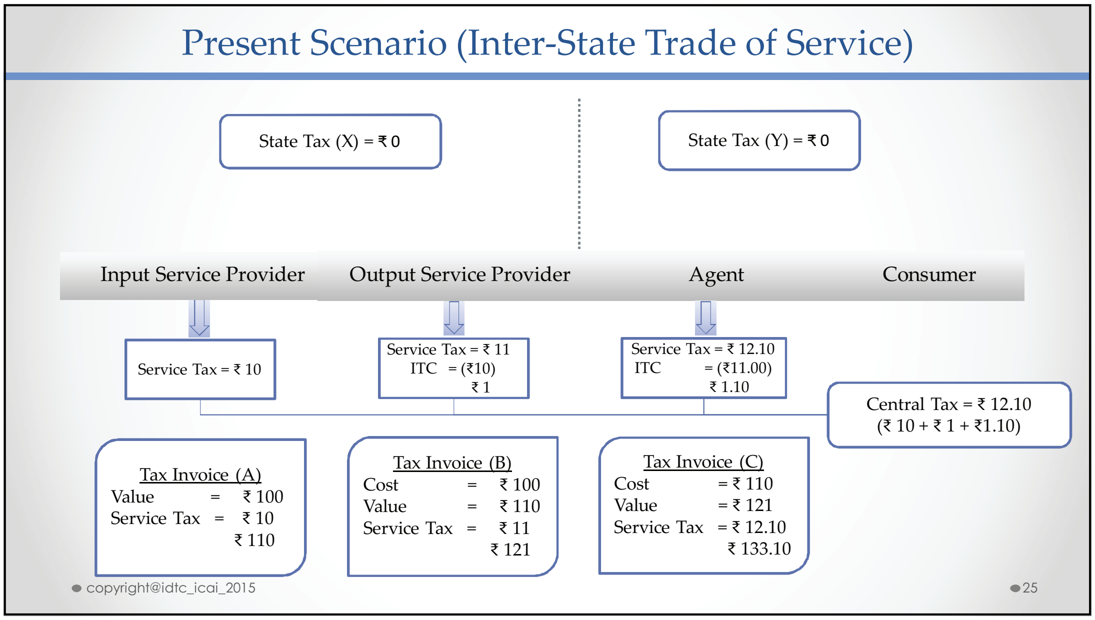
Sr. No.	Particular	Intra-State		Inter-State	
		Present	GST	Present	GST
1.	Initial Value	₹ 121.00	₹ 120.00	₹121.00	₹120.00
2.	Centre's Tax	₹ 11.00	₹ 12.10	₹ 11.00	₹ 12.22
3.	State (X)'s Tax	₹ 13.31	₹ 12.10	₹ 2.42	₹ 1.10
4.	State (Y)'s Tax	-	-	₹ 16.91	₹ 12.22
5.	State's Total	₹ 13.31	₹ 12.10	₹ 19.33	₹ 13.32
6.	Total Tax paid to Govt.	₹ 24.31	₹ 24.20	₹ 38.91- 8.58 (refund claim) = 30.33	₹ 25.54
7.	Non-Vatable Tax borne by Business	₹ 11.00	₹ 0.00	₹ 16.42 } **30.33**	₹ 1.10 } **25.54**
8.	Tax paid by end Consumer	₹ 13.31	₹ 24.20	₹ 13.91	₹ 24.44
9.	Final value paid by Consumer	₹ 146.41	₹ 145.20	₹ 152.97	₹ 146.65

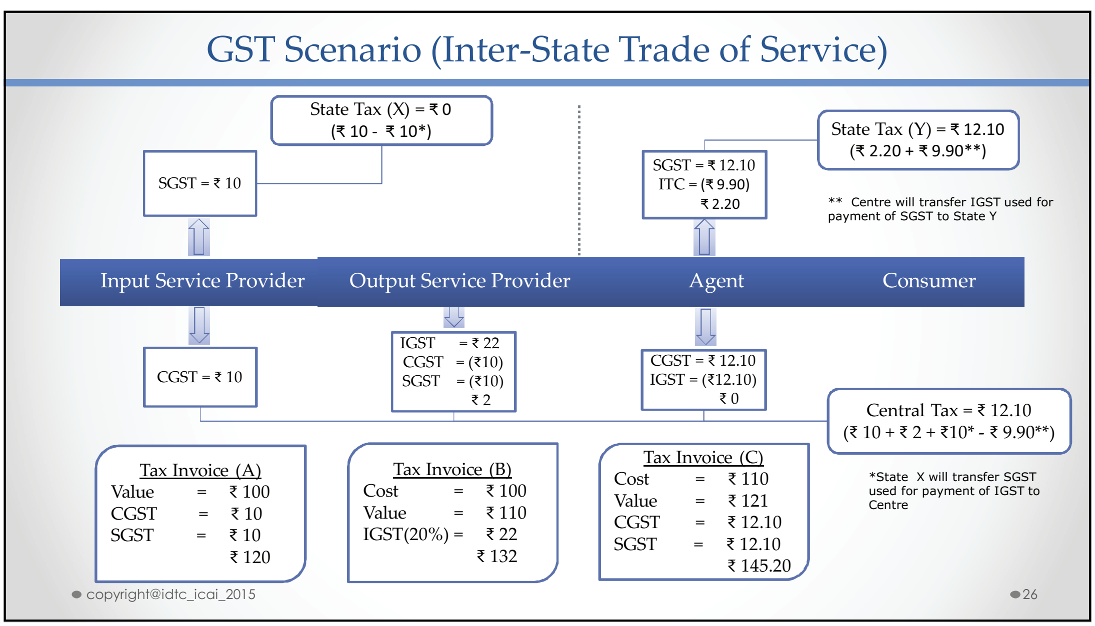


Present Scenario (Intra-State Trade of Service)
Input Service Provider
Output Service Provider
Consumer
Service Tax = ₹ 10
Service Tax = ₹ 11
ITC = (₹10)
₹ 1
Central Tax = ₹ 11
(₹ 10 + ₹ 1)
Tax Invoice (A)
Value = ₹ 100
Service Tax = ₹ 10
₹ 110
Tax Invoice (B)
Cost = ₹ 100
Value = ₹ 110
Service Tax = ₹ 11
₹ 121
copyright@idtc_icai_2015
23



GST Scenario (Intra-State Trade of Service)
State Tax = ₹ 11
(₹ 10 + ₹ 1)
SGST = ₹ 10
SGST = ₹ 11
ITC = (₹ 10)
₹ 1
Input Service Provider
Output Service Provider
Consumer
CGST = ₹ 10
CGST = ₹ 11
ITC = (₹10)
₹ 1
Central Tax = ₹ 11
(₹ 10 + ₹ 1)
Tax Invoice (A)
Value = ₹ 100
CGST = ₹ 10
SGST = ₹ 10
₹ 120
Tax Invoice (B)
Cost = ₹ 100
Value = ₹ 110
CGST = ₹ 11
SGST = ₹ 11
₹ 132
copyright@idtc_icai_2015
24


Present Scenario (Inter-State Trade of Service)
State Tax (X) = ₹ 0
State Tax (Y) = ₹ 0
Input Service Provider
Output Service Provider
Agent
Consumer
Service Tax = ₹ 10
Service Tax = ₹ 11
ITC = (₹10)
₹ 1
Service Tax = ₹ 12.10
ITC = (₹11.00)
₹ 1.10
Central Tax = ₹ 12.10
(₹ 10 + ₹ 1 + ₹1.10)
Tax Invoice (A)
Value = ₹ 100
Service Tax = ₹ 10
₹ 110
Tax Invoice (B)
Cost = ₹ 100
Value = ₹ 110
Service Tax = ₹ 11
₹ 121
Tax Invoice (C)
Cost = ₹ 110
Value = ₹ 121
Service Tax = ₹ 12.10
₹ 133.10
copyright@idtc_icai_2015
25


GST Scenario (Inter-State Trade of Service)
State Tax (X) = ₹ 0
(₹ 10 - ₹ 10*)
SGST = ₹ 10
State Tax (Y) = ₹ 12.10
(₹ 2.20 + ₹ 9.90**)
SGST = ₹ 12.10
ITC = (₹ 9.90)
₹ 2.20
** Centre will transfer IGST used for payment of SGST to State Y
Input Service Provider
Output Service Provider
Agent
Consumer
CGST = ₹ 10
IGST = ₹ 22
CGST = (₹10)
SGST = (₹10)
₹ 2
CGST = ₹ 12.10
IGST = (₹12.10)
₹ 0
Central Tax = ₹ 12.10
(₹ 10 + ₹ 2 + ₹10* - ₹ 9.90**)
Tax Invoice (A)
Value = ₹ 100
CGST = ₹ 10
SGST = ₹ 10
₹ 120
Tax Invoice (B)
Cost = ₹ 100
Value = ₹ 110
IGST(20%) = ₹ 22
₹ 132
Tax Invoice (C)
Cost = ₹ 110
Value = ₹ 121
CGST = ₹ 12.10
SGST = ₹ 12.10
₹ 145.20
*State X will transfer SGST used for payment of IGST to Centre
copyright@idtc_icai_2015
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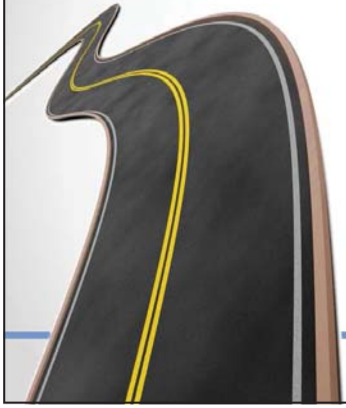
Comparison (Trade of Service)

Sr. No.	Particular	Intra-State		Inter-State	
		Present	GST	Present	GST
1.	Initial Value	₹ 110.00	₹ 120.00	₹110.00	₹120.00
2.	Centre's Tax	₹ 11.00	₹ 11.00	₹ 12.10	₹ 12.10
3.	State (X)'s Tax	₹ 0.00	₹ 11.00	₹ 0.00	₹ 0.00
4.	State (Y)'s Tax	-	-	₹ 0.00	₹ 12.10
5.	State's Total	₹ 0.00	₹ 11.00	₹ 0.00	₹ 12.10
6.	Total Tax paid to Govt.	₹ 11.00	₹ 22.00	₹ 12.10	₹ 24.20
7.	Non-Vatable Tax borne by Business	₹ 0.00	₹ 0.00	₹ 0.00	₹ 0.00
8.	Total Tax paid by Consumer	₹ 11.00	₹ 22.00	₹ 12.10	₹ 24.20
9.	Final value paid by Consumer	₹ 121.00	₹ 132.00	₹ 133.10	₹ 145.20

PART II

ROAD TO GST – MILESTONES



Road to GST- Milestones

- 2006, announcement of the intent to introduce GST by 01.04.2010
- November 2009 – First Discussion Paper (FDP) released by EC on which Comments were provided by Government of India.
- June 2010- Three sub-working Groups constituted by Government of India on:
  - Business Process related issues.
  - Drafting of Central GST and model State GST legislations.
  - Basic design of IT systems required for GST in general and IGST in particular.

Road TO GST- Milestones contd.

- March 2011 - Constitution (115th Amendment) Bill introduced in Parliament
- November 2012 – Committee on GST Design constituted by EC
- February 2013 - Three Committees constituted by EC
  - Dual Control, Thresholds and Exemptions in GST regime
  - RNRs for SGST & CGST and Place of Supply Rules
  - IGST and GST on Imports
- March 2013- GSTN Incorporated as Section 25 Company

Road TO GST- Milestones contd.

- June 2013- Committee constituted by EC to draft model GST Law
- August 2013- Standing Committee on Finance submitted Report
- April 2014- Committee constituted by EC to examine business processes under GST
- December 2014- 122nd Constitutional Amendment bill introduced in Parliament
- May 2015 - 122nd Constitutional Amendment bill passed by Lok Sabha and referred to Select Committee of Rajya Sabha which will submit its report in the first week of the Monsoon Session.

FEATURES OF CONSTITUTION AMENDMENT BILL

Features of Constitutional Amendment Bill

- 122 nd Amendment Bill introduced in LS on 19.12.2014 and has been passed on 6th May, 2015 and referred to Rajya Sabha's Select Committee
- Key Features
  - Concurrent jurisdiction for levy of GST by the Centre and the States –proposed Article 246A
  - Authority for Centre to levy & collection of IGST on supplies in the course of inter-State trade or commerce including imports – proposed Article 269A
  - Authority for Centre to levy non-vatable Additional Tax – to be retained by originating State
  - GST defined as any tax on supply of goods or services or both other than on alcohol for human consumption – proposed Article 366(12A)

Features of Constitutional Amendment Bill contd.

- **Key Features contd.**
- o Goods includes all materials, commodities & articles – Article 366 (12)
- o Services means anything other than goods – proposed Article 366 (26A)
- o Goods and Services Tax Council (GSTC) - proposed Article 279A
  - ✓ To be constituted by the President within 60 days from the coming into force of the Constitutional Amendments
  - ✓ Consists of Union FM & Union MOS (Rev)
  - ✓ Consists of all State Ministers of Finance
  - ✓ Quorum is 50% of total members
  - ✓ Decisions by majority of 75% of weighted votes of members present & voting
  - ✓ 1/3rd weighted votes for Centre & 2/3rd for all States together

Features of Constitutional Amendment Bill contd.

- **Key Features contd.**
  - ✓ Council to make recommendations on
    - ❖ Taxes, etc. to be subsumed in GST
    - ❖ Exemptions & thresholds
    - ❖ GST rates
    - ❖ Band of GST rates
    - ❖ Model GST Law & procedures
    - ❖ Special provisions for special category States
    - ❖ Date from which GST would be levied on petroleum products
  - ✓ Council to determine the procedure in performance of its functions
  - ✓ Council to decide modalities for dispute resolution arising out of its recommendations
- o Changes in entries in List – I & II
- o Compensation for loss of revenue to States for five years

PART III

Integrated Goods And Service Tax (IGST)

Integrated Goods and Service Tax (IGST)

- Basic Fundamental to discuss in IGST:
  - GST in India envisaged on destination/consumption principle.
  - Place of supply to determine the place where the supply of goods/services will take place and to determine whether supplies are inter state or intra state.
  - In sub-national taxation, determining the place of supply is important as tax revenue accrues to the State where the supply occur or deemed to occur.
  - IGST model envisage levy of IGST by the Centre on all transactions during inter state taxable supplies.
  - Tax revenues accrues to the destination/importing State based on **Place of Supply Rules.**

Integrated Goods and Service Tax (IGST) contd.

- IGST model permits cross-utilization of credit of IGST, CGST & SGST for paying IGST unlike intra-State supply where the CGST/SGST credit can be utilized only for paying CGST/SGST respectively.
- IGST credit can be utilized for payment of IGST, CGST and SGST in sequence by Importing dealer for supplies made by him.
- IGST Model envisages that the Centre will levy tax at a rate approximately equal to CGST+SGST rate on inter-State supply of goods & services.
- It would basically meet the objective of providing seamless credit chain to taxpayer located across States.

Integrated Goods and Service Tax (IGST) contd.

- IGST model obviates the need for refunds to exporting dealers as well as the need for every State to settle account with every other State
- The Exporting State will transfer to the Centre the credit of SGST used for payment of IGST
- The Centre will transfer to the importing State the credit of IGST used for payment of SGST
- Thus Central Government will act as a clearing house and transfer the funds across the States

Illustration for IGST Model

- Mr. A (based in Maharashtra) supplied Goods to Mr. B (based in Gujarat) and paid 17% IGST. Mr. A has Input credit of CGST 8% and SGST 8% from local Purchases. So he paid only 1% to Central Government Account i.e. in IGST code of that product. Maharashtra will transfer to Centre 8% SGST used for payment of IGST.
- Mr. B (based in Gujarat) who had purchased those goods supplied the same locally to Mr. C (based in Gujarat) and liable to SGST 10% and CGST 8%. He will utilize Credit of IGST of 17% first for CGST (8%) and balance for SGST (9%) and will pay 1% in cash. Gujarat Government where goods are consumed is entitled to get destination based tax i.e. SGST. Centre will transfer 9% IGST Credit used for payment of SGST to Gujarat. In this example, few important points may be noted:

Illustration for IGST Model

- Maharashtra Government in this transaction will not get any tax since it is inter state supply from Maharashtra to Gujarat
- Central Government will get 9% IGST on **inter-state supply** of goods to Gujarat (8% from Maharashtra Government and 1% paid as Cash by Mr. A)
- Gujarat Government will get 10% SGST for **intra-state supply** of Goods (9% from central Government and 1 % paid as cash by Mr. B)
- Important to note is that Mr. B (based in Gujarat) has been allowed full credit of IGST paid by Mr. A (based in Maharashtra) of 17%

Key Enablers for IGST

- Uniform e-Registration
- Common e-Return for CGST, SGST & IGST
- Common periodicity of Returns for a class of dealers
- Uniform cut-off date for filing of Returns
- System based validations/consistency checks on the ITC availed, tax refunds
- Effective fund settlement mechanism between the Centre and the States

Role of Dealers in GST Framework

- Every dealer has to submit one single GST return consisting information about all his purchases/sales at Invoice level along with line item.
- Accordingly necessary records, registers are to be maintained and consolidation for return will require automation and standard procedures.

Role of Central/State Government in GST framework

- Central Government to act as clearing house for accounts settlement across States.
- Handling disputes between states over jurisdictional and enforcement issues.
- Develop and maintain GSTN with best of facilities for uninterrupted flow of credit, less litigation and facility to register, file return and in future inbuilt other features like refund, scrutiny of returns.
- Draft model Legislation for CGST, IGST and SGST which will act as a Boundary wall, binding in nature both on Centre and States to legislate their respective GST Acts.
- Affix rate of SGST, within the parameters of band recommended by GST council.
- Formulate mechanism for reconciliation of tax payments.
- Develop systems for scrutiny of returns and record of assesses for GST.
- Establish dispute resolution mechanism for issues relating to levy of GST.

PART IV

Salient features of Proposed Place of Supply Rules

- Place of Supply Rules should be framed keeping in view the following principles:
  - **Rules for B2B Supplies and B2C supplies should be different.**
  - **Place of supply for B2B supplies should normally be the location of recipient of goods or services and not where services is actually performed.**
    - This is required to maintain smooth flow of credit. To illustrate, Mr. A (located in Rajasthan) participates in exhibition organized by Mr. B (located in Delhi). Normally place of supply will be Delhi and Mr. A located in Rajasthan will not be eligible for input tax credit.

Salient features of Proposed Place of Supply Rules contd.

- Rules for B2B supplies should be such so that input tax credit should be available to recipient.
- Place of Supply Rules should be guided by the principles that tax revenue at intermediate stage does not accrue to any tax administration as they are merely wash transactions.
- Place of Supply Rules should be guided by the principles that tax revenue accrues only when the goods/services are consumed by the final consumer.
- Place of Supply Rules should take care of the situation where intangibles are ordered from locations other than the locations where they are consumed.

Way Forward

Way Forward for Introduction of GST

- AMENDMENT BILL TO BE PASSED
  - Procedure for passage of Constitutional Amendment Bill
    - ✓ To be passed by 2/3rd majority in both Houses of Parliament
    - ✓ To be ratified by at least 50% of the State Legislatures
    - ✓ Assent by President of India
- Thereafter, GSTC to be constituted
- GSTC to recommend GST Law and procedure
- GST Law to be introduced in Parliament/ State legislatures
- GSTN (GST Network) a Section 25 Company formed to design automation of GST in line with TINXYS/NSDL

Key Questions before introduction of GST

Key Design issues under Discussion –

- Extent of Dual Control
- Rate structure (based on RNR)
- Exempted Goods or Services
- Exemption threshold
- Composition threshold
- Exclusion Vs. Zero rating of certain goods in GST regime
- Role of Centre / States in inter-State Trade
- Place of Supply Rules for Goods and Services
- Mechanics of IGST model
- Account settlement between the Centre and the States under IGST model

Key Questions before introduction of GST

Key Business processes under Discussion –

- Multiple registration within one State
- Dispute settlement over taxable and enforcement jurisdiction
- Audit, enforcement, recovery etc.

Revenue Neutral Rates (RNR)

- Rate which will give at-least the same level of revenue, which the Centre and States are presently earning from Indirect taxes.
- How to achieve this rate -- require analysis of GDP, Consumer Consumptions, exclusion and desired level of collection of Centre/state.
- We may derive the same by way of an illustration.

Illustration

- Country A desires to collect Rs. 3000 Crores of revenue from Indirect Taxes. The total Consumer Expenditure on Purchases/services is Rs. 30000 Crores.
- Now in case taxes are applicable on every product then a uniform rate of 10% will suffice the collection.
- In case certain products say foods, petroleum, tobacco, electricity are excluded from tax regime and the consumer expenditure on them is Rs. 10000 Crores, then to achieve the same level of taxes, rate need to be 15%.

Exclusion Vs. Zero Rated

- Exclusion while immune a product/Services from levy of taxes on the other hand disallow the benefit of CENVAT/Input Credit of taxes paid which in turn inflate the cost of production/services. Buyer of these products/services while paying this additional cost could not claim any benefit of taxes so paid and hidden in the cost. To illustrate Electricity company while paying 5% excise duty on coal has no option but to add the same into cost of generation while claiming electricity charges from a builder who in turn may have claimed credit if such duty is charged as input taxes from him.
- Zero rated good on the other hand enable the producer/service provider to claim the refund of input taxes paid from department, hence will not form part of cost of production/services.

International Perspective in GST

- Rates and Policy issues of VAT
- Emerging Issues
  - Bit Coins/Coupons
  - B2C
  - Online Supply of Services
  - E Commerce Transactions
  - Dispute Settlement between States
  - Exclusions
  - RNR

GST PLANNING

Impact Areas for Businesses

- Pricing, Costing, Margins
- Supply-chain management
- Change in IT systems
- Treatment of tax incentives
- Treatment of excluded sectors
- Transaction issues
- Tax compliance

Role of Professionals

- Tracking GST development
- Review of draft legislation and impact analysis
- Industry preparedness/Communication issues related to Industry
- Review of final legislation and impact analysis
- Implementation assistance
- Post implementation support
- Tax Planning
- Record Keeping
- Departmental Audit

Thank You

For any Clarification, Please Contact

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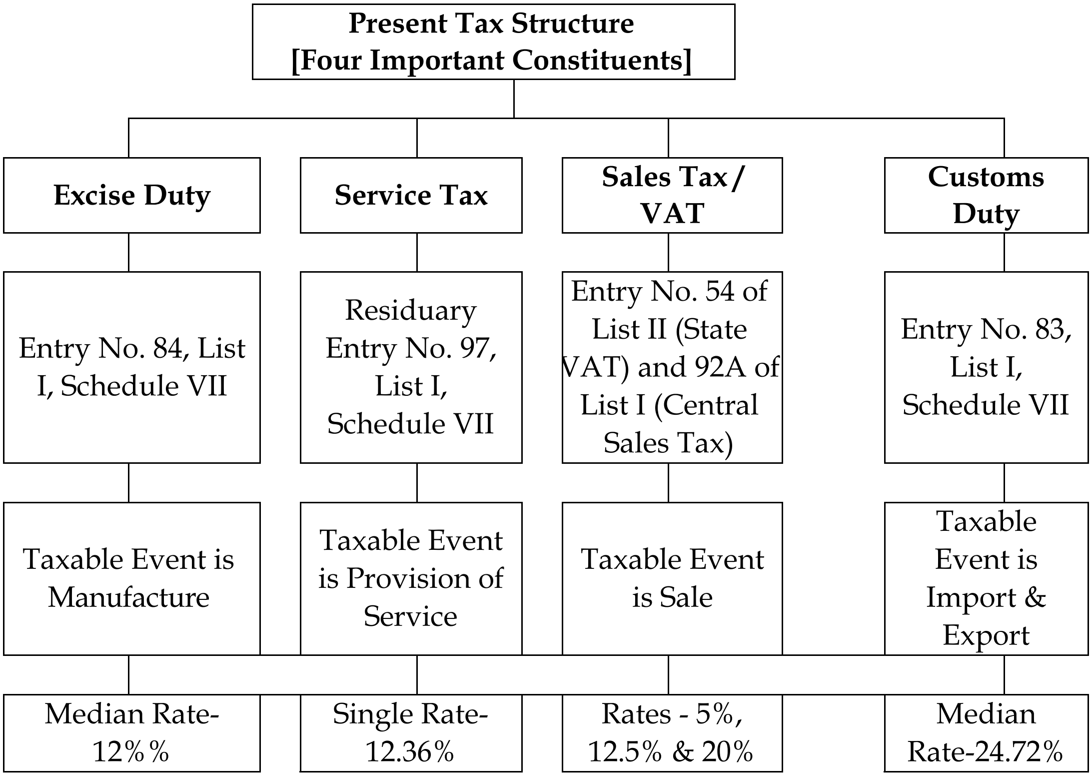
INDIRECT TAX STRUCTURE IN INDIA – AN INTRODUCTION

India currently has a dual system of taxation of goods and services, which is quite different from dual GST. Taxes on goods are described as "VAT" at both Central and State level. It has adopted value added tax principle with input tax credit mechanism for taxation of goods and services, respectively, with limited cross-levy set-off.

The present tax structure can best be described by the following chart:



Until the introduction of MODVAT (now CENVAT) Scheme in 1986 in respect of Central Excise Duty, duty was levied as origin based single point tax on manufacture of goods with some exceptions where set off scheme was used to reduce the cascading effect of taxes. CENVAT is only at manufacturing level and does not go up to retail level.

At State level, varieties of schemes were framed like origin based single point system (first point tax), multi point system with set off, last point (retail level) system, and so on. This was, again, not uniform even within a State. States adopted different systems for different commodities too. Cascading effect at that time was reduced to a great extent with the use of declaration forms, though, that by itself was a complex system. With the introduction of State VAT, there is combination of origin based (Central Sales Tax) and destination based multi point system of taxation.

Similarly, there was no Union level tax on services till the introduction of Service Tax in 1994 although, selective levy by the States on specified services like entertainment tax, is continuing. Service tax is currently charged on all the services except the services mentioned in the Negative List and specifically exempted from the service tax, although initially tax was charged on selected services. The VAT at Union (CENVAT) as well as State Level (VAT) is on goods only, except that at the Union level, there is input tax credit mechanism between CENVAT and Service Tax.

1.1 Excise Duty

- Central excise duty is an indirect tax levied on goods manufactured in India. The tax is administered by the Central Government under the authority of Entry 84 of the Union List (List 1) under Schedule VII read with Article 226 of the Constitution of India.
- The Central excise duty is levied in terms of the Central Excise Act, 1944 and the rates of duty, ad valorem or specific, are prescribed under the Schedule I and II of the Central Excise Tariff Act, 1985.
- The taxable event under the Central Excise Law is 'manufacture' and the liability of Central excise duty arises as soon as goods are manufactured, that is, it is not extended upto retail level. The Central Excise Officers are also entrusted to collect other types of duties levied under Additional Duties (Goods of Special Importance) Act, Additional Duties (Textiles and Textiles Articles) Act, Cess, etc.

- In 1986, the modified value added tax (MODVAT) was introduced as the first step towards reforming Union Excise Duty. This provided set-off for about a small number of commodities. In 1987, MODVAT was extended to some additional commodities. With the recommendations of the report of Tax Reforms Committee (TRC) (1991-93), MODVAT was further extended to a large number of commodities. Gradually, the procedures of MODVAT have also been overhauled, resulting in a full system of Central VAT (CENVAT).
- CENVAT is levied on all goods except petro-products and tobacco at manufacturing level. It allows instant credit for all the taxes paid on inputs as well as on countervailing duty (CVD).
- Excise duty has general rate of 12%. Additional excise duty in lieu of sales tax, special excise duty, cess and surcharges on specified commodities as additional levies are also levied.
- New Central Excise Rules, 2001 replaced the Central Excise Rules, 1944 with effect from 1st July, 2001. Other Rules have also been notified namely, CENVAT Credit Rules, 2001, Central Excise Appeal Rules, 2001, etc. With the introduction of the new rules, several changes have been effected in the procedures. These rules were later repealed by The CENVAT Credit Rules, 2004, having the following broad features: -
- Elimination of cascading effect through tax credit mechanism
- Integration of excise duty and service tax and set-off of one against another
- However, there is no integration of excise duty and sales tax/VAT.

1.2 Service Tax

- Service Tax was first imposed in India in the year 1994 with three services through Chapter V of the Finance Act, 1994. Over the years, more and more services were brought into the tax-net. There is no separate legislation for imposition of service tax in India, which is governed and administered by the Finance Act, 1994, as amended from time to time.
- The tax is administered by the Central Government under the authority of Residual Entry 97 of the Union List (List 1) under Schedule VII of the Constitution of India.

- Taxable event of the service tax is provision of services. However, tax is also levied on service to be provided, i.e., the advances received for provision of services.
- The CENVAT Credit Rules, 2004 provide for availing of the credit of the service tax and central excise duties paid on the input services/inputs/capital goods used for providing output services. Such credit amount can be utilised by an assessee towards payment of service tax on their output services.
- The CENVAT credit availed by a manufacturer on the input services can also be utilised for discharging its liability towards service tax on output services and/or central excise duties. Duties of excise and the countervailing customs duty (CVD) paid on the inputs and capital goods and the service tax paid on the 'input' services can be taken as credit.
- However, cross levy set-off of service tax and sales tax/VAT is not permissible.

1.3 Central Sales Tax / State Value Added Tax (VAT)

Broadly, for taxation purposes, sales can be divided into: -

(a) Sales within a State (known as 'Intra-State Sales' or 'Local Sales').

(b) Sales from one State to another State within the domestic boundaries of India (known as 'Inter-State Sales' or 'Central Sales').

(c) Sales in the course of export from or import into India.

While sales tax on the first head, i.e. local sales, is levied by the State Governments as per the provisions of their respective State Sales Tax Laws (presently VAT Laws), the taxability of inter-State sale under the second head is within the purview of the Central Government. Sales under the third head, i.e. in the course of export or import, though defined under the Central Sales Tax Act, are exempt from the sales tax.

Entry 92A in the Union List in the Seventh Schedule to the Constitution of India confers power upon the Union to legislate in respect of "taxes on the sale or purchase of goods other than newspapers, where such sale or purchase takes place in the course of inter-State trade or commerce". The power to impose sales tax in the Union Territory vests with the Parliament under Article 246(4) of the Constitution of India.

Entry 54 in List II (State List) of the Seventh Schedule read with Article 246(3) of the Constitution of India empowers the States to impose "tax on the sale or purchase of goods other than newspapers, subject to the provisions of Entry 92-A of the List I".

Restrictions imposed on States to tax sale or purchase of goods through Article 286 are as under: -

> "286(1) No law of a State shall impose a tax on the sale or purchase of goods where such sale or purchase takes place -
>
> (a) Outside the State; or
>
> (b) In the course of the import of the goods into, or export of the goods out of, the territory of India.
>
> 286(2) Parliament may by law formulate principles for determining when a sale or purchase of goods takes place in any of the ways mentioned in clause (1).
>
> 286(3) Parliament may impose restrictions and conditions in regard to the system of levy, rates and other incidents of the tax on any law of a State in relation to the imposition of -
>
> (a) A tax on the sale or purchase of goods declared by Parliament by law to be of special importance in inter-State trade or commerce, (declared goods), or
>
> (b) A tax on the sale or purchase of goods, being a tax of the nature referred to in sub-clause (b), sub-clause (c) or sub-clause (d) of sub-clause (29A) of Article 366."

In Article 269(1), clause (g) authorises the Government of India to collect tax on the sale or purchase of goods other than newspapers, where such sale or purchase takes place in the course of inter-State trade or commerce and making it obligatory upon the Government of India to assign the tax to the collecting States.

1.3.1 Enactment of the Central Sales Tax Act, 1956

In exercise of the authority conferred by the Constitution (Sixth Amendment) Act, 1956, the Parliament enacted on December 21, 1956, the Central Sales Tax Act, 1956. All sections except section 15 (restrictions on the powers of the States to tax on declared goods) were brought into force on 5th January 1957 and section 15 was made effective w.e.f. 1st October 1958. Imposition of tax became effective from 1st July 1957.

Therefore, inter-State sale of goods is taxable under the Central Sales Tax Act, 1956. For this purpose, goods have been classified into two categories: (a) Declared goods or goods of special importance in inter-State trade or commerce, and (b) Other goods. Rates of tax have been prescribed under section 8 and differ from State to State and for a particular item, it generally depends upon the tax rate prevailing in that State.

After the amendments vide Taxation Laws (Amendment) Act, 2007 w.e.f. 01.04.2007, central sales to unregistered dealers or to registered dealers without declaration in Form 'C' or other Forms prescribed under the CST Act attract tax at the rate equal to the local rate of tax (i.e. the rate applicable within the originating State). For sales (declared or other goods) supported by declaration Form C, the CST rate is 2%, or the local rate applicable in that State, whichever is lower. The Central Government had reduced the CST rate for sales made to registered dealers on the strength of Form C from 4% to 3% with effect from 1st April 2007, which has further been reduced to 2% w.e.f. 1st June 2008.

1.3.2 Value Added Tax

Value Added Tax, one of the significant reforms in the history of indirect tax structure in India, has been implemented by a majority of the States with effect from 1st April 2005, and this could be possible due to the joint efforts of the Central Government and the State Governments. The replacement of the State Sales Taxes by the Value Added Tax marked a substantial step forward in the reform of domestic trade taxes in India. Implemented under the leadership of Dr. Asim Dasgupta, Chairman, Empowered Committee of State Finance Ministers, it addressed the distortions and complexities associated with the levy of tax under the erstwhile system and resulted in a major simplification of the rate structure and broadening of the tax base.

"Value Added Tax" (VAT), as its name suggests, is a tax on value addition. It is a multi-point tax, which is levied at every stage of sale. It is collected at the stage of manufacture/resale and contemplates rebating of tax paid on inputs and purchases. Despite its name, VAT is intended as tax on consumption, and is origin based tax.

In India, VAT replaced the general sales tax which was levied at State level, the only difference being the manner of levy. Powers of the States to levy tax on sales transactions, in the form of VAT, continue to be drawn from Entry 54 in List II of

Seventh Schedule of the Constitution of India. In VAT, every transaction of sale of goods in the course of business is taxed, thus providing revenue to the Government on value addition at every stage. On account of set off being provided on preceding purchase, cascading effect on the cost of goods is avoided. It is a self policing system, reducing the scope of tax evasion. VAT reduces scope for under-valuation and tax evasion, and provides a broad tax base.

The first preliminary discussion on State-level VAT took place in a meeting of Chief Ministers convened by Dr. Manmohan Singh, the then Union Finance Minister in 1995. In this meeting, the basic issues on VAT were discussed in general terms and this was followed up by periodic interactions of State Finance Ministers. Thereafter, in a significant meeting of all Chief Ministers, convened on November 16, 1999 by Shri Yashwant Sinha (the then Union Finance Minister), three important decisions were taken: -

(i) Before the introduction of State-level VAT, the unhealthy sales tax rate "war" among the States would have to end and sales tax rates would need to be harmonized by implementing uniform floor rates of sales tax for different categories of commodities with effect from 1st January 2000.

(ii) In the interest again of harmonization of incidence of sales tax, the sales-tax-related industrial incentive schemes would also have to be discontinued with effect from 1st January 2000.

(iii) On the basis of achievement of the first two objectives, steps would be taken by the States for introduction of State-level VAT after adequate preparation. For implementing these decisions, an Empowered Committee of State Finance Ministers was set-up.

Thereafter, the Empowered Committee met regularly, attended by the State Finance Ministers, and also by the Finance Secretaries and the Commissioners of Commercial Taxes of the State Governments as well as senior officials of the Revenue Department of the Ministry of Finance, Government of India.

The design of State-level VAT has been worked out by the Empowered Committee through several rounds of discussion and striking a federal balance between the common points of convergence regarding VAT and flexibility for the local characteristics of the States. Since the State-level VAT centered around the basic concept of "set-off" for the tax paid earlier, the needed common points of convergence also relate to this concept of set-off/input tax credit, its coverage and related issues.

VAT has since been implemented in all the States of India.

1.4 Customs Duty

Indian Customs Department has been assigned a number of tasks; more important of which are:-

(i) Collection of customs duties on imports and exports as per basic Customs laws (Customs Act, 1962 and Customs Tariff Act, 1975).

(ii) Enforcement of various provisions of the Customs Act governing imports and exports of cargo, baggage, postal articles and arrival & departure of vessels, air crafts etc.

(iii) Discharge of various agency functions and enforcing various prohibitions and restrictions on imports and exports under Customs Act and other allied enactments.

(iv) Prevention of smuggling including interdiction of narcotics drug trafficking.

(v) International passenger processing.

The Constitutional provisions have given to the Union Government the right to legislate and collect duties on imports and exports as per Entry No. 83 of List 1 to Schedule VII of the Constitution. The Customs Act, 1962 is the basic Statute, effective from 1.2.1963 which empowers duties to be levied on goods imported into or exported from India.

The categories of items and the rates of duties which are leviable have been specified in the Schedules to the Customs Tariff Act, 1975. The First Schedule to the said Act specifies the various categories of import items in a systematic and well considered manner, in accordance with an international scheme of classification of internationally traded goods – termed 'harmonized system of commodity classification'. Different rates of duties are prescribed by the legislature on different commodities/ group of commodities mentioned in the First Schedule.

The duties are levied both on specific and ad valorem basis; while there are few cases where at times specific-cum-ad valorem duties are also collected on imported items. The Second Schedule to Customs Tariff Act, 1975 incorporates items subject to exports duties and rates thereof.

Where ad valorem duties (i.e., duties with reference to value) are collected, which are the predominant mode of levy, the value of the goods is determined for customs duty purposes as per provisions laid down under Section 14 of the Customs Act and the Customs Valuation (Determination of Prices of Imports Goods) Rules, 1988 issued thereunder.

Customs Duties on import are primarily of three types: -

(a) Basic Customs Duty (levied under section 12 of the Customs Act);

(b) Additional Customs Duty (CVD) under sections 3(1) and 3(3) of Customs Tariff Act, in lieu of excise duty;

(c) Special Additional Duty of Customs (SAD) under section 3(5) of Customs Tariff Act to counter-balance the sales tax, value added tax, local tax or any other charges for the time being leviable on a like article on its sale, purchase or transportation in India.

1.5 Other Important Indirect Taxes/Duties

- Octroi
- Entry Tax
- Luxury Tax
- Research and Development Cess
- Telecom License Fees
- Turnover Tax
- Tax on Consumption or Sale of Electricity
- Taxes on Transportation of Goods and Services
- Lottery Tax
- Betting and Gambling Tax
- Stamp Duty
- Property Tax
- Toll Tax, Passenger Tax and Road Tax.

1.6 Shortcomings in the Present Structure and need of GST

(a) Tax Cascading

Tax cascading occurs under both Centre and State taxes. The most significant contributing factor to tax cascading is the partial coverage by Central and State taxes. Oil and gas production and mining, agriculture, real estate construction, infrastructure projects, wholesale and retail trade, and range of services remain outside the ambit of the Cenvat and the Service Tax levied by the Centre. The exempt sectors are not allowed to claim any credit for the Cenvat or the Service Tax paid on their inputs.

Similarly, under the State VAT, no credits are allowed for the inputs to the exempted sectors, which include the entire service sector. Another major contributing factor to tax cascading is the Central Sales Tax (CST) on inter-State sales, collected by the Origin State for which no credit is allowed by any State Government.

(b) Levy of Excise Duty on manufacturing point

The CENVAT is levied on goods manufactured or produced in India. Limiting the tax to the point of manufacturing is a severe impediment to an efficient and neutral application of tax. Taxable event at manufacturing point itself forms a narrow base.

For example, valuation as per excise valuation rules of a product, whose consumer price is Rs. 100/-, is, say, Rs. 70/-. In such a case, excise duty as per the present provisions is payable only on Rs.70/-, and not on Rs.100/-.

Further, definitional issues as to what constitutes manufacturing, and valuation issues for determining the value on which the tax is to be levied, are other concerns. However, these concepts have evolved through judicial rulings to a great extent.

(c) Complexity in determining the nature of transaction – Sale *vs*. Service

The distinctions between goods and services found in the Indian Constitution have become more complex. Today, goods, services, and other types of supplies are being packaged as composite bundles and offered for sale to consumers under a variety of supply-chain arrangements. Under the current division of taxation powers in the Constitution, neither the Centre nor the States can apply the tax to such bundles in a seamless manner. Each

Government can tax only parts of the bundle, creating the possibility of gaps or overlaps in taxation.

Example:- In case of Installation of AC(Air Conditioner) where a bundle of services are provided like wood and other material used for installation , VAT is charged on such material and on labour part service tax is applicable, but no value is defined separately. VAT and Service Tax are charged on percentage basis as defined by State and Central Govt.

(d) Inability of States to levy tax on services

Exclusion of services from the State taxation powers is its negative impact on the buoyancy of State tax revenues. With no powers to levy tax on incomes or the fastest growing components of consumer expenditures, the States have to rely almost exclusively on compliance improvements or rate increases for any buoyancy in their own-source revenues. Alternatives to assigning the taxation of services to the States include assigning to the States a share of the Central VAT (including the tax from services).

(e) Lack of Uniformity in Provisions and Rates

Present VAT structure across the States lacks uniformity, which is not restricted only to the rates of tax, but also extends to procedures and, sometimes, to the definitions, computation and exemptions.

(f) Fixation of *situs* – Local Sale *vs.* Central Sale

Whether a sale takes place in one State or another, i.e. to fix the *situs* of a sale transaction, is the major conflict, as its taxability affects the revenue of the State. Though CST is a tax levied by the Central Government, it is collected and retained by the collecting State. Whether a transaction is a direct inter-State sale from State 'X' to the customer 'ABC' located in State 'Y'; or is a stock transfer from State 'X' to branch in State 'Y' first, and then a local sale to the customer 'ABC' in the State 'Y', will have a bearing on the revenue of the State 'X' or State 'Y', as the case may be.

A significant number of litigations pertain to this issue. Ultimately, the Central Government made provisions under the Central Sales Tax Act, 1956 and created a Central Appellate Authority to resolve such matters.

(g) Interpretational Issues

Another problem arises in respect of interpretation of various provisions and determining the category of the commodities. We find a significant number of litigation surrounding this issue only. To decide whether an activity is sale or works contract; sale or service, is not free from doubt in many cases.

(h) Narrow Base

The starting base for the CENVAT is narrow, and is being further eroded by a variety of area-specific and conditional exemptions.

Earlier the service tax was applicable on selective services but after the implementation of Finance Act, 2012 the system of comprehensive taxation of services was implemented, while excluding few service by specifying them in "negative list".

The complexities under the State VAT relate primarily to classification of goods to different tax rate Schedules. Theoretically, one might expect that the lower tax rates would be applied to basic necessities that are consumed largely by the poor. This is not the case under the State VAT. The lowest rate of 1% applies to precious metals and jewellery, and related products. The middle rate of 5% applies to selected basic necessities and also a range of industrial inputs and IT products. In fact, basic necessities fall into all three categories – exempted from tax, taxable at 5%, and taxable at the standard rate of 12.5%. Higher rate of 20% is also applicable mainly to petroleum products and liquor. However, most retailers find it difficult to determine the tax rate applicable to a given item without referring to the legislative schedules. Consumers are even less aware of the tax applicable to various items.

(i) Complexities in Administration

Compounding the structural or design deficiencies of each of the taxes is the poor or archaic infrastructure for their administration. Taxpayer services, which are a lynchpin of a successful self-assessment system, are virtually non-existent or grossly inadequate under both Central and State administrations. Many of the administrative processes are still manual, not benefiting from the efficiencies of automation. All these not only increase the costs of compliance, but also undermine the revenue collection.

1.7 Recent Improvements in Tax Structure

[Source: Economic Survey 2008-09]

Over the past several years, significant progress has been made to improve the indirect tax structure, broaden the base and rationalize the rates.

Notable among the improvements are:

- Replacement of the single-point State sales taxes by the VAT in all of the States and Union Territories.
- Reduction in the central sales tax rate to 2 per cent, from 4 per cent, as part of a complete phase out of the tax.
- Introduction of service tax by the Centre, and a substantial expansion of its base over the years.
- Rationalization of the CENVAT rates by reducing their multiplicity and replacing many of the specific rates by ad valorem rates based on the maximum retail price (MRP) of the products.

These changes have yielded significant dividends in economic efficiency of the tax system, ease of compliance, and growth in revenues. The State VAT eliminated all of the complexities associated with the application of sales taxes at the first point of sale. The consensus reached among the States for uniformity in the VAT rates has largely brought an end to the harmful tax competition among them. It has also lessened the cascading of tax. The application of CENVAT at fewer rates and the new system of CENVAT credits has likewise resulted in fewer classification disputes, reduced tax cascading, and greater neutrality of the tax. The design of the CENVAT and State VATs were dictated by the constraints imposed by the Constitution, with neither the Centre nor the States being able to levy taxes on a comprehensive base of all goods and services and at all points in their supply chain.

In spite of the improvements made in the tax design and administration over the past few years, the systems at both Central and State levels still remains complex. The most significant cause of complexity is, of course, policy related and is due to the existence of exemptions and multiple rates, and the extant structure of the levies. These deficiencies are the most glaring in the case of CENVAT and the service tax. The starting base for the CENVAT is narrow, and is being further eroded by a variety of area-specific, and conditional and unconditional exemptions. The introduction of Goods and Services Tax (GST) would thus be opportune for deepening the reform process already underway. The principal broad-based consumption taxes that the GST would replace are the CENVAT and the service tax levied by the Centre and the VAT levied by the States. All these are multi-stage value-added taxes.

In defining options for reform, the starting point is the basic structure of the tax. The Empowered Committee of State Finance Ministers in November 2007 had recommended a "Dual" GST, to be levied concurrently by both levels of Government. The dual GST option strikes a good balance between fiscal autonomy of the Centre and States, and the need for harmonization. It empowers both levels of Government to apply the tax to a comprehensive base of goods and services, at all points in the supply chain. It also eliminates tax cascading, which occurs because of truncated or partial application of the Centre and State taxes.

A-2
WHAT IS GST, HOW IT WORKS AND ITS ADVANTAGES

2.1 What is GST?

GST stands for "Goods and Services Tax", and is proposed to be a comprehensive indirect tax levy on manufacture, sale and consumption of goods as well as services at the national level. Its main objective is to consolidates all indirect tax levies into a single tax, except customs (excluding SAD) replacing multiple tax levies, overcoming the limitations of existing indirect tax structure, and creating efficiencies in tax administration.

One of the reasons to go the GST way is to facilitate seamless credit across the entire supply chain and across all States under a common tax base. The current framework allows limited inter-levy credits between CENVAT (tax on manufacture) and service tax. However, no cross credits are available across these taxes and the sales tax/VAT paid (on input) or payable (on output). Introduction of GST would thus rationalize the tax content in product price, enhance the ability of business entities to compete globally, and possibly trickle down to benefit the ultimate consumer.

Example: - A product whose base price is Rs.100 and after levying excise duty @ 12% value of the product is Rs. 112. On sale of such goods VAT is levied @ 12.5% and value to the ultimate consumer is Rs. 126. In the proposed GST system on base price of Rs.100 CGST and SGST both will be charged, say @ 8% each, then the value to the ultimate consumer is Rs. 116. So, in such a case the industry can better compete in global environment.

Therefore, GST is a broad based and a single comprehensive tax levied on goods and services consumed in an economy. GST is levied at every stage of the production-distribution chain with applicable set offs in respect of the tax remitted at previous stages. It is basically a tax on final consumption. To put at a single place, GST may be defined as a tax on goods and services, which is leviable at each point of sale or provision of service, in which at the time of sale of goods or providing the services the seller or service provider may claim the input credit of tax which he has paid while purchasing the goods or procuring the service.

Internationally, GST is a single levy for all transactions related to goods and services. In India, however, currently the power to prescribe the taxation framework, and levy and collect taxes has been segregated between the Centre and States under the Constitution.

For resolving disputes regarding GST, its implementation etc. a GST Council would be setup. Given this uniqueness, learnings of other countries cannot be directly implemented in India.

2.2 Illustration of GST [All parties are located in one State]

<u>Assumptions</u>: (1) Rate of Excise Duty – 8%; (2) VAT Rate – 12.5%; (3) Central GST Rate – 12%; (4) State GST Rate – 8%; (5) Profit Margin – Rs. 10,000/- fixed (before tax)

Particulars	**Under VAT**	**Under GST**
(I) Manufacturer (D1) to Wholesaler (D2)		
Cost of Production	90,000	90,000
Input Tax Credit (Assuming nil)	-	-
Add : Profit Margin	10,000	10,000
Producers Basic Price	1,00,000	1,00,000
Add: Central Excise Duty @ 12%	12,000	-
Add : Value Added Tax @ 12.5% on Rs. 1,12,000/-	14,000	-
Add : Central GST @ 12%	-	12,000
Add : State GST @ 8%	-	8,000
Sale Price	1,26,000	1,20,000
(II) Wholesaler (D2) to Retailer (D3)		
Cost of Goods to D2	1,12,000	1,00,000
Available Input Tax Credit for set off	*14,000*	*20,000*
Add : Profit Margin	10,000	10,000
Total	1,22,000	1,10,000
Add : Value Added Tax @ 12.5%	15,250	-
Add : Central GST @ 12%	-	13,200
Add : State GST @ 8%	-	8,800

Particulars	Under VAT	Under GST
Total Price to the Retailer	1,37,250	1,32,000
(III) Retailer (D3) to Final Consumer (C)		
Cost of Goods to D3	1,22,000	1,10,000
Input Tax Credit	*15,250*	*22,000*
Add : Profit Margin	10,000	10,000
Total	1,32,000	1,20,000
Add : Value Added Tax @ 12.5%	16,500	-
Add : Central GST @ 12%	-	14,400
Add : State GST @ 8%	-	9,600
Total Price to the Consumer	**1,48,500**	**1,44,000**
Total Tax Payable in All Transactions	**28,500**	**24,000**
*Verification:- VAT @12.5% [148,500 * 12.5 / 112.5] = 16,500 + 12,000 (CENVAT) = 28,500*		
- D1 (12,000 +14,000)	*26,000*	
- D2 (15,250 - 14,000)	*1,250*	
- D3 (16,500 - 15,250)	*1,250*	
*Verification:- GST @20% [144000 *20 / 120] =24000*		
- D1 (12,000 + 8,000)		*20,000*
- D2 (22,000 - 20,000)		*2,000*
- D3 (24,000 - 22,000)		*2,000*

Note: As per the above illustration the major benefit to the consumer in the GST regime is that GST is charged always on producer basic price.

[*For illustration on GST on inter-State transactions: Refer Para No. 7.4 (6) of Chapter A-7 (Inter-State Transactions and GST)]*

It is insignificant to ascertain who the gainer is in monetary terms – Government or the Consumer but certainly, GST is a better system which is self-disciplined. Moreover, the net impact would be marginal in most of the cases since the RNR (Revenue Neutral Rate) would be determined by the Government after taking the monetary impact into consideration.

2.3 Features of an Ideal GST

GST is a comprehensive value added tax on goods and services. It is levied and collected on value addition at each stage of sale or purchase of goods or supply of services based on input tax credit method but without State boundaries. There is no distinction between taxable goods and taxable services and they are taxed at a single rate in a supply chain of goods and services till the goods / services reach the consumer. The administrative power generally vests with a single authority to levy tax on goods and services. The main features of GST are as under:-

(a) GST is based on the principle of value added tax and either "input tax method" or "subtraction" method, with emphasis on voluntary compliance and accounts based system.

(b) It is a comprehensive levy and collection on both goods and services at the same rate with benefit of input tax credit or subtraction of value of penultimate transaction value.

(c) Minimum number of floor rates of tax, generally, not exceeding two rates.

(d) No scope for levy of cess, re-sale tax, additional tax, special tax, turnover tax etc.

(e) No scope for multiple levy of tax on goods and services, such as, sales tax, entry tax, octroi, entertainment tax, luxury tax, etc.

(f) Zero rating of exports and inter State sales of goods and supply of services.

(g) Taxing of capital goods and inputs whether goods or services relatable to manufacture at lower rate, so as to reduce inventory carrying cost and cost of production.

(h) A common law and procedures throughout the country under a single administration.

(i) GST is a destination based tax and levied at single point at the time of consumption of goods or services by the ultimate consumer.

2.4 Advantages of Comprehensive GST

(a) Introduction of GST would result in abolition of multiple types of taxes on goods and services.

(b) It reduces effective rates of tax to one or two floor rates.

(c) Reduces compliance cost and increases voluntary compliance.

(d) Removes cascading effect of taxation and also distortion in the economy.

(e) Enhances manufacturing and distribution efficiency, reduces cost of production of goods and services, increases demand and production of goods and services.

(f) As it is neutral to business processes, business models, organization structure, geographic location, product substitutes, it promotes economic efficiency and sustainable long term economic growth.

(g) Gives competitive edge in international market for goods and services produced in a country, leading to increased exports.

(h) Reduces litigation, and corruption.

(i) Results in widening tax base and increased revenue to the Center and State.

(j) Reduces administrative cost for the Government.

According to Dr. Vijay Kelkar, Chairman of the 13th Finance Commission and former Union Finance Secretary and Adviser to the Finance Minister, GST has a number of advantages, including:

(a) Brings a phase change on the tax firmament by redistributing the burden of taxation equitably between manufacturing and services.

(b) Lowers the tax rates by broadening the tax base and minimizing exemptions.

(c) Reduces distortions by completely switching to the destination principle.

(d) Fosters a common market across the country and reduces compliance costs.

(e) Provides a fiscal base for local bodies to enable them to fulfill their obligations.

(f) Facilitates investment decisions being made on purely economic concerns, independent of tax considerations.

(g) Promotes exports: - A recent study on the impact of GST on foreign trade indicates that the rate of growth of exports will be significantly higher than that for imports.

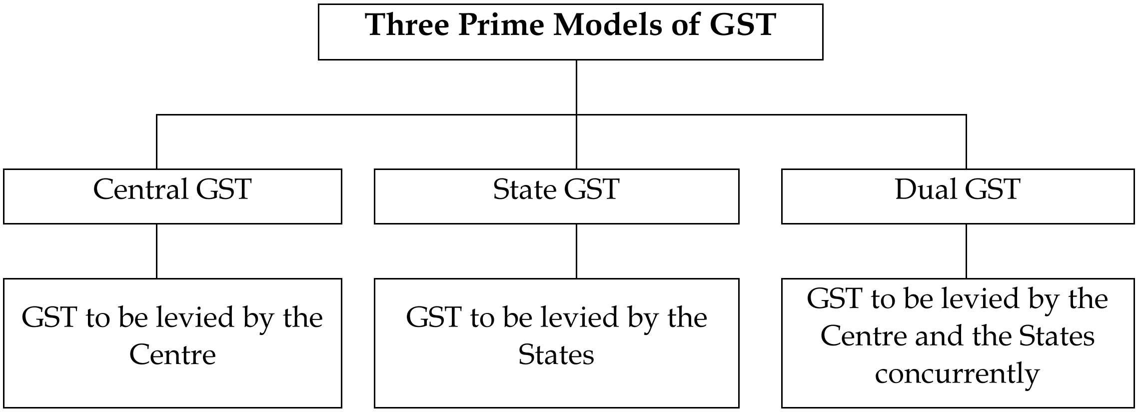
(h) Promotes employment.

(i) Most importantly, it will spur growth. It has been estimated that the GST implementation increased Canadian GDP by 1.4 percent. In India, a similar kind of positive impact is expected. This means gains of about 15 billion dollars annually. Discounting these flows at a modest 3 percent per annum, the present value of the GST works out to about half a trillion dollars.

A – 3
MODELS OF GST

There are three prime models of GST:

- GST at Central (Union) Government Level only
- GST at State Government Level only
- GST at both, Union and State Government Levels



Canada has GST at Union level extending to all goods and services covering all stages of value addition. In addition, there is tax at province (State) level in different forms which include VAT, Retail Sales tax and so on. European Union (EU) Nations (each one is independent Nation but, part of a Union and have agreed to adopt common principles for taxation of goods and services) have adopted "classic" VAT.

In the Indian context, Constitution of India specifically reserves the power to impose tax on specific activities to specific level of Government, e.g., tax on import of goods can be imposed by Union Government only whereas tax on sale of goods involving movement of goods within the State can be imposed by State Governments only.

3.1 Central GST

Under this option, the two levels of government would combine their levies in the form of a single National GST, with appropriate revenue sharing arrangements among them. The tax could be controlled and administered by the Central Government. There are several models for such a tax. Australia is the most recent example of a National GST, which is levied and collected by the Centre, but the proceeds are allocated entirely to the States.

In the case of a Central GST (where all goods and services are taxed by the Central government only), the Centre will collect most of the country's total tax revenue, leaving very little for the sub-national Governments. As against this, the present proposal is to have a dual GST.

A single national VAT has great appeal from the perspective of establishment and promotion of a common market in India. However, the States may worry about the loss of control over the tax design and rates. Indeed, some control over tax rates is a critical issue in achieving accountable sub-national governance and hard budget constraints. The States may also be apprehensive that the revenue sharing arrangements would over time become subject to social and political considerations, deviating from the benchmark distribution based on the place of final consumption. The Bagchi Report also did not favour this option for the fear that it would lead to too much centralization of taxation powers.

The key concerns about this option would thus be political. Notwithstanding the economic merits of a National GST, it might have a damaging impact on the vitality of Indian federalism.

Pros:

- If levied on a comprehensive base at a single rate, it would clear the system of virtually all economic distortions and classification disputes.
- Replacing 36 taxing Statutes (of the Centre and 35 States and Union Territories) with only one would lead to a substantial reduction in compliance costs and free up resources for other more productive pursuits.
- It would make common market for India a reality. Goods and services would move freely within India with no check-posts, internal-tax frontiers or other barriers to trade.

- Ideal structure from business perspective – greater stability and facilitation of decision making.
- Businesses will have to deal with only one tax authority and comply with only one tax - A significant reduction of compliance costs.
- Excellent from consumer perspective as the consumer will know exactly how much is the indirect tax burden in the goods and service consumed by him.
- Cascading effect can be removed to a large extent as there will not be taxes at two levels leading to improved competitiveness.

Cons:

- Near impossibility of achieving the structure – It will require drastic modification to the Constitution of India.
- It might upset the present concept of fiscal federalism, which is the cornerstone of Indian polity.
- Entire infrastructure developed for taxation at both levels will have to undergo huge change.
- States may not agree to give up the power of taxation and depend on the Union for resources.

3.2 State GST

The second model is to have a State GST in which the States alone levy GST and the Centre withdraws from the field of GST or VAT completely. It can be a desirable option given the mismatch in resources and responsibilities of the States. In this case, the State GST will work as the redistributing mechanism. The loss to the Centre from vacating this tax field could be offset by a suitable compensating reduction in fiscal transfers to the States. This would significantly enhance the revenue capacity of the States and reduce their dependence on the Centre. The USA is the most notable example of such arrangements, where the general sales taxes are relegated to the States. However, there would be significant hurdles in adopting this option in India, and it may not be suitable here.

Third, a complete withdrawal of the Centre from the taxation of inter-State supplies of goods and services could undermine the States' ability to levy their own taxes on such supplies in a harmonized manner. In particular, it would be impractical to bring inter-State services within the ambit of the State GST without a significant coordinating support from the Centre.

Pros:

- Reduction of cascading effect of taxes, as there will not be tax at two levels.
- It enhances the revenue capacity of the States and reduces their dependence on the Centre.

Cons:

- It would seriously impair the Centre's revenues. The reduction in fiscal transfers to the States would offset this loss, but still the Centre would want to have access to this revenue source for future needs.
- Major amendments to the Constitution of India will be required.
- The option may not be revenue neutral for individual States. The incremental revenues from the transfer of the Centre's tax collection would benefit the higher-income States, while a reduction in fiscal transfers would impact disproportionately the lower-income States.
- Businesses will have to comply with tax laws of each State – which will definitely lack uniformity and harmony. At the same time, decision making will be impacted and may affect business stability.
- A complete withdrawal of the Centre from the taxation of inter-State supplies of goods and services could undermine the States' ability to levy their own taxes on such supplies in a harmonized manner. In particular, it would be impractical to bring inter-State services within the ambit of the State GST without a significant coordinating support from the Centre.
- Governments, both States and Union will not find it workable as it will require complete change in its finances and allocation of resources - entire distribution of taxes will need to undergo changes. But, that too will not be workable as revenue collection by each State will vary depending on the level of activities in each State and need for support to States – redistribution of taxes will become an issue.
- There may be unhealthy competition among the States using local tax structure as a tool to attract industry within the States. This could lead to retaliatory measures by other States.

3.3 Dual GST

3.3.1 Non-Concurrent Dual GST

Under the concurrent dual GSTs, the Centre and State taxes apply concurrently to supplies of all goods and services. However, it poses two challenges. First, it requires a constitutional amendment. Second, a framework is needed for defining the place of supply of inter-State services and for the application of State GST to them.

Therefore, as suggested in the Poddar-Ahmed Working Paper, to circumvent both of these hurdles, GST on goods can be levied by the States only and on services by the Centre only. The States already have the power to levy the tax on the sale and purchase of goods (and also on immovable property), and the Centre for taxation of services. No special effort would be needed for levying a unified Centre tax on inter-State services.

Under this model, while levying the VAT on services, the Centre would essentially play the coordinating role needed for the application and monitoring of tax on inter-State services. The Centre would withdraw from the taxation of goods. Even the revenues collected from the taxation of services could be transferred back to the States, partially or fully.

Within this framework, cascading could be completely eliminated by the States agreeing to allow an input credit for the tax on services levied by the Centre. Likewise, the Centre would allow an input credit for the tax on goods levied by the States.

However, the said model may not be acceptable to the Centre as well as the States. Moreover, constitutional amendment would still be required in this model since the States are not presently empowered to levy sales tax on goods where movement of such goods take place in the course of inter-State trade or commerce. Therefore, the Government has already announced its intention to follow the Concurrent Dual GST.

3.3.2 Concurrent Dual GST

Here the GST will be levied by both tiers of Governments concurrently. There will be Central GST to be administered by the Central Government and there will be State GST to be administered by State Governments. Thus, the GST would comprise a Central GST and State GST: a Central-level GST will subsume central taxes, such as, excise duty, CVD, SAD and service tax; and a State-level GST will subsume VAT, octroi, entry taxes, luxury tax, etc.

Therefore, under this model, both goods and services would be subject to concurrent taxation by the Centre and the States. This variant is closer to the model recommended by the Kelkar Committee in 2002.

Example: Under existing system Centre can levy tax on goods as well as on services, such as Excise duty on manufacture of goods and Service tax on Services but State has no power to levy Tax on manufactured goods such as VAT but in concurrent dual GST model both Centre and State will have power to levy taxes on both Goods and Services.

Pros:

- This model is achievable in the short term and no significant changes are required in the current structure of indirect taxation, however, some amendments will be required in the Constitution.
- It removes cascading effect of taxes significantly.
- It strikes a good balance between fiscal autonomy of the Centre and States, and the need for harmonization.
- It empowers both levels of Government to apply the tax to a comprehensive base of goods and services, at all points in the supply chain.
- It requires least change in infrastructure of tax departments at the Union and State levels.
- It improves the competitive environment for company working globally, as single taxation system reduces cost to the consumer.

Cons:

- It is not an ideal model. It can be a temporary or transitional model since tax would continue to be levied at two levels and compliance costs may not reduce significantly.
- There will always be uncertainty since States might depart from the principles of uniformity.
- To frame a comprehensive model for taxation of inter-State transactions of goods and services and sharing of its revenue amongst the State will be a challenge.

- Taxation of services at State level, especially services provided nationwide (e.g. telecommunication service, transportation service), will pose challenge.

Looking to the facts, it is the most workable GST model especially taking into consideration the amendments required in the Constitution of India and achievability in the short term. This Model builds on the current structure of taxation of goods and services and does not envisage drastic changes in the broad mechanism for levy and collection of taxes.

A – 4
EXPECTED MODEL OF GST IN INDIA

In the Budget Speech for the year 2009-10, the Hon'ble Finance Minister Shri Pranab Mukherjee informed the House:

> *Para 85: "…………… The broad contour of the GST Model is that it will be a* ***dual GST*** *comprising of a Central GST and a State GST.* ***The Centre and the States will each legislate, levy and administer the Central GST and State GST, respectively****. I will reinforce the Central Government's catalytic role to facilitate the* ***introduction of GST by 1st April, 2010*** *after due consultations with all stakeholders."*

4.1 Indian Model of GST – Dual GST

4.1.1 Features

In India, the GST model will be "dual GST" having both Central and State GST component levied on the same base. All goods and services barring a few exceptions will be brought into the GST base. Importantly, there will be no distinction between goods and services for the purpose of the tax with common legislations applicable to both.

For Example, if a product have levy at a base price of Rs. 100 and rate of CGST and SGST are 8% then in such case both CGST and SGST will be charged on Rs 100 i.e. CGST will be Rs 8 and SGST will be Rs.8.

Interestingly, as per the recommendations of Joint Working Group (JWG) appointed by the Empowered Committee in May 2007, the GST in India may not have a dual VAT structure exactly but it will be a quadruple tax structure. It may have four components, namely -

(a) a Central tax on goods extending up to the retail level;

(b) a Central service tax;

(c) a State-VAT on goods; and

(d) a State-VAT on services.

Given the four-fold structure, there may be at least four-rate categories - one for each of the components given above. In this system the taxpayer may be required to calculate tax liability separately for the different rates of tax.

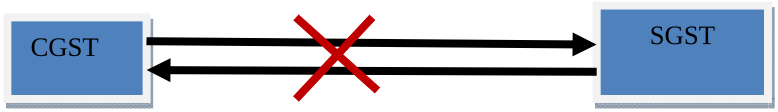
The significant features of Dual GST recommended in India, in conjunction with the recommendations by the JWG, are as under:

1. There will be Central GST to be administered by the Central Government and there will be State GST to be administered by State Governments.
2. Central GST will replace existing CENVAT and service tax and the State GST will replace State VAT.
3. Central GST may subsume following indirect taxes on supplies of goods and services:
    - Central Excise Duties (CENVAT)
    - Additional excise duties including those levied under Additional Duties of Excise (Goods of Special Importance) Act, 1957.
    - Additional customs duties in the nature of countervailing duties, i.e., CVD, SAD and other domestic taxes imposed on imports to achieve a level playing field between domestic and imported goods which are currently classified as customs duties.
    - Cesses levied by the Union viz., cess on rubber, tea, coffee etc.
    - Service Tax
    - Central Sales Tax – To be completely phased out
    - Surcharges levied by the Union viz., National Calamity Contingent Duty, Education Cess, Special Additional Duties of Excise on Motor-Spirit and High Speed Diesel (HSD).
4. State GST may subsume following State taxes:
    - Value Added Tax
    - Purchase Tax
    - State Excise Duty (except on liquor)
    - Entertainment Tax (unless it is levied by the local bodies)
    - Luxury Tax;

- Octroi
- Entry Tax in lieu of Octroi
- Taxes on Lottery, Betting and Gambling

5. The proposed GST will have two components – Central GST and State GST – the rates of which will be prescribed separately keeping in view the revenue considerations, total tax burden and the acceptability of the tax.
6. Taxable event in case of goods would be 'sale' instead of 'manufacture'.
7. Exports will be zero rated and will be relieved of all embedded taxes and levies at both Central and State level.
8. The JWG has also proposed a list of exempted goods, which includes items, such as, life saving drugs, fertilizers, agricultural implements, books and several food items.
10. Certain components of petroleum, liquor and tobacco are likely to be outside the GST structure. Further, State Excise on liquor may also be kept outside the GST.
11. Taxes collected by Local Bodies would not get subsumed in the proposed GST system.

As per the proposed GST regime, the input of Central GST can be utilized only for payment of CGST & the input of State GST can be utilized only for payment of SGST. Cross- Utilization of input of CGST in payment of SGST and vice-a- versa, will not be allowed. (Source:- Hindu Business Line, dated 30-06-2009)



4.1.2 Railways and Construction Sector might be included in GST

Dr. Vijay Kelkar, Chairman of the 13th Finance Commission, , has suggested that activities like housing, construction and railways should be included in the proposed goods and services tax (GST) to increase the tax base and enhance collections, either immediately or during a subsequent phase.

He added that construction sector is a significant contributor to the national economy and housing expenditure dominates the personal consumption expenditure, so the two sectors would increase the tax base.

He said that the inclusion of the railway sector in the tax regime will provide a level playing field to road and air transportation sector.

The inclusion will also ensure that all inter-State transportation of goods can be tracked through the proposed I.T. network and, in fact, the railways itself would benefit from the inclusion.

4.1.3 Liquor, Petro Sector, Taxes of Local Bodies might be out of GST

Goods such as petroleum products are kept outside the purview of GST. But, in the case of Tobacco & Liquor some products can be covered in GST and some products will be outside the purview of GST.

(*Source: Hindu Business Line dated 30-06-2009)*

4.1.4 Stamp Duty

It has not yet been decided whether stamp duty will be part of the GST or not. As per the Poddar-Ahmad Working Paper, under a modern GST/VAT (e.g., in Australia, New Zealand, Canada, and South Africa), housing and construction services are treated like any other commodity. Thus, when a real estate developer builds and sells a home, it is subject to VAT on the full selling price, which would include the cost of land, building materials, and construction services. Commercial buildings and factory sales are also taxable in the same way, as are rental charges for leasing of industrial and commercial buildings. There are only two exceptions:

(1) resale of used homes and private dwellings, and

(2) rental of dwellings.

The Working Paper also emphasized the need to incorporate these concepts in the design of GST in India as well, because -

- Conceptually, it is appropriate to include land and real property in the GST base. To exclude them would, in fact, lead to economic distortions and invite unnecessary classification disputes as to what constitutes supply of real property.
- In the case of commercial and industrial land and buildings, their exclusion from the base would lead to tax cascading through blockage of input taxes on

construction materials and services. It is for this reason that even under the European system an option is allowed to VAT registrants to elect to treat such supplies as taxable.

- Housing expenditures are distributed progressively in relation to income and their taxation would contribute to the fairness of the GST.
- The State VAT and the Service Tax already apply to construction materials and services respectively, but in a complex manner. For example, there is significant uncertainty whether a pre-construction agreement to sell a new residential dwelling is a works contract and subject to VAT. Where the VAT does apply, disputes arise about the allocation of the sale price to land, goods, and services. While land is the only major element that does not attract tax, the tax rates applicable to goods and services differ, necessitating a precise delineation of the two. Extending the GST to all real property supplies, including construction materials and services, would bring an end to such disputes, simplify the structure, and enhance the overall economic efficiency of the tax.
- Chairman of 13th Finance Commission, Dr. Vijay Kelkar, also expressed his concern on this issue, stating "The construction sector is a significant contributor to the national economy. Housing expenditure dominates personal consumption expenditure. Further, the present piece-meal taxation of this sector encourages perverse incentives. Raw material is charged CENVAT, the works contract is charged VAT and stamp duty is levied on the sale. With no provision of input tax credit in place, there is little incentive to record such transactions either at the construction stage or at the sale stage at their correct value. This leads to substantial loss of tax revenues and fuels the parallel economy."

4.1.5 Intangible Goods

The advancements in information technology and digitization have distorted the distinction between goods and services. Under the present Indian jurisprudence, goods are defined to include intangibles, e.g., copyright and software, bringing them within the purview of State taxation. However, intangibles are often supplied under arrangements which have the semblance of a service contract. For example, software upgrades (which are goods) can also be supplied as part of a contract for software repair and maintenance services. Software development contracts could take the character of contracts for manufacturing and sale of software goods or for rendering software development services, depending on the roles and responsibilities of the parties.

Likewise, the so-called 'value-added services' (VAS) provided as part of telecommunication services include supplies, e.g., wallpaper for mobile phones, ring tones, jokes, cricket scores and weather reports some of which could be considered as goods.

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

For example: online Subscription of Direct tax updates are considered as services and subscription of the same in the form of Magazine or books on regular interval basis are considered as purchase of goods.

Disputes have also arisen as to whether leasing of equipment without transfer of possession and control to the lessee would be taxable as a service or as a deemed sale of goods.

Therefore, the proposed Dual GST must address such issues carefully and should have clear provisions for taxation.

4.1.6 Financial Services

Financial services are exempt from VAT in all countries. The principal reason, as per Poddar-Ahmad Working Paper, is that the charge for the services provided by financial intermediaries (such as banks and insurance companies) is generally not an explicit fee but is taken as a margin, that is hidden in interest, dividends, annuity payments, or such other financial flows from the transactions. For example, banks provide the service of operating and maintaining deposit accounts for their depositors, for which they charge no explicit fee. The depositors do, however, pay an implicit fee, which is the difference between the pure interest rate (i.e., the interest rate which could otherwise be earned in the market without any banking services) and the interest actually received by them from the bank on the deposit balance. The fee is the interest foregone. Similarly, the charge for the services provided by banks to the borrowers is included in the interest charged on the loan. It is the excess of the interest rate on the loan over the pure rate of interest or cost of funds to the bank for that loan.

However, India has followed the approach of bringing virtually all financial services within the ambit of Service Tax where the consideration for them is in the form of an explicit fee. As there are no specific reasons for exempting financial services, the same approach can be continued under GST.

4.1.7 Threshold Limit, Assessment and Administration

For the purpose of assessment and administration of different assesses, following categorization has been recommended:-

Threshold limit (common for goods and services) can be allowed somewhere between Rs. 10 lacs and Rs. 20 lacs.

Gross turnover of goods upto Rs. 1.5 Crores may be assigned exclusively to the State;

Gross turnover of services upto Rs. 1.5 Crores may be assigned exclusively to the Centre.

Gross turnover of above Rs. 1.5 Crores may be assigned to both the Governments – for the administration of CGST to the Centre and for the administration of SGST to the State.

4.1.8 Probable GST Rates in India

The GST rates in India are expected to be 12% to 20% for the 1st year, 12% to 18% for the 2nd year and 16% for the 3rd Year and onwards.

Probably, the GST on goods will comprise of least two nominal rates; and a zero rate will also be present for exports and for specified goods. It will, thus, be a three-rate structure, at least. With regard to the Federal and the State GST rate on services, it should be at par with that on goods. However, a single tax rate for services is also on the cards.

The multiple rate structure is as follows:

Goods / Services	Levy	Rate in 1st Year	Rate in 2nd Year	Rate in 3rd Year
Goods – Lower Rate	CGST	6%	6%	8%
	SGST	6%	6%	8%
Goods – Standard Rate	CGST	10%	9%	8%
	SGST	10%	9%	8%
Services	CGST	8%	8%	8%
	SGST	8%	8%	8%

4.1.9 Other notable features of the Indian Dual GST

- There would a single registration or taxpayer identification number, based on the Permanent Account Number (PAN) for direct taxation. Three additional digits would be added to the current PAN to identify registration for the Centre and State GSTs. Also known as BIN (Business Identification Number).

- States would collect the State GST from all the registered dealers. To minimize the need for additional administrative resources at the Centre, States would also assume the responsibility for administering the Central GST for dealers with gross turnover below the current registration threshold of Rs 1.5 crores under the Central Excise (CENVAT). They might collect the Central GST from such dealers on behalf of the Centre and transfer the funds to the Centre.

- Procedures for collection of Central and State GSTs would be uniform. Moreover, tax payment Challan might contain some additional information, e.g., amount of CGST paid on SGST Challan, and *vice-a-versa.* Payment of tax might be only online through net-banking.

- There would be one common tax return for both taxes, with one copy given to the Central authority and the other to the relevant State authority electronically. Moreover, most likely, GST returns will be required to be filed online.

- HSN will form the basis of product classification for Central GST and State GST.
- Other indirect taxes levied by the Centre, States, or local authorities at any point in the supply chain would be subsumed under the Central or the State GST, as long as they are in the nature of taxes on consumption of goods and services.

At a broad conceptual level, this model has a lot to commend itself. It strikes a good balance between fiscal autonomy of the Centre and States, and the need for harmonization. It empowers both levels of Government to apply the tax to a comprehensive base of goods and services, at all points in the supply chain. It also eliminates tax cascading, which occurs because of truncated or partial application of the Centre and State taxes.

4.2 Inter-GST Credit / Set-Off

The GST will facilitate seamless credit across the entire supply chain and across all States under a common tax base. The current framework allows limited inter-levy credits between excise duty (tax on manufacture) and service tax. However, no cross credits are available across these taxes and the sales tax paid (on input) or payable (on output). Introduction of GST should, thus, rationalize tax content in product price, enhance the ability of companies to compete globally, and possibly trickle down to benefit the ultimate consumer.

The Union Budget for 2009-10 spelt out that the efforts of the Empowered Committee of State Finance Ministers have translated into a proposal for a dual GST model, comprising a Central GST and a State GST. The Centre and the State would each legislate, levy and administer the Central GST or the State GST, as the case may be.

Therefore, a dual structure in India would mean that there would be a Central GST and a State GST, each levied on a comprehensive base comprising both goods and services. Thus, every transaction would attract both taxes.

It is also learned that under the proposed GST regime, the Centre will give input tax credit (set off) only for Central GST and the States will give input tax credit only for State GST. Cross-utilisation of credit between Central GST and State GST will not be allowed. However, the dealers could claim set-off within the respective heads. If that is so and cross-set-off of Central GST and State GST is not available, the very purpose of reform, i.e. to remove cascading effect, would be defeated.

Taxability of sale/service also determines the exigibility of input tax credit, as under:

S. No.	Nature of Sale	Availability of Input Tax
1	Taxable Sales	Yes
2	Zero Rated Sales	Yes
3	Exempted Sales	No

Moreover, only the registered dealers would be eligible for input tax credit.

Documents for availing tax credit

Any one of the following may be prescribed as eligible documentary proof for claiming input tax credit:

- The Invoice
- Payment of tax
- Hybrid System

Most probably, credit would be allowed either on the basis of payment of tax or hybrid system. In payment basis, the legislature may stipulate that either the seller will pay tax or, alternatively, the buyer will pay tax on reverse charge basis.

4.3 Refund

Refund of GST may arise due to the following two factors: -

- Zero rated supplies, e.g., export of goods and services; or
- Inter-State transactions.

The quantum of refund in case of inter-State transactions would depend upon the model of payment of tax being adopted by the Government, discussed in Para No. 7.4 of Chapter A-7 (Inter-State Transactions). If the seller (or the buyer under reverse charge system) is required to pay full GST, without adjusting the input tax credit, the volume of refund will certainly be higher.

4.4 How Dual GST is better than Unified GST

The Economic Survey 2008-09 recommended the Government to implement the goods and services tax (GST) throughout the country as a part of continuing fiscal reforms, while favouring a dual GST structure to be levied concurrently by both the Centre and State.

Citing the recommendation on a dual GST by the empowered committee of State Finance Ministers, the survey said a dual GST strikes a good balance between Centre and State fiscal autonomy, along with eliminating tax cascading.

"It empowers both levels of Government to apply the tax to a comprehensive base of goods and services, at all points in the supply chain. It also eliminates tax cascading, which occurs because of truncated or partial application of the Centre and State taxes," said the survey.

Despite improvements in the country's tax design and administration over the past few years, the systems at both Central and State levels are still complex, said the survey.

The complexities, it says, are policy related and also due to the present system of multiple rates and exemptions at State and Centre level.

The survey noted that deficiencies in CENVAT (Central value added tax) and service tax are grave and need to be looked at. For instance, CENVAT's already narrowed base is being further eroded by a variety of area-specific exemptions. "The introduction of GST would thus be opportune for deepening the reform process already underway," the survey said.

A-5
REVENUE NEUTRAL RATE (RNR)

5.1 Meaning of RNR

In the proposed GST regime, the revenue of the Government would not be the same in comparison with the present tax structure due to tax credit mechanism or otherwise. Therefore, an adjustment in tax rate is required to avoid reduction in revenue of the Government. Hence, the rate of tax will have to be suitably adjusted to ensure that tax revenue does not reduce. This rate is termed as 'Revenue Neutral rate' (RNR). It is the rate at which tax revenue remains the same despite giving credit of duty paid on inputs and other factors.

5.2 Determination of RNR

"For the RNR calculations for 2005-06, the latest year for which the necessary data was available the total excise/service tax/VAT/sales tax revenues of the Centre and the States in that year were Rs. 134 thousand crore and Rs. 139 thousand crore respectively.

Assuming that approximately 40% of the central excise revenues and 20% of the State VAT/sales tax revenues are from motor fuels, the balance of the revenues from other goods and services that need to be replaced by the GST are Rs. 89 thousand crore for the Centre and Rs 111 thousand crore for the States, making up a total of Rs. 200 thousand crore.

In 2005-06, the total private consumer expenditure on all goods and services was Rs. 2,072 thousand crore at current market prices. Making adjustments for sales and excise taxes included in these values and for the private consumption expenditure on motor fuels, the total tax base (at pre-tax prices) for all other goods and services is Rs 1,763 thousand crore.

These values yield a revenue-neutral GST rate of approximately 11% (200 as per cent of 1,763 is 11.3%). The RNR for the Centre is 5% and for the States 6.3%. Allowing for some leakages, the combined RNR could be in the range of 12%. These estimates are by no means precise. Even so, they give a broad idea of the levels at which the rate or rates of GST could be set to achieve revenue neutrality for both levels of Government."

The GST rates in India are expected to be 12% to 20% for the 1st year, 12% to 18% for the 2nd year and 16% for the 3rd Year and onwards.

Goods / Services	Levy	Rate in 1st Year	Rate in 2nd Year	Rate in 3rd Year
Goods – Lower Rate	CGST	6%	6%	8%
	SGST	6%	6%	8%
Goods – Standard Rate	CGST	10%	9%	8%
	SGST	10%	9%	8%
Services	CGST	8%	8%	8%
	SGST	8%	8%	8%

The Finance Minister has asked the Revenue Department to advance a payment of Rs. 500 crores to States as a compensation of CST.

5.3 Factors for determination of RNR

- Present tax rates and collection in absolute numbers:
    - Excise duty, which is levied at various rates, median rate is 12%
    - CVD rate on import of goods
    - Service tax rate, presently 12.36%
    - State VAT rate, varies from 0% to 20% (0, 5, 12.5, 20)
    - Collection of the Government from these levies
- Broadening of tax base in GST:
    - Excise duty may be levied on a lower base by the States. Present threshold limit under CENVAT is Rs. 1.5 crores, whereas under GST, it may be between Rs. 10 lacs and 20 lacs,

- Excise duty would be levied up to retail point instead of at manufacturing point
- More services would come into net
- Withdrawal of various exemptions
- Minimizing the number of tax rates.

- Coverage of GST:
  - Share of revenue from such commodities, which would be kept outside the GST structure, e.g., petroleum products, tobacco, liquor, etc. However, Central Govt. can charge excise duty on tobacco products over and above GST.
  - Number of taxes to be subsumed in the GST, for example stamp duty, property tax, toll tax, etc. might be kept outside the GST structure.

5.4 Success of GST would depend upon the RNR

The success of GST will largely depend on the determination of ideal rate at Central level as well as State level which should be acceptable to the public and revenue neutral to Government.

The golden rule for collection of tax is given by world's oldest economist Sage Kautilya *alias* Chanakya Muni more than 2000 years ago. He said that the King should collect tax from different persons as the humble bee collects honey from different flowers without making any harm to them. Thus, all efforts should be made to keep the GST rate as low as possible.

The median rate of 12% adopted for CENVAT, Service Tax rate of 12%, along with residuary rate of VAT 12.5% brings the overall rate to 25% to 30%, which is too high a rate compared globally.

Elaborating on why the tax rates are lower in some countries, Dr. P. Shome said that voluntary compliance even by large corporations in India was not at the desirable level and that countries that had reduced VAT/GST rates have subsumed many taxes in that framework and tax structure was made linear by doing away with tax breaks.

Therefore, the GST rates would be fixed after ensuring that there would be no revenue loss from the proposed changes and a normal growth is maintained.

5.6 Most States agree to common GST rate: Revenue Secretary

In VAT each State had a separate rate of tax but unlike VAT in the case of GST all the States have reached on a consensus to charge a common rate of tax.

(*Source:* Times of India dated 16-07-2009)

5.7 GST/VAT Rate Globally

S. No.	Country	Rate (%)
1.	Australia	10
2.	Austria	20
3.	Canada	7
4.	China	17
5.	Denmark	25
6.	Finland	22
7.	France	19.6
8.	Germany	16
9.	Indonesia	10
10.	Italy	20
11.	Japan	5
12.	Malaysia	5
13.	Mexico	15
14.	New Zealand	12.5
15.	Philippines	10
16.	Russia	18
17.	Singapore	7
18.	South Africa	14
19.	Sweden	25
20.	Taiwan	5
21.	U.K.	17.5

A-6
TAXES/DUTIES LIKELY TO BE SUBSUMED IN GST

6.1 Probable Taxes/Duties to be subsumed in GST

As per the dual tax regime that has been announced for GST in India, there will be a Central stream for taxes and a State stream for the same taxes. In order to allow this model of taxation both the Centre and States will have to make policy changes. It is expected that the proposed concurrent dual GST system would preserve and protect the fiscal powers and at the same time rationalize the indirect tax structure by subsuming a plethora of Central and Local Taxes into a consolidated levy.

(A) Central GST may subsume the following indirect taxes/duties on supply of goods and services:

- Central Excise Duties (CENVAT)
- Additional Excise Duties including those levied under Additional Duties of Excise (Goods of Special Importance) Act, 1957
- Additional Custom Duties in the nature of countervailing duties, i.e., CVD, SAD and other domestic taxes impose on imports to achieve a level playing field between domestic and imported goods although, under the GST regime all the imports will suffer a reverse charge.
- Cesses levied by the Union viz., Cess on rubber, tea, coffee etc.
- Service Tax
- Central Sales Tax – to be completely phased out
- Surcharges levied by the Union viz., National Calamity Contingent Duty, Education Cess, Special Additional Duties of Excise on Motor-Spirit and High Speed Diesel (HSD).

(B) State GST may subsume the following State taxes

- Value Added Tax

- Purchase Tax
- State Excise Duty (except on liquor)
- Entertainment Tax (unless it is levied by the local bodies)
- Luxury Tax
- Octroi
- Entry tax in lieu of Octroi
- Taxes on Lottery, Betting and Gambling

6.2 Taxes/Duties <u>not</u> to be subsumed in GST

(A) In Central GST

- Basic Customs Duty
- Excise Duty on Tobacco products
- Export Duty
- Specific Cess
- Specific Central Cess like Education and Oil Cess.

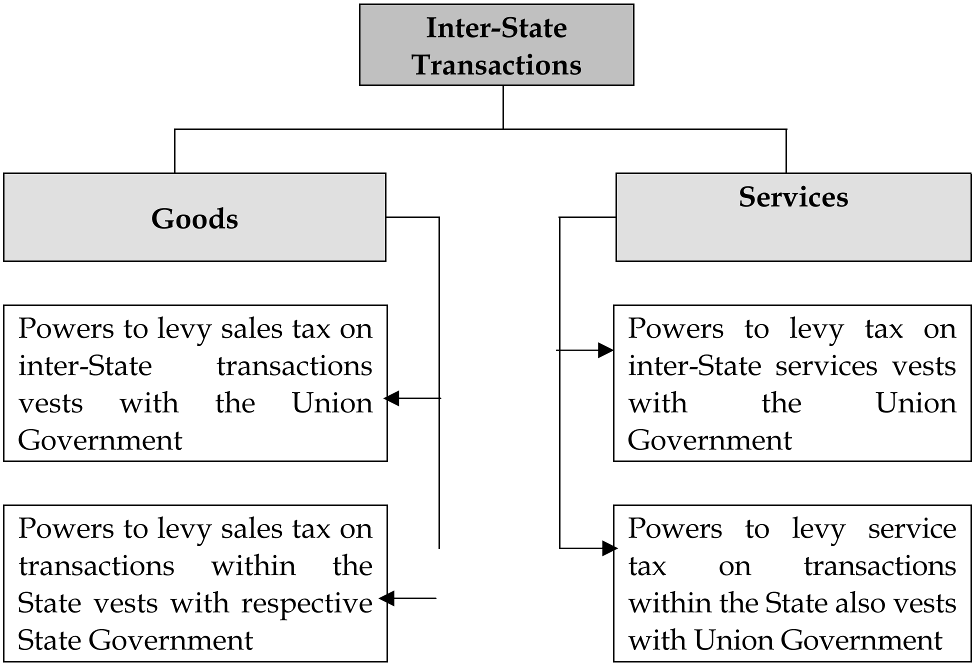
(B) In State GST

- Taxes on Liquors
- Toll Tax
- Environment Tax
- Road Tax
- Property Tax
- Tax on Consumption or Sale of Electricity – Not certain
- Stamp Duty – Not certain

(C) Certain components of petroleum, liquor are likely to be outside the GST structure. Further, State Excise on liquor may also be kept outside the GST. In other words, in such circumstances, all taxes and duties on these goods will be outside the scope of GST.

A-7
INTER-STATE TRANSACTIONS AND GST

7.1 Present Indirect Tax Structure – Inter-State Transactions



7.1.1 Tax on sale of goods

Entry 92A in the Union List in the Seventh Schedule to the Constitution of India confers power upon the Union to legislate in respect of "taxes on the sale or purchase of goods other than newspapers, where such sale or purchase takes place in the course of inter-State trade or commerce". The power to impose sales tax in the Union Territory vests with the Parliament under Article 246(4) of the Constitution of India.

Entry 54 in List II (State List) of the Seventh Schedule read with Article 246(3) of the Constitution of India empowers the States to impose "tax on the sale or purchase of goods other than newspapers, subject to the provisions of Entry 92-A of the List I".

Restrictions are imposed on the States to impose tax on sale or purchase of goods through Article 286, as under: -

286(1) No law of a State shall impose a tax on the sale or purchase of goods where such sale or purchase takes place -

(a) outside the State; or

(b) in the course of the import of the goods into, or export of the goods out of, the territory of India.

286(2) Parliament may by law formulate principles for determining when a sale or purchase of goods takes place in any of the ways mentioned in clause (1).

286(3) Parliament may impose restrictions and conditions in regard to the system of levy, rates and other incidents of the tax on any law of a State in relation to the imposition of -

(a) a tax on the sale or purchase of goods declared by Parliament by law to be of special importance in inter-State trade or commerce, (declared goods), or

(b) a tax on the sale or purchase of goods, being a tax of the nature referred to in sub-clause (b), sub-clause (c) or sub-clause (d) of sub-clause (29A) of Article 366.

In Article 269(1), clause (g) authorises the Government of India to collect tax on the sale or purchase of goods other than newspapers, where such sale or purchase takes place in the course of inter-State trade or commerce and making it obligatory upon the Government of India to assign the tax to the collecting States.

Import of goods into India is taxed by the Union Government under the Customs Act. State Governments are not authorized to impose tax on import and sale in the course of import.

Inter-State sale of goods is taxable under the Central Sales Tax Act, 1956. For this purpose, goods have been classified into two categories: (a) Declared goods or goods of special importance in inter-State trade or commerce, and (b) Other goods. Rates of tax have been prescribed under section 8 and differ from State to State; and for a particular commodity, it generally depends upon the tax rate prevailing in that State.

After the amendments vide Taxation Laws (Amendment) Act, 2007 w.e.f. 01.04.2007, central sales to unregistered dealers or to registered dealers without declaration in Form 'C' or other Forms prescribed under the CST Act attract tax at the rate equal to the local rate of tax (i.e. the rate applicable within the originating State). For sales (declared or other goods) supported by declaration Form C, central sales tax rate is 2%, or the local rate applicable in that State, whichever is lower. The Central Government had reduced the CST rate for sales made to registered dealers on the strength of Form C from 4% to 3% with effect from 1st April 2007, which has further been reduced to 2% w.e.f. 1st June 2008.

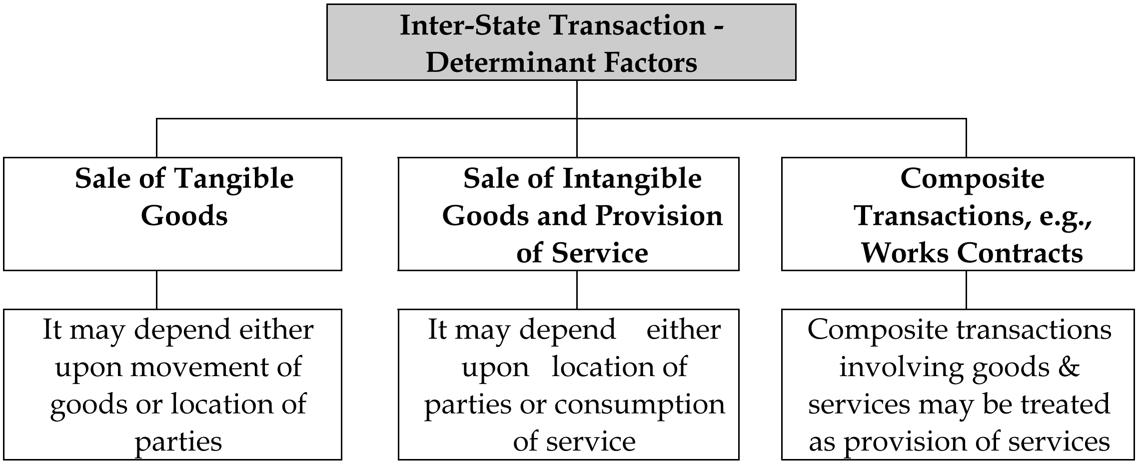
7.1.2 Tax on provision of services

Service tax is imposed by the Central Government under the authority of Residual Entry 97 of the Union List (List 1) under Schedule VII of the Constitution of India. The Central Government has absolute authority to impose tax on the services whether provided within the State or from one State to another.

Import of services in India are taxable through reverse charge method, i.e., tax is payable by the recipient of services in India at the time of import of service.

Currently, service tax is generally paid by the service provider in the jurisdiction where such person is registered, i.e., the place of rendering of service. Since the power of levy/collection vests only with Centre, it does not matter where the taxpayer is registered and where the service is actually provided, i.e., *situs* is not an issue.

7.2 GST – To Determine whether a Transaction is an Inter-State supply or Not – Determinant Factors



7.3 GST - To determine the Place of Taxation

GST is generally levied on the basis of the destination principle. For this purpose, some countries follow the practice of prescribing a set of rules for defining the place of taxation or place of supply. A supply is taxable in a given jurisdiction only if the supply is considered to take place in that jurisdiction. An alternative approach followed by other countries is to first define what supplies are potentially within the scope of the tax, and then provide the criteria for determining which of those supplies would be zero-rated as exports. The two approaches yield the same result, even though one excludes exports from the scope of the tax, while the other zero-rates them, having first included them in the scope. A supply of services or intangible property might be taxable in a jurisdiction depending upon one or more of the following factors:

- Place of performance of the service
- Place of use or enjoyment of the service or intangible property,
- Place of residence/location of the recipient, or
- Place of residence/location of the supplier.

However, following services can have their own set of Rules for fixation of *situs* :

- Services relating to immovable property, e.g., services of estate agents or architects
- Banking & other financial services
- Business auxiliary and event management services
- Transport of goods by road
- Advertisement, which are given on Pan India basis either in print or electronic media.

Further, special rules might be required for certain other supplies (also referred to as mobile services) for which there is no fixed place of performance or use/enjoyment, such as:

- Passenger travel services
- Freight transportation services
- Telecommunication Services
- Motor vehicle leases/rentals

- E-commerce supplies.
- Development of Software through electronic mode.
- Supply of Goods during transportation.

Possible Place of Taxation

B2B (Business to Business)

- Place of destination can be the place where the recipient is established or located.

B2C (Business to Customer)

- Supplies of a tangible/ physical nature (e.g., hair cuts, hotel accommodation, local transport, & entertainment services) - Place of destination could be the place where the supplier is established or located, which is generally also the place where the service is performed.
- For mobile supplies of an intangible nature (e.g., telecommunication and e-commerce services), or general insurance service - Place of supply could be the place of residence of the customer, or the place where services are used or enjoyed.

Special rules for specific supplies can be designed to yield best results. They serve the purpose of providing greater certainty and clarity in situations where the place or location or residence of the supplier or the recipient is not well defined or easily ascertainable at the time of supply.

7.4 Collection and Payment of Tax - Possible Mechanism in GST

A mechanism is needed for proper application of sub-national tax on inter-State supplies of goods as well as services. Instead of zero-rating of inter-State supplies, a preferred approach will be required. Various models have been adopted in other countries and have been suggested at various forums after improvisation. These are:

1. Prepaid VAT (PVAT) Model

In this system, the vendors will collect the destination State GST (SGST) on inter-State supplies (of goods and services) and remit the full tax (without claiming input tax) directly to the Destination State through Bank. The tax will then be creditable in the destination State under the normal rules, i.e., if it relates to inputs for use in making taxable supplies. Input tax credit on purchases will be claimed by the seller from his State either by way of refund or through adjustment against his local CGST and SGST output tax liability.

Features:

- Under the present CST Act, tax on inter-State sales is charged and retained by the Origin State. However, under PVAT, the tax on inter-State supplies will be charged and remitted to the Destination State. It preserves the destination principle of VAT. Vendor in the Origin State collects the tax on all of their domestic supplies, whether intra-State or inter-State. The tax collected on inter-State supplies will belong to the Destination State and remitted to that State by the vendor. On intra-State supplies, the tax collected will be that of the Origin State and paid to that State.
- Buyers who are GST registrants (in B2B transactions) will have a strong incentive to ensure that the vendor properly applies the destination tax, which will then be creditable against their output tax in the State of destination. Otherwise, the goods will be subject to the tax of the origin State, which will not be creditable in the State of destination.
- Most supplies of services and intangibles to consumers and other exempt buyers (in B2C transactions) will be taxable in the State of origin, without the benefit of zero-rating. However, inter-State shipments of goods to consumers will be zero-rated in the State of origin and attract the tax of the destination State. An inducement could be created for consumers also to ensure that the vendor charges the destination State tax on such shipments.

- However, payment of tax by the customers in the consuming State may involve many administrative problems, and the Government may decide to tax these transactions in the State of origin only since the involvement of tax might not be very significant. But, this practice may disturb the essential character of the GST, i.e., destination based GST.
- The PVAT mechanism establishes the output-tax-and-input-credit chain for inter-State transactions. Subject to documentary evidence that the seller has paid output tax, he (the seller) could claim input GST from the selling State by way of refund or through adjustment against local CGST and SGST output tax liability.
- The buyer in the other State could claim credit to the extent of tax deposited and remitted by the seller.
- Demat version can also be incorporated in this Model, where both the seller and buyer have to open their respective Demat accounts. When an inter-State seller deposits the tax in his State, he will also furnish the details of the purchaser on the basis of which, Demat Agency will allow credit to the purchaser's Demat account.
- Inter-State stock transfer and consignment sales will be carried out in the same manner. However, for valuation of these transactions, separate valuation rules have to be framed.

Drawbacks:

- It may violate the concept of destination based tax to the extent to B2C transactions.
- Buyer will pay the amount of tax (along with sale consideration) to the seller, who will deposit the tax in the designated bank. However, both these payments are not inter-dependant. Therefore, the buyer will have to unnecessarily wait for the remittance, which is subject to payment of tax by the seller in his State.
- Delay in remittance by bank will create unnecessary hassle to the buyer.
- Involves extensive refunds in the selling State.
- Involves heavy administrative cost, resources and infrastructure.

2. Postpaid VAT (TDS) Model

As a contradiction of Model No. 1 (PVAT), in TDS model, the buyer pays SGST in his (buying) State on the basis of invoice raised by the seller, claims input tax of the amount he has paid into Bank, and issues TDS certificate to the seller. The seller, on the basis of such TDS certificate, claims exemption/refund in his (selling) State.

Features:

- Separate rules are required for B2C transactions.
- The buyer will deposit tax electronically and also generate the TDS certificate through system only, so that the same amount could also appear against the TIN of the seller.
- Buyer will have an upper hand since seller can claim credit only on the basis of TDS certificate issued by the buyer.
- Bank is not required to transfer the funds to the other State since tax is collected in the Destination State itself.
- Involves considerable refunds in the selling State.

3. Demat 'C' Form Model

Under this Model, transactions are zero rated/exempt in the selling State, subject to Dematted Form C. The procedure can be designed in the following manner:

- Seller will first enter the details of sale and purchaser through internet.
- Buyer will access through internet and fill the details of transaction, seller and other necessary columns. Subsequently, he will verify and confirm the transaction using his digital signature.
- The State Government will grant permission through internet.
- On permission being received, system will generate Demat Form C. The said Form C will be issued by the buyer to the seller, who can use the same for claiming exemption in his State.
- Inter-State stock transfer and consignment sales will be conducted in the same manner.
- The Model requires extensive automation both at the Department level and the dealer level.

4. Reverse Charge Model with Demat C Form

This Model is modification of Demat C Form Model, and can have the following elements:

- Zero rating of inter-State transactions in the selling State.
- Levy of SGST in the purchasing State using "Reverse Charge Method", similar to that applicable presently for import of services for imposition of service tax.
- Claim of credit by the purchaser in his State for the amount of tax paid by him.
- Issue of Demat Form C by the buying State Authorities to buyer.
- Submission of Form C by the buyer to the seller for claiming exemption by the later in his State.
- The system of issuing and furnishing of Demat Form C is akin to the existing system.
- Inter-State stock transfer and consignment sales will also be conducted in the same manner.

5. IGST Model

Features

- Seller in the origin State will charge IGST [(CGST+SGST) on ISS transactions, by whatever name called], which will be aggregate of CGST & SGST, i.e., IGST = CGST+SGST.
- Inter-State Seller shall use his input CGST and input SGST for payment of IGST, i.e., he shall pay net IGST.
- Inter-State Buyer shall avail input tax credit on the basis of tax invoice for payment of his own IGST, CGST or SGST.
- Both, the seller and the buyer shall report these transactions in their respective e-returns.
- To maintain the GST to be a destination based tax, amount paid by the seller in his State (along with input tax credit claimed by him) will be remitted by the Central Agency to the buying State through some mechanism.
- B2B transactions could get input tax credit without break till it reaches the final consumer.
- It involves lesser refunds since the seller will pay net IGST (after claiming input tax credit) in his State.

6. Illustration – Inter-State GST

Assumptions:

(1) *Central GST Rate – 12%;*

(2) *State GST Rate – 8%;*

(3) *Profit Margin – Rs. 10,000/- fixed (before tax);*

(4) *Both, CGST & SGST, are levied on every transaction starting from manufacturing level till it reaches the final consumer, irrespective of State boundaries; and*

(5) *The seller pays net GST (after claiming input tax) in his State.*

Illustration

Particulars	**GST A/C**		**Total**
	CGST @ 12%	**SGST @ 8%**	
(I) Manufacturer (D1-Delhi) to Wholesaler (H2- Haryana)			
Cost of production			90,000
Input GST on Raw Material	*6,000*	*4,000*	-
Add : Profit Margin			10,000
Producers Basic Price			1,00,000
Add : GST	12,000	8,000	20,000
Less : Input GST	*6,000*	*4,000*	
GST Payable	*6,000*	*4,000*	
Sale Price			1,20,000
(II) Wholesaler (H2) to Retailer (H3) in Haryana			
Cost of Goods to H2			1,00,000
Input GST	*12,000*	*8,000*	
Add : Profit Margin			10,000
Total			1,10,000

Particulars	GST A/C		Total
	CGST @ 12%	**SGST @ 8%**	
Add : GST	13,200	8,800	22,000
Less : Input GST	*12,000*	*8,000*	
GST Payable	*1,200*	*800*	
Total Price to the Retailer (H3)			1,32,000
(III) Retailer (H3) to Final Consumer (C) in Haryana			
Cost of Goods to H3			1,10,000
Input GST	*13,200*	*8,800*	
Add : Profit Margin			10,000
Total			1,20,000
Add : GST	14,400	9,600	24,000
Less : Input GST	*13,200*	*8,800*	
GST Payable	*1,200*	*800*	
Total Price to the Consumer (C)			**1,44,000**
Total Tax Payable in All Transactions	**14,400**	**9,600**	**24,000**
Verification: GST @20% on 120000 = 24000			
- D1 on inputs -	*6,000*	*4,000*	*10,000*
- D1 on output -	*6,000*	*4,000*	*10,000*
- H2 -	*1,200*	*800*	*2,000*
- H3 -	*1,200*	*800*	*2,000*

7. Pre-requisites of all these models

All these Models discussed above require the following pre-requisites for successful implementation of GST:

- Extensive Computerization and strong IT infrastructure
- E-filing of periodical returns
- E-payment of tax

- Common tax period
- National portal for access of information
- National Agency
- Trained and well equipped staff.

7.5 Taxation of Import

As per Poddar-Ahmad Working Paper, in most countries, imports attract VAT/GST at the time of entry into the country. The tax is generally applied on the value of goods declared for customs purposes, including the amount of the customs duty. However, there are no well-established precedents for the application of sub-national taxes to imports. In India, the Centre levies an additional duty (called the special additional duty - SAD) on imports at the rate of 4%, which is meant to be in lieu of the State VAT. This duty is allowed as a credit against the central excise duty on manufacturing or refunded where the imports are resold and the State VAT is charged on them.

In Canada, the provincial HST is collected by the Customs Authorities on non--commercial importations of goods. The tax is collected at the time of importation on the basis of place of residence of the person importing the goods, regardless of where the goods enter the country. Commercial importations do not attract the provincial HST because of difficulties in determining their destination within the country. For example, a large consolidated commercial shipment could contain goods that are initially destined to a central warehouse, for subsequent distribution to various parts of the country.

The Canadian system is conceptually appealing and could be considered for the application of State taxes under the Dual GST in India.

7.6 Other Issues that Need consideration of the Government

(a) Specific provisions are required for determination of nature of an activity, i.e., whether it is a sale or service.

(b) Specific rules for determination of sale price/consideration, i.e., what form part of the sale price. To illustrate, in a transaction of sale of aggregates (of stone) to other State, freight element is sometimes more than the price of aggregates in total consideration - to decide whether amount of such freight is service or sale.

(c) Provisions to allow inter-GST (between Central GST and State GST) set-off/credit of input tax to avoid cascading effect. It is understood that these two taxes will run parallel to each other and there will not be cross set-off. If that is so, it may defeat the basic purpose of the reform.

(d) Whether to continue exemption for sale in the course of import and high seas sales under section 5(2) of the CST Act. Presently States are not authorized to impose tax on sale in the course of import under Article 286(1) of the Constitution of India.

(e) Whether to allow exemption to penultimate exports as defined under section 5(3) of the CST Act – Probably, will not be allowed.

(f) Whether to continue exemption on subsequent sales under section 6(2) of the CST Act – Probably, will have to go.

(g) Taxation on the sale or purchase of goods declared by Parliament to be of special importance in inter-State trade or commerce, (declared goods) under Article 286(3) of the Constitution of India read with Sections 14 and 15 of the CST Act.

(h) To prescribe extensive rules for determination of value in case of transfer of goods to branches or consignment agent or inter-related parties.

(i) Since the Government has decided to levy dual GST, measures to avoid litigation which may arise due to fixation of *situs*.

(j) Precise provisions for sharing of revenue amongst the States on inter-State transactions to avoid disputes in relation thereto.

A-8
PRESENT TAXATION *VS.* GST

S.N.	Particulars	Present Taxation	GST (Expected)
1.	Structural Difference	• Two separate VAT systems operate simultaneously at two levels, Centre and State, and tax paid (input tax credit) under one is not available as set off against the other • Tax on services is levied under separate legislation by Centre • No comprehensive taxation of services at the State level; few services are taxed under separate enactments • Imports in India are not subjected to State VAT	A dual tax with both Central GST (CGST) & State GST (SGST) levied on the same base. Thus, all goods and services, barring a few exceptions, will be brought into the GST base. There will be no distinction between goods and services for the purpose of tax with a common legislation appli-cable to both It allows seamless tax credit amongst Excise Duty, Service Tax & VAT
2.	Place of Taxation	Taxable at the place of sale of goods or rendering of service	It is consumption (destination) based tax
3.	Excise Duty	Imposed by Centre under separate Act; Taxable event: Manufacture; Taxed up to manufacturing point	To be subsumed in CGST; Taxable event : Sale; To be taxed up to retail level
4.	Basic Customs Duty	Imposed by Centre, under separate Act; Taxable event: Import	- No Change -
5.	CVD/SAD	Imposed by Centre under	To be subsumed in

S.N.	Particulars	Present Taxation	GST (Expected)
		separate Act; Taxable event: Import	CGST; Taxable event : Import
6.	Service Tax	Imposed by Centre under separate Act; Taxable event: Provision of Service	To be subsumed in CGST & SGST ; Taxable event : Provision of Service
7.	Central Sales Tax	Imposed by Centre under CST Act; Collection assigned to States; Taxable event : Movement of goods from one State to another	To be phased out
8.	State VAT	Imposed by States; Taxable event : Sale within the State	To be subsumed in SGST; Taxable event : Sale within State
9.	Inter-State Transactions	Goods & Services : Imposed by the Centre	To be subsumed in GST & subject to SGST & CGST
10.	Powers to levy Tax on Manufacture	As Excise Duty (CENVAT) :Centre	No such powers in GST
11.	Powers to levy Tax on Sale of Goods	- Inter-State: Centre - Local: State	Concurrent powers to Centre & State
12.	Powers to levy Tax on Provision of Services	Centre	Concurrent powers to Centre & State; States to tax more than 40 services
13.	Tax on Import in India	- Goods : Under Customs Duty (comprises Basic Customs Duty, CVD & SAD); - Services : Under Service Tax	- Basic Custom Duty on goods : No Change; - CVD & SAD on import of goods and import of services : To be subsumed in GST
14.	Tax on Export of Goods & Services	Exempt/Zero-rated	- No Change -
15.	Tax on inter-State Transfer of Goods	Exempt against Form F	To be taxable

S.N.	Particulars	Present Taxation	GST (Expected)
	to Branch or Agent		
16.	Tax on Transfer of Goods to Branch or Agent within States	Generally exempt; Depending upon State procedures	Might be taxable, unless BIN of transferor and transferee is same
17.	Cross-Levy set-off	Excise duty and Service tax : Cross set off allowed	No cross set-off between CGST and SGST
18.	Cascading Effect	Allows tax credit between Excise Duty & Service Tax, but not with VAT	Allows seamless tax credit amongst Excise Duty, Service Tax & VAT
19.	Non-Creditable Goods	Exists	Might exist
20.	Credit on Inputs used for Exempted Activities	Not allowed	Will not be allowed
21.	Various Exemptions – Excise Free Zone or VAT Exemption	Exists	May go in a phased manner
22.	Exemption for transit Inter-State Sale and High Seas Sale	Exists	Might be taxable
23.	Transactions against Declaration Forms	Exists under the CST Act	Forms will be abolished
24.	Taxation on Govt. and Non-Profit Public Bodies	Partially taxed	Might not Change
25.	Stamp Duty	Presently taxed concurrently by the Centre and State	Status not clear; If subsumed under GST, big relief to real estate industry : to claim input tax
26.	Tax Base	Comparatively, Narrow	Wider

S.N.	Particulars	Present Taxation	GST (Expected)
27.	Excise Duty – Threshold Limit	Rs. 1.5 crores	- Rs.10 lacs to 20 lacs (Turnover of Rs. 1.5 crores & above to be administer by Centre and less than Rs. 1.5 crores to be administer by States)
28.	VAT - Threshold Limit	Rs. 5 lacs to 10 lacs	Rs. 10 lacs to Rs. 20 lacs
29.	Service Tax - Threshold Limit	Rs. 10 lacs	Rs. 10 lacs to Rs. 20 lacs
30.	Classification of Commodities	- Excise Duty : HSN; - VAT : None	HSN
31.	VAT/GST Registration Number	Simple TIN (some States : PAN based)	PAN based BIN
32.	Procedures for Collection of Tax and Filing of Return	CENVAT & Service Tax: Uniform VAT : Vary from State to State	Will be uniform
33.	Administration	Complex due to number of Taxes	Comparatively, simple
34.	Use of Computer Network	Just started by the States; very minimum	Extensive; It is necessity for implementation of GST
35.	Nature of Present Litigations	a. Sale *vs.* Service b. Classification of goods c. *Situs* issue : between States d. Interpretation of provisions e. Sale *vs.* Works Contract f. Valuation of Composite Transactions, etc.	Will be reduced, provided GST Legislations are properly drafted

A-9

ROADMAP TO GST IN INDIA

STEPS TOWARD IMPLEMENTATION OF GST

YEARWISE DEVELOPMENTS

2004	• Dr. Kelkar Task Force recommended the need of a National GST
Jan. 2007	• First GST study released by Dr. Shome
2007	• Consultation with stakeholders on GST Model
April 2007	• CST phase out started
May 2007	• Joint Working Groups appointed by E.C.
Nov 2007	• 13th Finance Commission Constituted
Nov 2007	• Joint Working Groups submitted Report
Feb 2008	• F.M. Announced introduction of GST from 1.4.2010 in Budget Speech 2008-09
April 2008	• Empowered Committee (EC) finalized its views on GST Structure
July 2009	• F.M. announced Dual GST from April 1, 2010 in Budget Speech 2009-10
Oct 2009	• 13th Finance Commission to submit its Report
Nov 2009	• Release of First Discussion Paper on GST
2009-2010	• Consultation on Model of inter-State transactions, RNR and other issues - In progress • **Nandan Nilekani** given the responsibility for creating the required IT structure and NSDL has been chosen as the technology partner for operating the structure.
Dec 2014	• 122nd Constitution Amendment Bill introduced in Parliament
May 2015	• 122nd Constitutional Amendment bill passed by Lok Sabha and referred to the Select Committee of Rajya Sabha to submit its report in first week on Monsoon Session.

9.1 Roadmap to GST

"Let us Gear Up for Goods & Service Tax". This is the call given by Dr. Asim K. Dasgupta, Chairman of Empowered Committee and the then Finance Minister Shri Pranab Mukherjee. They had firmly reiterated that GST will be definitely introduced w.e.f. 1.4.2010. In the Budget Speech 2009-10, the F.M. informed the House:

> *Para 85: I have been informed that the Empowered Committee of State Finance Ministers has made considerable progress in preparing the roadmap and the design of the GST. Officials from the Central Government have also been associated in this exercise. I am glad to inform the House that, through their collaborative efforts, they have reached an agreement on the basic structure in keeping with the principles of fiscal federalism enshrined in the Constitution. I compliment the Empowered Committee of State Finance Ministers for their untiring efforts. The broad contour of the GST Model is that it will be a dual GST comprising of a Central GST and a State GST. The Centre and the States will each legislate, levy and administer the Central GST and State GST, respectively. I will reinforce the Central Government's catalytic role to facilitate the introduction of GST by 1st April, 2010 after due consultations with all stakeholders.*

Former Finance Minister Mr. P. Chidambaram had also been making this call in his four Budget Speeches, as under:

Budget Speech 2004-05:

> *Para 119: Now I turn to my indirect tax proposals ………….. It is my intention to align India's tariff structure to those of ASEAN countries. Eventually, there should be a uniform rate of tax on goods and services.*

Budget Speech 2005-06:

> *Para 94: In the medium to long term, it is my goal that the entire production – distribution chain should be covered by a National VAT, or even better a goods and service tax, encompassing both the Centre and State.*

Budget Speech 2006-07:

> *Para 155 : It is my sense that there is large consensus that the country should move towards a National level Goods and Service Tax (GST) that should be shared between the Centre and the State. I propose that we set April 1, 2010 as the date for introduction of GST. World over goods and services attract the same rate of tax. That*

is the foundation of the GST. People must get used to the idea of GST. Hence we must progressively converge the service tax rate and the CENVAT rate. …….

Budget Speech 2007-08:

Para 116: I wish to record my deep appreciation of the spirit of cooperative federalism displayed by State Governments and especially their Finance Ministers. At my request, the Empowered Committee of State Finance Ministers has agreed to work with the Central Government to prepare a roadmap for introducing a national level Goods and Services Tax (GST) with effect from April 1, 2010.

Budget Speech 2014-15:

The debate whether to introduce a Goods and Services Tax (GST) must now come to an end. We have discussed the issue for the past many years. Some States have been apprehensive about surrendering their taxation jurisdiction; others want to be adequately compensated. I have discussed the matter with the States both individually and collectively. I do hope we are able to find a solution in the course of this year and approve the legislative scheme which enables the introduction of GST. This will streamline the tax administration, avoid harassment of the business and result in higher revenue collection both for the Centre and the States. I assure all States that government will be more than fair in dealing with them.

9.2 Background - Kelkar II Task Force Report

GST was first brought to the fore by Kelkar II Task Force Report. This Committee made a number of recommendations that are, it is learnt, under the study of Union Finance Ministry.

The Kelkar Task Force was constituted with the mandate to recommend measures to enable the Government of India to implement the Fiscal Responsibility and Budget Management (FRBM) Act, 2003, which sought to eliminate the revenue deficit by March 31, 2008.

As the main proposal for tax reform, Dr. Vijay Kelkar and his team recommended a single GST (Goods and Services Tax) – replacing the CENVAT/excise duty, sales tax, service tax, etc. It would use the VAT principle to tax consumption of almost all goods and services – with full tax credits across all goods and services.

The Task Force has adopted the following strategy: -

- Widen the tax base

- Few Rates; Low rates
- Enhance equity of the tax system
- Shift to non-distortionary consumption taxes
- Tariffs, excises, turnover taxes etc. have cascading effects. The aim is to eliminate these taxes by using the destination-based VAT
- Focus on buoyancy and not on immediate sources of tax revenue – The report asserts that though it is always easier to resort to imposing taxes in an ad-hoc manner on particular sectors like telecom, banking etc., the strategy focuses on increasing tax revenues by first, increasing GDP growth and second, increasing buoyancy.

9.3 First Report on GST released by Dr. Shome

The first Report on GST was released by the Advisor to Finance Minister, Dr. P. Shome in January 2007. While releasing the report, Dr. Shome said,

> "Developing a common market is the crux of the issue here. GST should enable free trade within the country. Impediments to free trade within the country have to be removed, especially when we are signing a number of free trade agreements abroad. This is an important challenge before us."

He emphasized, "We have to think of a rate that is not too high and at the same time appropriate for meeting State expenditure". Enlisting the challenges in the implementation of GST, he said one of the biggest tasks was to conceptualize a model, which will fetch adequate revenues for the Centre and States, but that too with a lower rate.

Dr. Shome identified six major challenges that policy makers need to overcome for introduction of GST. These include issues relating to Constitutional provisions, tax assignments vis-à-vis revenue sharing, the overall level of rates, the type of rate structures, development of a common market, and successful operation of TINXSYS (Tax information exchange system).

9.4 Appointment of Joint Working Group

The real work started with the appointment of Joint Working Group (JWG) in May 2007 by the Empowered Committee of State Finance Ministers to give recommendations regarding detailed framework to be adopted for GST. JWG was given the task to suggest a model for the base and rate structure of GST.

The Working Group consisted of the following members:

a	Dr. Parthasarathi Shome	Adviser to Hon'ble Union Finance Minister. Permanent Invitee, Empowered Committee	Convener
b	Shri Satish Chandra	Member Secretary, Empowered Committee of State Finance Ministers	Convener
c	Shri L.K. Gupta	Joint Secretary (ST), Department of Revenue	Member
d	Shri Gautam Ray	Joint Secretary (TRU-I), Department of Revenue	Member
e	Shri R. Sekar	Joint Secretary (TRU-II), Department of Revenue	Member
f	Shri P.K. Mohanty	Joint Secretary (DBK), Department of Revenue	Member
g	Secretaries/Principal Secretaries of Finance/Taxation from all the States and Union Territories		Members

9.5 Role of Joint Working Group

The Joint Working Group was required to study the various models of GST existing globally and other relevant material available on the subject. It was also to identify the possible alternative models for introduction of GST in India and examine their various characteristics and assess their suitability in India's fiscal federal context. After these studies, the Working Group had to present its findings before the Empowered Committee for decision on the most appropriate model for introduction of GST in India.

The Working Group was also assigned the role to identify the Central Taxes and State Taxes which possess properties to be appropriately subsumed under GST. The Working Group was required to keep the following in mind:

(a) GST should be so designed that it should be revenue neutral to the Centre and States. Interests of the Special Category, North Eastern State and Union Territories have to be especially kept in mind.

(b) The group should examine different models and see that power of levy, collection and appropriation of revenue needs to be vested in the Centre and the States by looking at the pros and cons.

(c) Various models suggested by the working group should ensure that double taxation is avoided.

(d) Working Group should ensure that the suggested model takes into account the problems faced during inter-State transactions and any revenue loss.

(e) Working Group should consider how zero rated goods and services and Non-VAT items, such as, petroleum goods and alcohol might be treated under the new regime.

(f) The model to be developed should reflect the interest of the Centre, States, trade, industry, agriculture and services.

9.6 Recommendations of Joint Working Group

JWG submitted its report in November 2007 after making study of GST Acts of several countries and making study tours to Brazil, Australia and Singapore. The JWG of EC laid down various recommendations. Few of them are:

(1) GST, when it rolls out on 1st April 2010, shall have two components a Central tax and a single uniform State tax across the country.

(2) A tax over and above GST, which may be levied by the States on tobacco, petroleum and liquor, may help the report to find favour with the States.

(3) The GST may not have a dual VAT structure but a quadruple tax structure. It may have four components, namely: -

    (a) a Central tax on goods extending up to the retail level;

    (b) a Central service tax;

    (c) a State-VAT on goods; and

    (d) a State-VAT on services.

Given the four-fold structure, there may be at least four-rate categories - one for each of the components given above. In this system, the taxpayer may be required to calculate tax liability separately for the different rates of tax.

(4) The States must tax intra-State services while inter-State services must remain with the Centre.

(5) Petroleum products, including crude, high-speed diesel and petrol, may remain outside the ambit of GST.

(6) Elimination of the area-based and sectorial excise duty exemptions that are being given by the Centre.

(7) Central cess, like education and oil cess may be kept outside the dual GST structure to be introduced from April 2010. Besides Central Cess, the EC of State Finance Ministers has also recommended to keep purchase tax and octroi, which are collected at State and local levels, outside the GST framework.

(8) To keep Stamp duty, which is a good source of revenue for States, out of the purview of the GST. Stamp duty is levied on transfer of immovable like houses and land.

(9) To keep levies, like the toll tax, environment tax and road tax, outside the GST ambit, as these are user charges.

(10) If the levies are in the nature of user charges and royalty for use of minerals, and then they must be kept out of the purview of the proposed tax.

9.7Constitution of the 13th Finance Commission

The President constituted the Thirteenth Finance Commission under Article 280(1) of the Constitution. Dr. Vijay L. Kelkar, former Union Finance Secretary and Adviser to the Finance Minister was appointed as Chairman of the Commission. Shri B.K. Chaturvedi, Member, Planning Commission was appointed as the part-time Member, and Dr. Indira Rajaraman, Emeritus Professor, National Institute of Public Finance and Policy, Dr. Abusaleh Shariff, Chief Economist, National Council of Applied Economic Research, Prof. Atul Sarma, Former Vice-Chancellor, Rajiv Gandhi University (formerly Arunachal University) as the full time Members of the Commission. Shri Sumit Bose was the Secretary to the Commission.

The 13th Finance Commission was also required to study the likely impact of the proposed implementation of Goods and Services Act (GST) with effect from 1st April, 2010, including its impact on foreign trade.

The recommendations of the 13th Finance Commission were to cover the period of five years from 1st April, 2010 to 31st March 2015. The Commission was expected to make available its report by 31st October, 2009.

9.8 A clear roadmap to implement GST Needed

At a workshop on Goods and Services Tax organised by the Indian Chamber of Commerce, several speakers, while welcoming the Government's plan to launch the tax from next April, also emphasized the need for a clear roadmap on implementation of the new system of taxation to enable people at large and the business community, in particular, to familiarize themselves with the same, according to a press release issued by the chamber.

It was felt that the implementation of GST might require amendment to the Constitution authorizing the Centre to tax sale or supplies of goods outside factory gates at any point in the supply chain and to permit States to levy tax on services. Another key issue that needed to be addressed was the determination of the manner of application of GST on inter-State or cross-border transactions.

[*Source:* The Hindu Business Line, dated 30/07/2009]

A-10
CHALLENGES BEFORE THE GOVERNMENT & TRANSITIONAL ISSUES

10.1 Challenges before the Government

Most concerns expressed about the implementation of GST can broadly be divided into three categories –

A. Design issues

B. Operational issues

C. Infrastructure issues.

A. Design issues

The broad framework of GST is now clear. This is on the lines of the model approved by the Empowered Committee of the State Finance Ministers. The GST will be a dual tax with both Central and State GST component levied on the same base. Thus, all goods and services barring a few exceptions will be brought into the GST base. Importantly, there will be no distinction between goods and services for the purpose of the tax with a common legislation applicable to both.

However, a number of issues remain to be resolved, which are under the consideration of the Empowered Committee. These issues include: -

(a) Constitutional Amendments. Amongst other, significant are:

- To shift the taxable event in case of excise duty from 'manufacture' to 'sale'.
- To allow the States to levy tax on services.
- To authorize the Union Government to impose tax on sale of goods which take place within the State.

- To authorize States to impose tax on sales of goods which take place in the course of inter-State trade or commerce.

(b) Enactment of Legislations - It has been stated by the Hon'ble Finance Minister in his Budget speech for 2009-10 that the Centre and the States will each legislate, levy and administer the Central GST and State GST, respectively.

(c) GST Rates:

- Finalizing the rate structure – Separate RNR for Central GST and State GST.
- Which tax/duty/cess will finally be subsumed in CGST and SGST respectively?
- How many rates of tax would be there in GST.
- Finalization of goods and services that will enjoy exemption, such as, food grains, education, health, etc.

(d) Activities which will be exempted and zero rated.

(e) Extensive definition of 'goods' and 'services'.

(f) Rules of supply for goods and services.

(g) Seamless input tax credit removing all cascading effects.

(h) Treatment of inter-State transaction of goods and services, determining the taxable event thereof and model of payment and collection of tax.

(i) How to broaden the tax base.

(j) To determine the threshold limit (basic exemption).

(k) Non-Vatable goods and services; and other circumstances when input tax credit would be denied.

(l) The framework for exemptions and composition.

(m) Future of various existing exemptions under CENVAT and State VAT.

(n) Taxation on the sale or purchase of goods declared by Parliament to be of special importance in inter-State trade or commerce, (declared goods) under Article 286(3) of the Constitution of India read with Sections 14 and 15 of the Central Sales Tax Act.

(o) The taxes to be charged on Long Duration Projects, say for three-four years.

(p) To make Points of Taxation and place of Provision rules, etc.

(q) Taxation of imports under GST.

B. Operational issues

(a) Common approach of the States, i.e., a common law, a common assessment procedure and even a common return.

(b) Monitoring of inter-State trade, whether to abolish check-posts.

(c) Sharing of information using comprehensive IT network.

(d) Improving relations between the Centre and the States.

C. Infrastructural Issues

(a) **IT infrastructure -** A simple system for inter-State transactions and verification of dealers is essential to ensure tax compliance and check avoidance. Given the volume of such transactions, this system necessarily has to be IT based. The present Tax Information Exchange System (TINXSYS) does not appear to be fully operational across all States. There are asymmetric benefits to States in putting in place such infrastructure and this appears to be affecting their incentives to do so.

(b) **Decision on elimination of Check Posts** to avoid enormous delays in road traffic, and reducing delivery times for goods.

(c) **Impact on Small Enterprises -** The impact of GST on small enterprises is often cited a concern. On the State GST component, the position will be exactly the same as under the present VAT regime. There may be three categories of small enterprises in the GST regime:

- Those below the threshold need not register for the GST.
- Those between the threshold and composition turnovers might have the option to pay a turnover based tax or opt to join the GST regime. Given the possibilities of input tax credit, not all small enterprise may seek the turnover tax option.
- The third category of small enterprises above the turnover threshold will need to be within the GST framework.

- Possible downward changes in the threshold in some States consequent to the introduction of GST may result in obligations being created for some dealers. In such cases suitable provisions could be made to provide direct assistance to the affected small enterprises, if considered desirable.
- In respect of Central GST, the position is slightly more complex. Small scale units manufacturing specified goods are allowed exemption of excise up to a turnover of Rs 1.5 crores presently. These units, which may be required to register for payment of State GST, may see this as an additional cost.

(d) **Harmonization** - For GST to be effective there should be identical GST laws across States as well as at the Centre. Moreover, not only the law but also the procedures relating to levy, assessment, collection and appropriation of the GST should be similar across States and the Centre.

(e) There should be a **thorough re-engineering of the departments of SGST and the CGST**. This is to clearly define the responsibility, accountability and authority of both departments. The day-to-day operations should be assigned to the States. That is the dealers would register and submit their return to the State department where they are located. The dealers should interact with a single tax authority only.

(f) **Cross-verification of documents must be strengthened -** In the absence of proper cross-verification; the dealers avoid tax payment and claim undue credit for taxable sales. Tax evasion can be prevented by setting up departments similar to centralized and regional anti-evasion organisation in France.

(g) **Common procedure for Levy, assessment, collection and appropriation -** For industry to reduce the transaction and compliance costs, it is necessary that apart from a common law, implementation of the law be also similar across States. All stages of the taxation chain from the levy of the tax to its assessment, collection and appropriation should be similar. This would involve similar rules across the States dealing not only with assessments, audit, refunds, but also more basic issues, like registration, filing of returns, treatment of transportation of goods etc.

(h) **A common dispute resolution mechanism** as well as a mechanism for giving advance rulings would further facilitate trade and industry.

(i) **Persuasions of the State Government -** Few State Governments have recently indicated their opposition to the implementation of GST at the present juncture. While their objections need to be carefully examined, it must also be recognized that while implementation of the GST is aimed at being revenue neutral to the States, it will be budget positive for the Government. This is because Governments are large purchasers in the market for their own consumption and their cost of procurement will come down significantly with the implementation of GST.

(j) **Role of the Finance Commission -** It is possible that some States may want assurances that existing revenues will be protected when they implement GST. The Commission is willing to consider providing for compensation in order to advance the implementation of a "flawless" GST.

(k) **Training -** Since the dual GST is considerably different from the present indirect tax regime, a massive training initiative would be required at both federal and State levels to familiarize the respective administrations with the concepts and procedures of the dual GST. However, the task is not limited to technical training but also extends to a similar effort to re-orient the attitude and approach of the tax administration in order to achieve a fundamental change in mindset.

10.2 Compensation Package to the States for Losses

Another major challenge before the Government is to finalize the compensation package for the States in case of loss due to implementation of the GST.

State Finance Ministers, at a pre-budget meeting with the then Finance Minister Sh. Pranab Mukherjee, demanded that the Center should compensate States for any loss of revenue following implementation of the GST. Although the Centre is mulling a five-year compensation programme, States are of the view that there should not be any time-frame for compensation scheme.

Under the GST structure, the tax would be collected by the States where the goods or services are consumed, and hence losses could be heavy for the producer States and the Centre would be required to compensate them for loss of revenue.

The Centre had earlier come out with a similar scheme to compensate States for loss of revenue following implementation of value added tax (VAT), which came into effect from April 1, 2005. The compensation structure was 100% in the first year, 75% in the second year and 50% in the third year. Compensation was also provided to the States for loss of revenue due reduction in CST rate from 4% to 2%.

CHALLENGES

Given the above context, let us look at some of the challenges.

GST rates

Clearly, arriving at the appropriate GST rates is the fundamental challenge. The Empowered Committee (EC) has set up a Working Group to address this issue and the group is likely to finalize its recommendations in the near future. As yet, no official confirmation of the GST rates is available. According to information available in the public domain, it appears that the aggregate rate of GST, on both goods and services, is likely to be in the range of 14 per cent to 16 per cent, with a high probability of introduction of the 16 per cent rate. The question remains as to whether the GST rate on goods at the Federal and State levels ought to be a single or a multiple one. It is most likely that the GST on goods would comprise at least of two nominal rates and a zero rate would also be present for exports and for specified goods. It would, thus, be a three-rate structure, at the least. There are many other dimensions to this debate. With regard to the Federal and the State GST rate on services, the country needs to come to terms with the fact that the GST rate on services will be at par with that on goods. Given that there is no State service tax at the moment, this would mean a significant enhancement in the aggregate incidence of taxation of services.

Constitutional changes

Another fundamental challenge is with regard to the Statute. Evidently, the GST law needs to be written from first principles and the present myriad indirect tax laws such as the Central Excise Act, 1944, the Finance Act, 1994 as well as various State VAT Acts need to be replaced by a new legislation relating to the GST. In addition, various amendments/ modifications to the Constitution would also be required, based on the particular dual GST model that will be finally adopted. This challenge is a formidable one. It is unclear whether enough preparatory work has been done and how soon it can be completed.

Inter-State transactions

A key challenge under the dual GST model concerns the taxation of inter-State supplies of goods and services. Given that the existing taxable events of manufacture and sale of goods under the present excise and VAT regimes respectively will no longer be relevant, it would be essential to draw up comprehensive rules for identifying the time and the place of 'supplies' of goods and services in order to tax them appropriately. The problem is limited to the State GST on such inter-State supplies since the Federal GST would, in any event, be charged and collected by the Federal Government. Here again, it is understood that a specific Working Group has been formed within the EC to come up with recommendations on the taxation of such inter-State supplies. Since the Central Sales Tax, which is relevant for inter-State sales of goods, is scheduled to go down to zero with the introduction of the GST, and since there is presently no service tax at the State level, the final model of taxation of inter-State supplies of goods and services under the GST would need to evolve through a mature give-and-take approach between the Centre and the States in the EC. This consensual approach is key to the successful implementation of the GST.

Threshold levels

It is well-recognized that GST is inherently a tax which only reasonably-sized businesses can comply with, for several reasons. Consequently, it is the universal practice not to extend the GST to taxpayers below a certain size. Hence, a key decision needs to be taken with respect to the threshold of turnover for dealers which would determine the cut-off for inclusion within the ambit of the GST. In India, this discussion is made complex because of the present varying levels of exemption threshold that exist under the federal excise and service tax as also under the State VAT regimes. The relevant threshold under excise is Rs. 1.5 crore and that under service tax is Rs. 10 lakh. As regards the State VAT, varying threshold exist ranging from Rs. 10 lakh to Rs. 20 lakh. There are serious equity considerations that need to be kept in mind and a final decision on threshold will inevitably be influenced by political compulsions.

IT readiness

It is, by now, quite clear that a successful implementation of the dual GST is based on substantive IT capability both at the tax administration level and at the taxpayer level. While efforts are going on to implement an all-India VAT data exchange and validation model called the TINSYS, significant additional investment required in either scaling up this system to cater to the GST or, alternatively, to put in place an entirely independent IT infrastructure to administer the tax.

Training

Finally, since the dual GST is considerably different from the present indirect tax regime, a massive training initiative would be required at both federal and State levels to familiarize the respective administrations with the concepts and procedures of the dual GST. However, the task is not limited to technical training but also extends to a similar effort made to re-orient the attitude and approach of the tax administration in order to achieve a fundamental change in mindset. The knowledge and awareness of the GST, at both Federal and State levels, at the staff and operational levels at present is almost non-existent and the challenge in regard to training is, thus, perhaps the most formidable of all that have been discussed in this article.

Therefore, it is now universally acknowledged and recognized that the GST, in whatever form, should be introduced at the earliest as a fundamental fiscal reform measure. If we are really serious about the early introduction policy makers, as also the tax administrations at the Federal and State levels, need to be immediately galvanised into action under a clearly laid-out timetable for introduction and implementation.

A-11
IMPACT ON KEY INDUSTRIES / SECTORS

11.1 India's GST Model

With the announcement of Finance Minister in Budget Speech 2009-10, it is now clear that India's GST will be a "Dual GST". Both, Central Government and the State Governments will levy respective GST concurrently on a common base value. Thus, all goods and services, barring a few exceptions, will be brought into the GST base. Importantly, there will be no distinction between goods and services for the purpose of imposition of tax.

11.2 Impact – Generally

(a) *Change in law, concept and procedure:* Since it is a major indirect tax reform in India, there would be new legislations and procedures. The industry, traders and professionals would be required to devote a lot of time in understanding the new concept.

Industries' gains or losses, depending upon the existing laws that are settled, need examination afresh especially when the repealed laws will have no significance at all. The entire indirect tax code will be a new one and any comparison with the old laws will be doing disfavour to the new legislations.

(b) *Change in tax-rates:* The standard rate of 12% adopted for CENVAT, Service Tax rate of 12%, along with residuary rate of VAT at 12.5% brings the overall rate to 25%-30%. But, post GST, it is likely to be in the range of 18%-20%; a net gain of almost 6%-10%.

Therefore, most of the dealers would experience the change in tax rates, either significantly or marginally. Therefore, they would be required to conduct a detailed study of the changed scenario.

(c) *Changed system of tax credit:* The GST will facilitate seamless credit across the entire supply chain and across all States under a common tax base. The current framework allows limited inter-levy credits between excise duty (tax on manufacture) and service tax However, presently, no cross credits are available across these taxes and the sales tax paid (on input) or payable (on output). Introduction of GST should thus rationalize tax content in product price, enhance the ability of companies to compete globally, and possibly trickle down to benefit the ultimate consumer.

However, it is learnt that under the proposed GST regime, the Centre will give input tax credit (set off) only for Central GST and the States will give input tax credit only for State GST. Cross-utilisation of credit between Central GST and State GST will not be allowed. Nevertheless, the dealers could claim set-off within the respective heads.

Presently, input tax credit is available under the Excise Duty and Service Tax on payment basis. However, under the State VAT, it is allowable on the basis of tax invoice, irrespective of date of payment. It is probable that tax credit under GST would be available on the payment basis. The dealers, who are presently registered under the VAT only, will have to accordingly adjust their business norms to avoid unnecessary blockage of working capital for payment of tax.

(d) *Stock transfers from one State to another:* Presently, such transfers take place free of tax against Form F. However, under the GST, stock transfers from one State to other to one's branch or consignment agent might be treated as inter-State sale.

(e) *Stock transfers to branches/consignment agents within the State:* Presently, treatment of these transactions varies from State to State. However, under GST, these transfers might also be subject to tax, unless the BIN of transferor and transferee is same.

For Example if a dealer is transferring any goods or service from one branch in a State to other branch in the same State having the same BIN (Business Identification Number) the Dealer would not be liable to pay GST on such transaction.

(f) *Sale vs. Service:* Presently, in a number of cases, particularly, transfer of intangible goods suffers the VAT as well as Service Tax. This issue could be resolved in GST by redefining the both definitions. This will reduce perennial litigation on this issue.

(g) *Situs Issue:* Since it is the Dual GST, *situs* issue, i.e., where a transaction is taxable, may continue, causing stupendous litigation. However, if the overall principles of GST are practiced seriously by all the stake holders, this may ultimately finish litigation on this issue.

(h) Industries will have to learn to *redesign their business procurement models* to optimize tax outgo.

(i) *All existing contracts may go under changes*; industry has to examine the impact without delay and go for amendments etc., or they might have to face losses.

(j) *GST will be based on HSN:* It will reduce the interpretational issues in respect of class of commodities.

(k) *Grey-market operators:* Will have a field day; with total GST levy likely to be in the range of 20%-22%; hence industry will have to take all precautions to ensure such operators are curbed by the Government very seriously. Especially on consumer goods markets, this phenomenon has been playing havoc in countries where GST was introduced. With high tax rate on purchase and sale of goods; the greed will only increase.

(l) *Upgradation of Software:* Dealers and service providers need to upgrade their accounting and tax software. In the modern world, when all large companies have sophisticated software like SAP etc., to upgrade and customize the same will be a big challenge to the software companies. Huge Cost to begin with; continuous training and development of people at each level and continuous updation of all operating system.

(m) *Training:* Comprehensive training will be required to the staff members of the business community, both at senior level and also at junior level. Further, the scope of such training should be extended to the marketing personnel, apart from accountants and legal department.

(n) *Competent Professionals:* At present, the industry, generally, has separate consultants for Excise Duty, Service Tax and VAT. With the merger of all three major taxes, they might require only a single consultant who can handle their GST matters.

11.3 Impact on specific Sector

11.3.1 Agriculture

In India, food items are generally exempt from the CENVAT. However, many food items, including food grains and cereals, attract the State VAT at the rate of 4% in many States. In Delhi, these are exempt from VAT. However, exemption under the State VAT is restricted to unprocessed food, e.g., fresh fruits and vegetables, meat and eggs, and coarse grains.

These items may be subject to tax in GST at a lower rate, which is likely to be 8% (combined GST rate), which, if so, will certainly make these items dearer by 4%.

The alternative of exempting (or zero rating) food altogether would not be any better, which would certainly have an adverse impact on the Revenue Neutral Rate. While the poor would pay less tax on food, they would pay more on other items in their consumption basket. Whether and to what extent they would be better off would depend on the composition of their consumption basket.

11.3.2 Traders

- ***Central Sales Tax Act:*** Since CST Act will be abolished, no sale or purchase could take place against Form C. Moreover, inter-State purchases (against Form C) presently costs minimum @2% of the purchase price (non-vatable), whereas, in GST, the traders would be saved from this non-vatable burden.
- ***Requirement of additional working capital:*** There are various models suggested for payment of tax on inter-State transactions. PVAT model (full tax paid by seller) and Post VAT model (tax paid by the buyer in his State) must be discouraged since gross tax will first be paid, and then, claimed as refund by the seller from the Department, which would require a lot of additional working capital.
- ***No subsequent sale under the CST Act against Form E-I/II:*** Such exemption under section 6(2) of the CST Act might be withdrawn.

11.3.3 Manufacturers

The activity of manufacture is subjected to CENVAT levied and administered by Union Government. CENVAT has a VAT mechanism and is creditable against CENVAT and Service tax. As CENVAT is imposed by the Union Government, the rates of tax are uniform across the country and no complications are created by movement of goods throughout the country. Threshold limit under the excise duty is Rs. 1.5 crores. In addition to excise duty, they are also liable to pay central sales tax/VAT, and sometimes, service tax.

Following are the main impacts on the manufacturers:

- ***Manufacturers having turnover less than Rs. 1.5 Crores:*** Under the proposed GST, States will assume the responsibility for administering the Central GST of dealers having gross turnover of less than Rs. 1.5 crores, whereas such dealers are presently exempt under the Central Excise (CENVAT). This would adversely impact the tiny sector and household industry.
- ***Purchasing capital goods against Form C from other States*:** Under the State VAT, the manufactures are facing certain restrictions in respect of eligibility of input tax credit on capital goods. To avoid the same, they can purchase such capital goods from other States at a concessional rate of tax against Form C. However, with the withdrawn of form C under the GST, they have to redesign their procurement model.
- ***Valuation for the purpose of Excise Duty*:** With the shift of taxable event from 'manufacture' to 'sale', confusion in respect of valuation of goods for the purpose of levy of CENVAT will be removed to a great extent. Under the GST, sale consideration will be subject to GST.
- ***Other impacts:*** Same as to those on Traders – Refer Para . 11.3.2.

11.3.4 Works Contractors

Works contracts can straddle three taxable activities as per the current law. There is supply of goods, then, due to the very nature of the contract, there is supply of services. Further, if in the process of completing the works contract a new commodity comes into existence, there is the taxable event of manufacture.

As of now, the supply of goods is taxable in the form of Value Added Tax (VAT), while the services element is taxable as service tax. If a new commodity comes into existence, in the process of executing a works contract, then, Central Excise duty may be levied. Hence, different aspects of the same activity have a potential to be taxed by different Statutes.

In law, this is covered by the doctrine of aspects. However, there have been differing views of the Supreme Court and the High Courts on the applicability of this theory. The final word of the Apex court in *BSNL and Others vs. Union of India* (SC 2006)[Give correct citation] was that the aspects doctrine pertains to legislative competence and not the application of taxation on the same components of a transaction.

At present, State VAT laws have specific provisions for taxing works contracts. To avoid taxing the services element, these laws and associated rules provide for either separation of labour and materials or percentage deductions in transaction value. The Central Statute of service tax has also provided for similar treatment to avoid taxation of sale of goods as part of a works contract.

With the probable introduction of GST in India, it is expected that simplification and consolidation of taxes would lead to multitude of case laws and legislative history on works contracts becoming irrelevant.

The overarching concept in a GST is one of supply which subsumes the concepts of sale of goods, provision of services and manufacture. If States and the Central Government share the powers of taxing services and goods, the separation instituted between provision of services and sale of goods, for segregation of taxing powers, will become redundant. The elaborate schema of deductions and credits for taxing works contracts may slide into history.

This, of course, is based on the premise that GST will have a simple structure, and goods as well as services will be taxed on a uniform rate. Multiplicity of rates in goods or services in GST may lead to complexity of interpretation as well as implementation.

Other impacts on the contractors are as under: -

- ***Interpretational Issues:*** Complexities and confusion presently faced might be resolved in the GST to a great extent, as follows:
  - Whether a given activity is a works contract or a sale.
  - When a transaction relating to works contract does takes place in the course of inter-State trade and commerce.
  - Can tax be levied on goods, having a nominal value, which are transferred incidentally while executing a works contract.
  - Determination of taxable turnover and manner of raising invoice by the contractor and sub-contractor respectively.
  - How much consideration is taxable under the VAT/CST and how much under service tax, and so on.

- ***Goods fabricated at site:*** Presently, the contractors are generally liable to either VAT or the Service Tax; and are not liable to CENVAT, either due to certain specific exemptions or since the goods fabricated by them are not marketable commodities. Therefore, the contractors are liable only for a tax of maximum of 12.5%. However, these exemptions and interpretations might go away in GST and the contractors would be liable to a total tax of 16% to 20%, leaving an additional tax of 4% to 8%; particularly, in relation to building projects where the contractee could not get through benefit of input tax credit.

- ***No subsequent sale under the CST Act against Form E-I/II:*** The contractors are generally engaged in subsequent sales and high seas sales to the Contractee. However, in GST, in the absence of such exemptions, they have to change their execution and revenue model.

11.3.5 Leasing Companies

- ***Interpretational Issues:*** Like, the works contractors, leasing companies and the persons engaged in renting activities are facing, sometimes, the dual taxation: both under the VAT and Service Tax. If there is transfer of right to use goods involving transfer of effective control and possession, then it is subject to VAT; otherwise, it is subject to service tax. However, to decide the exact nature is to invite the litigation. Therefore, GST might bring a relief to such Companies in deciding: -
  - Whether transaction is subject to VAT or service tax.
  - When does a transaction relating to transfer of right to use goods takes place in the course of inter-State trade and commerce.
  - Where is *situs* of a transaction of transfer of right to use movable goods.

11.3.6 Power Sector

Power to levy tax on the consumption or sale of electricity vests with the State Governments under Entry No. 53 in List II of Seventh Schedule of the Constitution of India. Though electricity is "goods", sales tax is not imposed on sale of electricity in India. Therefore, it is tax-free goods.

The noteworthy advantage available to the Power Companies is that they can purchase goods for generation and distribution of electricity from other States at a concessional rate of tax (CST) of 2%.

With the abolition of CST Act and inability of these companies to purchase at concessional rate, this sector will certainly be adversely affected, unless sale of electricity is brought within the scope of GST and set-off of input tax credit is allowed for tax paid on purchases.

11.3.7 Telecommunication

Revenue of telecommunication sector is either subject to service tax or the VAT. Therefore, GST would not have any adverse impact of this sector, except that which may arise due to variation in tax rates. However, for certain activities, e.g., sale of sim cards, rental on telecom equipments and composite transactions (such as, sale of phone instrument with talk time), confusion persists whether such activities are subject to service tax or sales tax, or both. With the integration of service tax and VAT into the GST, such controversy will be resolved to a great extent.

Similar to Power Companies, Telecom Companies can also purchase goods for telecommunication network from other States at a concessional rate of tax (CST) of 2%. With the abolition of Central Sales Tax Act and inability of these companies to purchase at concessional rate, these companies could claim input tax credit on capital goods since their activities would be subject to GST.

11.3.8 Intangible goods

Controversy in relation to transfer of intangible goods (such as software, intellectual property rights, goodwill, copyright, etc.) in respect of taxability, i.e., whether taxable under the service tax or VAT or both, will definitely be resolved. Generally, in other countries, transfer of intangible goods is taxed as service.

11.3.9 Exempt units

These exemptions can be classified into two parts:

(a) Area based exemption, such as, North East, J&K etc. – These exemptions might continue till their current eligibility period.

(b) Product based exemption, such as, exemptions available in Himachal Pradesh, Uttarakhand, etc. – These exemptions might be converted into cash refund.

Considerable litigation on this issue is expected post GST era. It is better that such exempt units start dialogue with the respective Governments immediately and ensure their benefits are incorporated into the new Enactment. Once the old Acts are repealed without a saving clause in clear words, the Governments will be helpless to give benefits.

11.3.10 Certain petroleum, liquor and tobacco products

There are indications that certain components of petroleum, liquor and tobacco shall be kept outside the GST.

At present these products are known as demerit goods and are taxable not only at higher rate of tax but also subject to multiple taxes. However, these products contribute a major share to the total Government revenue.

By excluding these products from GST, its manufacturers would be adversely affected by cascading effect since they could not claim full input tax credit.

11.3.11 International Trade

Importers of goods and services may be affected under the GST regime due to -

- probable withdrawal of exemption high-seas sales under the CST Act (subject to amendment in the Constitution); and
- the impact which may arise due to change in tax rates.

Exporters of goods and services shall continue to be zero rated and will be eligible to claim refund of input tax credit.

11.3.12 Land & Real Estate

It is not yet clear whether land and real estate would form part of GST. However, in many countries (e.g., in Australia, New Zealand, Canada, and South Africa), for the purpose of imposing GST/VAT, housing and construction services are treated like any other commodity. Thus, when a real estate developer builds and sells a home, it is subject to VAT on the full selling price, which would include the cost of land, building materials, and construction services. Commercial buildings and factory sales are also taxable in the same way, as are rental charges for leasing of industrial and commercial buildings. However, there are only two exceptions: (1) resale of used homes and private dwellings, and (2) rental of dwellings.

As per Poddar-Ahmad working paper, conceptually, it is appropriate to include land and real property in the GST base. To exclude them would, in fact, lead to economic distortions and invite unnecessary classification disputes as to what constitutes supply of real property. In the case of commercial and industrial land and buildings, their exclusion from the base would lead to tax cascading through blockage of input taxes on construction materials and services. It is for this reason that even under the European system, an option is allowed to VAT registrants to elect to treat such supplies as taxable.

Further, the State VAT and the Service Tax already apply to construction materials and services respectively, but in a complex manner. For example, there is significant uncertainty whether or not a pre-construction agreement to sell a new building is a works contract and subject to VAT. Where the VAT does apply, disputes arise about the allocation of the sale price to land, goods, and services. While land is the only major element that does not attract tax, the tax rates applicable to goods and services differ, necessitating a precise delineation of the two. Extending the GST to all real property supplies, including construction materials and services, would bring an end to such disputes, simplify the structure, and enhance the overall economic efficiency of the tax.

One potential argument against the levy of GST to land and real property would be that they already attract stamp duty. As per the said Working Paper, this argument can be quickly discarded, as the purpose and structure of the stamp duty is quite different from that of the GST. Stamp duty is a cascading tax on each conveyance of title to real property, whereas the GST is a tax on final consumer expenditures. Thus, the two taxes cannot be viewed as substitutes. However, the application of GST to real property transactions does warrant a review of the structure and rates of stamp duties and registration fees. The rates should be lowered and the structure rationalized when the GST is introduced.

11.3.13 Service Providers

Presently, services are taxed at the place of rendering; however in GST, they would be taxed at the place of consumption. If services are rendered from one State to another, then tax would ultimately go to the consuming State. Therefore, in terms of procedure, their compliance will increase substantially.

Moreover, more than 40 services will be transferred to the States. Further, their base may further be widened by specifying more services or withdrawing the existing exemptions.

With the inclusion of VAT and Service Tax into GST, the controversy as to the nature of activity will be resolved. Moreover, disputes as to availability of certain exemption towards value of goods sold (such as photography services) will also be put to rest.

11.4 Conclusion

All stake holders need to get ready for a Dual GST – whether we like it or not. Tax is money and whether the stake holders will gain or loss depends upon the tax schedules, final GST rates and the laws that are framed for availing input tax credit on item-to-item basis or on cross basis. The stake holders need to take immediate steps and start discussions, industry specific, to frame their final view on the draft legislation, as and when released.

We would only say that the impact will be tremendous; laws will be simplified and if the stake holders rightly understand the intricacies of the law, take timely steps to upgrade their software and systems; the financial gains will be all pervasive.

The exact impact of GST on various industries could be quantified only after the release of, at least, draft legislation. A good gesture can be inverted if it is done in a wrongful manner. That is, if the provisions are susceptible to conflicting interpretations, or drafted erroneously, definitely, with the continuance of litigation the entire process and purpose of the reform will be adversely affected.

A-12
EXPECTATIONS OF INDUSTRY FROM GST

[Based on Papers by Experts in Industries and Media Reports]

12.1 Expectations from GST in general

A. Expectations from the Central & State Government – Gearing up by both Governments for GST

(a) Centre-State interaction

Considering the federal nature of our country and Centre – State relationships, Central Government should be prepared to pass more powers of taxation to the States and share more revenue with the States, if GST has to be successful.

(b) Constitutional amendments

Under the scheme of our Constitution, no tax can be levied without the authority of law. Power to levy tax on goods and services are vested with both Central Government and State Government under Article 246 and List-I and List-II of the VII Schedule of the Constitution of India. Neither the Central Government nor the State Government can usurp the powers of others without amending several provisions of the Constitution.

(c) Stability of GST Act and Rates

As recommended by Dr. Kelkar, there should be an agreement between Central Government and all State Governments that there should not be any change in the GST Act or rates without concurrence of both Central and State Governments. Only this can lead to stability of GST Act and will give global reputation to Indian continent. Such gearing up for GST by the two tiers of Government is the industries' expectation because it will facilitate smooth introduction and operations of GST.

(d) Re-engineering of Central & State employees

There should be a thorough re-engineering of the department of GST at Central level as well as State level. This is very much required to clearly define, understand and administer functions in such a way that the responsibility, accountability and authority of each tax department at the Central and State level are clearly understood.

(e) Single Authority to deal with

As it is known that the number of officials at the Centre is less as compared to State level officials, it is expected that Central officials be assigned special task to monitor the operations of large dealers (who have pan India operations) under CGST and SGST. The day to day operations related to registration, payment of tax and submission of returns for all the dealers (irrespective of their size) should be assigned to the State. The assesses with specific turnover, say, upto Rs. 500 Crore and the assesses whose operations are limited to one State only should be assessed by State Department for both CGST and SGST. In general, the idea is that assesses should interact with a single tax authority only.

Presently, under the recommendation of Joint Working Group, CGST will be monitored by the Central Government and SGST will be monitored by the State Government. It means that assesses will have to deal with two authorities which may be unacceptable by all dealers. Because from the past practical experience, everyone knows that interpretations, procedures, whims and approach widely differ at both levels. If this happens, then instead of helping, GST will create more harassment and nuisance.

(f) Verification Agency

Cross verification of documents should be strengthened under GST to avoid evasion and wrong claims. In France, the Government has created an organization called "National Directorate of Verification" which verifies transactions above 300 million Francs, involving national and international dealings. Similarly, there is Regional Directorate of Verification which verifies similar transactions within the districts / divisions. Similar arrangements should be made under Indian GST regime also.

(g) MIS amongst different Government Departments

MIS has to be an integrated activity of the CGST and SGST offices as well as other Government Departments.

The integration of activities of CGST, SGST, customs and income tax through PAN number - TINXYS should be an essential part of GST regime.

(h) Creation of IT infrastructure – GST Public Services Offices

Cross verification, MIS and interaction between different departments and dealers necessitate complete computerization of all Government departments in all States and availability of computer facility with each and every dealer covered under GST. Even today, it is observed that computers and internet facilities are not easily available in villages and towns. Lack of knowledge of computer in such areas is a hard reality. Therefore, there is a need to bring the awareness about the computer amongst the dealers across India. In the initial period of five years, opening of Government sponsored kiosk at various centers facilitating compliance of law through internet and computers should be seriously considered. In fact, we are reminded of Mr. Sam Pitroda who created the Center for Development of Telematics (C-DOT), an autonomous telecom R&D organization which made yellow signed Public Call Offices (PCO) ubiquitous throughout India. In the same fashion, it is expected that GST PSO (Public Service Offices) should be created in every town in the form of computer kiosks.

Currently,Mr. Nandan Nilekani has been given the responsibility for creating the required IT structure for GST wherein 3 major services i.e. registration, return and payments will likely be provided . The technology partner for operating the structure would be NSDL.

(i) Training of Staff

Today excise and service tax officials do not know much about VAT provisions. Similarly, State employees administering VAT Act do not know excise and service tax provisions. Thus, both Central and State staff will require learning and training in the administration of GST Act. Further, staff needs to be trained in computer operations also.

B. Expectations from the GST Acts

(a) Uniformity in the rates of tax, definitions and provisions across the States.

(b) Inter-changeable set-off/credit of Central GST and State GST.

(c) ***No SGST on CGST or vice-a-versa -*** As per legal position as on today, sales tax/VAT is charged on excise duty element also. Under the new system, excise duty, i.e., CGST will be levied on each value added transactions upto consumers. It means that, SGST will further increase on such element with each value added transaction. For example, if CGST is 10% and SGST is also 10%, with each value added transaction, there will be additional burden of 1% of SGST (10% SGST on 10% CGST). Ultimately, there will be a heavy burden on consumers. Hence, it is highly recommend that no SGST should be levied on any CGST element, or vice-a-versa; and both taxes to be levied at the common base.

(d) ***Inter-State transactions*:** It is presumed that Central Sales Tax will be phased out with the introduction of GST, but issue of GST on inter-State transactions will be there. Proper mechanism needs to be introduced so that dealers get input credits for any GST levied on inter-State transactions. Only this can avoid cascading effect in the real sense.

(e) Uniformity across the States in procedures relating to granting of registrations, preparation of bills, filing of returns, scrutiny of returns, assessments, granting of refund, audit, cross-verification, appeal, allowance of credit notes, etc.

(f) While VAT has been implemented in most of the States w.e.f. 01.04.2005 and by other States subsequently, the State machinery is still engrossed in the pending work related to assessment, appeals etc. relating to previous sales tax regime in all States. As a result, many officers are not well equipped with the VAT laws, which is not desirable. Hence, it is highly expected that when GST is planned to be implemented with effect from 01.04.2010, all steps are taken to ensure that no pending work relating to either sales tax, VAT or other indirect taxes remains outstanding so that everybody can concentrate on the new law. It is therefore, suggested that some schemes for summary disposal for all the pending cases should be pronounced before GST comes into operation. In such schemes, the approach should be to lure almost all the dealers to settle their all the disputes rather than miserly offering schemes, which do not help in achieving the objective of the scheme.

C. A clear Roadmap

Recently, at a workshop on Goods and Services Tax organised by the Indian Chamber of Commerce, the need for a clear roadmap on implementation of the new system of taxation was emphasized to enable people at large and the business community, in particular, to familiarize themselves with the same.

12.2 Expectations of Works Contractors

A transaction of works contract, which was immune from any tax till the 46th Constitutional Amendment in 1982, is now, sometimes, taxed twice; firstly as sale by the State Government and secondly as service by the Central Government. The tax payer, who along with his consultants is under confusion till date as to which tax to be levied on which portion, is left in the hands of both the imposition authorities and the Courts to litigate the matter.

A. Competing Taxes

Works contracts can straddle three taxable activities as per the current law. There is of course supply of goods. Then, due to the very nature of the contract, there is supply of services. Further, if in the process of completing the works contract, a new commodity comes into existence, there is the taxable event of manufacture.

As of now, the supply of goods is taxable in the form of Value Added Tax (VAT), while the services element is taxable as service tax. If a new commodity comes into existence, in the process of executing a works contract, then, at least in theory, Central Excise duty may be levied. Hence, different aspects of the same activity have a potential to be taxed by different Statutes.

B. Legislative, judicial background

In law, this is covered by the doctrine of aspects. However, there have been differing views of the Supreme Court and the High Courts on the applicability of this theory. The final word of the Apex court in *BSNL and Others vs. Union of India* (SC 2006) was that the aspects doctrine pertains to legislative competence and not the application of taxation on the same components of a transaction.

C. Present Status

At present, State VAT laws have specific provisions for taxing works contracts. To avoid taxing the services element, these laws and associated rules provide for either separation of labour and materials or percentage deductions in transaction value.

Another method is of prescription of a lower rate of tax in a composition/lump-sum scheme for works contracts. The service tax law has also provided for similar treatment to avoid taxation of sale of goods as part of a works contract.

As far as Central Excise is concerned, the law seeks to preclude the applicability of service tax wherever the activity amounts to manufacture. In case the works contract leads to an immoveable property coming into existence, the operation of Central Excise levy anyway is out of question, as only goods can be taxed.

The actual picture on the ground is however not as clear. Disputes on taxability and taxable value for the three competing taxes still refuse to fade away.

D. Opportunity in GST

Taxes on works contracts assume significance for the real estate/construction industry and those engaged in erection, commissioning and installation of plant and machinery. In these activities, apart from taxability, the concepts of right to use, credit of capital goods, and usage of consumables also come into play giving rise to various tax consequences.

With the probable introduction of GST in India, it is expected that simplification and consolidation of taxes would lead to multitude of case laws and legislative history on works contracts becoming irrelevant.

The overarching concept in a GST is one of supply which subsumes the concepts of sale of goods, provision of services and manufacture. If States and the Central Government share the powers of taxing services and goods, the separation instituted between provision of services and sale of goods, for segregation of taxing powers, will become redundant. The elaborate scheme of deductions and credits for taxing works contracts may slide into history.

This, of course, is based on the premise that GST will have a simple structure; and goods as well as services will be taxed on a uniform rate. Multiplicity of rates in goods or services in GST may lead to complexity of interpretation as well as implementation.

12.3 Expectations to have Kelkar's GST

Following were the expectations of Chairman of 13th Finance Commission, Dr. Vijay Kelkar who has always pitched for the introduction of GST:

A well designed destination-based GST on all goods and services should be the most elegant method of eliminating distortions and taxing consumption.

- Under this structure, all stages of production and distribution should be interpreted as a mere tax pass-through, and the tax essentially 'sticks' on the final consumption within the taxing jurisdiction.
- The introduction of GST should also bring about a macro-economic dividend, as it reduces the overall incidence of indirect taxation, and therefore, the overall tax burden by removing many adverse features of the present sales tax system.
- The effective revenue neutral rate at which GST can be implemented should be far lower than 30% indicating a significant reduction in the effective tax burden on our economic agents.
- The comprehensive GST should fully eliminate the export of taxes and improve international competition. This, in turn, should help in increasing the production and exports of labor-intensive manufacturers and also, boost employment in our economy.
- Considering the high level of distortions in the indirect tax system, one can argue that the real output effect of a well implemented GST in India would be at least 1.4% of the GDP in Canada. This amounts to $15 billion annually, implying that the economic value of GST reforms would, at a modest 3% discount rate, be close to half a trillion dollars or 50% of the country's present GDP.
- More importantly, this means potentially creating an additional productive employment for as many as 4 to 5 million persons. Introduction of GST would also be a reform measure whose economic impact will rival that of the elimination of licensing in 1991.
- The existing tax system introduces myriad distortions which favour some goods and services at the expense of others. Such distortions in our tax system are also adversely affecting the growth of manufacturers, particularly labor-intensive manufacturers, who are extremely important in meeting the challenge of providing productive employment. This should be achieved by the introduction of GST.

A-13
GST IN OTHER COUNTRIES

13.1 GST/HST in Canada

The goods and services tax (GST) is a tax that applies to the supply of most goods and services in Canada. Three provinces (Nova Scotia, New Brunswick, and Newfoundland and Labrador, referred to as the participating provinces) harmonized their provincial sales tax with the GST to create the harmonized sales tax (HST). The HST applies to the same base of taxable goods and services as the GST.

Effective from January 1, 2008, the GST rate was reduced from 6% to 5%, and the HST rate from 14% to 13%.

Almost everyone has to pay GST/HST on purchase of taxable supplies of goods and services (other than zero-rated supplies). Some sales and supplies are exempt from GST/HST.

Although the consumer pays the tax, businesses are generally responsible for collecting and remitting it to the government. Businesses that are required to have a GST/HST registration number are called registrants.

Registrants collect the GST/HST on most of their sales and pay the GST/HST on most purchases they make to operate their business. They can claim a credit, called an input tax credit (ITC), to recover the GST/HST they paid or owe on the purchases they use in their commercial activities.

***Taxable supplies*:** Taxable supplies refer to supplies of goods and services that are provided in the course of a commercial activity and are subject to GST/HST, or are 0% (zero-rated).

***Zero-rated supplies*:** Zero-rated supplies refer to a limited number of goods and services that are taxable at the rate of 0%. This means there is no GST/HST charged on the supply of these goods and services, but GST/HST registrants can claim an ITC for the GST/HST they pay or owe on purchases and expenses made to provide them.

Exempt supplies: Exempt supplies are goods and services that are not subject to GST/HST. Registrants cannot claim input tax credits to recover the GST/HST they pay or owe on expenses related to such supplies.

What is HST?

Three provinces - Nova Scotia, New Brunswick and Newfoundland and Labrador - harmonized their provincial sales tax with GST to create HST. These three provinces are known as participating provinces. Effective from January 1, 2008, the GST rate was reduced from 6% to 5%, and the HST rate from 14% to 13%.

The HST is composed of the GST and the 8% provincial tax and applies to the same base of goods and services that are taxable under GST. HST follows the same general rules as GST.

GST/HST registrants continue to collect GST on taxable supplies (other than zero-rated supplies) of goods and services made in Canada outside the participating provinces. On supplies made within the participating provinces, they collect HST. All GST registrants are automatically registered for HST.

[Source: http://www.cra-arc.gc.ca]

13.2 Australian GST

In Australia, the GST is a broad-based tax of 10% on most goods and services. In most cases, GST is included in the price which is paid. Only registered business entities are entitled to a tax credit. The effect of this provision is that consumers are not reimbursed for the GST paid on purchased goods and services.

Most food items, including meat, fruit and vegetables, are GST-free. However, some food and beverages have been included in GST — for example, prepared food, takeaway food, restaurant meals, confectionery, ice cream, snack foods, alcoholic beverages and soft drinks. Other GST-free items include most education and health services, eligible child care, and a range of other goods and services.

Supply

A sale in GST terms is referred to as a “supply”. The definition of supply has been drafted very widely to cover most receipts so that all revenue of business is subject to GST. A supply includes: -

- Supplying goods
- Providing services

- Providing advice or information.
- Granting, assigning or surrendering real property.
- Creating, granting, transferring, assigning or surrendering any right.
- Financial services.
- Entering into an obligation to do something, refrain from doing something, or to tolerate something, or releasing someone from such an obligation.
- Any combination of these, that involves value (money, or goods/services, or in-kind) changing hands is a supply for GST purposes.

Categories of Supplies

There are three types of GST sale or supply:

- Taxable supplies
- GST-free supplies
- Input taxed supplies

It is important to mention that collection and payment of GST or entitlement to claim GST credits depends upon the category of sales/ supply, as foretasted.

Taxable Supplies

It means supplies of goods and services, connected with Australia, made by registered persons or entities, for consideration. Entities that are registered for GST must charge GST on their taxable supplies, and will be entitled to input tax credits on the GST they have paid on purchases to make those supplies. Such entities which are not registered for GST cannot charge GST on their invoices.

A taxable supply specifically excludes supplies that are GST-free and supplies that are input taxed. The main elements, which must exist in order for the supply to be a taxable supply, are:

- Supply must be for consideration
- Supply must be made in the course of or furtherance of an enterprise
- Supply must be connected with Australia
- The supplier must be registered or required to be registered for GST.

Therefore, a taxable supply is:

- a supply made for consideration
- in the course and furtherance of an enterprise,
- of a registered entity
- And the supply is connected with Australia.

unless the supply is -

- GST-free
- Input-Taxes.
- outside the scope

GST-Free Supplies

GST is not charged, or payable on GST-Free supplies. The major categories of GST-free supplies are:

- Child care
- Exports (goods and services)
- Religious services
- Non commercial activities of charitable institution
- Raffles and bingo conducted by charitable institutions
- Water, sewerage and drainage
- Overseas transport
- Sale of a continuing business
- Grants of freehold or similar interests by Governments
- Certain farmland
- Cars for use by disabled people
- International mail
- Certain transitional arrangements

Input Taxed Supplies

If a person provides input taxed suppliers, GST is not charged to the purchaser, and the seller is unable to claim any input tax credit for GST paid on purchases made for the input taxed supply. The major categories of input taxed supplies are:

- Residential rents
- Certain residential premises
- Financial Services such as interest, loans, dealings in shares Superannuation, life insurance and other financial instruments.
-

Collecting and claiming GST on different types of sales

Type of sale	*Whether to collect GST?*	*Whether to claim GST credits?*
Taxable	Yes	Yes
GST-free	No	Yes
Input taxed	No	No

Out of Scope Supplies

All supplies do not fall into the three categories listed above. Some supplies will be outside the scope of reporting as far as GST is concerned if they do not meet one of the tests outlined for a taxable supply.

Examples of transactions outside the scope of GST include: -

- supplies made by unregistered persons
- supplies made for no consideration
- payments of certain Government taxes and charges
- unconditional grants and donations (no supply is made in these circumstances by the recipient of the grant/donation)
- Salaries and wages.

GST will not be included in the price of supplies outside the scope of GST. However, if a person is registered for GST purposes, he will be entitled to claim input tax credits for GST included in the price of things acquired for the purpose of making these types of supply.

13.3 Indirect Tax in U.K.

In U.K., the indirect tax structure comprises excise duty as well as VAT. However, the scope of excise duty is restricted to limited commodities.

Excise duties are charged on certain goods, such as, motor fuel, alcohol, tobacco, betting and vehicles. Taxable event in case of excise duty is manufacture of goods.

Value Added Tax (VAT) is a tax that is charged on most goods and services that VAT-registered businesses provide in the UK. It is also charged on goods and some services that are imported from countries outside the European Union (EU), and brought into the UK from other EU countries.

VAT is charged when a VAT-registered business sells to either another business or to a non-business customer. When VAT-registered businesses buy goods or services, they can generally reclaim the VAT they have paid.

There are three rates of VAT, depending on the goods or services the business provides. The rates are: -

- Standard - 15 per cent
- Reduced - 5 per cent
- Zero - 0 per cent

There are also some goods and services that are: -

- exempt from VAT, or
- Outside the UK VAT system altogether.

VAT is a tax that is charged on most business transactions in the UK. Businesses add VAT to the price they charge when they provide goods and services to: -

- business customers - for example a clothing manufacturer adds VAT to the prices they charge a clothes shop;
- Non-business customers - members of the public or 'consumers' - for example a hair-dressing salon includes VAT in the prices they charge members of the public.

If a person is a VAT-registered business, in most cases, he: -

- charges VAT on the goods and services he provides
- Reclaims the VAT he pays when he buys goods and services for his business.

If he is not a VAT-registered business or organization, then he cannot reclaim the VAT he pays when he purchases goods and services.

If he is VAT-registered, the VAT he adds to the sale price of his goods or services is called his 'output tax'. The VAT he pays, when he buys goods and services for his business, is called his 'input tax'.

13.4 GST in Singapore

In Singapore, Goods and Services Tax (GST) is a tax on domestic consumption. The tax is paid when money is spent on goods or services, including imports. It is a multi-stage tax which is collected at every stage of the production and distribution chain.

"Output tax" is the GST a registered trader charges on his local supplies of goods and services. The tax is collected by him on behalf of the Comptroller of GST. "Input tax" is the GST that the trader has paid on purchases of goods and services for the purpose of his business. The input tax is deductible from output tax to arrive at the GST payable by the trader, or amount to be refunded to him.

Overview of Singapore GST

GST was first introduced in Singapore on 1st April 1994 at 3%. The GST rate was increased to 4% in 2003 and to 5% in 2004. As announced in Budget 2007, the GST rate was raised to 7% in 2007.

GST is levied on:

- goods and services supplied in Singapore by any taxable person in the course or furtherance of a business; and
- goods imported into Singapore by any person.

In general, a supply is either taxable or exempt. A taxable supply is one that is standard-rated or zero-rated. Only a standard-rated supply is liable to GST at 7%.

Zero-rating a supply means applying GST at 0% for the transaction. A GST registered trader need not charge GST on his zero-rated supplies, but he is, nevertheless, allowed a refund of the tax he has paid on his inputs. In Singapore, only "export" of goods and "international" services are zero-rated.

If a supply is exempt from GST, no tax is chargeable on it. A GST registered trader does not charge his customer any GST on his exempt supplies. At the same time, he is not entitled to claim input tax credits for any GST paid on goods and services supplied to him for the purpose of his business. The "sale and lease of residential properties" and "financial services" are exempt from GST in Singapore.

[*Source : http://www.mof.gov.sg*]

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GST - ROLE OF CHARETRED ACCOUNTANTS

A Chartered Accountant is, by virtue of his academic knowledge and practical training, well equipped to play a pivotal role as an advisor and facilitator for due compliances of law relating to goods and services tax to the general business community. The nature of services can be:

(i) Restructuring of Business System

Under the proposed GST, taxes would be levied on destination base as compared origin base in the existing excise and VAT law. The business would require restructuring their system to minimise taxation and require the services of Chartered Accountants for the same.

(ii) Tax planning

In order to establish an efficient plan for purchases and sales, a careful study of VAT is required. A Chartered Accountant is competent to analyze the impact of various alternatives and choose the most optimum way of doing business in order to minimize the tax impact.

(iii) Advisory services

A chartered accountant is a qualified, competent and knowledgeable professional who can interpret the proposed GST law and may provide required guidance and advisories to the business.

(iv) Audit of books of account

The return under the proposed GST is expected to be assessed on 'self-assessment' basis meaning thereby that the tax liability calculated and paid by the tax payers through their periodical returns will be accepted by and large and the tax payers will not be called to substantiate the tax liability shown by them in the returns by producing books of account and other relevant material. The assessments with books of account will be an exception. Thus, a check on compliance becomes necessary. Chartered

Accountants can play a very vital role in ensuring tax compliance by audit of VAT accounts.

(v) Certification work

A Chartered Accountant can certify the record/documents required by the various authorities and Banks.

(vi) Procedural Compliances

Like present tax law, assessee would be required to do the following under the proposed GST law:

- Registration;
- Filing of Returns;
- Payment of taxes and;
- Assessment etc.

A Chartered Accountant is well equipped to assist the business entities in ensuring all the above the necessary legal compliances.

(vii) Record keeping

GST would require proper record keeping and accounting. Systematic records of credit of input/input service and its proper utilisation is necessary for the success of GST. Chartered Accountants are well equipped to perform such tasks.

(viii) Negotiations with suppliers

Credit of input/input service would alter cost structure of goods/services supplied as input/input services. A Chartered Accountant will ensure that the benefit of such cost reduction is passed on by the suppliers to his company. However, if the buyers of his company make the similar demand, he must be ready with full data to resist the claims.

(ix) Personal Representation

At present, a Chartered Accountant is allowed to appear before the VAT, Excise, Service Tax, Customs authorities and are fully equipped professional to represent his /her clients before the GST authorities too as and when required.

(x) Appellate work

At present, a Chartered Accountant is allowed to file and contest the appeals on the legal and factual issues before Commissioner (Appeals) and Appellate Tribunals of VAT, Service Tax, Customs and Excise for and on behalf of his clients. In GST regime, a Chartered Accountant can play this role also.

(xi) Authoring book

The experienced members of accountancy profession may also play a significant role by authoring books on GST which may help other professional members in understanding the GST law.

B-1

WORKING PAPER [NO. 1/2009-DEA] ON GOODS & SERVICES TAX[1]

GST REFORMS AND INTER-GOVERNMENTAL CONSIDERATIONS IN INDIA

[Source : www.finmin.nic.in]

1. Introduction

The replacement of the state sales taxes by the Value Added Tax in 2005 marked a significant step forward in the reform of domestic trade taxes in India. Implemented under the leadership of Dr. Asim Dasgupta, Chairman, Empowered Committee of State Finance Ministers, it addressed the distortions and complexities associated with the levy of tax at the first point of sale under the erstwhile system and resulted in a major simplification of the rate structure and broadening of the tax base. The State VAT design is based largely on the blueprint recommended in a 1994 Report of the National Institute of Public Finance and Policy, prepared by a team led by late Dr. Amaresh Bagchi (hereinafter, the "Bagchi Report").[2] In recommending a State VAT, the Bagchi Report clearly recognized that it would not be the perfect or first best solution to the problems of the domestic trade tax regime in a multi-government framework. However, the team felt that this was the only feasible option within the existing framework of the Constitution and would lay the foundation for an even more rational regime in the future.

Buoyed by the success of the State VAT, the Centre and the States are now embarked on the design and implementation of the perfect solution alluded to in the Bagchi Report. As announced by the Empowered Committee of State Finance Ministers in November 2007, the solution is to take the form of a 'Dual' Goods and Services Tax (GST), to be levied concurrently by both levels of government.

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[1] By Satya Poddar and Ehtisham Ahmad.

[2] Bagchi, Amaresh et al (1994).

The essential details of the dual GST are still not known. Will it necessitate a change in the Constitutional division of taxation powers between the Centre and the States? Will the taxes imposed by the Centre and the States be harmonized, and, if so, how? What will be treatment of food, housing, and inter-state services such as transportation and telecommunication? Which of the existing Centre and State taxes would be subsumed into the new tax? What will be the administrative infrastructure for the collection and enforcement of the tax? These are issues which ultimately define the political, social, and economic character of the tax and its impact on different sectors of the economy, and households in different social and economic strata.

It is some of these aspects of the proposed GST that are the subject matter of this paper. We focus on the essential questions relating to the Dual GST design, and first discuss the need for, and the objectives of GST reform. We then describes alternatives to the Dual GST already endorsed by the Empowered Committee, not because they are superior in any way to the Dual GST, but to allow a fuller discussion of the trade-offs involved in the choice among them. Subsequent sections consider the question of tax base and rate, and proper treatment of various components of the tax base (e.g., food, housing, and financial services) in light of international best practices. The last section provides a discussion of the issues that arise in the taxation of cross-border transactions, both inter-state and international. An important question in this regard is the feasibility of, and the rules for, taxation of inter-state supplies of services.

2. The Current Taxes and Their Shortcomings

The principal broad-based consumption taxes that the GST would replace are the CENVAT and the Service Tax levied by the Centre and the VAT levied by the States. All these are multi-stage value-added taxes. The structure of these taxes today is much better than the system that prevailed a few years ago, which was described in the Bagchi Report as "archaic, irrational, and complex – according to knowledgeable experts, the most complex in the world". Over the past several years, significant progress has been made to improve their structure, broaden the base and rationalize the rates. Notable among the improvements made are: -

- the replacement of the single-point state sales taxes by the VAT in all of the states and union territories
- reduction in the Central Sales Tax rate to 2%, from 4%, as part of a complete phase out of the tax

- the introduction of the Service Tax by the Centre, and a substantial expansion of its base over the years, and
- rationalization of the CENVAT rates by reducing their multiplicity and replacing many of the specific rates by *ad valorem* rates based on the maximum retail price (MRP) of the products.

These changes have yielded significant dividends in economic efficiency of the tax system, ease of compliance, and growth in revenues.

The State VAT eliminated all of the complexities associated with the application of sales taxes at the first point of sale. The consensus reached among the States for uniformity in the VAT rates has brought an end to the harmful tax competition among them. It has also lessened the cascading of tax.

The application of CENVAT at fewer rates and the new system of CENVAT credits has likewise resulted in fewer classification disputes, reduced tax cascading, and greater neutrality of the tax. The introduction of the Service Tax has been a mixed blessing. While it has broadened the tax base, its structure is complex. The tax is levied on specified services, classified into one hundred different categories. This approach has spawned many disputes about the scope of each category. Unlike goods, services are malleable, and can and are often packaged into composite bundles that include taxable as well as non-taxable elements. Also, there is no standardized nomenclature for services, such as the HSN for goods.

The design of the CENVAT and State VATs was dictated by the constraints imposed by the Constitution, which allows neither the Centre nor the States to levy taxes on a comprehensive base of all goods and services and at all points in their supply chain. The Centre is constrained from levying the tax on goods beyond the point of manufacturing, and the States in extending the tax to services. This division of tax powers makes both the CENVAT and the State VATs partial in nature and contributes to their inefficiency and complexity. The principal deficiencies of the current system, which need to be the primary focus of the next level of reforms, are discussed below.

A. Taxation at Manufacturing Level

The CENVAT is levied on goods manufactured or produced in India. This gives rise to definitional issues as to what constitutes manufacturing, and valuation issues for determining the value on which the tax is to be levied.[1] While these concepts have evolved through judicial rulings, it is recognized that limiting the tax to the point of manufacturing is a severe impediment to an efficient and neutral application of tax. Manufacturing itself forms a narrow base.

Moreover, the effective burden of tax becomes dependent on the supply chain, i.e., the taxable value at the point of manufacturing relative to the value added beyond this point.[2] It is for this reason that virtually all countries have abandoned this form of taxation and replaced it by multi-point taxation system extending to the retail level.[3]

Australia is the most recent example of an industrialized country replacing a tax at the manufacturing or wholesale level by the GST extending to the retail level. The previous tax was found to be unworkable, in spite of the high degree of sophistication in administration in Australia. It simply could not deal with the variety of supply chain arrangements in a satisfactory manner.

B. Exclusion of Services

The States are precluded from taxing services. This arrangement has posed difficulties in taxation of goods supplied as part of a composite works contract involving a supply of both goods and services, and under leasing contracts, which entail a transfer of the right to use goods without any transfer of their ownership. While these problems have been addressed by amending the Constitution to bring such transactions within the ambit of the State taxation[4] (by deeming a tax on them to be a tax on the sale or purchase of goods), services per se remain outside the scope of state taxation powers. This limitation is unsatisfactory from two perspectives.

First, the advancements in information technology and digitization have blurred the distinction between goods and services. Under Indian jurisprudence, goods are defined to include intangibles, e.g., copyright, and software, bringing them within

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[1] A detailed discussion of the problems can be found in the Bagchi Report.

[2] See Ahmad and Stern (1984) for the definition of effective taxes and applications to India. Bagchi (1994) provides estimates of effective excise tax rates, which are shown to vary from less than one percent to more than 22%.

[3] For example, these were precisely the reasons for the replacement of the federal manufacturers' sales tax by the Goods and Services Tax in 1991. See Canada Department of Finance (1987), and Poddar, Satya and Nancy Harley (1989).

[4] The Constitution (46th Amendment) Act 1982 amended Article 366 (29A) of the Constitution to deem a tax on six items to be a tax on the sale or purchase of goods.

the purview of state taxation. However, intangibles are often supplied under arrangements which have the appearance of a service contract. For example, software upgrades (which are goods) can be supplied as part of a contract for software repair and maintenance services. Software development contracts could take the character of contracts for manufacturing and sale of software goods or for rendering software development services, depending on the roles and responsibilities of the parties. The so-called 'value-added services (VAS) provided as part of telecommunication services include supplies (e.g., wallpaper for mobile phones, ring tones, jokes, cricket scores and weather reports), some of which could be considered goods. An on-line subscription to newspapers could be viewed as a service, but online purchase and download of a magazine or a book could constitute a purchase of goods. This blurring also clouds the application of tax to transactions relating to tangible property. For example, disputes have arisen whether leasing of equipment without transfer of possession and control to the lessee would be taxable as a service or as a deemed sale of goods.

The traditional distinctions between goods and services (and for other items such as land and property, entertainment, and luxuries) found in the Indian Constitution have become archaic. In markets today, goods, services, and other types of supplies are being packaged as composite bundles and offered for sale to consumers under a variety of supply-chain arrangements. Under the current division of taxation powers, neither the Centre nor the States can apply the tax to such bundles in a seamless manner. Each can tax only parts of the bundle, creating the possibility of gaps or overlaps in taxation.

The second major concern with the exclusion of services from the State taxation powers is its negative impact on the buoyancy of State tax revenues. With the growth in per capita incomes, services account for a growing fraction of the total consumer basket, which the states cannot tax. With no powers to levy tax on incomes or the fastest growing components of consumer expenditures, the States have to rely almost exclusively on compliance improvements or rate increases for any buoyancy in their own-source revenues. Alternatives to assigning the taxation of services to the states include assigning to the states a share of the central VAT (including the tax from services), as under the Australian model.

C. Tax Cascading

Tax cascading occurs under both Centre and State taxes. The most significant contributing factor to tax cascading is the partial coverage Central and State taxes.

Oil and gas production and mining, agriculture, wholesale and retail trade, real estate construction, and range of services remain outside the ambit of the CENVAT and the service tax levied by the Centre. The exempt sectors are not allowed to claim any credit for the CENVAT or the service tax paid on their inputs.

Similarly, under the State VAT, no credits are allowed for the inputs of the exempt sectors, which include the entire service sector, real property sector, agriculture, oil and gas production and mining. Another major contributing factor to tax cascading is the Central Sales Tax (CST) on inter-state sales, collected by the origin state and for which no credit is allowed by any level of government.

While no recent estimates are available for the extent of tax cascading under the Indian tax system (although see Ahmad and Stern 1984 and 1991, and Bagchi for earlier work), it is likely to be significant, judging by the experience of other countries which had a similar tax structure. For example, under the Canadian manufacturers' sales tax, which was similar to the CENVAT, the non-creditable tax on business inputs and machinery and equipment accounted for approximately one-third of total revenues from the tax. The extent of cascading under the provincial retail sales taxes in Canada, which are similar to the State VAT, is estimated to be 35-40% of total revenue collections. A priori, one would expect the magnitude of cascading under the CENVAT, service tax, and the State VAT to be even higher, given the more restricted input credits and wider exemptions under these taxes.[1] The Service Tax falls predominantly on business to business (B2B) services and is thus highly cascading in nature.

Tax cascading remains the most serious flaw of the current system .It increases the cost of production and puts Indian suppliers at a competitive disadvantage in the international markets. It creates a bias in favor of imports, which do not bear the hidden burden of taxes on production inputs. It also detracts from a neutral application of tax to competing products. Even if the statutory rate is uniform, the effective tax rate (which consists of the statutory rate on finished products and the implicit or hidden tax on production inputs) can vary from product to product depending on the magnitude of the hidden tax on inputs used in their production and distribution. The intended impact of government policy towards sectors or

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[1] Kuo, C.Y., Tom McGirr, Saya Poddar (1988), "Measuring the Non-neutralities of Sales and Excise Taxes in Canada", Canadian Tax Journal, 38, 1988, provide estimates of tax cascading under the Canadian federal manufacturers' sales tax and the provincial retails sales taxes.

households may be negated by the indirect or hidden taxation in a cascading system of taxes.

D. Complexity

In spite of the improvements made in the tax design and administration over the past few years, the systems at both central and state levels remain complex. Their administration leaves a lot to be desired. They are subject to disputes and court challenges, and the process for resolution of disputes is slow and expensive. At the same time, the systems suffer from substantial compliance gaps, except in the highly organized sectors of the economy. There are several factors contributing to this unsatisfactory state of affairs.

The most significant cause of complexity is, of course, policy related and is due to the existence of exemptions and multiple rates, and the irrational structure of the levies. These deficiencies are the most glaring in the case of the CENVAT and the Service Tax.

The starting base for the CENVAT is narrow, and is being further eroded by a variety of area-specific, and conditional and unconditional exemptions. A few years ago the Government attempted to rationalize the CENVAT rates by reducing their multiplicity but has not adhered to this policy and has reintroduced concessions for several sectors/ products.

The key problem with the service tax is the basic approach of levying it on specified services, each of which generates an extensive debate as to what is included in the base. Ideally, the tax base should be defined to include all services, with a limited list of exclusions (the so-called "negative list").[1] The Government has been reluctant to adopt this approach for the fear that it could bring into the tax net many services that are politically sensitive.

The complexities under the State VAT relate primarily to classification of goods to different tax rate schedules. Theoretically, one might expect that the lower tax rates would be applied to basic necessities that are consumed largely by the poor. This is not the case under the State VAT. The lowest rate of 1% applies to precious metals and jewellery, and related products—hardly likely to be ranked highly from the distributional perspective. The middle rate of 4% applies to selected basic necessities

[1] For a detailed discussion of the flaws of the current approach to taxation of services, see Rao (2001), which recommended replacement of taxation of selected services by a general tax on all services (other than excluded services).

and also a range of industrial inputs and IT products. In fact, basic necessities fall into three categories – exempted from tax, taxable at 4%, and taxable at the standard rate of 12.5%. The classification would appear to be arbitrary, with no well accepted theoretical underpinning. Whatever the political merits of this approach, it is not conducive to lower compliance costs. Most retailers find it difficult to determine the tax rate applicable to a given item without referring to the legislative schedules. Consumers are even less aware of the tax applicable to various items. This gives rise to leakages and rent seeking.

Another source of complexity under the State VAT is determining whether a particular transaction constitutes a sale of goods. This problem is most acute in the case of software products and intangibles such as the right to distribute/exhibit movies or time slots for broadcasting advertisements.

Compounding the structural or design deficiencies of each of the taxes is the poor or archaic infrastructure for their administration. Taxpayer services, which are a lynchpin of a successful self-assessment system, are virtually non existent or grossly inadequate under both central and state administrations. Many of the administrative processes are still manual, not benefiting from the efficiencies of automation. All this not only increase the costs of compliance, but also undermines revenue collection.

3. Objectives of Tax Reform

A. Basic Objectives

The basic objective of tax reform would be to address the problems of the current system discussed above. It should establish a tax system that is economically efficient and neutral in its application, distributionally attractive, and simple to administer.

As argued in Ahmad and Stern (1991), distributional or sectoral concerns have been at the heart of the excessive differentiation of the Indian tax system—but that the objectives are negated by the cascading effects of the taxes. While an optimal design of the consumption tax system, taking into account both production efficiency and distributional concerns, would not imply uniformity of the overall tax structure, the desired structure can be achieved by a combination of taxes and transfers.

Ahmad and Stern (1991) analyze the optimal pattern of tax rates implied by a given degree of aversion to poverty and concern for the poor. At high levels of concern for the poor, one would reduce the tax on cereals (but not dairy products) and increase the taxes on non-food items (durables). Thus, a differentiated overall structure appears desirable for a country in which the government has consistently expressed a concern for the poor. However, individual taxes should not be highly differentiated, as that complicates administration and makes it difficult to evaluate the overall effects of the tax design. This applies particularly to value-added type of taxes. In principle, a single rate (or at the most two-rate) VAT, together with excises and spending measures could achieve the desired distributional effects, for reasonable degrees of inequality aversion of policy makers.

In particular, it is important from an administrative perspective that close substitutes should not be taxed at very different rates—to avoid leakages and distortions. Revenue considerations suggest that the tax base should be broad, and comprise all items in the consumer basket, including goods, services, as well as real property.

The neutrality principle would suggest that:

- the tax be a uniform percentage of the final retail price of a product, regardless of the supply-chain arrangements for its manufacturing and distribution;
- the tax on inputs be fully creditable to avoid tax cascading; and
- the tax be levied on the basis of the destination principle, with all of the tax on a given product/service accruing in the jurisdiction of its final consumption.

Multiple VAT rates become a source of complexity, and disputes, for example, over borderlines, adding to the costs of tax administration and compliance. It is for this reason that countries like New Zealand, Singapore, and Japan have chosen to apply the tax at a low and uniform rate, and address any concerns about vertical equity through other fiscal instruments, including spending programs targeted to lower-income households.[1]

Another important objective of tax reform is simplification of tax administration and compliance, which is dependent on three factors. The first determining factor for simplicity is the tax design itself. Generally, the more rational and neutral the tax design, the simpler it would be to administer and encourage compliance. If the tax is levied on a broad base at a single rate, there would be few classification disputes and the tax-specific record keeping requirements for vendors would be minimal.

[1] Canada provides a refundable tax credit, GST Credit, lower-income households through the personal income tax system. The credit is paid in quarterly installments and income -tested for higher-income households.

The tax return for such a system can be as short as the size of a postcard. It would simplify enforcement, and encourage voluntary compliance.

The second factor is the infrastructure for tax administration, including the design of tax forms, data requirements, system of tax rulings and interpretations, and the procedures for registration, filing and processing of tax returns, tax payments and refunds, audits, and appeals. A modern tax administration focuses on providing services to taxpayers to facilitate compliance. It harnesses information technology to enhance the quality of services, and to ensure greater transparency in administration and enforcement.

The third factor in a federation such as India is the degree of harmonization among the taxes levied by the Centre and the States. The Empowered Committee has already indicated a preference for a dual GST, consisting of a Centre GST and a State GST. Under this model, harmonization of the Centre and State GSTs would be critical to keep the overall compliance burden low. Equally important is harmonization of GSTs across the states.

B. Fiscal Autonomy and Harmonization

An important consideration in the design of reform options is the degree of fiscal autonomy of the Centre and the States. It goes without saying that the power to govern and to raise revenues go together. The Constitution of India lays down a clear division of powers between the Centre and the States, including the power to levy taxes. Should the Centre and the States then have complete autonomy in levying and collecting the taxes within the parameters specified in the Constitution, or should they voluntarily or otherwise conform to certain common principles or constraints? Should they collectively agree to have their individual taxes consolidated into a single national tax, the revenues from which get shared in some agreed manner among the constituent units? Such a system would have much to commend itself from the perspectives of economic efficiency and the establishment of a common market within India. Indeed, such political-economy compromises have been adopted by China and Australia. China moved to a centralized VAT with revenue sharing with the provinces — ensuring that provinces got as much revenues as under the prior arrangements, plus a share of the increment. In Australia, the GST is a single national levy and all the GST revenues collected by the Center are returned to the states. However, such a compromise is unlikely to find much favor with the States in India, as is already revealed in their preference for the Dual GST.

To give political substance to the federal structure in India, the States (as well as the Centre) are likely to insist that they have certain autonomy in exercise of their taxation powers. Full autonomy would mean that: -

- retain the power to enact the tax,
- enjoy the risks and rewards of 'ownership' of the tax (i.e., not be insulated from fluctuations in revenue collections),
- be accountable to their constituents, and
- be able to use the tax as an instrument of social or economic policy.

Notwithstanding the above, there is a clear recognition of the need for harmonization of the Centre and State Taxes. Fiscal autonomy is important to allow the Centre and the States to set the tax rates according to their revenue needs. Harmonization of tax laws and administrative procedures is needed to simplify compliance and enforcement. It is also necessary to ensure that inter-state differences in policies and procedures do not generate additional economic distortions. An important question then is the desired degree of harmonization and the mechanism for achieving it.

The elements of harmonization can be divided into three broad sets: tax rates, tax base and tax infrastructure, i.e., the administration and compliance system. The first two elements could be viewed as important levers on which States would want to have some degree of control to achieve their social, economic, and fiscal policy objectives. However, the experience of other countries as well as their sub-national governments suggests that changes to the GST base are not a suitable instrument for social and economic policy (as discussed in greater detail in a later section in considering the treatment of food). While the tax base is a subject of intense debates at the time the tax is introduced, changes in the base after its introduction have been infrequent. This has especially been the case where the tax was initially levied on a broad and comprehensive base. Where the tax was initially levied on a narrow base, subsequent changes in the base have then been felt necessary to minimize anomalies, distortions, and revenue leakages created by the narrow base. Achieving such changes once the tax has been brought in, however logical, is invariably politically contention because of vested interests. It is thus important to get the structure right at the outset, as the base (and quite often the rate) cannot be easily changed, *ex post facto*.

The VAT in the European Union is an example reflecting these policy considerations. The base for the EU VAT is uniform, as codified in the EU Directive[1], which is binding in all Member States. There are important variations in the base, but these are essentially in the form of derogations granted for the arrangements existing at the time of introduction of the tax, and were intended to be temporary (though this has not always been the case). The tax rates are specified as floor rates (with some provision for reduced rates and maximum rates), below which Member States cannot set their rates.

Administration and compliance is an area where the need for harmonization is the greatest, and where Centre-State or inter-state variations are unlikely to serve any social or economic policy objective. This includes items such as the taxpayer registration system, taxpayer identification numbers, tax forms, tax reporting periods and procedures, invoice requirements, cross-border trade information systems and IT systems. Harmonization of these elements would result in significant savings in costs of implementing the GST (by avoiding duplication of effort in each government), as well as recurring savings in compliance costs. Harmonization would also permit sharing of information among governments, which is essential for effective monitoring of cross-border transactions. A common set of tax identifier numbers across States and the Central Government is a key element in the efficient exchange of information.

Harmonization of tax laws is also critical. Variation in the wording and structure of tax provisions can be an unnecessary source of confusion and complexity, which can be avoided by having the Centre and the States adopt a common GST law. An alternative is to agree on the key common elements if separate laws are chosen. Some of the critical elements for harmonization include common time and place of supply rules, as well as common rules for recovery of input tax, valuation of supplies and invoicing requirements. There would then be merit in harmonizing the system of tax interpretations and rulings as well (e.g., about classification of goods and services, determination of what constitutes taxable consideration, and definition of export and import).

These considerations suggest that harmonization of virtually all major areas of GST law and administration would be desirable. There is merit in keeping even the GST rate(s) uniform, at least during the initial years until the infrastructure for the new

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[1] The Commission Directive on the Common System of Value Added Tax, which replaced the Sixth Directive.

system is fully developed (see Ahmad, Poddar et al, 2008 for the GCC proposals). Harmonized laws would mean lower compliance costs for taxpayers and may also improve the efficiency of fiscal controls.

The Central Sales Tax (CST) in India provides a very useful for model for such harmonization. The CST is a state-level tax, applied to inter-state sales of goods, based on the origin principle. The tax law (including the base, rates, and the procedures) is enacted by Parliament, but the States collect and keep the tax. It is a perfect example of absolute harmonization, with the States enjoying the risks and rewards of ownership of the tax.

It is worth emphasizing that harmonization should not be viewed as constraining the fiscal autonomy of the Centre or the States. Rather, this is a framework that facilitates more efficient exercise of taxation powers, and all jurisdictions would be worse off without harmonization. This was the case under the previous State sales tax system, under which inter-state tax rate wars became a race to the bottom. Even today, they all suffer because of lack of harmonization of information and technology architectures, as a result of which they are unable to share information on inter-state trade. Harmonization should allow greater exploitation of the benefits of a common market.

C. Centre and State Taxation Powers

As noted earlier, the current division of taxation of powers under the Constitution is constraining for both the Centre and the States. Neither is able to design a comprehensive and neutral tax on goods and services of the type found in modern tax systems. The Constitution divides taxation powers between the Centre and the States by sector (e.g., agriculture, manufacturing, and land and property) or type of taxes (e.g., luxury tax, tax on the sale or purchase of goods, and excise duty). A notable feature of the current division is that the two levels of government have no area of concurrent jurisdiction, with the exception of stamp duties. This approach, while it may have served the country well in the past, is no longer optimal for modern economies where the traditional dividing lines between sectors are blurred, and new social, environmental, and economic issues emerge which require new forms of taxation instruments. The need for a substantial realignment of taxation powers is also emphasized by Rao (2008):

> "Paradigm shift in tax policy is necessary to recognise that tax bases of central and state governments are interdependent. The principle of separation of tax bases followed in the Constitutional assignment does not recognise the

interdependence. It is therefore desirable to provide concurrent tax powers to Centre and States in respect of both income and domestic consumption taxes. In the case of personal income tax, separation of tax powers between the centre and states based on whether the income is from agricultural or non-agricultural sector has been a major source of tax evasion. As agriculture is transformed into a business it is important to levy the tax on incomes received from all the sources both for reasons of neutrality and to minimise tax evasion. At the same time, both Centre and States could be allowed to levy the tax with the latter piggybacking the levy on the central tax subject to a ceiling rate. Similarly, it is important to unify multiple indirect taxes levied by the Central and State Governments into a single goods and services tax (GST) preferably with States piggybacking on the Central levy with clearly defined tax rooms for the two levels of government. The transition to such a concurrent tax system requires integrating the existing CENVAT and service taxes and extending the tax to the retail level which would, *inter alia*, entail amendment of the Constitution. The States could piggyback on the levy."

Thus, the current search for options for tax reform warrants a review of the existing Constitutional arrangements, which may well require a substantial realignment. For example, the dual GST would require giving the Centre and the States concurrent indirect taxation powers, subject to prohibition on extra-territorial taxation, i.e., that the incidence of tax be restricted to consumption within the territory of the taxing jurisdiction.[1]

While such a review is beyond the scope of this paper, our discussion of alternative options in the next section proceeds with the assumption that suitable constitutional amendments would be made to enable the implementation of the chosen option.

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[1] The division of taxation powers between federal and provincial governments in Canada provides an interesting example of such concurrent powers. Under the Canadian Constitutions, the federal government can levy any tax, and the provinces have the power to levy any direct tax within the province. A tax is considered to be a direct tax if its incidence falls on the person on whom it is levied. Thus, it includes all forms of income and wealth taxes. A sales tax or VAT is also viewed to be a direct if it is levied on the buyer/consumer, but not on the vendor. The tax can be collected and remitted by the vendor, acting as an agent of the government, but it has to be levied on the buyer. As a result, the two levels of concurrent powers for all types of taxes, subject to the condition that the provincial taxes can only be levied on persons within the geographical boundary of the provinces.

4. Options for the Centre and State GSTs

In defining options for reform, the starting point is the basic structure of the tax. For purposes of this discussion, we start with the assumption that any replacement of the current taxes would be in the form of a classical VAT, which is consumption type (allowing full and immediate credit for both current and capital inputs attributable to taxable supplies) and destination based (i.e., the tax levied on the basis of the place of consumption of the goods and services, not the place of production). Under this system, credits for input taxes are allowed on the basis of invoices issues by the vendors registered for the tax. This is the most common type of structure adopted around the world. Its superiority over other forms of consumption taxes is well accepted in India as well as other countries.

The choices that remain then relate essentially to the assignment of powers to levy the tax to the Centre and the States, and the tax base and rates. In the remainder of this section we deal with the question of assignment, and then turn to the question of tax base and rates in the next section.

The main options for the VAT assignments include:

- Concurrent Dual GST
- National GST and
- State GSTs.

All these options require an amendment to the Constitution. For the sake of completeness of discussion, we also consider an additional option, Non-concurrent Dual VAT, that does not require an amendment to the Constitution. We now discuss each of these options in turn below.

A. Concurrent Dual GST

Under this model, the tax is levied concurrently by the Centre as well as the States. Both the Central Government and the Empowered Committee appear to favor this model.

While full details of the model are still awaited, two variants have been identified in public discussions so far. The initial variant, discussed in November, 2007, entailed both the Centre and the States levying concurrently the GST on goods, but most of the services (except services of a local nature) remaining subject to the Centre GST only. The Central GST would thus apply to both goods and services, extending to the entire supply chain, including wholesale and retail trade. The State GSTs would largely be confined to goods only, with minor changes from the current State VATs.

Under the more recent variant,[1] both goods and services would be subject to concurrent taxation by the Centre and the States. This variant is closer to the model recommended by the Kelkar Committee in 2002.[2]

The main difference between the two variants is in the treatment of services, reflecting apprehensions about the feasibility of defining the place of supply (i.e., destination) of inter-state services. Even the more recent variant recognizes that there would be a set of inter-State services for which the place of destination would be difficult to determine. The State tax on these services would be collected by the Centre, and then apportioned among the States in some manner.

Other notable features of this variant are as follows:

- There would a single registration or taxpayer identification number, based on the Permanent Account Number (PAN) for direct taxation. Three additional digits would be added to the current PAN to identify registration for the Centre and State GSTs.
- States would collect the State GST from all of the registered dealers. To minimize the need for additional administrative resources at the Centre, States would also assume the responsibility for administering the Central GST for dealers with gross turnover below the current registration threshold of Rs 1.5 crores under the central Excise (CENVAT). They would collect the Central GST from such dealers on behalf of the Centre and transfer the funds to the Centre.
- Procedures for collection of Central and State GSTs would be uniform. There would be one common tax return for both taxes, with one copy given to the Central authority and the other to the relevant State authority.
- Other indirect taxes levied by the Centre, States, or local authorities at any point in the supply chain would be subsumed under the Central or the State GST, as long as they are in the nature of taxes on consumption of goods and services.

At a broad conceptual level, this model has a lot to commend itself. It strikes a good balance between fiscal autonomy of the Centre and States, and the need for

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[1] See Empowered Committee of State Finance Ministers (2008).

[2] Kelkar, Vijay, et al (2004).

harmonization. It empowers both levels of government to apply the tax to a comprehensive base of goods and services, at all points in the supply chain. It also eliminates tax cascading, which occurs because of truncated or partial application of the Centre and State taxes.

The apprehension about feasibility of application of State GST to inter-state services is understandable, given the complete absence of any framework in India for determining their place of supply. However, the task of developing such a framework is not insurmountable. In fact, such frameworks do already exist for application of national VAT to international cross-border services, which could be adapted for inter-state services. Canada has developed such a framework for application of provincial sales taxes or GST to services.

Another point to note is that inter-State services are provided predominantly by the organized sector (e.g., telecom and transportation services), which is generally tax compliant. Once the rules are framed, they would program their accounting and invoicing systems to collect and remit the tax accordingly.

Admittedly, there are inter-State services which have no unique place of supply. Take for example the supply of group health insurance to a corporation with employees throughout India, or auditing or business consulting services provided to a corporation or conglomerate with business establishments in several States. The determination of place of supply of such services is going to be somewhat arbitrary. However, such services are almost entirely B2B supplies, the tax on which is fully creditable to the recipient under a comprehensive taxation model. The arbitrariness in the rules would thus have no impact on the final tax collections of the Centre or the States.

The Empowered Committee proposal is silent on the treatment of land and real property transactions in the description of this option. Assuming this omission is deliberate, it is a major drawback of the option. As discussed further in the next section, modern VATs apply to all supplies, including supplies of land and real property. The Service Tax has already been extended to rentals of commercial property and construction services. There are no compelling social or economic policy reasons for excluding these services from the scope of the GST.

B. National GST

Under this option, the two levels of government would combine their levies in the form of a single national GST, with appropriate revenue sharing arrangements among them. The tax could be controlled and administered by the Centre, States, or a separate agency reporting to them. There are several models for such a tax. Australia is the most recent example of a national GST, which is levied and collected by the Centre, but the proceeds of which are allocated entirely to the States.[1]

In China, the VAT law and administration is centralized, but the revenues are shared with the provinces. In going to this model, the Centre had assured the provinces that they would continue to get what they did under the previous arrangement and those changes in revenue shares would be phased in over an extended period of 15 years—see Ahmad 2008.

Under the Canadian model of the Harmonized Sales Tax (HST), the tax is levied at a combined Federal and Provincial rate of 13 per cent (5% federal rate, 8% provincial rate) in the three participating provinces. Tax design and collection are controlled by the Centre, but the provinces have some flexibility to vary their tax rate. The revenues from the tax are shared among the participating provinces on the basis of consumer expenditure data for the participating provinces.

In Austria, and Germany, the tax design is controlled by the Centre, but States collect the taxes. This has led to incentive problems, as some of the Länders have begun to use tax administration measures to achieve tax policy goals. In Mexico, the establishment of a VAT at the Center replaced State sales taxes, but had to be part of a political-economy compromise that assured the states an automatic share of the revenues generated from all federal taxes.

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[1] The Australian Constitutional situation is that both the States and the Commonwealth (the Federal Government) have power to tax supplies of goods and services. The Constitution prevents laws interfering with interstate trade (including tax laws) and gives the power to collect Customs and excise taxes exclusively to the Federal Government. It is forbidden for the Commonwealth to tax State Property. To meet this requirement, the GST implementation laws, of which there are 6, simply state that they do not impose tax on State properties and the States accept that view, at least at the moment. The GST was introduced on the pretence that it was a State tax being collected by the Commonwealth in order to (a) secure the States' agreements to abolish some of their preexisting transaction taxes, in particular certain stamp duties, financial institutions duties, etc and (b) to ensure that the States wouldn't start a round of attempts to challenge the constitutional validity of the law (as was done, unsuccessfully, in the past with income tax, which both States and Commonwealth also have power to collect. The current Government has acknowledged that GST is in fact simply a Federal Tax that it uses to make grants to the States and as a result of this acknowledgement, the Auditor General has for the first time since 2000 agreed to approve the Commonwealth accounts.

A single national VAT has great appeal from the perspective of establishment and promotion of a common market in India. However, the States may worry about the loss of control over the tax design and rates. Indeed, some control over tax rates is a critical issue in achieving accountable sub-national governance and hard budget constraints (Ambrosiano and Bordignon, 2006). The States may also be apprehensive that the revenue sharing arrangements would over time become subject to social and political considerations, deviating from the benchmark distribution based on the place of final consumption. The Bagchi Report also did not favor this option for the fear that it would lead to too much centralization of taxation powers.

These concerns can be addressed partially through suitable administrative arrangements and Centre-State agreements. The tax design could be made subject to joint control of the Centre and the States. The States would necessarily lose the flexibility of inter-state variation in tax design, but that is also the perceived strength of this option. Given that the Centre does not have the machinery for the administration of such a tax, the States would presumably play a significant role in its administration. The revenue sharing formula could also be mandated to be based on the destination principle, as under the Canadian HST.

The key concerns about this option would thus be political. Notwithstanding the economic merits of a national GST, will it have a damaging impact on the vitality of Indian federalism? With no other major own-source revenues, will individual States become too dependent on collective choices and feel dis-empowered to act on their priorities? Will it be possible for the governments with such diverse political interests and philosophies to reach a consensus and adhere to it?

While one can have a healthy debate on each of these issues, international experience suggests that discretionary use of broad-based consumption taxes for social, political, or economic policy purposes tends to be limited. The dominant consideration in their design is their neutrality and efficiency in raising revenues. This is also reflected in the design of the State VATs in India. In spite of vast political and economic differences among them, States have been able to forge a consensus on a common VAT design. A national GST would extend this consensus to the Centre. But participation of the Centre could fundamentally alter the delicate balance of interests that currently prevails in the Empowered Committee and make the consensus harder to achieve.

C. State GSTs

Under this option, the GST would be levied by the States only. The Centre would withdraw from the field of general consumption taxation. It would continue to levy income taxes, customs duties, and excise duties on selected products such as motor fuels to address specific environmental or other policy objectives. The loss to the Centre from vacating this tax field could be offset by a suitable compensating reduction in fiscal transfers to the States. This would significantly enhance the revenue capacity of the States and reduce their dependence on the Centre. The USA is the most notable example of these arrangements, where the general sales taxes are relegated to the states.

There would be significant hurdles in adopting this option in India. First, it would seriously impair the Centre's revenues. The reduction in fiscal transfers to the States would offset this loss, but still the Centre would want to have access to this revenue source for future needs. Second, the option may not be revenue neutral for individual States. The incremental revenues from the transfer of the Centre's tax room would benefit the higher-income states, while a reduction in fiscal transfers would impact disproportionately the lower-income states. Thus the reform would be inequality enhancing—and against the traditions of successive governments in India (of all political shades). Third, a complete withdrawal of the Centre from the taxation of inter-state supplies of goods and services could undermine the States' ability to levy their own taxes on such supplies in a harmonized manner. In particular, it would be impractical to bring inter-state services within the ambit of the State GST without a significant coordinating support from the Centre.

D. Non-concurrent Dual VATs

Under the concurrent dual GSTs, the Centre and State taxes apply concurrently to supplies of all goods and services. It poses two challenges. First, it requires a Constitutional amendment. Second, a framework is needed for defining the place of supply of inter-state services and for the application of State GST to them. Both of these hurdles can be circumvented if the GST on goods were to be levied by the States only and on services by the Centre only. The States already have the power to levy the tax on the sale and purchase of goods (and also on immovable property), and the Centre for taxation of services. No special effort would be needed for levying a unified Centre tax on inter-State services.

This option would not address any of the deficiencies of the current system identified in Section 2 above, if the taxes on goods and services were to be levied in an uncoordinated manner as two separate partial taxes. It would perpetuate the difficulties in delineating supplies of goods and services, and compound tax cascading.

The main appeal of this option is as a variant of the State GST option discussed immediately above. In levying the VAT on services, the Centre would essentially play the coordinating role needed for the application and monitoring of tax on inter-state services. The Centre would withdraw from the taxation of goods. Even the revenues collected from the taxation of services could be transferred back to the States, partially or fully.

Within this framework, cascading could be completely eliminated by the States agreeing to allow an input credit for the tax on services levied by the Centre. Likewise, the Centre would allow an input credit for the tax on goods levied by the States.

The discussion above suggests that the design of a GST is going to be a challenge, regardless of the option chosen. All options require significant Centre-State coordination and harmonization, and there may be very little room for variance in rate setting by States at least in the near future. The best option would appear to be a national GST (either through the constitution or on a voluntary basis), with an appropriate Centre-State and inter-State revenue sharing arrangement. If a framework for taxation of inter-state services can be devised, then the concurrent dual VAT could be the most supportive of the objective of fiscal autonomy. To ensure harmonization of tax base, rules and procedures, it would be desirable to have a single common legislation enacted by Parliament, following the model for the CST. The law would delegate the collection of tax to the Centre and States on their respective tax bases, i.e., the Centre to collect the central GST on supplies of goods and services anywhere in India, and the States to collect the State GST on supplies within their states (as per the place-of-supply rules specified in the legislation).

5. Tax Base and Rates

We turn now to the question of the tax base and rates, within the broad structure of a consumption-type, destination-based, credit-invoice GST. Ideally, the tax should be levied comprehensively on all goods and services at a single rate to achieve the objectives of simplicity and economic neutrality. However, governments often deviate from this ideal either because of concerns about distribution of tax burden (e.g., food), or because of administrative and conceptual difficulties in applying the tax to certain sectors of the economy (e.g., health care, education, and financial services). These concerns are likely to be paramount at both Centre and State levels and there will inevitable be calls to exempt, or tax at a reduced rate, items of importance to the poor or other particular groups.

As noted earlier, reduced rates or exemptions for basic necessities may not be an efficient way of helping the poor, because of a significant spillover of their benefits to the rich. Although the rich spend a smaller *proportion* of their income on such goods than do the poor, because their income is higher they are also likely to spend a larger *absolute* amount. As a result, the rich might gain most from applying a reduced tax rate to such goods. The needs of the poor could be more effectively addressed through spending and transfer programs. Distributional concerns should be seen as part of the overall balance of all fiscal instruments and not solely for the GST. Moreover, multiple rates and exemptions increase the costs of administration and compliance. They give rise to classification disputes, necessitate additional record keeping, and create opportunities for tax avoidance and evasion through misclassification of sales.

Notwithstanding the virtues of a single-rate and comprehensive base, debates about the proper treatment of food and a variety of other items are inevitable. In what follows, we discuss some of the most critical aspects this debate, starting with a discussion of the revenue neutral tax rates in the absence of any exemptions or other preferences.

A. Tax Rates

In discussions on the GST design for India, it has been suggested that the tax would need to be levied at a combined Centre-State tax rate of 20 per cent, of which 12% would go to the Centre and 8% to the states (vide, for example, the Kelkar Task Force Report). While they fall below the present combined Centre and State statutory rate of 26.5% (CENVAT of 14%, and VAT of 12.5%), GST at these rates would encounter significant consumer resistance, especially at the retail level, and would give rise to pressures for exemptions and/or lower rates for items of daily consumption. With the notable exception of Scandinavian countries, where the tax is levied at the standard rate of 25%, few countries have been successful in levying and sustaining a VAT/GST at such high rates.

Successful GST models adopted by other countries had a very broad base and a relatively modest tax rate, especially at the time of inception. For example, the New Zealand GST was introduced at the rate of 10%, with a base consisting of virtually all goods and services (with the exception of financial services). The Singapore GST was introduced at 3%, but the rate has now been raised to 7% as inefficient excises and customs duties have been progressively eliminated.

Table 1 provides a comparison of the tax base and rates in selected international jurisdictions with 'modern' VAT/GST. It provides data on C- efficiency, which is a widely-used measure of the comprehensiveness of the tax base. It is calculated as the ratio of the share of GST revenues in consumption to the standard rate. Any deviation from a 100 per cent C-efficiency indicates deviation from a single tax rate on all consumption. Zero-rating of some consumption items would lead to a C-efficiency of less than 100 per cent while inclusion of investment or a break in the GST chain could lead to a C-efficiency higher than 100 per cent. While a C-efficiency of 100 does not imply a perfect VAT, it can serve as a useful indicator of the productivity of GST revenue per percentage point of GST rate. The last column in the table shows revenue productivity of GST in these countries, measured as GST revenues per point of the standard rate divided by the GDP (i.e., (Aggregate Revenues/Standard Rate)/GDP).

Table 1

Comparison of GST Base and Rates, Selected Jurisdictions

Country	*Year*	*Standard Rate %*	*Consumption % of GDP*	*C-Efficiency*	*Revenue Productivity*
Canada	2005	7	74.8	0.46	0.34
Japan	2004	5	75.5	0.67	0.50
New Zealand	2005	12.5	76.0	0.94	0.73
Singapore	2004	5	54.2	0.70	0.40

[*Source: Various IMF reports and authors' own estimates*]

As shown in Table 1, the New Zealand GST, which is levied at a single rate on virtually all goods and services, has the highest C-efficiency. The Canadian GST, also levied at a single rate, has low C-efficiency because of zero-rating of food and medicines, and rebates for housing and non-profit sector. Japan and Singapore levy tax at a single rate to a comprehensive base, including food. Yet, their C-efficiency is lower than in New Zealand mainly on account of exemptions for supplies by non-profit organizations. The C-efficiency of European VATs is generally much lower, in the range of 50%, as these taxes are levied at multiple rates, and with exemption for land and housing, financial services, and supplies by public bodies. In general, VATs that have been introduced around the world in the last few years have a higher C-efficiency than the 'old' VATs.

A low C-efficiency translates into lower revenue productivity of tax, as shown in the last column of the table.

With this background, we turn to an estimation of the size of the GST base in India and the GST rates that would be required to replace the current indirect tax revenues of the Centre and the States.

Poddar and Bagchi (2007) calculations show that if the GST were to be levied on a comprehensive base, the combined Centre-State revenue neutral rate (RNR) need not be more than 12%. This rate would apply to all goods and services, with the exception of motor fuels which would continue to attract a supplementary levy to maintain the total revenue yield at their current levels.

Here are some basic ingredients of the RNR calculations for 2005-06, the latest year for which the necessary data are available. The total excise/service tax/VAT/sales tax revenues of the Centre and the States in that year was Rs.134 thousand crore and Rs. 139 thousand crore respectively. Assuming that approximately 40% of the central excise revenues and 20% of the state VAT/sales tax revenues are from motor fuels, the balance of the revenues from other goods and services that need to be replaced by the GST are Rs 89 thousand crore for the Centre and Rs 111 thousand crore for the states, making up a total of Rs 200 thousand crore.

In 2005-06, the total private consumer expenditure on all goods and services was Rs. 2,072 thousand crore at current market prices. Making adjustments for sales and excise taxes included in these values and for the private consumption expenditure on motor fuels, the total tax base (at pre-tax prices) for all other goods and services is Rs 1763 thousand crore.

These values yield a revenue neutral GST rate of approx. 11% (200 as per cent of 1763 is 11.3%). The RNR for the Centre is 5% and for the states 6.3%. Allowing for some leakages, the combined RNR could be in the range of 12%. The Centre excise duty rates have been reduced substantially (the standard rate reduced from 16% to 10%) since 2005. At the current duty rates, the Centre RNR is likely to be in the range of 3%, bringing the combined RNR to below 10%.

These estimates are by no means precise. Even so, they give a broad idea of the levels at which the rate of a national GST could be set to achieve revenue neutrality for both levels of government. An important question for policy makers is the costs and benefits of deviating from this benchmark of single rate GST. While there would be pressing calls for all kinds of exemptions and lower rates, the economic benefits of a single rate are enormous. The experience of countries like New Zealand, Japan and Singapore suggests that it is feasible to resist such calls by keeping the tax rate low. There is increasing political support for such an option. It would mark a clean break from the legacy structures and herald a new era of simple and transparent tax administration.

There is virtue in keeping the GST rate in the 10% range, especially at inception. Any revenue shortfall at this rate could be made up by the use of supplementary excises on select demerit goods (e.g., tobacco, and alcohol), besides motor fuels. Excises could also be used for select luxury items which do already attract tax at higher rates. This would help minimize undesirable shifts in the distribution of tax burden (see the discussion in Ahmad and Stern, 1984 and 1991). Clearly, such excises should be limited to a very small list of items which are discrete and not amenable to tax avoidance and evasion.

B. Food

The main issue in the application of GST to food is the impact it would have on those living at or below subsistence levels. In 2005, data, food accounted for one-third of total private final consumer expenditures. For those at the bottom of the income scale, it doubtless accounts for an even higher proportion of total expenditures and incomes. Taxing food could thus have a major impact on the poor. By the same token, a complete exemption for food would significantly shrink the tax base.

There are additional considerations that are pertinent to the treatment of food.

- Food includes a variety of items, including grains and cereals, meat, fish, and poultry, milk and dairy products, fruits and vegetables, candy and confectionary, snacks, prepared meals for home consumption, restaurant meals, and beverages. In most jurisdictions where reduced rates or exemptions are provided for food, their scope is restricted to basic food items for home consumption. However, the definition of such items is always a challenge and invariably gives rise to classification disputes. In India, basic food, however defined, would likely constitute the vast bulk of total expenditures on food.

- In India, while food is generally exempt from the CENVAT, many of the food items, including food grains and cereals, attract the state VAT at the rate of 4%. Exemption under the state VAT is restricted to unprocessed food, e.g., fresh fruits and vegetables, meat and eggs, and coarse grains. Beverages are generally taxable, with the exception of milk.
- In the rural sector, the predominant distribution channel for unprocessed food would be either a direct sale by the farmer to final consumers or through small distributors/retailers. Even where food is within the scope of the GST, such sales would largely remain exempt because of the small business registration threshold.
- Given the large size of farm community in India, which is mostly unorganized, consideration needs to be given to whether it is advisable to exempt (with no right of input tax deduction) all unprocessed farm produce sold by them at the farm gate. In the case of cash crops (produce for further manufacturing or processing, e.g., cotton, coffee beans, and oil seeds), it would not be in the interest of the farmers to be exempted from tax. They should thus be allowed the option of voluntary registration to pay the tax. It is recognized that an exemption for first sale at the farm gate would be difficult to administer and create inefficiencies in distribution and marketing of farm produce.

These considerations pose some difficult policy issues. Given that food is currently exempt from the CENVAT, the GST under a single-rate, comprehensive-base model would lead to at least a doubling of the tax burden on food (from 4% state VAT to a combined GST rate of 10-12%). It would call for some tangible measures to offset the impact on the lower-income households. One would be to limit the exemption only to cereals (see Table 1) as some of the other food items have lower distributional characteristics.

The alternative of exempting food altogether (or zero rating) would not be any better. First, the revenue neutral rate would jump from 10-12% to 18%. While the poor would pay less tax on food, they would pay more on other items in their consumption basket. Whether and to what extent they would be better off would depend on the composition of their consumption basket. The higher standard rate would, in turn, lead to pressures for exempting other items (e.g., medicines, books, LPG, and kerosene). Third, it could preclude unification of the tax rate on goods with that on services, which are currently taxable 12.36%. Imposition of tax rate at 18% on hitherto exempt services (e.g., passenger travel, health, and education) would encounter significant political resistance. Fourth, one cannot expect any improvement in taxpayer compliance at such high rates. To the contrary, greater visibility of the Centre tax at the retail level could have a negative impact on compliance. Thus, an exemption for food has the potential to totally unravel the simplicity and neutrality of GST.

One could consider a lower rate for food, instead of complete exemption. If the lower rate were to be 5%, the revenue neutral standard rate (based on 2005 rate structure) would be pushed up to 16%. This may be a reasonable compromise, provided all other goods and services are made taxable at the single standard rate of 16%. The risk is that the lower rate for food would become the thin edge of the wedge which would create irresistible demands for the opening the door wider.

An important question is the definition of food that would be eligible for the lower rate. To keep the base broad, and limit the preference to items of consumption by the lower-income households, the lower rate should be confined to 'unprocessed' food items (including vegetables, fruit, meat, fish, and poultry). Its scope can be further restricted by excluding from the preference food pre-packaged for retail sale. This definition would not be without problems, especially where the processing value added is small. For example, if wheat were taxable at 5% as unprocessed food, but flour taxable at 16% as processed food, it would encourage consumers to buy wheat and then have it processed into flour.

Overall, the preferred option would appear to be a single-rate, comprehensive-base GST. While no option is perfect, it has the advantage of simplicity and neutrality. As noted earlier, sales of unprocessed food in rural India would largely remain exempt under this option because of the small business exemption. The poor can be further insulated from its impact through direct spending programs, and/or exempt from tax any sales under the Public Distribution System (PDS).

C. Land and Real Property

Under the 'old' VATs (such as those in Europe), land and real property supplies are excluded from the scope of the tax. To minimize the detrimental impact of an exemption under a VAT, business firms are given the option to elect to pay tax on land real property supplies.

Under a modern GST/VAT (e.g., in Australia, New Zealand, Canada, and South Africa), housing and construction services are treated like any other commodity. Thus, when a real estate developer builds and sells a home, it is subject to VAT on the full selling price, which would include the cost of land[1], building materials, and construction services. Commercial buildings and factory sales are also taxable in the same way, as are rental charges for leasing of industrial and commercial buildings. There are only two exceptions: (1) resale of used homes and private dwellings, and (2) rental of dwellings:

- A sale of used homes and dwellings is exempted because the tax is already collected at the time of their first purchase, especially for homes acquired after the commencement of the tax. If the sale were to be made taxable, then credit would need to be given for the tax paid on the original purchase and on any renovations and additions after the purchase. Except where the prices have gone up, the net incremental tax on resale may not be significant. Theoretically, this system does create a windfall for the existing homes build and acquired prior to the commencement of the tax. In practice, the windfall is not significant as the home construction would have attracted other taxes on construction materials and services that prevailed at the time.
- Residential rentals are also exempted for the same reason. If rents were to be made taxable, then credit would need to be allowed on the purchase of the dwelling and on repairs and maintenance. Over the life of the dwelling, the present value of tax on the rents would be approximately the same as the tax paid on the purchase of the dwelling and on any renovation, repair, and maintenance costs. In effect (and as with other consumer durables), payment of VAT on the full purchase price at acquisition is a prepayment of all the VAT due on the consumption services that the house will yield over its full lifetime. A resale of a dwelling is exempted for the same reason: the tax was pre-paid when the dwelling was initially acquired.

[1] Actually, in Australia and New Zealand, this is not always the case. In New Zealand, land (like any other "goods") is the subject of a deemed input tax credit under the "second hand goods" scheme, which has the effect that the tax on a development of land acquired from an unregistered person is the margin of the supplier. This provision affects mainly the land held by individuals outside a business at the commencement of the GST. Such land is permanently sheltered from tax, even where it subsequently enters a commercial supply chain. In Australia, a margin scheme for land is used to work out the taxable value in similar circumstances: the margin scheme operates as a second hand scheme and as a transitional rule to prevent the value of most (but not all) of the value of land as at 1 July 2000 entering into the tax base.

- Many private individuals and families own residential dwellings (including their homes and summer residences) which they may rent to others. They are generally not in the VAT system, so do not get a credit for the VAT paid when they initially acquire their new home. Nor do they claim any credit for any repairs or renovations they may have made to the existing homes. If the rental of such dwelling were subject to tax, owners should also be given a credit for the taxes paid on such costs—which would be complex, and difficult to monitor.

Thus, virtually all countries exempt long-term residential rents and resale of used residential dwelling. However, short-term residential accommodation (in hotels, for example) is normally subject to VAT. Any commission charged by the agents and brokers for the sale or rental of a dwelling are treated as a service separate from the sale or rental of the dwelling and attract tax regardless of whether paid by the buyer or the seller.[1]

Sale or rental of vacant land (which includes rental of car parking spaces, fees for mooring of boats and camping sites) is also taxable under the 'modern' VAT system.

It would make sense to incorporate these concepts in the design of GST in India as well.

- Conceptually, it is appropriate to include land and real property in the GST base. To exclude them would, in fact, lead to economic distortions and invite unnecessary classification disputes as to what constitutes supply of real property.
- In the case of commercial and industrial land and buildings, their exclusion from the base would lead to tax cascading through blockage of input taxes on construction materials and services. It is for this reason that even under the European system an option is allowed to VAT registrants to elect to treat such supplies as taxable.
- Housing expenditures are distributed progressively in relation to income and their taxation would contribute to the fairness of the GST.
- The State VAT and the Service Tax already apply to construction materials and services respectively, but in a complex manner. For example, there is significant uncertainty whether a pre-construction agreement to sell a new

[1] Poddar (2009) provides a more detailed discussion of the options for taxation of housing under VAT/GST.

residential dwelling is a works contract and subject to VAT. Where the VAT does apply, disputes arise about the allocation of the sale price to land, goods, and services. While land is the only major element that does not attract tax, the tax rates applicable to goods and services differ, necessitating a precise delineation of the two. Extending the GST to all real property supplies, including construction materials and services, would bring an end to such disputes, simplify the structure, and enhance the overall economic efficiency of the tax.

One potential argument against the levy of GST to land and real property would be that they already attract the stamp duty. This argument can be quickly discarded as the purpose and structure of the stamp duty is quite different from that of the GST. Stamp duty is a cascading tax on each conveyance of title to real property, whereas the GST is a tax on final consumer expenditures. The GST does not impinge on commercial property transactions, after taking into account the benefit of input tax credits. It does not result in tax cascading. Under the model described above, in the case of residential dwellings, the GST would apply to the first sale only. Thus, the two taxes cannot be viewed as substitutes. However, the application of GST to real property transactions does warrant a review of the structure and rates of stamp duties and registration fees. The rates should be lowered and the structure rationalized when the GST is introduced.

D. Non-profit Sector and Public Bodies

Historically, supplies made by governmental bodies and non-profit organizations (including religious institutions, social welfare agencies, and sports and cultural organizations) have been exempted from VAT on the grounds that such bodies are not engaged in a business and their activities are not commercial in nature. But this is often, and increasingly, not the case. Public enterprises are involved in a wide range of industrial and commercial activities. As deregulation proceeds, the dividing line between public administration and industrial/commercial activities becomes increasingly blurred. For example, postal and telecommunication services were historically viewed as public administration, but this is no longer the case. Government agencies/ enterprises provide such services in competition with private firms. The same is true for other activities such as local and inter-city transit, operation of airports, radio and television broadcasting, and provision of water, sewer, and sanitation services. Moreover, the public sector in India, as in many other countries, is large and pervasive.

Under the EU VAT Directive, activities of the public sector are divided into three categories: non-taxable, taxable, and exempt. A public body is in principle eligible to claim input tax deductions only in respect of the VAT paid on inputs acquired for use in making taxable supplies (though a number of member states pay refunds of VAT by matching grant). While this approach may have provided the EU Member States with the needed flexibility in dealing with their domestic environment, it falls short of achieving the principal criteria of an efficient VAT system identified above. The exempt or nontaxable status of a wide range of supplies by public bodies violates the criterion of economic neutrality. Biases are created in favor of the self-supply of services within the public sector to minimize the amount of non-deductible VAT on inputs. Consumers may be influenced in their purchasing decisions by the fact that the VAT does not apply to certain public sector goods and services. The non-deductible input VAT embedded in the prices of public sector goods and services is passed along to persons in the production-distribution chain who are not final consumers.

The application of a value added tax requires identification of a supply and the consumer or buyer to whom the supply is made, and valuation of consideration for the supply.

Determination of each of these elements gives rise to issues in the public sector due to the nature of the way services are delivered by governments and the manner in which the services are funded. For example, a public body may provide its services for no explicit charge (e.g., museum admissions, water, health, and education) and there may not be any identifiable buyer or consumer for certain services provided on a collective basis (e.g., sanitation, and police protection). In addition, the political sensitivity to the taxation of certain services, and the methods of inter-governmental funding may detract from a neutral application of tax to the public sector activities. As a result, the public sector is subject to special rules in almost all VAT systems currently in place throughout the world.

This is a matter that cannot be dealt with satisfactorily without a systematic review of all of the activities of the governmental bodies and non-profit organizations. However, at this stage it is useful to describe the two broad approaches that other countries have followed.

First, the highly-regarded VAT system in New Zealand (and later Australia[1]) treats all activities of public sector and non-profit bodies as fully taxable[2]. They thus collect the VAT on all of their revenues, with the sole exception of revenues from taxes, interest and dividends, and gifts and charitable donations. Under this broad and comprehensive approach, no distinction is made between public administration and commercial/ industrial activities of the state or non-profit organizations. By the same token, these bodies are eligible to claim a full credit for their input VAT in the same manner as private enterprises. This system is conceptually simple, and consequently is in some respects easy to operate. And—by putting public and private sectors on an equal footing—it minimizes potential distortions of competition. In Australia, certain basic medical and educational supplies, and supplies by non-profit organizations below market value (i.e., subsidized supplies) are zero-rated.[3] Other supplies are taxable under the standard GST rules, as in New Zealand.

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[1] The Australian system is structured quite different from the New Zealand one, even though the net outcome is similar. New Zealand's GST is designed to tax all flows of money through the Government, whereas Australia's is complicated by the Federal Structure. The Commonwealth does not in fact pay GST or claim ITCs--it just does so notionally--, whereas the States actually do pay and claim. New Zealand taxes appropriations, whereas Australian says that they are not taxed. In addition, a range of Government provided services are GST-free or exempt.

[2] See Peter Barrand (1991), for a description of the New Zealand system. Aujean, Michel, Peter Jenkins and Satya Poddar provide an analytical framework for such a system.

[3] Zero-rated (called GST-free) supplies are defined as follows:

38-7 Medical services

(1) A supply of a medical service is GST-free.

(2) However, a supply of a medical service is not GST-free under sub-section (1) if:

(a) it is a supply of a professional service rendered in prescribed circumstances within the meaning of regulation 14 of the Health Insurance Regulations made under the Health Insurance Act 1973 [other than the prescribed circumstances set out in regulations 14(2)(ea), (f) and (g)]; or

(b) it is rendered for cosmetic reasons and is not a professional service for which Medicare benefit is payable under Part II of the Health Insurance Act 1973.

[Medical services are defined by cross-reference to services covered by a health and health insurance law]

38-85 Education courses

A supply is GST-free if it is a supply of:

(a) an education course; or

The second is the traditional approach followed in most other countries. Under this approach, the activities of public and non-profit bodies are divided into two lists: taxable and exempt. There are no simple or mechanical rules for this division, which in practice is based on a variety of economic, social, and practical considerations. For example, public enterprises engaged in industrial or commercial activities are generally taxable, especially if their revenues from their clients are expected to exceed their costs. Some countries exempt all other fees and charges, while others tax them on a selective basis (including postal charges, airport landing fees, port loading and unloading charges, sale of statistical and other publications, and fees for licenses and permits). Given that not all of the activities of an organization are considered taxable under this approach, an input tax credit is allowed for only those inputs that relate to the taxable activities of the organization.

This latter approach creates difficulties in determining what is taxable and what is exempt, and also in allocating the input taxes between the two (since credit would be given only in respect of taxable activities). It also creates a distortion in the form of a bias against the use of outside contractors by public bodies in their exempt activities. For example, if a municipality used a contractor for construction of a road or a bridge, it would pay the VAT on the contractor's fees, and not be eligible to claim a credit for the tax. However, it could avoid the tax if it hired its own employees to do the construction work. As noted above, some countries provide a full or partial rebate of the tax related to minimize this 'self-supply' bias.

There is little doubt that the New Zealand approach is conceptually superior. It does, however, lead to a larger number of taxpayers, many of which will be entitled

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(b) Administrative services directly related to the supply of such a course, but only if they are supplied by the supplier of the course.

['Education course' defined as a course leading to a diploma or degree from a primary, secondary or tertiary school with cross-references to recognition by the appropriate State education authority]

38-250 Nominal consideration etc.

(1) A supply is GST-free if:

- (a) the supplier is a charitable institution, a trustee of a charitable fund, a gift-deductible entity or a government school; and
- (b) the supply is for consideration that:
  - (i) if the supply is a supply of accommodation – is less than 75% of the GST inclusive market value of the supply; or
  - (ii) if the supply is not a supply of accommodation – is less than 50% of the GST inclusive market value of the supply.

to refunds. Since the management of refunds is an especially problematic aspect of the VAT, particularly in developing countries, the control issues may be a significant drawback.

If Governments and public bodies are partially exempted, then one other issue that needs to be considered is the treatment of supplies to governments. This is especially important in a federation. Should one Government apply its non-creditable tax to supplies to another Government? Or should all Governments be immune from taxation as sovereign bodies? In India, CENVAT and State VAT currently apply to Government procurement.

Likewise, the GST could be made applicable to supplies to Governments with no special rules. However, as noted earlier, this then would create a self-supply bias for public bodies where they buy inputs for an exempt activity.

E. Financial Services

Financial services are exempted from VAT in all countries. The principal reason is that the charge for the services provided by financial intermediaries (such as banks and insurance companies) is generally not explicit - a fee - but is taken as a margin, that is hidden in interest, dividends, annuity payments, or such other financial flows from the transactions. For example, banks provide the service of operating and maintaining deposit accounts for their depositors, for which they charge no explicit fee. The depositors do, however, pay an implicit fee, which is the difference between the pure interest rate (i.e., the interest rate which could otherwise be earned in the market without any banking services) and the interest actually received by them from the bank on the deposit balance. The fee is the interest foregone. Similarly, the charge for the services provided by banks to the borrowers is included in the interest charged on the loan. It is the excess of the interest rate on the loan over the pure rate of interest or cost of funds to the bank for that loan.

It would be straight-forward to levy the tax on this implicit fee if the reference 'pure rate' were easily observable—but it is not. The spread between borrowing and lending rates, could be measured, and taken as measuring the *total* value added by the intermediary. But in order for the crediting mechanism to work properly, it is necessary to go further and *allocate* this value-added to borrower and lender (with a credit on the tax paid due only to registered taxpayers)—which again raises the problem of identifying a reference pure interest rate.[1]

Some financial services are, of course, charged for by a direct and explicit fee, examples being an account charge or foreign exchange commission. Services provided for an explicit charge could be subjected to VAT in the normal way with the taxable recipient having a right of deduction, and a growing number of countries do this. Nevertheless, some countries exempt them all, while others limit the exemption to banking and life insurance. The exemption avoids the need to measure the tax base for financial transactions, but gives rise to other distortions in the financial markets. The denial of credit to the exempt financial institutions for the VAT charged on their inputs creates disincentives for them to outsource their business process operations. Where they render services to business clients, the blockage of input tax credits results in tax cascading, adversely affecting their competitive position in the international markets.

Taxing explicit fees for financial services, but treating margin services as exempt, is a possible answer, but it is conceptually flawed (as the same service will be treated differently for VAT purposes depending on how the remuneration for it is taken) and runs the risk that there will be some arbitrage between the two methods of charging to lessen the VAT charge (particularly in the case of supplies to final consumers with no right of deduction).

In China, financial services are taxable under their business tax, which is a tax on turnover with no tax credits allowed on inputs. Because it is a turnover tax, it can be applied to the total spread for margin services, with no need to allocate the spread between borrowers and depositors. Israel, and Korea also apply tax in such alternative forms.

Under the Service Tax, India has followed the approach of bringing virtually all financial services within the ambit of tax where the consideration for them is in the form of an explicit fee. It has gone beyond this by bringing selected margin services (where the consideration is the spread between two financial inflows and outflows) within the Service Tax net. The following are principal examples of such taxable margin services: -

[1] These concepts are discussed in greater detail in Poddar, S. and M. English (1997) and Poddar, Satya (2003).

- Merchant discounts on credit/debit card transactions are taxable as a consideration for credit card services, as are any explicit fees or late payment charges collected from the card member.
- In foreign currency conversion transactions without an explicit fee, tax applies to a deemed amount of consideration equal to 2% of the amount converted.
- The tax applies to that portion of life insurance premiums that represents a cover for risks.

As there are no compelling economic or social policy reasons for exempting financial services (other than the practical difficulties of defining the consideration for margin services), it would be appropriate to continue this approach under GST. There are, however, certain technical flaws in the measurement of consideration that need to be addressed when switching over to GST. For example, in the case of insurance, the tax applies to the gross amount of risk premium, while a proper measure would be the premiums net of any claims (whether the claim is settled in cash or in kind). This can be accomplished by allowing a credit in respect of any claims paid.

Consideration could also be given to bringing interest margin on non-commercial loans and deposits within the next net on an aggregate basis, as opposed to for each transaction separately[1]. This could be done by computing the aggregate interest margin and apportioning it between the margin from B2B and B2C transactions. The B2B margin could then be zero-rated, and the tax applied to the B2C margin.

In some countries, transactions in gold, silver and other precious metals are also treated as part of the financial sector, given that these metals are often bought as investments, and not for consumption. They are exempted from tax. However, unlike the approach followed in India of applying a reduced rate of 1% to such metals and articles made of such metals, the exemption is confined to only metals of investment-grade purity levels. Jewellery and other articles made of such metals remain taxable at the standard rate.

6. Treatment of Inter-State and International Trade

Treatment of inter-State and international supplies of goods and services is one of the most crucial elements of the design of a Dual GST. A set of rules is needed to

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[1] For a more complete discussion of the system in India and how it can be modified and extended, see Poddar, Satya (2007).

define the jurisdiction in which they would be taxable under the destination principle. Further a mechanism is needed for enforcing compliance to those rules.

The Rules can be relatively straightforward for the application of the Central GST. However, there is a concern that, under a sub-national destination-based VAT, taxation of cross-border transactions could be a significant challenge in the absence of any inter-state fiscal border controls. Even if such border controls were to exist, they would be ineffective for taxation of services, which entail no physical inter-state movement. This concern has been a topic of increased discussion over the recent years due to the growth in internet sales and transactions. Cross-border VAT leakage is also a growing concern in the EU because of the removal of border controls between Member Countries.

In what follows, we first start with the basic framework for defining the place of supply, then look at the policy options for ensuring proper compliance. This discussion draws on Ahmad, Poddar et al (2008) for the GCC Secretariat.

A. Place of Taxation, International Transactions

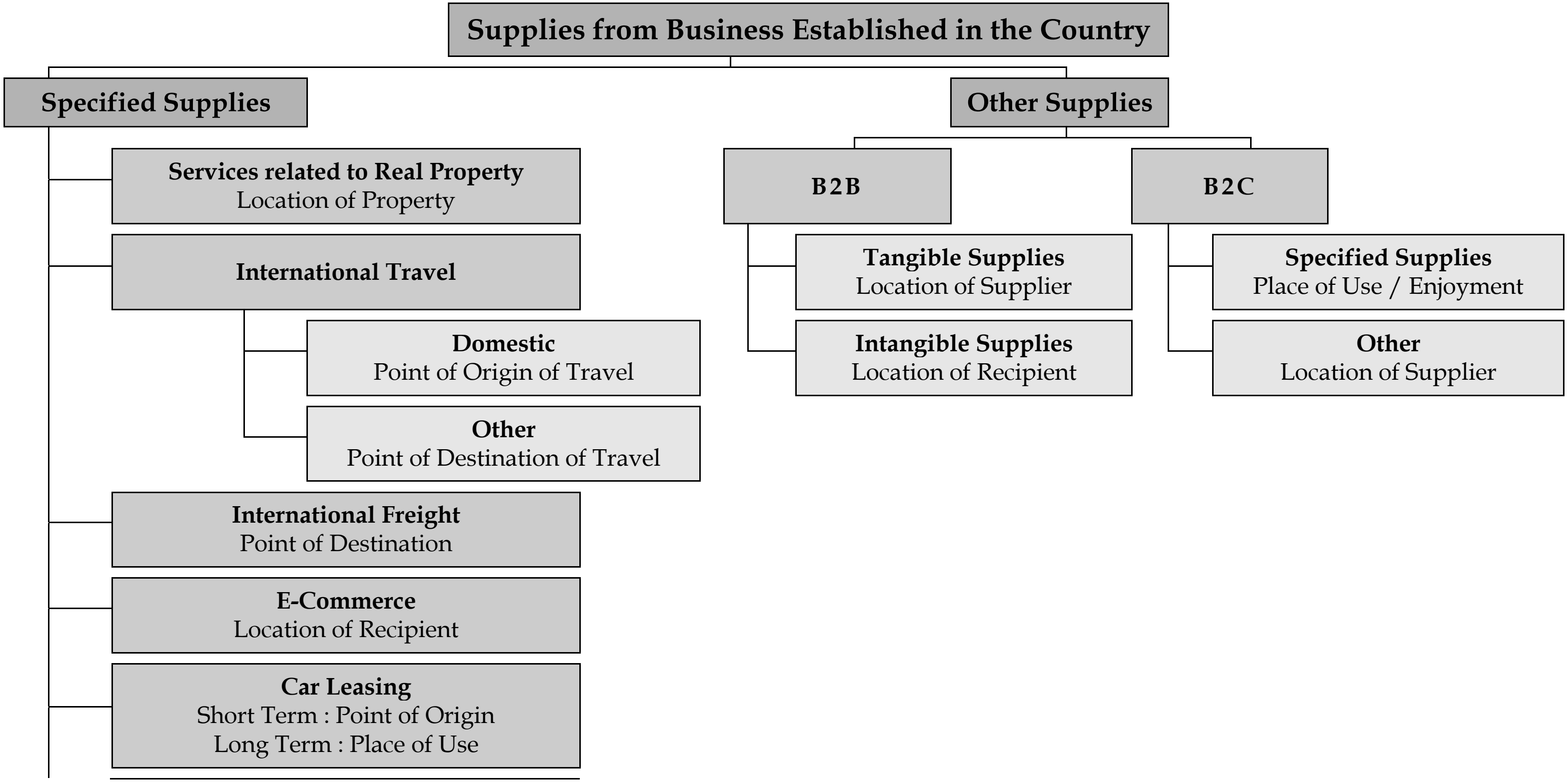
In virtually all countries, VAT is levied on the basis of the destination principle. For this purpose, some countries follow the practice of prescribing a set of rules for defining the place of taxation or place of supply. A supply is taxable in a given jurisdiction only if the supply is considered to take place in that jurisdiction. An alternative approach followed by other countries is to first define what supplies are potentially within the scope of the tax, and then provide criteria for determining which of those supplies would be zero-rated as exports. The two approaches yield the same result, even though one excludes exports from the scope of the tax, while the other zero-rates them, having first included them in the scope. The Service Tax in India follows the second approach.

While the rules and approaches vary from country to country, the basic criteria for defining the place of taxation are as follows (approaches for taxation of services depicted in Chart 1):[1]

[1] What are discussed below are only the basic concepts. The actual rules can be complex, and highly varied from one jurisdiction to the next. For a more rigorous discussion of the approaches being followed in selected international jurisdictions, see Millar, Rebecca (2007).

- A sale of goods is taxable if the goods are made available in or delivered/shipped to that jurisdiction (i.e., on the basic of place of delivery or shipment to the recipient).
- A sale of real property is taxable if the property is located in that jurisdiction (i.e., on the basis of place of location of the property). Services directly connected with real property are also taxable on this basis (e.g., services of estate agents or architects).
- A supply of other services or intangible property is taxable in that jurisdiction depending on one or more of the following factors:
  - Place of performance of the service
  - Place of use or enjoyment of the service or intangible property
  - Place of residence/location of the recipient
  - Place of residence/location of the supplier
- Special rules apply for certain supplies (also referred to as mobile services) for which there is no fixed place of performance or use/enjoyment, such as:
  - Passenger travel services
  - Freight transportation services
  - Telecommunication Services
  - Motor vehicle leases/rentals
  - E-commerce supplies

CHART-1
PLACE OF TAXATION (Of Supplies Other Than Goods)



In defining the place of taxation of services and intangible property, a distinction is often made between supplies made to businesses (B2B) and final consumers (B2C). B2B supplies are generally defined to be made where the recipient is located or established, regardless of where the services are performed or used. This is particularly the case for the so-called intangible services (e.g., advisory or consulting services) for which the place of performance is not important. Thus, all such services rendered to non residents become zero-rated, and subject to a reverse charge in the country of the recipient, which charge is deductible as long as the recipient is fully taxable. This avoids tax cascading, which would otherwise occur.

By contrast, B2C services are deemed to be made in the jurisdiction where the supplier is located. Many B2C services tend to be tangible or physical in nature, e.g., haircuts, and admissions to place of amusement, which are used/consumed at the place of their performance. In some countries, B2C intangible services are treated in the same manner as B2B services, i.e., they are zero-rated when rendered to non-resident customers.

Special rules apply to the so-called mobile services. For transportation services, the place of supply is defined by reference to the point of origin or destination. In Europe, rail passenger transportation is taxed based on distance traveled in the taxing jurisdiction. For telecommunication, e-commerce and satellite broadcasting services, the origin rule (taxation in the country of the supplier) can lead to non-taxation, and various solutions have been followed to prevent this. For example, in the EU, e-commerce suppliers to EU final consumers are required to register and account for tax in the country of their customer, using a 'one stop shop' registration facility, if they wish. This rule is being extended to intra-EU supplies of telecommunications, e-commerce and satellite broadcasting from 1/1/2015 to present suppliers obtaining an arbitrage advantage by setting up their business in a low rate member state. In Canada, a "two-out-of-three" rule is followed, i.e., the supply is made in the jurisdiction if the points of origin and termination are in that jurisdiction, or if one of the points is in the jurisdiction and the supply is billed to an account in the jurisdiction. The rules for e-commerce are varied, but generally follow the rules for telecommunication services. Internet connectivity services are in fact telecommunication services. Goods and services bought and sold on-line are generally taxed on the same manner as those bought off-line.

For short-term car rentals, in Europe the place of supply is where the car is first made available to the customer, regardless of the place of its subsequent use. For long-term leases, place of supply could depend on the place of use of the vehicle or the residence of the customer; the EU is adopting such a rule from 1/1/2010 to prevent 'rate shopping'. Often, similar rules are adopted for leases and rentals of other goods also.

In addition to the above, there are a variety of other complex cross-border transactions' for which supplementary rules are required. They relate to global transactions (or master service agreements) for individual supplies to legal entities of a corporate group around the world, triangular transactions, supplies among branches and between branches and head office, and cost reimbursement/ allocation arrangements. The complexity of the rules for such transactions has been an issue under discussion by working groups at the OECD, with a view to developing a framework or guidance for uniformity and consistency in the treatment of international services and intangibles in different jurisdictions.[1]

It is recognized that under these rules tax could be charged to nonresident business customers on supplies of an intermediate nature (i.e., not for final consumption) which would lead to cascading and create competitive distortions. To address this concern, many countries have provisions to provide a rebate of the tax charged to business customers.[2] Such rebates can also be extended to non-business customers, e.g., rebates to foreign tourist for the tax paid on goods bought locally for subsequent export when they return back.

Generally, these rules apply in a symmetrical manner to define exports and imports. Thus, where the supply of, say, consulting services by a domestic supplier is zero-rated because it is supplied to a business located outside the country, the supply of such services by a foreign supplier to a business located in the country would be taxable as an imported service. Imports generally attract tax at the customs border. For services and intangibles, the tax is self-assessed by the recipient under the reverse-charge mechanism.

The combined result of these rules (including the system of rebates for nonresident customers) is to define the place of destination of services and intangibles as follows:

- For B2B supplies, the place of destination is the place where the recipient is established or located.
- For B2C supplies of a tangible/physical nature (e.g., hair cuts, hotel accommodation, local transportation, and entertainment services), the place of

[1] For discussion of the issues and approaches, see OECD (2004).
[2] For example, such rebates are provided under Article XXX of the EU VAT Directive.

destination is the place where the supplier is established or located, which is generally also the place where the service is performed. For highly mobile B2C supplies of an intangible nature (e.g., telecommunication, e-commerce and satellite broadcasting services, for which the place of performance is not linked to the rendering of the service), the place of supply could be the place of residence of the customer (as for B2B supplies), or the place where the services are used or enjoyed. But, because it is wholly impractical to subject final consumers to the reverse charge, in Europe the non-resident supplier is required to register and account for VAT to customers resident in the European Union.

- Special rules for specific supplies are generally designed to yield a result similar to that for other supplies. They serve the purpose of providing greater certainty and clarity in situations where the place of location or residence of the supplier or the recipient may not be well defined or easily ascertainable at the time of the supply.

B. Place of Taxation, Inter-State Transactions

An important question in the context of the Dual GST is whether these rules for international cross-border supplies can be adopted for domestic inter-State supplies also. Conceptually, there are no compelling reasons to deviate from them for defining the place of supply at the sub-national level. The only precedent available of a destination-based VAT at the sub-national level is that of Harmonized Sales Tax (HST) in Canada. (The precedent of the EU is different because it is a community of 27 Sovereign Member States rather than a single nation made up of a union of states in a federation. The EU solution of taxing intra-EU B2B supplies of goods and services by means of zero-rating and then reverse charge accounting in the member state of the taxable recipient may not be the right answer—and has led to the problem of carousel fraud). Surprisingly, Canada deviated from these rules in defining the place of supply in a province in one important respect. In defining the place of supply of services at the provincial level, the primary criterion used in Canada is the place of performance of the service. Thus, if all or substantially all of a service is performed in a province, then the place of supply of the service is considered to be that province, regardless of whether it is a B2B or B2C supply, and where it is used or enjoyed. There appear to be two reasons for it, which are also relevant for the design of the Dual GST in India.

First, it is recognized that the place where the supplier or the recipient is established cannot be defined uniquely at the sub-national level within a common market. A supplier may have establishments/ offices in several States and one or more of them could be involved in rendering the service. At the national level, the country of residence of the counter parties to a transaction needs to be determined for direct tax as well as other regulatory purposes. However, at the sub-national level, such determination is not necessary, especially where there is no direct tax at that level. The basic rules outlined above for international supplies cannot be applied in the absence of supplementary rules for defining the place where the supplier and the recipient are located or established. Take, for example, an HR consulting firm with offices in several States providing recruitment services to a corporate entity with operations through India. In this case, the basic rule of defining the place of supply of the service to be where the recipient is established cannot be applied as the recipient is established in more than one State.

Second, under the Canadian HST, any input tax paid by a business can be claimed back as an input credit under the federal GST or the HST regardless of where it is established, as long as the inputs are used in a taxable activity. Thus, there is no adverse consequence of collecting the HST on services rendered to businesses located in other provinces. The HST is integrated with the GST to such an extent that it best fits the description of as a national GST, not a Dual GST.

Given these considerations, Canada defines the place of supply of services (other than those subject to special rules) to be the place where they are performed. If they are performed in more than one province, supplementary rules are employed to determine the place of supply. The main supplementary rule defines the place of supply/taxation to be the place to which the employee/officer of the supplier, who had responsibility for negotiating the service contract with the recipient, reports. In effect, under these rules the sub-national tax on services is applied on the basis of the origin principle, i.e., where the services are performed.

The Canadian approach does not appear to be suitable for the Dual GST in India where the Centre and State GSTs would be harmonized, but not integrated. It would be desirable to tax B2B supplies of services (and intangibles) in the State of destination, and not of origin.

Given that any tax on B2B supplies would generally be fully creditable, excessive sophistication would not be warranted for defining the place of destination of such supplies. For multi-establishment business entities, the place of destination could be defined simply as the place of predominant use of the service. Where there is no unique place of predominant use, the place of destination could be simply the mailing address of the recipient on the invoice, which would normally be the business address of the contracting party. The risk of misuse of this provision would be minimal if it is limited to B2B supplies where the tax is fully creditable.

For B2C services, the tax should apply in the State where the supplier is established, which, in turn, could be defined as the place where the services are performed. Where there is no unique place of performance of the service, the place of taxation could be defined to be the State where the supplier's establishment most directly in negotiations with the recipient is located. This would be similar to the Canadian rule.

C. Taxation of Imports by the States

In most countries, imports attract the VAT/GST at the time of entry into the country. The tax is generally applied on the value of goods declared for customs purposes, including the amount of the customs duty. However, there are no well-established precedents for the application of sub-national taxes to imports. In India, the Centre levies an additional duty (called the special additional duty) on imports at the rate of 4%, which is meant to be in lieu of the state VAT. This duty is allowed as a credit against the central excise duty on manufacturing or refunded where the imports are resold and the State VAT is charged on them.

In Canada, the provincial HST is collected by the Customs authorities on non-commercial importations of goods. The tax is collected at the time of importation on the basis of place of residence of the person importing the goods, regardless of where the goods enter the country. Commercial importations do not attract the provincial HST because of difficulties in determining their destination within the country. For example, a large consolidated commercial shipment could contain goods that are initially destined to a central warehouse, for subsequent distribution to various parts of the country.

The Canadian system is conceptually appealing and could be considered for the application of State taxes under the Dual GST in India.

D. Monitoring of Inter-State Supplies

We turn now to the design of a suitable mechanism for payment and collection of tax on inter-state supplies. As noted earlier, there is a concern that a sub-national destination-based VAT could be subject to substantial leakages in the absence of effective inter-state border controls. Many policy prescriptions have been made to deal with the issue, but none implemented so far at the sub-national level.[1]

In our view, these concerns are exaggerated, especially under a dual GST, harmonized between the Centre and the States and across the States. It is possible to design suitable mechanisms for proper application of tax on inter-state supplies, without resorting to border controls. The current border controls for goods, in the form of inter-state check posts have not been effective in the past. Border controls would not even be feasible for services and intangibles, which involve no physical inter-State movement.

As noted by Bird and Gendron[2], under a dual GST, the application of the Centre GST to all domestic supplies would automatically serve as an audit control for reporting of inter-State supplies for purposes of the State GST. The aggregate of the turnovers reported for the State GSTs must equal the total turnover reported for the Centre GST. Dealers can misclassify the turnover to different States, but would not be able suppress the turnover for State GST below the level reported for the Centre GST. Where the GST design, rate and the base is harmonized across the States, the dealers would have little incentive to misclassify the turnover. Under such a system, the focus of the authorities should be on proper reporting of the total turnover, not inter-State turnover.

Notwithstanding the above, a mechanism is needed for proper application of sub-national tax on inter-State supplies of goods as well as services. For reasons outlined elsewhere[3], zero-rating of inter-State supplies is not advisable. Instead, the preferred approach would be to require the vendors to collect the destination state GST on inter-State supplies (of goods and services) and remit the tax directly to the destination state. The tax would then be creditable in the destination state under the normal rules, i.e., if it relates to inputs for use in making taxable supplies.

This mechanism, referred to as Prepaid VAT (PVAT), is similar to the mechanism of the CST. Under the CST, the tax on inter-state sales is charged and remitted to the origin state. Under PVAT, the tax on inter-state supplies would be charged and

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[1] See, for example, McLure, Charles (2000):, Keen, Michael and Stephen Smith (2000), and Poddar, Satya (1990).

[2] See Bird and Gendron (1998).

[3] See Poddar, Satya, Eric Hutton, (2001).

remitted to the destination state.[1] It preserves the destination principle of VAT. Vendor in the origin State collect tax on all of their domestic supplies, whether intra-State or inter-State. The tax collected on inter-state supplies would be that of the destination state and remitted to that state by the vendor. On intra-State supplies, the tax collected would be that of the origin State and paid to that State.

Buyers who are GST registrants (in B2B transactions) would have a strong incentive to ensure that the vendor properly applies the destination tax, which would then be creditable against their output tax in the state of destination. Otherwise, the goods would be subject to the tax of the origin state, which would not be creditable in the state of destination.

Most supplies of services and intangibles to consumers and other exempt buyers (in B2C transactions) would be taxable in the State of origin, without the benefit of zero-rating. However, inter-State shipments of goods to consumers would be zero-rated in the state of origin and attract the tax of the destination state (including, for example, mail order supplies of goods). An inducement could be created for consumers also to ensure that the vendor charges the destination State tax on such shipments. This could be done by imposing a self-assessment requirement in the destination state on any inter-state purchases on which the vendor has not charged and remitted the destination state tax.

The PVAT mechanism establishes the output-tax-and-input-credit chain for inter-state transactions and, thereby, strengthens the audit trail property of the VAT system. Unlike the system of zero-rating, it creates strong incentives for both the origin and the destination states to monitor compliance independently of each other, as revenues of both are affected by the zero-rated sales declared by the vendor. This is a unique feature of PVAT, and perhaps it is most significant. Under the traditional system of zero-rating, the quantum of zero-rated sales reported by the vendor affects the revenues of the origin state, but not of the destination state. PVAT creates a simple and effective link between the two.

[1] The PVAT mechanism as originally developed by the authors entailed a prepayment of the destination State VAT before the goods are shipped. However, under a harmonized Dual GST, such prepayment may not be necessary. There would be enough safeguards in the system to enforce payment of tax on inter-state supplies at the same time as on intra-state supplies.

7. Harmonization of Laws and Administration

The need for Centre-State and inter-State harmonization is paramount under the Dual GST. The ultimate goal would be a unified base and one set of rules for the two taxes.

What should be the mechanism for achieving this harmonization? Different options have been adopted in other federations or trading blocks. At one extreme is the example of Australia where the GST is imposed and administered as a single unified tax levied by the national government. All the revenues from the tax are then distributed to the States. Another such example is that of Harmonized Sales Tax (HST) in Canada, which is levied in three of the ten provinces. The tax is levied and administered under a unified law by the national Government, much like the Australian GST. The key difference is in the revenue allocation system. Under the Canadian system, provincial participation in the HST is elective, not mandatory. The tax is levied at the national rate of 7 per cent (now reduced to 5%), which is increased by 8% per cent in those provinces which have elected to participate in it. The revenues attributable to the supplementary rate of 8 per cent are then distributed among the participating provinces on the basis of a statistical calculation of the tax base in those provinces (which approximates the revenues they would have collected if they had levied a separate tax of their own). In Australia, there is no State “participation”. The tax is a federal tax that is distributed to the States under a political agreement. The revenues are distributed as grants to the States, taking into account factors such as fiscal capacity and need of individual States. In terms of the operation of the law, the enactment of the law, and the jurisdiction of law, it is exclusively a federal tax.

The system in the Province of Quebec in Canada offers another model of harmonization of the national and sub-national taxes. Quebec levies a goods and services tax, called Quebec Sales Tax (QST), the legislation for which follows very closely the model for the federal GST. The two taxes have the same base, definitions, and rules, but levied under two separate statutes. To ensure harmonization of administration, the two governments have entered into a tax collection agreement under which the collection, administration and enforcement of the federal GST is delegated to the provincial government. The agreement defines the role and responsibilities of the two governments and the policies and procedures to be followed in administering the tax. The federal government retains the power to make any changes in the legislation and to issue rulings, and interpretations, which are adhered to by the province in administering the federal GST. In practice, the province accepts the federal rulings and interpretations for both GST and QST, given the similarities in the two statues.

The EU model is yet another example. This model is quite distinct from the Australian and Canadian models. The focus in the EU model is on minimization of distortions in trade and competition, and not on harmonization of administration. Thus, the VAT base (subject to continuing derogations) is harmonized, as are the basic rules governing the mechanism and application of VAT (time of supply, valuation, place of supply etc). The rates are harmonized only within broad bands (e.g., the standard rate may not be less than 15%) and administration is largely a matter for the member states to decide (but must respect basic principles such as neutrality).

As noted earlier, the CST in India also offers an interesting model of the harmonization mechanism. The CST law is Central, but the tax is administered and collected by the States. Indeed, this appears to be most suitable model for India. The GST law for both the Centre and the States would be enacted by Parliament under this model. It would define the tax base, place of taxation, and the compliance and enforcement rules and procedures. The rates for the State GST could be specified in the same legislation, or delegated to the State legislatures. The legislation would empower the Centre and the States to collect their respective tax amounts, as under the CST.

If the Governments fail to reach a political compromise on the CST model, the Quebec model would appear to be the next best alternative. It respects fiscal autonomy of the two levels of government, yet facilitates harmonization through the mechanism of binding tax collection agreements between the Centre and the States. These agreements would, in turn, encourage adoption of a common GST law.

The Centre can play an important role of providing a forum to discuss and develop the common architecture for the harmonized administration of the two taxes. It would have responsibility to develop policies and procedures for GST, in consultation with the Empowered Committee, e.g., on the place of supply rules, taxpayer registration and identification numbers, model GST law, design of tax forms and filing procedures, data requirements and computer systems, treatment of specific sectors (e.g., financial services, public bodies and governments, housing, and telecommunications), and procedures for collection of tax on cross-border trade, both inter-State and international. The proposal made by the Empowered Committee (for delegation of administration of the Centre GST for smaller dealers to the States) is very similar, even though the contractual framework for it is yet to be developed.

8. Conclusion

The Empowered Committee describes the GST as "a further significant improvement – the next logical step -towards a comprehensive indirect tax reforms in the country." Indeed, it has the potential to be the single most important initiative in the fiscal history of India. It can pave the way for modernization of tax administration -make it simpler and more transparent – and significant enhancement in voluntary compliance. For example, when the GST was introduced in New Zealand in 1987, it yielded revenues that were 45% higher than anticipated, in large part due to improved compliance. Its more neutral and efficient structure could yield significant dividends to the economy in increased output and productivity. The Canadian experience is suggestive of the potential benefits to the Indian economy. The GST in Canada replaced the federal manufacturers' sales tax which was then levied at the rate of 13% and was similar in design and structure as the CENVAT in India. It is estimated that this replacement resulted in an increase in potential GDP by 1.4%, consisting of 0.9% increase in national income from higher factor productivity and 0.5% increase from a larger capital stock (due to elimination of tax cascading).

However, these benefits are critically dependent on a neutral and rational design of the GST. The discussion of selected issues in this paper suggests that there are many challenges that lie ahead in such a design. The issues are not trivial or technical. They would require much research and analysis, deft balancing of conflicting interests of various stakeholders, and full political commitment for a fundamental reform of the system.

Opportunities for a fundamental reform present themselves only infrequently, and thus need to be pursued vigorously as and when they do become available. As the choices made today would not be reversible in the near future, one needs a longer-term perspective. Achieving the correct choice is then a political economy balancing act that takes into account the technical options and the differing needs and constraints of the main partners. Fortunately, there is a very substantial consensus among all stakeholders in the country for a genuine reform. In the circumstances, an incremental or timid response would be neither politically expedient, nor would it serve the needs of India of the 21st century. Experience of countries with modern VATs, such as New Zealand, Singapore, and Japan suggests that a GST with single-rate and comprehensive base can be a win-win proposition for taxpayers and the fisc alike.

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B-2
ICAI's CONCEPT PAPER – GST MODEL FOR INDIA SUGGESTIONS

1 Background

1.1 India is on a growth trajectory with the economy growing at higher and higher rate, year on year. Economic liberalization and sectoral reforms have been the chief contributors to this growth. Tax reforms too have kept pace and India has moved from the origin based system of taxation of goods to destination based system; introduced taxation of services and moved to a more robust system based on value added principles. The tax reform process is also gaining ground with experience and exposure and the pace of reform is now faster.

1.2 After achieving, what many considered as an almost impossible task, of moving from sales tax system for taxation of goods at State level to more modern system of value added tax at the state level, now is the time to move to consolidation of taxes on goods and services and achieve true value added tax system (also referred to – as Goods and Service Tax) encompassing both goods and services at all levels. This, as compared to the earlier task of moving to value added tax system, is an even greater challenge in the political and constitutional structure of the country. But, given the resolve of the States to have a fairly simple to comply and less burdensome system of taxation, India will achieve the target set by Finance Minister of introducing a comprehensive Goods and Services Tax (GST) by 2010.

2 Scope of this Concept Paper

2.1 This Concept Paper suggests GST Model for the country that could be adopted in short term and identifies issues that arise in designing and implementation of comprehensive GST in India.

3 Design Alternatives

3.1 There are a variety of models for taxation of goods and services. All models either adopt one of the following principles or are derived from a combination of:

– Origin based single point levy (e.g. excise duties)

– Destination based single point levy (e.g. retail sales tax)

– Destination based multi point levy with input tax credit mechanism (e.g. GST/VAT).

3.2 The models may be comprehensive covering all goods and services or be selective, applicable only to specified goods and/or services.

3.3 The model may provide for levy of taxes at all stages or only at specified stages of value chain from manufacture to consumption. The stage at which tax is imposed may also vary between commodities and services.

3.4 All these combinations result in a wide variety of models adopted across countries. Different countries adopt different models for taxing goods and services to suit their own situations. Vast majority of countries, during the last 50 years, have moved to destination based system for taxation of goods and services. Some start at the origin and follow the goods through its journey from origin to destination e.g. countries in the European Union, Australia, Canada whereas some levy tax at retail level (e.g. USA). More than 100 countries have adopted Value Added Tax (VAT) system with input tax credit mechanism covering transactions from origin (manufactured or imported into the country) to destination (final consumption). The VAT system adopted by countries varies from what could be described as "classic" VAT system encompassing all transactions of sale/supply of goods and services in the economy at all levels, from manufacturing to consumption, to modified versions applicable only to select goods and/or services, applied upto different stages of value chain.

3.5 The design of model depends a great deal on the nature of activities in the economy, level of growth of economy, sizes of businesses, political structure, Constitutional powers, stage of advancement of the economy and like. No one model can be said to be ideal for all countries.

3.6 Thus, India will have to design its own model to suit its own requirements especially, given the federal structure of governance and the provisions of Constitution.

4 India’s Current Model

4.1 India currently has a mixed system of taxation of goods and services; it is not “classic” VAT or GST system although the taxes on goods are described as “VAT” at both Central and State level on goods and it has adopted value added tax principle with input tax credit mechanism for taxation of goods and services.

4.2 Until introduction of MODVAT (now CENVAT) Scheme in 1986 in Central Excise Duty, that duty was an origin based single point taxation system on manufacture of goods with some exceptions where set off scheme was used to reduce cascading effect of taxes. At that time, at State level, variety of schemes were used like origin based single point system, multi point system with set off, last point (retail level) system and so on. This was, again, not standard even within a State. States adopted different systems for different commodities too. Even now, with introduction of State VAT, there is combination of origin based (Central Sales Tax) and destination based multi point system of taxation. CENVAT is only at manufacturing level and does not go upto retail level.

4.3 Similarly, there was no union level tax on services till introduction of Service Tax in 1994 although, there was and there continues selective levy by States of Service Tax on specified services like entertainment tax, electricity duty etc.. Even now, Union Service Tax is not comprehensive; it is levied on large number of select services and there is no comprehensive Service Tax at State Level. The “VAT” at Union as well as State Level is on goods only except that at the Union level there is input tax credit mechanism between CENVAT and Service Tax.

4.4 Principal differences between the current structure and classic VAT are:

- Two separate VAT systems operate simultaneously at two levels, Centre and State, and tax paid under one is not available as set off (input tax credit) against the other.
- Tax on services and on goods is under separate legislations at Centre Level.
- There is no comprehensive taxation of services at the State level – few services are taxed under separate enactments.
- Imports in the country are not subjected to VAT.

4.5 Current structure of indirect taxes is, thus, in a sense, dual one where tax on activity of manufacture and provision of services is collected by Union Government and that on sale of goods is collected by State Governments (refer Annexure 1). Relevant provisions of Constitution are in Annexure 2.

4.6 Finance Commission determines the overall and individual share of states in the taxes collected by Union. The overall share of states in taxes at present is 30.5 % 1of the total taxes collected by Union Government from all taxes i.e. direct and indirect.

5 GST – Alternative models and issues

5.1 Design of a GST model involves three key components:

- Determination of the system – origin based, destination based, single point, multi point and so on
- Identification of activities and/or goods and services to be covered under each system
- Determination of level of government imposing and collecting GST.

5.2 There is a fair degree of consensus in India so far as system is concerned; we have adopted and are moving towards consolidation of goods and services tax under destination based multi point system of taxation. Also, there is fair degree of consensus so far as coverage of activities and goods and services are concerned; we will, like most other countries, continue to have customs duty which would not be rebatable and rest of the principal taxes i.e. CENVAT, State VAT and Service Taxes would form part of proposed GST.

5.3 Few other issues remain to be addressed like whether stamp duty should also become part of GST, which are other taxes being levied by each of the states and to determine whether they should become part of GST or remain out of it. Stamp duty, being more in the nature of tax on property, rather than on transaction, ought to remain outside GST as is the position in other countries. However, to the extent, stamp duties are imposed on agreements involving sale of goods and/or provision of services (e.g. agreement for works contract in the State of Maharashtra), the same ought to be removed. Similar issue relates to octroi which is currently levied by various municipalities and, in some cases, by states on entry of goods in the local area for use, consumption or sale therein. This also ought to be merged with GST and a mechanism to transfer resources to local authorities from out of the total revenues of the states needs to be worked out.

5.4 This Concept Paper thus addresses the third key component on which consensus building is in progress. This component of the design is relevant for a country having federal structure of governance (e.g. Canada, Brazil or, for that matter, even European Union).

5.5 There are three alternatives in this context:

- GST at Union Government Level only (Alternative I)
- GST at State Government Level only (Alternative II)
- GST at both, Union and State Government Levels (Alternative III).

5.6 Canada has GST at Union Level extending to all goods and services covering all stages of value addition. In addition, there is tax at Province (State) level in different forms which include VAT, Retail Sales tax and so on. European Union (EU) nations (each one is independent nation but, part of a Union and have agreed to adopt common principles for taxation of goods and services) have adopted "classic" VAT. If we consider EU as a country equivalent and member nations as state equivalents, EU has only State Level VAT with special rules for intra-community (inter-member state) transactions.

5.7 In the Indian context, an additional dimension is added by the provisions of Constitution which specifically reserve power to impose tax on specific activities to specific level of government e.g. tax on import of goods can be imposed by Union Government only whereas tax on sale of goods involving movement of goods within the state can be imposed by State Governments only.

6 Analysis

6.1 Alternative I: GST at Union Level Only

This Model envisages principal indirect taxes on goods and services to be levied by Union Government only. No such taxes to be levied by State Governments leading to only one GST throughout the country.

Pros

- Ideal structure from business perspective – greater stability and facilitation of decision making – also, businesses will have to deal with only one tax authority and comply with only one tax - there will be significant reduction of compliance costs.

- Excellent from consumer perspective as the consumer will know exactly how much is the indirect tax burden in the goods and service consumed by it.
- Cascading effect can be removed to a large extent as there will not be taxes at two levels leading to improved competitiveness.
- Feel good factor for any one doing business with the country.

Cons

- Near impossibility of achieving the structure – will require modification of Constitution.
- States may not agree to give up power of taxation and depend on the Union for resources.
- Entire infrastructure developed for taxation at both levels will have to undergo huge change.

6.2 Alternative II : GST at State Level Only

This Model envisages levy of GST by State Governments only meaning only State specific GST across the country and no GST by Union Government.

Pros

- Reduction of cascading effect of taxes as there will not be tax at two levels.

Cons

- Amendment(s) will be required in Constitution which may be supported by industrial and large States and opposed by smaller States which do not have significant source of revenues.
- Businesses will have to comply with tax laws of each State – not worse off than current situation but not better off as well except that they will not have to deal with Central Level taxation which is the current position. At the same time, decision making will be impacted and may affect business stability.
- Governments, both local and Union will not find it workable as it will require complete change in its finances and allocation of resources -entire distribution of taxes will need to undergo changes - Centre can retain entire direct tax collection and States may retain indirect taxation collection. But, that too will not be workable as revenue collection by each State will vary depending on the

level of activities in each state and need for support to states – redistribution of taxes will become an issue.

- There may be unhealthy competition among states using local tax structure as a tool to attract investments within the states, which may be at the cost of other states. This could lead to retaliatory measures by other States.
- Entire infrastructure for taxation will have to undergo change as States will need additional resources whereas Union's infrastructure will be freed up.

6.3 Alternative III : GST at both levels

This model envisages GST at two levels operating parallelly – one, at Union Level and another at State Level.

Pros

- Achievable in the short term.
- No significant change required in the current structure of indirect taxation although, some amendments may be required to the Constitution.
- Partial removal of cascading effect of taxes.
- No change required in infrastructure of tax departments at the Union and State levels.

Cons

- Not ideal model – tax would continue to be at two levels and compliance costs may not reduce significantly.
- Constitutional amendments may be required – principal one being extension of CENVAT to the consumer level and granting authority to states to impose taxes on services.
- Uncertainty of states changing laws, rates of taxation and like will continue affecting business sentiments.
- Taxation of services at state level especially services provided nation wide (e.g. telecommunication service, transportation service) will pose challenge.

6.4 Suggested GST Model

We suggest that Alternative III - GST at two levels – Union and State operating parallelly be adopted to begin with this reform process. Although, it is not ideal Model, we recommend the same to – kick start the move to GST as:

- It is the most workable model especially taking into consideration the changes required in the Constitution and achievability in the short term.
- This Model builds on the current structure of taxation of goods and services and does not envisage drastic changes in the broad mechanism for levy and collection of taxes.
- It results in allocation of taxes between Union and States and between states based on fair and transparent criteria of consumption within a State.

6.5 Implementation Imperatives

This implementation of this suggested Model will require following steps:

- Constitutional Amendments :
  - Consolidate separate Entries in the Constitution empowering Union and State Governments to impose taxes on manufacture and sale of goods and services into one Entry which empowers both Union and State Governments to impose tax on sale and supply of goods and services (Refer Annexure 2 for relevant entries).
  - Alternatively, modify Constitution only to the extent required immediately specifically, to extend CENVAT to consumer level and to authorize States to collect and retain tax on services.
- **Amend CST law** to introduce VAT on import of goods and **introduce import VAT** – tax on imports is within the jurisdiction of Union Government and Union Government could appropriate it to the State Governments. This collection would need to be allocated to the states where the goods move on importation since that is the state where the sale will take place and which will give credit for import VAT against output VAT.
- **Consolidate taxes on services** imposed under different enactments by State Governments e.g., duty on entertainment, and electricity, luxury tax.
- **Consolidate taxes on goods and services at each Union Level and State Level.**

  This will require many steps, significant ones being:

- – bringing into effect provision empowering State Governments to collect and retain Service Tax; determination of services which could be taxed at both levels and those which could be taxed only by Union Government. Ideally, all services ought to be taxed at both levels as services are used by businesses for making sales or providing services which could be taxable at either or both levels and non availability of input tax credit could lead to cascading. At the same time, considering difficulties of developing structure or taxation of services which are nationwide such that there is no double taxation or no taxation is extremely tough task and, therefore, to begin with, some services like telecommunication, transportation, banking and financial services could be retained at the Union level.

- – enacting comprehensive GST law (Standard draft could be used at both levels) consolidating CENVAT and Service Tax at Union Level and State VAT and taxes on various services at the state level.

- – determination of tax system for sales and services involving inter-state movements. A Concept Paper on these issues is under development at Fiscal Law Committee.

- – Determination of GST rate at Union and State Levels – Current standard rate of 16% adopted for CENVAT can be lowered and possibly brought down with extension of CENVAT to consumer level due to additional revenue to be generated from subsequent value addition which is currently not captured although, some part of it is already captured under Service Tax. Similarly, the standard rate of State VAT of 12.5 % could be reduced as additional resources will be generated from taxation of services.

- – Developing standard system of classification to be adopted by both Union and States -the current system adopted for Customs and CENVAT may be adopted by the States with separate list of items of local nature which may not find place in Customs or CENVAT classification list.

- – Determination of exemption threshold – the threshold at Union level, is currently Rs 200 lakhs (SSI Exemptions) whereas that for services is Rs 8 lakhs and atSstate level it is, generally, Rs. 5 lakhs.

- Consequential changes in determination of share of States in Union Tax collection may also be required.

Annexure 1

Broad overview of current structure of principal Indirect Taxes

1. Import of goods into India

Imports are subjected to customs duty which is imposed and administered by Union Government.

Customs duty has different components; the principal ones being Basic Customs Duty and Additional Customs Duty. Current rate of Basic Customs Duty is 10%. Additional Customs Duty is equivalent to CENVAT (Central Value Added Tax) imposed and administered by Union Government. This component is creditable against CENVAT if imported products are used for manufacture of Cenvatable goods in India and against Service Tax if imported goods are used in providing taxable services. The standard rate of CENVAT is 16 %.

Imports are not subjected to import VAT as of now since VAT is imposed by State Governments and State Governments do not have power to impose tax on imports; that power is with the Union Government only.

2. Manufacture in India

The activity of manufacture is subjected to CENVAT levied and administered by Union Government.

CENVAT has a VAT mechanism and is creditable against CENVAT and Service tax. As CENVAT is imposed by the Union Government, the rate of tax is uniform across the country (16 %) and no complications are created by movement of goods throughout the country. Export of goods outside India is freed of CENVAT and import of goods is subjected to CENVAT (See 1 above).

3. Sale of goods in India

This activity, to the extent the sale involves intra-State movement, attracts State VAT (applicable in major states except state of Uttar Pradesh which has yet to transition to VAT system, it continues with the system of Sales Tax). This is a modified form of classic VAT. The principal difference is that it covers goods only. VAT paid in one state is creditable against VAT paid on purchase of goods within the same state only. The standard rates of VAT are 4% and 12.5% with few exceptions where goods are exempt or where higher rate of 20% applies.

There is reasonable degree of uniformity in classification and rate of tax across India and differences do exist.

If the transaction of sale involves movement of goods from one state of India to another state, it constitutes inter-state sale and is subject to Central Sales Tax (CST). CST is a Union levy but is administered by states and the revenue is retained by the state from which the movement of goods originates. It is an origin based levy. The standard rate of CST for sales to registered dealers in other states is 3% (reduced from 4% with effect from 1.4.2007 and will be reduced by 1% every year hereafter). All other states (direct to consumers) attract the VAT rate applicable in the originating state.

Many destination States i.e. the States receiving goods from another State, impose Entry Tax (often equivalent to VAT rate) on the goods entering the State for sale, consumption or use within the State. This Entry Tax is creditable against VAT when goods are sold in the state.

States have physical barriers to check entry of goods in the States.

Import of goods into India is not subjected to State VAT (see 1 above). Export of goods outside India is freed from VAT by different mechanisms.

4. Provision of services

These are subjected to Service Tax which is imposed and administered by the Union Government.

Service Tax is creditable against CENVAT (levied on manufacture of goods and) Service Tax. It is not creditable against state VAT. The standard rate of Service Tax is 12% and is the same across the country.

Specific services are subjected to tax by States principal being entertainment which is taxed fairly heavily by states and rates vary from State to State.

Annexure 2

Relevant Articles of Constitution : *Refer Chapter B-3 of this Book*

Relevant Entries in Lists I and II as contained in the Seventh Schedule to the Constitution: *Refer Chapter B-4 of this Book*

B-3
RELEVANT ARTICLES OF THE CONSTITUTION OF INDIA

245. Extent of laws made by Parliament and by the Legislatures of States

(1) Subject to the provisions of this Constitution, Parliament may make laws for the whole or any part of the territory of India, and the Legislature of a State may make laws for the whole or any part of the State.

(2) No law made by Parliament shall be deemed to be invalid on the ground that it would have extra-territorial operation.

246. Subject-matter of laws made by Parliament and by the Legislatures of States

(1) Notwithstanding anything in clauses (2) and (3), Parliament has exclusive power to make laws with respect to any of the matters enumerated in List I in the Seventh Schedule (in this Constitution referred to as the "Union List").

(2) Notwithstanding anything in clause (3), Parliament, and, subject to clause (1), the Legislature of any State also, have power to make laws with respect to any of the matters enumerated in List III in the Seventh Schedule (in this Constitution referred to as the "Concurrent List").

(3) Subject to clauses (1) and (2), the Legislature of any State has exclusive power to make laws for such State or any part thereof with respect to any of the matters enumerated in List II in the Seventh Schedule (in this Constitution referred to as the "State List"').

(4) Parliament has power to make laws with respect to any matter for any part of the territory of India not included in a State notwithstanding that such matter is a matter enumerated in the State List.

248. Residuary powers of legislation

(1) Parliament has exclusive power to make any law with respect to any matter not enumerated in the Concurrent List or State List.

(2) Such power shall include the power of making any law imposing a tax not mentioned in either of those Lists.

249. Power of Parliament to legislate with respect to a matter in the State List in the national interest

(1) Notwithstanding anything in the foregoing provisions of this Chapter, if the Council of States has declared by resolution supported by not less than two-thirds of the members present and voting that it is necessary or expedient in the national interest that Parliament should make laws with respect to any matter enumerated in the State List specified in the resolution, it shall be lawful for Parliament to make laws for the whole or any part of the territory of India with respect to that matter while the resolution remains in force.

(2) A resolution passed under clause (1) shall remain in force for such period not exceeding one year as may be specified therein:

Provided that, if and so often as a resolution approving the continuance in force of any such resolution is passed in the manner provided in clause (1), such resolution shall continue in force for a further period of one year from the date on which under this clause it would otherwise have ceased to be in force.

(3) A law made by Parliament which Parliament would not but for the passing of a resolution under clause (1) have been competent to make shall, to the extent of the incompetency, cease to have effect on the expiration of a period of six months after the resolution has ceased to be in force, except as respects things done or omitted to be done before the expiration of the said period.

265. Taxes not to be imposed save by authority of law

No tax shall be levied or collected except by authority of law.

268. Duties levied by the Union but collected and appropriated by the States

(1) Such stamp duties and such duties of excise on medicinal and toilet preparations as are mentioned in the Union List shall be levied by the Government of India but shall be collected—

(a) in the case where such duties are leviable within any Union territory, by the Government of India, and

(b) in other cases, by the States within which such duties are respectively leviable.

(2) The proceeds in any financial year of any such duty leviable within any State shall not form part of the Consolidated Fund of India, but shall be assigned to that State.

268A. Service tax levied by Union and collected and appropriated by the Union and the States

(1) Taxes on services shall be levied by the Government of India and such tax shall be collected and appropriated by the Government of India and the States in the manner provided in clause (2).

(2) The proceeds in any financial year of any such tax levied in accordance with the provisions of clause (1) shall be –

(a) collected by the Government of India and the States;

(b) appropriated by the Government of India and the States,

in accordance with such principles of collection and appropriation as may be formulated by Parliament by law.

269. Taxes levied and collected by the Union but assigned to the States

(1) Taxes on the sale or purchase of goods and taxes on the consignment of goods shall be levied and collected by the Government of India but shall be assigned and shall be deemed to have been assigned to the States on or after the 1st day of April, 1996 in the manner provided in clause (2).

Explanation.—For the purposes of this clause, -

(a) the expression "taxes on the sale or purchase of goods" shall mean taxes on sale or purchase of goods other than newspapers, where such sale or purchase takes place in the course of inter-State trade or commerce;

(b) the expression "taxes on the consignment of goods" shall mean taxes on the consignment of goods (whether the consignment is to the person making it or to any other person), where such consignment takes place in the course of inter-State trade or commerce.

(2) The net proceeds in any financial year of any such tax, except in so far as those proceeds represent proceeds attributable to Union territories, shall not form part of the Consolidated Fund of India, but shall be assigned to the States within which that tax is leviable in that year, and shall be distributed among

those States in accordance with such principles of distribution as may be formulated by Parliament by law.

(3) Parliament may by law formulate principles for determining when a sale or purchase of, or consignment of, goods takes place in the course of inter-State trade or commerce.

270. Taxes levied and distributed between the Union and the States

(1) All taxes and duties referred to in the Union List, except the duties and taxes referred to in Articles 268 and 269, respectively, surcharge on taxes and duties referred to in article 271 and any cess levied for specific purposes under any law made by Parliament shall be levied and collected by the Government of India and shall be distributed between the Union and the States in the manner provided in clause (2).

(2) Such percentage, as may be prescribed, of the net proceeds of any such tax or duty in any financial year shall not form part of the Consolidated Fund of India, but shall be assigned to the States within which that tax or duty is leviable in that year, and shall be distributed among those States in such manner and from such time as may be prescribed in the manner provided in clause (3).

(3) In this Article, "prescribed" means, —

(i) until a Finance Commission has been constituted, prescribed by the President by order, and

(ii) after a Finance Commission has been constituted, prescribed by the President by order after considering he recommendations of the Finance Commission.

271. Surcharge on certain duties and taxes for purposes of the Union

Notwithstanding anything in Articles 269 and 270, Parliament may at any time increase any of the duties or taxes referred to in those articles by a surcharge for purposes of the Union and the whole proceeds of any such surcharge shall form part of the Consolidated Fund of India.

274. Prior recommendation of President required to Bills affecting taxation in which States are interested

(1) No Bill or amendment which imposes or varies any tax or duty in which States are interested, or which varies the meaning of the expression "agricultural income" as defined for the purposes of the enactments relating to Indian income-tax, or which affects the principles on which under any of the foregoing provisions of this Chapter moneys are or may be distributable to States, or which imposes any such surcharge for the purposes of the Union as is mentioned in the foregoing provisions of this Chapter, shall be introduced or moved in either House of Parliament except on the recommendation of the President.

(2) In this Article, the expression "tax or duty in which States are interested" means—

(a) a tax or duty the whole or part of the net proceeds whereof are assigned to any State; or

(b) a tax or duty by reference to the net proceeds whereof sums are for the time being payable out of the Consolidated Fund of India to any State.

276. Taxes on professions, trades, callings and employments

(1) Notwithstanding anything in Article 246, no law of the Legislature of a State relating to taxes for the benefit of the State or of a Municipality, District Board, Local Board or other local authority therein in respect of professions, trades, callings or employments shall be invalid on the ground that it relates to a tax on income.

(2) The total amount payable in respect of any one person to the State or to any one municipality, district board, local board or other local authority in the State by way of taxes on professions, trades, callings and employments shall not exceed two thousand and five hundred rupees per annum.

(3) The power of the Legislature of a State to make laws as aforesaid with respect to taxes on professions, trades, callings and employments shall not be construed as limiting in any way the power of Parliament to make laws with respect to taxes on income accruing from or arising out of professions, trades, callings and employments.

286. Restrictions as to imposition of tax on the sale or purchase of goods

(1) No law of a State shall impose, or authorise the imposition of, a tax on the sale or purchase of goods where such sale or purchase takes place—

(a) outside the State; or

(b) in the course of the import of the goods into, or export of the goods out of, the territory of India.

(2) Parliament may by law formulate principles for determining when a sale or purchase of goods takes place in any of the ways mentioned in clause (1).

(3) Any law of a State shall, in so far as it imposes, or authorises the imposition of,—

(a) a tax on the sale or purchase of goods declared by Parliament by law to be of special importance in inter-State trade or commerce; or

(b) a tax on the sale or purchase of goods, being a tax of the nature referred to in sub-clause (b), sub-clause (c) or sub-clause (d) of clause (29A) of Article 366,

be subject to such restrictions and conditions in regard to the system of levy, rates and other incidents of the tax as Parliament may by law specify.

287. Exemption from taxes on electricity

Save in so far as Parliament may by law otherwise provide, no law of a State shall impose, or authorise the imposition of, a tax on the consumption or sale of electricity (whether produced by a Government or other persons) which is—

(a) consumed by the Government of India, or sold to the Government of India for consumption by that Government; or

(b) consumed in the construction, maintenance or operation of any railway by the Government of India or a railway company operating that railway, or sold to that Government or any such railway company for consumption in the construction, maintenance or operation of any railway,

and any such law imposing, or authorising the imposition of, a tax on the sale of electricity shall secure that the price of electricity sold to the Government of India for consumption by that Government, or to any such railway company as aforesaid for consumption in the construction, maintenance or operation of any railway, shall be less by the amount of the tax than the price charged to other consumers of a substantial quantity of electricity.

288. Exemption from taxation by States in respect of water or electricity in certain cases

(1) Save in so far as the President may by order otherwise provide, no law of a State in force immediately before the commencement of this Constitution shall impose, or authorise the imposition of, a tax in respect of any water or electricity stored, generated, consumed, distributed or sold by any authority established by any existing law or any law made by Parliament for regulating or developing any inter-State river or river-valley.

Explanation.—The expression "law of a State in force" in this clause shall include a law of a State passed or made before the commencement of this Constitution and not previously repealed, notwithstanding that it or parts of it may not be then in operation either at all or in particular areas.

(2) The Legislature of a State may by law impose, or authorise the imposition of, any such tax as is mentioned in clause (1), but no such law shall have any effect unless it has, after having been reserved for the consideration of the President, received his assent; and if any such law provides for the fixation of the rates and other incidents of such tax by means of rules or orders to be made under the law by any authority, the law shall provide for the previous consent of the President being obtained to the making of any such rule or order.

301. Freedom of trade, commerce and intercourse

Subject to the other provisions of this Part, trade, commerce and intercourse throughout the territory of India shall be free.

302. Power of Parliament to impose restrictions on trade, commerce and intercourse

Parliament may by law impose such restrictions on the freedom of trade, commerce or intercourse between one State and another or within any part of the territory of India as may be required in the public interest.

303. Restrictions on the legislative powers of the Union and of the States with regard to trade and commerce

(1) Notwithstanding anything in article 302, neither Parliament nor the Legislature of a State shall have power to make any law giving, or authorising the giving

of, any preference to one State over another, or making, or authorising the making of, any discrimination between one State and another, by virtue of any entry relating to trade and commerce in any of the Lists in the Seventh Schedule.

(2) Nothing in clause (1) shall prevent Parliament from making any law giving, or authorising the giving of, any preference or making, or authorising the making of, any discrimination if it is declared by such law that it is necessary to do so for the purpose of dealing with a situation arising from scarcity of goods in any part of the territory of India.

304. Restrictions on trade, commerce and intercourse among States

Notwithstanding anything in Article 301 or Article 303, the Legislature of a State may by law—

(a) impose on goods imported from other States or the Union territories any tax to which similar goods manufactured or produced in that State are subject, so, however, as not to discriminate between goods so imported and goods so manufactured or produced; and

(b) impose such reasonable restrictions on the freedom of trade, commerce or intercourse with or within that State as may be required in the public interest:

Provided that no Bill or amendment for the purposes of clause (b) shall be introduced or moved in the Legislature of a State without the previous sanction of the President.

366 Definition

In this Constitution, unless the context otherwise requires, the following expressions have meaning hereby respectively assigned to them, that is to say:

(12) 'goods' includes all materials, commodities and articles;

(28) "taxation" includes the imposition of any tax or impost, whether general or local or special, and "tax" shall be construed accordingly;

(29-A) "tax on the sale or purchase of goods" includes -

(a) a tax on the transfer, otherwise than in pursuance of a contract, of property in any goods for cash, deferred payment or other valuable consideration;

(b) a tax on the transfer of property in goods (whether as goods or in some other form) involved in the execution of a works contract;

(c) a tax on the delivery of goods on hire-purchase or any system of payment by installments;

(d) a tax on the transfer of the right to use any goods for any purpose (whether or not for a specified period) for cash deferred payment or other valuable consideration;

(e) a tax on the supply of goods by any unincorporated association or body of person to a member thereof for cash, deferred or other valuable consideration;

(f) a tax on the supply, by way of or as part of any service or in any other manner whatsoever, of goods, being food or any other article for human consumption or any drink (whether or not intoxicating), where such supply or service, is for cash, deferred payment or other valuable consideration; and such transfer, delivery or supply of any goods shall be deemed to be a sale of those goods by the person making the transfer, delivery or supply and a purchase of those goods by the person to whom such transfer, delivery or supply is made.

B-4
ENTRIES IN SCHEDULE VII TO THE CONSTITUTION OF INDIA (RELATING TO INDIRECT TAXES)

List I—Union List

83. Duties of customs including export duties.

84. Duties of excise on tobacco and other goods manufactured or produced in India except—

    (a) alcoholic liquors for human consumption;

    (b) opium, Indian hemp and other narcotic drugs and narcotics,

    but including medicinal and toilet preparations containing alcohol or any substance included in sub-paragraph (b) of this entry.

89. Terminal taxes on goods or passengers, carried by railway, sea or air; taxes on railway fares and freights.

90. Taxes other than stamp duties on transactions in stock exchanges and futures markets.

91. Rates of stamp duty in respect of bills of exchange, cheques, promissory notes, bills of lading, letters of credit, policies of insurance, transfer of shares, debentures, proxies and receipts.

92. Taxes on the sale or purchase of newspapers and on advertisements published therein.

92A. Taxes on the sale or purchase of goods other than newspapers, where such sale or purchase takes place in the course of inter-State trade or commerce.

92B. Taxes on the consignments of goods (whether the consignment is to the person making it or to any other person), where such consignment takes place in the course of inter-State trade or commerce.

92C. Taxes on services.

97. Any other matter not enumerated in List II or List III including any tax not mentioned in either of those Lists.

List II—State List

45. Land revenue, including the assessment and collection of revenue, the maintenance of land records, survey for revenue purposes and records of rights, and alienation of revenues.

47. Duties in respect of succession to agricultural land.

49. Taxes on lands and buildings.

50. Taxes on mineral rights subject to any limitations imposed by Parliament by law relating to mineral development.

51. Duties of excise on the following goods manufactured or produced in the State and countervailing duties at the same or lower rates on similar goods manufactured or produced elsewhere in India:—

(a) alcoholic liquors for human consumption;

(b) opium, Indian hemp and other narcotic drugs and narcotics,

but not including medicinal and toilet preparations containing alcohol or any substance included in sub-paragraph (b) of this entry.

52. Taxes on the entry of goods into a local area for consumption, use or sale therein.

53. Taxes on the consumption or sale of electricity.

54. Taxes on the sale or purchase of goods other than newspapers, subject to the provisions of Entry 92A of List I.

55. Taxes on advertisements other than advertisements published in the newspapers and advertisements broadcast by radio or television.

56. Taxes on goods and passengers carried by road or on inland waterways.

57. Taxes on vehicles, whether mechanically propelled or not, suitable for use on roads, including tramcars subject to the provisions of Entry 35 of List III.

58. Taxes on animals and boats.

59. Tolls.

60. Taxes on professions, trades, callings and employments.

61. Capitation taxes.

62. Taxes on luxuries, including taxes on entertainments, amusements, betting and gambling.

63. Rates of stamp duty in respect of documents other than those specified in the provisions of List I with regard to rates of stamp duty.

66. Fees in respect of any of the matters in this List, but not including fees taken in any court.

List III—Concurrent List

44. Stamp duties other than duties or fees collected by means of judicial stamps, but not including rates of stamp duty.

47. Fees in respect of any of the matters in this List, but not including fees taken in any court.

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FIRST DISCUSSION PAPER ON GOODS AND SERVICES TAX IN INDIA

The Empowered Committee of State Finance Ministers
New Delhi
November 10, 2009

Foreword

If the Value Added Tax (VAT) is considered to be a major improvement over the pre-existing Central excise duty at the national level and the sales tax system at the State level, then the Goods and Services Tax (GST) will be a further significant breakthrough - the next logical step - towards a comprehensive indirect tax reform in the country.

Keeping this overall objective in view, an announcement was made by Shri P. Chidambaram, the then Union Finance Minister in the Central Budget (2007-2008) to the effect that GST would be introduced from April 1, 2010 and that the Empowered Committee of State Finance Ministers, on his request, would work with the Central Government to prepare a road map for introduction of GST in India. After this announcement, the Empowered Committee of State Finance Ministers decided to set up a Joint Working Group (May 10, 2007), with the then Adviser to the Union Finance Minister and the Member-Secretary of Empowered Committee as Co-convenors and the concerned Joint Secretaries of the Department of Revenue of Union Finance Ministry and all Finance Secretaries of the States as its members. This Joint Working Group, after intensive internal discussions as well as interaction with experts and representatives of Chambers of Commerce and Industry, submitted its report to the Empowered Committee (November 19, 2007).

This report was then discussed in detail in the meeting of Empowered Committee (November 28, 2007). On the basis of this discussion and written observations of the States, certain modifications were made and a final version of the views of Empowered Committee at that stage was prepared and was sent to the Government of India (April 30, 2008). The comments of the Government of India were received on December 12, 2008 and were duly considered by the Empowered Committee (December 16, 2008). It was decided that a Committee of Principal Secretaries/Secretaries of Finance/Taxation and Commissioners of Trade Taxes of the States would be set up to consider these comments, and submit their views. These views were submitted and were accepted in principle by the Empowered Committee (January 21, 2009). Consequent upon this in-principle acceptance, a Working Group, consisting of the concerned officials of the State Governments was formed who, in close association with senior representatives of the Government of India, submitted their recommendations in detail on the structure of GST. An important interaction has also recently taken place between Shri Pranab Mukherjee, the Union Finance Minister and the Empowered Committee (October 19, 2009) on the related issue of compensation for loss of the States on account of phasing out of CST. The Empowered Committee has now taken a detailed view on the recommendations of the Working Group of officials and other related matters. This detailed view of the Empowered Committee on the structure of GST is now presented in terms of the First Discussion Paper, along with an Annexure on Frequently Asked Questions and Answers on GST, for discussions with industry, trade, agriculture and people at large.

The Discussion Paper is divided into four sections. Since GST would be further improvement over the VAT, Section 1 begins with a brief reference to the process of introduction of VAT at the Centre and the States and also indicates the precise points where there is a need for further improvement. This section also shows how the GST can bring about this improvement. With this as the background for justification of GST, Section 2 then describes the process of preparation for GST. Thereafter, Section 3 presents in detail the comprehensive structure of the GST model. For illustrating this GST model further, there is in the end an Annexure on Frequently Asked Questions and Answers.

This Discussion Paper has been the result of truly collective efforts on the basis of hardwork of all the concerned officials of the States, the officials of Empowered Committee Secretariat and the Adviser and officials of the Union Finance Ministry, the counsel and active participation of Finance Ministers and concerned Senior

Ministers of the States at each stage, and the encouragement and advice of the Union Finance Minister.

With the release of this First Discussion Paper and the Annexure on Frequently Asked Questions and Answers, we now sincerely invite interaction with the representatives of industry, trade, agriculture and common people. This interaction and campaign will immediately start at the national level and at the State levels. As a part of this interaction, we look forward to receiving the views of industry, trade, agriculture as well as consumers in a time-bound manner.

Asim Kumar Dasgupta
Chairman,
Empowered Committee of
State Finance Ministers
&
Minister of Finance & Excise,
Government of West Bengal

New Delhi, November 10, 2009

1. Introduction

1.1 Introduction of the Value Added Tax (VAT) at the Central and the State level has been considered to be a major step – an important breakthrough – in the sphere of indirect tax reforms in India. If the VAT is a major improvement over the pre-existing Central excise duty at the national level and the sales tax system at the State level, then the Goods and Services Tax (GST) will indeed be a further significant improvement – the next logical step – towards a comprehensive indirect tax reforms in the country.

1.2 Keeping this objective in view, an announcement was made by the then Union Finance Minister in the Central Budget (2007-08) to the effect that GST would be introduced with effect from April 1, 2010 and that the Empowered Committee of State Finance Ministers, on his request, would work with the Central Government to prepare a road map for introduction of GST in India. After this announcement, the Empowered Committee of State Finance Ministers decided to set up a Joint Working Group (May 10, 2007), with the then Adviser to the Union Finance Minister and Member-Secretary of the Empowered Committee as its Co-convenors and concerned four Joint Secretaries of the Department of Revenue of Union Finance Ministry and all Finance Secretaries of the States as its members. This Joint Working Group got itself divided into three Sub-Groups and had several rounds of internal discussions as well as interaction with experts and representatives of Chambers of Commerce & Industry. On the basis of these discussions and interaction, the Sub-Groups submitted their reports which were then integrated and consolidated into the report of Joint Working Group (November 19, 2007).

1.3 This report was discussed in detail in the meeting of the Empowered Committee on November 28, 2007, and the States were also requested to communicate their observations on the report in writing. On the basis of these discussions in the Empowered Committee and the written observations, certain modifications were considered necessary and were discussed with the Co-convenors and the representatives of the Department of Revenue of Union Finance Ministry. With the modifications duly made, a final version of the views of Empowered Committee on the model and road map for the GST was prepared (April 30, 2008). These views of Empowered Committee were then sent to the Government of India, and the comments of Government of India were received on December 12, 2008. These comments were duly considered by the Empowered Committee (December 16, 2008), and it was decided that a Committee of Principal Secretaries/Secretaries of

Finance/Taxation and Commissioners of Trade Taxes of the States would be set up to consider these comments, and submit their views. These views were submitted and were accepted in principle by the Empowered Committee (January 21, 2009). As a follow-up of this in-principle acceptance, a Working Group consisting of the concerned officials of the State Governments was formed who, in association with senior representatives of Government of India, submitted their recommendations in detail on the structure of GST. An important interaction has also recently taken place between Shri Pranab Mukherjee, the Union Finance Minister and the Empowered Committee (October 19, 2009) on the related issue of compensation for loss of the States on account of phasing out of CST. The Empowered Committee has now taken a detailed view on the recommendations of the Working Group of officials and other related matters. This detailed view is now presented in terms of the First Discussion Paper, along with an Annexure on Frequently Asked Questions and Answers on GST, for discussion with industry, trade, agriculture and people at large. Since the GST at the Centre and States would be a further improvement over the VAT, a brief recalling of the process of introduction of VAT in India is worthwhile.

Value Added Tax at the Central and the State level

1.4 Prior to the introduction of VAT in the Centre and in the States, there was a burden of multiple taxation in the pre-existing Central excise duty and the State sales tax systems. Before any commodity was produced, inputs were first taxed, and then after the commodity got produced with input tax load, output was taxed again. This was causing a burden of multiple taxation (i.e. "tax on tax") with a cascading effect. Moreover, in the sales tax structure, when there was also a system of multi-point sales taxation at subsequent levels of distributive trade, then along with input tax load, burden of sales tax paid on purchase at each level was also added, thus aggravating the cascading effect further.

1.5 When VAT is introduced in place of Central excise duty, a set-off is given, i.e., a deduction is made from the overall tax burden for input tax. In the case of VAT in place of sales tax system, a set-off is given from tax burden not only for input tax paid but also for tax paid on previous purchases. With VAT, the problem of "tax on tax" and related burden of cascading effect is thus removed. Furthermore, since the benefit of set-off can be obtained only if tax is duly paid on inputs (in the case of Central VAT), and on both inputs and on previous purchases (in the case of State VAT), there is a built-in check in the VAT structure on tax compliance in the Centre as well as in the States, with expected results in terms of improvement in transparency and reduction in tax evasion. For these beneficial effects, VAT has now been introduced in more than 150 countries, including several federal countries. In Asia, it has now been introduced in almost all the countries.

1.6 In India, VAT was introduced at the Central level for a selected number of commodities in terms of MODVAT with effect from March 1, 1986, and in a step-by-step manner for all commodities in terms of CENVAT in 2002-03. Subsequently, after Constitutional Amendment empowering the Centre to levy taxes on services, these service taxes were also added to CENVAT in 2004-05. Although the growth of tax revenue from the Central excise has not always been specially high, the revenue growth of combined CENVAT and service taxes has been significant.

1.7 Introduction of VAT in the States has been a more challenging exercise in a federal country like India, where each State, in terms of Constitutional provision, is sovereign in levying and collecting State taxes. Before introduction of VAT, in the sales tax regime, apart from the problem of multiple taxation and burden of adverse cascading effect of taxes as already mentioned, there was also no harmony in the rates of sales tax on different commodities among the States. Not only were the rates of sales tax numerous (often more than ten in several States), and different from one another for the same commodity in different States, but there was also an unhealthy competition among the States in terms of sales tax rates – so-called "rate war" – often resulting in, revenue-wise, a counter-productive situation.

1.8 It is in this background that attempts were made by the States to introduce a harmonious VAT in the States, keeping at the same time in mind the issue of sovereignty of the States regarding the State tax matters.

The first preliminary discussion on State-level VAT took place in a meeting of Chief Ministers convened by Dr. Manmohan Singh, the then Union Finance Minister in 1995. In this meeting, the basic issues on VAT were discussed in general terms and this was followed up by periodic interactions of State Finance Ministers. Thereafter, in a significant meeting of all the Chief Ministers, convened on November 16, 1999 by Shri Yashwant Sinha, the then Union Finance Minister, two important decisions, among others, were taken. First, before the introduction of State-level VAT, the unhealthy sales tax "rate war" among the States would have to end, and sales tax rates would need to be harmonised by implementing uniform floor rates of sales tax for different categories of commodities with effect from January 1, 2000. Secondly, on the basis of achievement of the first objective, steps would be taken by the States for introduction of State-level VAT after adequate preparation. For implementing these decisions, a Standing Committee of State Finance Ministers was formed which was then made an Empowered Committee of State Finance Ministers.

1.9 Thereafter, the Empowered Committee has met regularly. All the decisions were taken on the basis of consensus. On the strength of these repeated discussions and collective efforts, involving the Ministers and the concerned officials, it was possible within a period of about a year and a half to achieve nearly 98 per cent success in the first objective, namely, harmonisation of sales tax structure through implementation of uniform floor rates of sales tax.

1.10 After reaching this stage, steps were initiated for systematic preparation for introduction of State-level VAT. In order again to avoid any unhealthy competition among the States which may lead to distortions in manufacturing and trade, attempts have been made from the very beginning to harmonise the VAT design in the States, keeping also in view the distinctive features of each State and the need for federal flexibility. This has been done by the States collectively agreeing, through discussions in the Empowered Committee, to certain common points of convergence regarding VAT, and allowing at the same time certain flexibility to accommodate the local characteristics of the States. In the course of these discussions, references to the Tenth Five Year Plan Report of the Advisory Group on Tax Policies & Tax Administration (2001) and the report of Kelkar (Chairman) Task Force were helpful.

1.11 Along with these measures, steps were taken for necessary training, computerization and interaction with trade and industry. While these preparatory steps were taken, the Empowered Committee got a significant support from Shri P. Chidambaram, the then Union Finance Minister, when he responded positively in providing Central financial support to the States in the event of loss of revenue in transitional years of implementation of VAT.

1.12 As a consequence of all these steps, the States started implementing VAT beginning April 1, 2005. After overcoming the initial difficulties, all the States and Union Territories have now implemented VAT. The Empowered Committee has been monitoring closely the process of implementation of State-level VAT, and deviations from the agreed VAT rates has been contained to less than 3 per cent of the total list of commodities. Responses of industry and also of trade have been indeed encouraging. The rate of growth of tax revenue has nearly doubled from the average annual rate of growth in the pre-VAT five year period after the introduction of VAT.

Justification of GST

1.13 Despite this success with VAT, there are still certain shortcomings in the structure of VAT both at the Central and at the State level. The shortcoming in CENVAT of the Government of India lies in non-inclusion of several Central taxes in the overall framework of CENVAT, such as additional customs duty, surcharges, etc., and thus keeping the benefits of comprehensive input tax and service tax set-off out of reach for manufacturers/ dealers. Moreover, no step has yet been taken to capture the value-added chain in the distribution trade below the manufacturing level in the existing scheme of CENVAT. The introduction of GST at the Central level will not only include comprehensively more indirect Central taxes and integrate goods and service taxes for the purpose of set-off relief, but may also lead to revenue gain for the Centre through widening of the dealer base by capturing value addition in the distributive trade and increased compliance.

1.14 In the existing State-level VAT structure there are also certain shortcomings as follows. There are, for instance, even now, several taxes which are in the nature of indirect tax on goods and services, such as luxury tax, entertainment tax, etc., and yet not subsumed in the VAT. Moreover, in the present State-level VAT scheme, CENVAT load on the goods remains included in the value of goods to be taxed under State VAT, and contributing to that extent a cascading effect on account of CENVAT element. This CENVAT load needs to be removed. Furthermore, any commodity, in general, is produced on the basis of physical inputs as well as services, and there should be integration of VAT on goods with tax on services at the State level as well, and at the same time there should also be removal of cascading effect of service tax. In the GST, both the cascading effects of CENVAT and service tax are removed with set-off, and a continuous chain of set-off from the original producer's point and service provider's point upto the retailer's level is established which reduces the burden of all cascading effects. This is the essence of GST, and this is why GST is not simply VAT plus service tax but an improvement over the previous system of VAT and disjointed service tax. However, for this GST to be introduced at the State-level, it is essential that the States should be given the power of levy of taxation of all services. This power of levy of service taxes has so long been only with the Centre. A Constitutional Amendment will be made for giving this power also to the States. Moreover, with the introduction of GST, burden of Central Sales Tax (CST) will also be removed. The GST at the State-level is, therefore, justified for (a) additional power of levy of taxation of services for the States, (b) system of comprehensive set-off relief, including set-off for cascading burden of

CENVAT and service taxes, (c) subsuming of several taxes in the GST and (d) removal of burden of CST. Because of the removal of cascading effect, the burden of tax under GST on goods will, in general, fall.

1.15 The GST at the Central and at the State level will thus give more relief to industry, trade, agriculture and consumers through a more comprehensive and wider coverage of input tax set-off and service tax setoff, subsuming of several taxes in the GST and phasing out of CST. With the GST being properly formulated by appropriate calibration of rates and adequate compensation where necessary, there may also be revenue/ resource gain for both the Centre and the States, primarily through widening of tax base and possibility of a significant improvement in tax-compliance. In other words, the GST may usher in the possibility of a collective gain for industry, trade, agriculture and common consumers as well as for the Central Government and the State Governments. The GST may, indeed, lead to the possibility of collectively positive-sum game.

2. Preparation for GST

2.1 Keeping this significance of GST in view, an announcement was made by the then Union Finance Minister in the Union Budget, as mentioned before, to the effect that GST would be introduced from April 1, 2010, and that the Empowered Committee of State Finance Ministers would work with the Central Government to prepare a road map for introduction of the GST. After this announcement, the Empowered Committee, as stated earlier, had set up a Joint Working Group which submitted a report on a model and road map for GST. After accommodating the views of the States appropriately on this report, the views of the Empowered Committee on the model and road map were sent to the Government of India on 30th April, 2008. The comments of the Government of India were received on 12th December, 2008. These comments were duly considered by the Empowered Committee in its meeting held on 16th December, 2008 and it was decided that a Committee of Principal Secretaries/Secretaries (Finance/Taxation) and Commissioners of Trade Taxes should consider the comments received from the Government of India and submit its views and also work out the Central GST and State GST rates. The Committee held detailed deliberations on 5th and 6th January, 2009, and submitted its recommendations to the Empowered Committee. The Empowered Committee considered these recommendations in its meeting held on 21st January, 2009 and accepted them in principle. The Empowered Committee also decided to constitute a Working Group consisting of Principal Secretaries/

Secretaries (Finance/Taxation) and Commissioners of Trade Taxes of all States/UTs to give their recommendations on (a) the commodities and services that should be kept in the exempted list, (b) the rules and principles of taxing the transactions of services including the transactions in inter-State services, and (c) finalization of the model suggested for inter-state transaction/movement of goods including stock transfers in consultation with the State Bank of India and some other nationalized banks. It was also decided that the senior representatives from the Government of India may also be associated. The Working Group deliberated on the issues on 10th February, 2009 and decided to form three Sub Working Groups to deliberate each item in depth. The Reports of the Working Group on the three issues have already been received, and the Empowered Committee has taken a view on these recommendations for concluding the details of GST structure.

While making this preparation of GST, it was also necessary, as mentioned earlier, to phase out the CST, because it did not carry any set-off relief and there was a distortion in the VAT regime due to export of tax from one State to other State. The Empowered Committee accordingly took a decision to phase out CST on the understanding with the Centre that, since phasing out of CST would result in a loss of revenue to the States on a permanent basis, an appropriate mechanism to compensate the States for such loss would be worked out. The rate of CST has already been reduced to 2% and will be phased out with effect from the date of introduction of GST on the basis of such GST structure which, with necessary financial support to the States, should adequately compensate for the loss of the States on a permanent basis. With these steps at preparation in mind, it is important now to turn to the proposed model of GST.

3. Goods & Services Tax Model For India

3.1 It is important to take note of the significant administrative issues involved in designing an effective GST model in a federal system with the objective of having an overall harmonious structure of rates. Together with this, there is a need for upholding the powers of Central and State Governments in their taxation matters. Further, there is also the need to propose a model that would be easily implementable, while being generally acceptable to stakeholders.

Salient features of the GST model

3.2 Keeping in view the report of the Joint Working Group on Goods and Services Tax, the views received from the States and Government of India, a dual GST structure with defined functions and responsibilities of the Centre and the States is recommended. An appropriate mechanism that will be binding on both the Centre and the States would be worked out whereby the harmonious rate structure along with the need for further modification could be upheld, if necessary with a collectively agreed Constitutional Amendment. Salient features of the proposed model are as follows:

(i) The GST shall have two components; one levied by the Centre (hereinafter referred to as Central GST), and the other levied by the States (hereinafter referred to as State GST). Rates for Central GST and State GST would be prescribed appropriately, reflecting revenue considerations and acceptability. This dual GST model would be implemented through multiple statutes (one for CGST and SGST statute for every State). However, the basic features of law such as chargeability, definition of taxable event and taxable person, measure of levy including valuation provisions, basis of classification etc. would be uniform across these statutes as far as practicable.

(ii) The Central GST and the State GST would be applicable to all transactions of goods and services made for a consideration except the exempted goods and services, goods which are outside the purview of GST and the transactions which are below the prescribed threshold limits.

(iii) The Central GST and State GST are to be paid to the accounts of the Centre and the States separately. It would have to be ensured that account-heads for all services and goods would have indication whether it relates to Central GST or State GST (with identification of the State to whom the tax is to be credited).

(iv) Since the Central GST and State GST are to be treated separately, taxes paid against the Central GST shall be allowed to be taken as input tax credit (ITC) for the Central GST and could be utilized only against the payment of Central GST. The same principle will be applicable for the State GST. A taxpayer or exporter would have to maintain separate details in books of account for utilization or refund of credit. Further, the rules for taking and utilization of credit for the Central GST and the State GST would be aligned.

(v) Cross utilization of ITC between the Central GST and the State GST would not be allowed except in the case of inter-State supply of goods and services under the IGST model which is explained later.

(vi) Ideally, the problem related to credit accumulation on account of refund of GST should be avoided by both the Centre and the States except in the cases such as exports, purchase of capital goods, input tax at higher rate than output tax etc. where, again refund/adjustment should be completed in a time bound manner.

(vii) To the extent feasible, uniform procedure for collection of both Central GST and State GST would be prescribed in the respective legislation for Central GST and State GST.

(viii) The administration of the Central GST to the Centre and for State GST to the States would be given. This would imply that the Centre and the States would have concurrent jurisdiction for the entire value chain and for all taxpayers on the basis of thresholds for goods and services prescribed for the States and the Centre.

(ix) The present threshold prescribed in different State VAT Acts below which VAT is not applicable varies from State to State. A uniform State GST threshold across States is desirable and, therefore, it is considered that a threshold of gross annual turnover of Rs.10 lakh both for goods and services for all the States and Union Territories may be adopted with adequate compensation for the States (particularly, the States in North-Eastern Region and Special Category States) where lower threshold had prevailed in the VAT regime. Keeping in view the interest of small traders and small scale industries and to avoid dual control, the States also considered that the threshold for Central GST for goods may be kept at Rs.1.5 crore and the threshold for Central GST for services may also be appropriately high. It may be mentioned that even now there is a separate threshold of services (Rs. 10 lakh) and goods (Rs. 1.5 crore) in the Service Tax and CENVAT.

(x) The States are also of the view that Composition/ Compounding Scheme for the purpose of GST should have an upper ceiling on gross annual turnover and a floor tax rate with respect to gross annual turnover. In particular, there would be a compounding cut-off at Rs. 50 lakh of gross annual turn over and a floor rate of 0.5% across the States. The scheme would also allow option for GST registration for dealers with turnover below the compounding cut-off.

(xi) The taxpayer would need to submit periodical returns, in common format as far as possible, to both the Central GST authority and to the concerned State GST authorities.

(xii) Each taxpayer would be allotted a PAN-linked taxpayer identification number with a total of 13/15 digits. This would bring the GST PAN-linked system in line with the prevailing PAN-based system for Income tax, facilitating data exchange and taxpayer compliance.

(xiii) Keeping in mind the need of tax payer's convenience, functions such as assessment, enforcement, scrutiny and audit would be undertaken by the authority which is collecting the tax, with information sharing between the Centre and the States.

Central and State Taxes to be subsumed under GST

3.3 The various Central, State and Local levies were examined to identify their possibility of being subsumed under GST. While identifying, the following principles were kept in mind:

(i) Taxes or levies to be subsumed should be primarily in the nature of indirect taxes, either on the supply of goods or on the supply of services.

(ii) Taxes or levies to be subsumed should be part of the transaction chain which commences with import/ manufacture/ production of goods or provision of services at one end and the consumption of goods and services at the other.

(iii) The subsumation should result in free flow of tax credit in intra and inter-State levels.

(iv) The taxes, levies and fees that are not specifically related to supply of goods & services should not be subsumed under GST.

(v) Revenue fairness for both the Union and the States individually would need to be attempted.

3.4 On application of the above principles, it is recommended that the following Central Taxes should be, to begin with, subsumed under the Goods and Services Tax:

(i) Central Excise Duty

(ii) Additional Excise Duties

(iii) The Excise Duty levied under the Medicinal and Toiletries Preparation Act

(iv) Service Tax

(v) Additional Customs Duty, commonly known as Countervailing Duty (CVD)

(vi) Special Additional Duty of Customs - 4% (SAD)

(vii) Surcharges, and

(viii) Cesses.

Following State taxes and levies would be, to begin with, subsumed under GST:

(i)	VAT / Sales tax
(ii)	Entertainment tax (unless it is levied by the local bodies).
(iii)	Luxury tax
(iv)	Taxes on lottery, betting and gambling.
(v)	State Cesses and Surcharges in so far as they relate to supply of goods and services.
(vi)	Entry tax not in lieu of Octroi.

Purchase tax: Some of the States felt that they are getting substantial revenue from Purchase Tax and, therefore, it should not be subsumed under GST while majority of the States were of the view that no such exemptions should be given. The difficulties of the food grains producing States and certain other States were appreciated as substantial revenue is being earned by them from Purchase Tax and it was, therefore, felt that in case Purchase Tax has to be subsumed then adequate and continuing compensation has to be provided to such States. This issue is being discussed in consultation with the Government of India.

Tax on items containing Alcohol: Alcoholic beverages would be kept out of the purview of GST. Sales Tax/VAT can be continued to be levied on alcoholic beverages as per the existing practice. In case it has been made Vatable by some States, there is no objection to that. Excise Duty, which is presently being levied by the States may not be also affected.

Tax on Tobacco products: Tobacco products would be subjected to GST with ITC. Centre may be allowed to levy excise duty on tobacco products over and above GST without ITC.

Tax on Petroleum Products: As far as petroleum products are concerned, it was decided that the basket of petroleum products, i.e. crude, motor spirit (including ATF) and HSD would be kept outside GST as is the prevailing practice in India. Sales Tax could continue to be levied by the States on these products with prevailing floor rate. Similarly, Centre could also continue its levies. A final view whether Natural Gas should be kept outside the GST will be taken after further deliberations.

Taxation of Services : As indicated earlier, both the Centre and the States will have concurrent power to levy tax on all goods and services. In the case of States, the principle for taxation of intra-State and inter-State has already been formulated by the Working Group of Principal Secretaries/Secretaries of Finance/Taxation and Commissioners of Trade Taxes with senior representatives of Department of Revenue, Government of India. For inter-State transactions an innovative model of Integrated GST will be adopted by appropriately aligning and integrating CGST and SGST. The working of this model is elaborated below.

3.5 Inter-State Transactions of Goods and Services: The Empowered Committee has accepted the recommendations of the Working Group of concerned officials of Central and State Governments for adoption of IGST model for taxation of inter-State transaction of Goods and Services. The scope of IGST Model is that Centre would levy IGST which would be CGST plus SGST on all inter-State transactions of taxable goods and services with appropriate provision for consignment or stock transfer of goods and services. The inter-State seller will pay IGST on value addition after adjusting available credit of IGST, CGST, and SGST on his purchases. The Exporting State will transfer to the Centre the credit of SGST used in payment of IGST. The Importing dealer will claim credit of IGST while discharging his output tax liability in his own State. The Centre will transfer to the importing State the credit of IGST used in payment of SGST. The relevant information will also be submitted to the Central Agency which will act as a clearing house mechanism, verify the claims and inform the respective governments to transfer the funds.

The major advantages of IGST Model are:

(a) Maintenance of uninterrupted ITC chain on inter-State transactions.

(b) No upfront payment of tax or substantial blockage of funds for the inter-State seller or buyer.

(c) No refund claim in exporting State, as ITC is used up while paying the tax.

(d) Self monitoring model.

(e) Level of computerization is limited to inter-State dealers and Central and State Governments should be able to computerize their processes expeditiously.

(f) As all inter-State dealers will be e-registered and correspondence with them will be by e-mail, the compliance level will improve substantially.

(g) Model can take 'Business to Business' as well as 'Business to Consumer' transactions into account.

3.6 GST Rate Structure: The Empowered Committee has decided to adopt a two-rate structure –a lower rate for necessary items and goods of basic importance and a standard rate for goods in general. There will also be a special rate for precious metals and a list of exempted items. For upholding of special needs of each State as well as a balanced approach to federal flexibility, and also for facilitating the introduction of GST, it is being discussed whether the exempted list under VAT regime including Goods of Local Importance may be retained in the exempted list under State GST in the initial years. It is also being discussed whether the Government of India may adopt, to begin with, a similar approach towards exempted list under the CGST.

The States are of the view that for CGST relating to goods, the Government of India may also have a two-rate structure, with conformity in the levels of rate under the SGST. For taxation of services, there may be a single rate for both CGST and SGST.

The exact value of the SGST and CGST rates, including the rate for services, will be made known duly in course of appropriate legislative actions.

3.7 Zero Rating of Exports: Exports would be zero-rated. Similar benefits may be given to Special Economic Zones (SEZs). However, such benefits will only be allowed to the processing zones of the SEZs. No benefit to the sales from an SEZ to Domestic Tariff Area (DTA) will be allowed.

3.8 GST on Imports: The GST will be levied on imports with necessary Constitutional Amendments. Both CGST and SGST will be levied on import of goods and services into the country. The incidence of tax will follow the destination principle and the tax revenue in case of SGST will accrue to the State where the imported goods and services are consumed. Full and complete set-off will be available on the GST paid on import on goods and services.

3.9 Special Industrial Area Scheme: After the introduction of GST, the tax exemptions, remissions etc. related to industrial incentives should be converted, if at all needed, into cash refund schemes after collection of tax, so that the GST scheme on the basis of a continuous chain of set-offs is not disturbed. Regarding Special Industrial Area Schemes, it is clarified that such exemptions, remissions etc. would continue up to legitimate expiry time both for the Centre and the States. Any new exemption, remission etc. or continuation of earlier exemption, remission etc. would not be allowed.

In such cases, the Central and the State Governments could provide reimbursement after collecting GST.

3.10 IT Infrastructure: After acceptance of IGST Model for Inter-State transactions, the major responsibilities of IT infrastructural requirement will be shared by the Central Government through the use of its own IT infrastructure facility. The issues of tying up the State Infrastructure facilities with the Central facilities as well as further improvement of the States' own IT infrastructure, including TINXSYS, is now to be addressed expeditiously and in a time bound manner.

3.11 Constitutional Amendments, Legislations and Rules for administration of CGST and SGST: It is essential to have Constitutional Amendments for empowering the States for levy of service tax, GST on imports and consequential issues as well as corresponding Central and State legislations with associated rules and procedures. With these specific tasks in view, a Joint Working Group has recently been constituted (September 30, 2009) comprising of the officials of the Central and State Governments to prepare, in a time bound manner a draft legislation for Constitutional Amendment, draft legislation for CGST, a suitable Model Legislation for SGST and rules and procedures for CGST and SGST. Simultaneous steps have also been initiated for drafting of a legislation for IGST and rules and procedures. As a part of this exercise, the Working Group will also address the issues of dispute resolution and advance ruling.

3.12 Harmonious structure of GST and the States' autonomy in a Federal Framework: As a part of the exercise on Constitutional Amendment, a special attention would be given, as mentioned earlier in para 3.2, to the formulation of a mechanism for upholding the need for a harmonious structure for GST along with the concern for the States' autonomy in a federal structure.

3.13 Dispute Resolution and Advance Ruling: As a part of the exercise on drafting of legislation, rules and procedures for the administration of CGST and SGST, specific provisions would also be made to the issues of dispute resolution and advance ruling.

3.14 Need for compensation during implementation of GST: Despite the sincere attempts being made by the Empowered Committee on the determination of GST rate structure, revenue neutral rates, it is difficult to estimate accurately as to how much the States will gain from service taxes and how much they will lose on account of removal of cascading effect, payment of input tax credit and phasing out of CST. In view of this, it would be essential to provide adequately for compensation for loss that might emerge during the process of implementation of GST for the next five years. This issue may be comprehensively taken care of in the recommendations of the Thirteenth Finance Commission. The payment of this compensation will need to be ensured in terms of special grants to be released to the States duly in every month on the basis of neutrally monitored mechanism.

3.15 With the release of this First Discussion Paper and the Annexure on Frequently Asked Questions and Answers on GST, interaction with the representatives of industry, trade and agriculture would begin immediately at the national level, and then also simultaneously at the State levels. Similarly awareness campaign for common consumers would also be initiated at the same time. As a part of the discussion and campaign, the views of the industry, trade and agriculture as well as consumers are being sought in a structured and time bound manner.

Annexure

Frequently Asked Questions and Answers on GST

Question 1 : What is the justification of GST ?

Answer : There was a burden of "tax on tax" in the pre-existing Central excise duty of the Government of India and sales tax system of the State Governments. The introduction of Central VAT (CENVAT) has removed the cascading burden of "tax on tax" to a good extent by providing a mechanism of "set off" for tax paid on inputs and services upto the stage of production, and has been an improvement over the pre-existing Central excise duty. Similarly, the introduction of VAT in the States has removed the cascading effect by giving set-off for tax paid on inputs as well as tax paid on previous purchases and has again been an improvement over the previous sales tax regime.

But both the CENVAT and the State VAT have certain incompleteness. The incompleteness in CENVAT is that it has yet not been extended to include chain of value addition in the distributive trade below the stage of production. It has also not included several Central taxes, such as Additional Excise Duties, Additional Customs Duty, Surcharges etc. in the overall framework of CENVAT, and thus kept the benefits of comprehensive input tax and service tax set-off out of the reach of manufacturers/dealers. The introduction of GST will not only include comprehensively more indirect Central taxes and integrate goods and services taxes for set-off relief, but also capture certain value addition in the distributive trade.

Similarly, in the present State-level VAT scheme, CENVAT load on the goods has not yet been removed and the cascading effect of that part of tax burden has remained unrelieved. Moreover, there are several taxes in the States, such as, Luxury Tax, Entertainment Tax, etc. which have still not been subsumed in the VAT. Further, there has also not been any integration of VAT on goods with tax on services at the State level with removal of cascading effect of service tax. In addition, although the burden of Central Sales Tax (CST) on inter-State movement of goods has been lessened with reduction of CST rate from 4% to 2%, this burden has also not been fully phased out. With the introduction of GST at the State level, the additional burden of CENVAT and services tax would be comprehensively removed, and a continuous chain of set-off from the original producer's point and service provider's point upto the retailer's level would be established which would eliminate the burden of all cascading effects, including the burden of CENVAT and service tax. This is the essence of GST. Also, major Central and State taxes will get subsumed into GST which will reduce the multiplicity of taxes, and thus bring down the compliance cost. With GST, the burden of CST will also be phased out.

Thus GST is not simply VAT plus service tax, but a major improvement over the previous system of VAT and disjointed services tax – a justified step forward.

Question 2. What is GST? How does it work ?

Answer : As already mentioned in answer to Question 1, GST is a tax on goods and services with comprehensive and continuous chain of set-off benefits from the producer's point and service provider's point upto the retailer's level. It is essentially a tax only on value addition at each stage, and a supplier at each stage is permitted to set-off, through a tax credit mechanism, the GST paid on the purchase of goods and services as available for set-off on the GST to be paid on the supply of goods and services. The final consumer will thus bear only the GST charged by the last dealer in the supply chain, with set-off benefits at all the previous stages.

The illustration shown below indicates, in terms of a hypothetical example with a manufacturer, one wholeseller and one retailer, how GST will work. Let us suppose that GST rate is 10%, with the manufacturer making value addition of Rs.30 on his purchases worth Rs.100 of input of goods and services used in the manufacturing process. The manufacturer will then pay net GST of Rs. 3 after setting-off Rs. 10 as GST paid on his inputs (i.e. Input Tax Credit) from gross GST of Rs. 13. The manufacturer sells the goods to the whole seller. When the whole seller sells the same goods after making value addition of (say), Rs. 20, he pays net GST of only Rs. 2, after setting-off of Input Tax Credit of Rs. 13 from the gross GST of Rs. 15 to the manufacturer. Similarly, when a retailer sells the same goods after a value addition of (say) Rs. 10, he pays net GST of only Re.1, after setting-off Rs.15 from his gross GST of Rs. 16 paid to whole seller. Thus, the manufacturer, whole seller and retailer have to pay only Rs. 6 (= Rs. 3+Rs. 2+Re. 1) as GST on the value addition along the entire value chain from the producer to the retailer, after setting-off GST paid at the earlier stages. The overall burden of GST on the goods is thus much less. This is shown in the table below. The same illustration will hold in the case of final service provider as well.

Table

Stage of supply chain	**Purchase value of Input**	**Value addition**	**Value at which supply of goods and services made to next stage**	**Rate of GST**	**GST on output**	**Input Tax credit**	**Net GST= GST on output – Input tax credit**
Manufacturer	100	30	130	10%	13	10	13–10 = 3
Whole seller	130	20	150	10%	15	13	15–13 = 2
Retailer	150	10	160	10%	16	15	16–15 = 1

Question 3 : How can the burden of tax, in general, fall under GST ?

Answer : As already mentioned in Answer to Question 1, the present forms of CENVAT and State VAT have remained incomplete in removing fully the cascading burden of taxes already paid at earlier stages. Besides, there are several other taxes, which both the Central Government and the State Government levy on production, manufacture and distributive trade, where no set-off is available in the form of input tax credit. These taxes add to the cost of goods and services through "tax on tax" which the final consumer has to bear. Since, with the introduction of GST, all the cascading effects of CENVAT and service tax would be removed with a continuous chain of set-off from the producer's point to the retailer's point, other major Central and State taxes would be subsumed in GST and CST will also be phased out, the final net burden of tax on goods, under GST would, in general, fall. Since there would be a transparent and complete chain of set-offs, this will help widening the coverage of tax base and improve tax compliance. This may lead to higher generation of revenues which may in turn lead to the possibility of lowering of average tax burden.

Question 4 : **How will GST benefit industry, trade and agriculture ?**

Answer : As mentioned in Answer to Question 3, the GST will give more relief to industry, trade and agriculture through a more comprehensive and wider coverage of input tax set-off and service tax set-off, subsuming of several Central and State taxes in the GST and phasing out of CST. The transparent and complete chain of set-offs which will result in widening of tax base and better tax compliance may also lead to lowering of tax burden on an average dealer in industry, trade and agriculture.

Question 5 : How will GST benefit the exporters?

Answer : The subsuming of major Central and State taxes in GST, complete and comprehensive setoff of input goods and services and phasing out of Central Sales Tax (CST) would reduce the cost of locally manufactured goods and services. This will increase the competitiveness of Indian goods and services in the international market and give boost to Indian exports. The uniformity in tax rates and procedures across the country will also go a long way in reducing the compliance cost.

Question 6 : How will GST benefit the small entrepreneurs and small traders?

Answer : The present threshold prescribed in different State VAT Acts below which VAT is not applicable varies from State to State. The existing threshold of goods under State VAT is Rs. 5 lakhs for a majority of bigger States and a lower threshold for North Eastern States and Special Category States. A uniform State GST threshold across States is desirable and, therefore, the Empowered Committee has recommended that a threshold of gross annual turnover of Rs. 10 lakh both for goods and services for all the States and Union Territories may be adopted with adequate compensation for the States (particularly, the States in North-Eastern Region and Special Category States) where lower threshold had prevailed in the VAT regime. Keeping in view the interest of small traders and small scale industries and to avoid dual control, the States considered that the threshold for Central GST for goods may be kept at Rs.1.5 crore and the threshold for services should also be appropriately high. This raising of threshold will protect the interest of small traders. A Composition scheme for small traders and businesses has also been envisaged under GST as will be detailed in Answer to Question 14. Both these features of GST will adequately protect the interests of small traders and small scale industries.

Question 7 : **How will GST benefit the common consumers?**

Answer : As already mentioned in Answer to Question 3, with the introduction of GST, all the cascading effects of CENVAT and service tax will be more comprehensively removed with a continuous chain of set-off from the producer's point to the retailer's point than what was possible under the prevailing CENVAT and VAT regime. Certain major Central and State taxes will also be subsumed in GST and CST will be phased out. Other things remaining the same, the burden of tax on goods would, in general, fall under GST and that would benefit the consumers.

Question 8 : **What are the salient features of the proposed GST model?**

Answer : The salient features of the proposed model are as follows:

(i) Consistent with the federal structure of the country, the GST will have two components: one levied by the Centre (hereinafter referred to as Central GST), and the other levied by the States (hereinafter referred to as State GST). This dual GST model would be implemented through multiple statutes (one for CGST and SGST statute for every State). However, the basic features of law such as chargeability, definition of taxable event and taxable person, measure of levy including valuation provisions, basis of classification etc. would be uniform across these statutes as far as practicable.

(ii) The Central GST and the State GST would be applicable to all transactions of goods and services except the exempted goods and services, goods which are outside the purview of GST and the transactions which are below the prescribed threshold limits.

(iii) The Central GST and State GST are to be paid to the accounts of the Centre and the States separately.

(iv) Since the Central GST and State GST are to be treated separately, in general, taxes paid against the Central GST shall be allowed to be taken as input tax credit (ITC) for the Central GST and could be utilized only against the payment of Central GST. The same principle will be applicable for the State GST.

(v) Cross utilisation of ITC between the Central GST and the State GST would, in general, not be allowed.

(vi) To the extent feasible, uniform procedure for collection of both Central GST and State GST would be prescribed in the respective legislation for Central GST and State GST.

(vii) The administration of the Central GST would be with the Centre and for State GST with the States.

(viii) The taxpayer would need to submit periodical returns to both the Central GST authority and to the concerned State GST authorities.

(ix) Each taxpayer would be allotted a PAN-linked taxpayer identification number with a total of 13/15 digits. This would bring the GST PAN-linked system in line with the prevailing PAN-based system for Income tax facilitating data exchange and taxpayer compliance. The exact design would be worked out in consultation with the Income-Tax Department.

(x) Keeping in mind the need of tax payers convenience, functions such as assessment, enforcement, scrutiny and audit would be undertaken by the authority which is collecting the tax, with information sharing between the Centre and the States.

Question 9 : Why is Dual GST required ?

Answer : India is a federal country where both the Centre and the States have been assigned the powers to levy and collect taxes through appropriate legislation. Both the levels of Government have distinct responsibilities to perform according to the division of powers prescribed in the Constitution for which they need to raise resources. A dual GST will, therefore, be in keeping with the Constitutional requirement of fiscal federalism.

Question 10 : How would a particular transaction of goods and services be taxed simultaneously under Central GST (CGST) and State GST (SGST)?

Answer : 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 which are outside the purview of GST and the transactions which are below the prescribed threshold limits. Further, both would be levied on the same price or value unlike State VAT which is levied on the value of the goods inclusive of CENVAT. 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.

Illustration I: Suppose hypothetically that the rate of CGST is 10% and that of SGST is 10%. When a wholesale dealer of steel in Uttar Pradesh supplies steel bars and rods to a construction company which is also located within the same State for , say Rs. 100, the dealer would charge CGST of Rs. 10 and SGST of Rs. 10 in addition to the basic price of the goods. He would be required to deposit the CGST component into a Central Government account while the SGST portion into the account of the concerned State Government. Of course, he need not actually pay Rs. 20 (Rs. 10 + Rs. 10) in cash as he would be entitled to set-off this liability against the CGST or SGST paid on his purchases (say, inputs). But for paying CGST he would be allowed to use only the credit of CGST paid on his purchases while for SGST he can utilize the credit of SGST alone. In other words, CGST credit cannot, in general, be used for payment of SGST. Nor can SGST credit be used for payment of CGST.

Illustration II: Suppose, again hypothetically, that the rate of CGST is 10% and that of SGST is 10%. When an advertising company located in Mumbai supplies advertising services to a company manufacturing soap also located within the State of Maharashtra for, let us say Rs. 100, the ad company would charge CGST of Rs. 10 as well as SGST of Rs. 10 to the basic value of the service. He would be required to deposit the CGST component into a Central Government account while the SGST portion into the account of the concerned State Government. Of course, he need not again actually pay Rs. 20 (Rs. 10+Rs. 10) in cash as it would be entitled to set-off this liability against the CGST or SGST paid on his purchase (say, of inputs such as stationery, office equipment, services of an artist etc). But for paying CGST he would be allowed to use only the credit of CGST paid on its purchase while for SGST he can utilise the credit of SGST alone. In other words, CGST credit cannot, in general, be used for payment of SGST. Nor can SGST credit be used for payment of CGST.

Question 11 : Which Central and State taxes are proposed to be subsumed under GST ?

Answer : The various Central, State and Local levies were examined to identify their possibility of being subsumed under GST. While identifying, the following principles were kept in mind:

(i) Taxes or levies to be subsumed should be primarily in the nature of indirect taxes, either on the supply of goods or on the supply of services.

(ii) Taxes or levies to be subsumed should be part of the transaction chain which commences with import/ manufacture/ production of goods or provision of services at one end and the consumption of goods and services at the other.

(iii) The subsumation should result in free flow of tax credit in intra and inter-State levels.

(iv) The taxes, levies and fees that are not specifically related to supply of goods & services should not be subsumed under GST.

(v) Revenue fairness for both the Union and the States individually would need to be attempted.

On application of the above principles, the Empowered Committee has recommended that the following Central Taxes should be, to begin with, subsumed under the Goods and Services Tax:

(i) Central Excise Duty

(ii) Additional Excise Duties

(iii) The Excise Duty levied under the Medicinal and Toiletries Preparation Act

(iv) Service Tax

(v) Additional Customs Duty, commonly known as Countervailing Duty (CVD)

(vi) Special Additional Duty of Customs - 4% (SAD)

(vii) Surcharges, and

(viii) Cesses. [43??]

The following State taxes and levies would be, to begin with, subsumed under GST:

(i) VAT / Sales tax

(ii) Entertainment tax (unless it is levied by the local bodies).

(iii) Luxury tax

(iv) Taxes on lottery, betting and gambling.

(v) State Cesses and Surcharges in so far as they relate to supply of goods and services.

(vi) Entry tax not in lieu of Octroi.

Purchase tax: Some of the States felt that they are getting substantial revenue from Purchase Tax and, therefore, it should not be subsumed under GST while majority of the States were of the view that no such exemptions should be given. The difficulties of the food grain producing States was appreciated as substantial revenue is being earned by them from Purchase Tax and it was, therefore, felt that in case Purchase Tax has to be subsumed then adequate and continuing compensation has to be provided to such States. This issue is being discussed in consultation with the Government of India.

Tax on items containing Alcohol: Alcoholic beverages would be kept out of the purview of GST. Sales Tax/VAT could be continued to be levied on alcoholic beverages as per the existing practice. In case it has been made Vatable by some States, there is no objection to that. Excise Duty, which is presently levied by the States may not also be affected.

Tax on Tobacco products: Tobacco products would be subjected to GST with ITC. Centre may be allowed to levy excise duty on tobacco products over and above GST with ITC.

Tax on Petroleum Products: As far as petroleum products are concerned, it was decided that the basket of petroleum products, i.e. crude, motor spirit (including ATF) and HSD would be kept outside GST as is the prevailing practice in India. Sales Tax could continue to be levied by the States on these products with prevailing floor rate. Similarly, Centre could also continue its levies. A final view whether Natural Gas should be kept outside the GST will be taken after further deliberations.

Taxation of Services : As indicated earlier, both the Centre and the States will have concurrent power to levy tax on goods and services. In the case of States, the principle for taxation of intra-State and inter State has already been formulated by the Working Group of Principal Secretaries /Secretaries of Finance / Taxation and Commissioners of Trade Taxes with senior representatives of Department of Revenue, Government of India. For inter-State transactions an innovative model of Integrated GST will be adopted by appropriately aligning and integrating CGST and IGST.

Question 12 : What is the rate structure proposed under GST ?

Answer : The Empowered Committee has decided to adopt a two-rate structure –a lower rate for necessary items and items of basic importance and a standard rate for goods in general. There will also be a special rate for precious metals and a list of exempted items. For upholding of special needs of each State as well as a balanced approach to federal flexibility, it is being discussed whether the exempted list under VAT regime including Goods of Local Importance may be retained in the exempted list under State GST in the initial years. It is also being discussed whether the

Government of India may adopt, to begin with, a similar approach towards exempted list under the CGST.

For CGST relating to goods, the States considered that the Government of India might also have a two-rate structure, with conformity in the levels of rate with the SGST. For taxation of services, there may be a single rate for both CGST and SGST.

The exact value of the SGST and CGST rates, including the rate for services, will be made known duly in course of appropriate legislative actions.

Question 13: What is the concept of providing threshold exemption for GST?

Answer : Threshold exemption is built into a tax regime to keep small traders out of tax net. This has three-fold objectives:

(a) It is difficult to administer small traders and cost of administering of such traders is very high in comparison to the tax paid by them.

(b) The compliance cost and compliance effort would be saved for such small traders.

(c) Small traders get relative advantage over large enterprises on account of lower tax incidence.

The present thresholds prescribed in different State VAT Acts below which VAT is not applicable varies from State to State. A uniform State GST threshold across States is desirable and, therefore, as already mentioned in Answer to Question 6, it has been considered that a threshold of gross annual turnover of Rs. 10 lakh both for goods and services for all the States and Union Territories might be adopted with adequate compensation for the States (particularly, the States in North-Eastern Region and Special Category States) where lower threshold had prevailed in the VAT regime. Keeping in view the interest of small traders and small scale industries and to avoid dual control, the States also considered that the threshold for Central GST for goods may be kept Rs.1.5 Crore and the threshold for services should also be appropriately high.

Question 14 : What is the scope of composition and compounding scheme under GST?

Answer: As already mentioned in Answer to Question 6, a Composition/ Compounding Scheme will be an important feature of GST to protect the interests of small traders and small scale industries. The Composition/Compounding scheme for the purpose of GST should have an upper ceiling on gross annual turnover and a floor tax rate with respect to gross annual turnover. In particular there will be a compounding cut-off at Rs. 50 lakhs of the gross annual turnover and the floor rate of 0.5% across the States. The scheme would allow option for GST registration for dealers with turnover below the compounding cut-off.

Question 15 : How will imports be taxed under GST ?

Answer : With Constitutional Amendments, both CGST and SGST will be levied on import of goods and services into the country. The incidence of tax will follow the destination principle and the tax revenue in case of SGST will accrue to the State where the imported goods and services are consumed. Full and complete set-off will be available on the GST paid on import on goods and services.

Question 16 : Will cross utilization of credits between goods and services be allowed under GST regime?

Answer : Cross utilization of credit of CGST between goods and services would be allowed. Similarly, the facility of cross utilization of credit will be available in case of SGST. However, the cross utilization of CGST and SGST would generally not be allowed except in the case of inter-State supply of goods and services under the IGST model which is explained in answer to the next question.

Question 17 : How will be Inter-State Transactions of Goods and Services be taxed under GST in terms of IGST method ?

Answer : The Empowered Committee has accepted the recommendation for adoption of IGST model for taxation of inter-State transaction of Goods and Services. The scope of IGST Model is that Centre would levy IGST which would be CGST plus SGST on all inter-State transactions of taxable goods and services. The inter-State seller will pay IGST on value addition after adjusting available credit of IGST, CGST, and SGST on his purchases. The Exporting State will transfer to the Centre the credit of SGST used in payment of IGST. The Importing dealer will claim credit of IGST while discharging his output tax liability in his own State. The Centre will transfer to the importing State the credit of IGST used in payment of SGST. The relevant information is also submitted to the Central Agency which will act as a clearing house mechanism, verify the claims and inform the respective governments to transfer the funds.

The major advantages of IGST Model are:

(a) Maintenance of uninterrupted ITC chain on inter-State transactions.

(b) No upfront payment of tax or substantial blockage of funds for the inter-State seller or buyer.

(c) No refund claim in exporting State, as ITC is used up while paying the tax.

(d) Self monitoring model.

(e) Level of computerisation is limited to inter-State dealers and Central and State Governments should be able to computerise their processes expeditiously.

(f) As all inter-State dealers will be e-registered and correspondence with them will be by e-mail, the compliance level will improve substantially.

(g) Model can take 'Business to Business' as well as 'Business to Consumer' transactions into account.

Question 18: Why does introduction of GST require a Constitutional Amendment?

Answer : The Constitution provides for delineation of power to tax between the Centre and States. While the Centre is empowered to tax services and goods upto the production stage, the States have the power to tax sale of goods. The States do not have the powers to levy a tax on supply of services while the Centre does not have power to levy tax on the sale of goods. Thus, the Constitution does not vest express power either in the Central or State Government to levy a tax on the 'supply of goods and services'. Moreover, the Constitution also does not empower the States to impose tax on imports. Therefore, it is essential to have Constitutional Amendments for empowering the Centre to levy tax on sale of goods and States for levy of service tax and tax on imports and other consequential issues.

As part of the exercise on Constitutional Amendment, there would be a special attention to the formulation of a mechanism for upholding the need for a harmonious structure for GST along with the concern for the powers of the Centre and the States in a federal structure.

Question 19: How are the legislative steps being taken for CGST and SGST ?

Answer : A Joint Working Group has recently been constituted (September 30, 2009) comprising of the officials of the Central and State Governments to prepare, in a time-bound manner a draft legislation for Constitutional Amendment.

Question 20: How will the rules for administration of CGST and SGST be framed?

Answer : The Joint Working Group, as mentioned above, has also been entrusted the task of preparing draft legislation for CGST, a suitable Model Legislation for SGST and rules and procedures for CGST and SGST. Simultaneous steps have also been initiated for drafting of legislation for IGST and rules and procedures. As a part of this exercise, the Working Group will also address to the issues of dispute resolution and advance ruling.

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Comments of the Department of Revenue (DoR) on the First Discussion Paper on GST*

Sr. No.	Para No. of the Discussion Paper	Issues	Comments of the DoR
1	3.1	It is important to take note of the significant administrative issues involved in designing an effective GST model in a federal system with the objective of having an overall harmonious structure of rates. Together with this, there is a need for upholding the powers of Central and State Governments in their taxation matters. Further, there is also the need to propose a model that would be easily implementable, while being generally acceptable to stakeholders.	Agreed.
2	3.2	Keeping in view the report of the Joint Working Group on Goods and Services Tax, the views received from the States and Government of	Dual GST model with appropriate binding mechanism to harmonise the various important aspects of the GST like rate structure,

* *Source:* http://finmin.nic.in/gst/index.asp

Sr. No.	Para No. of the Discussion Paper	Issues	Comments of the DoR
		India, a dual GST with defined functions and responsibilities of the Centre and the States is recommended. An appropriate mechanism that will be binding on both the Centre and the States should be worked out whereby the harmonious rate structure along with the need for further modification could be upheld, if necessary with a collectively agreed Constitutional Amendment.	taxation base, exemption etc. between Centre and States is agreed.
3	3.2 (i)	The GST shall have two components: one levied by the Centre (hereinafter referred to as Central GST), and the other levied by the States [hereinafter referred to as State GST]. Rates for Central GST and State GST should be prescribed appropriately, reflecting revenue considerations and acceptability. This dual GST model would be implemented through multiple statutes (one for CGST and a SGST statute for every state). However, the basic features of law such as	Agreed. In addition, IGST on inter-State transactions should be levied by the Centre. SGST on imports should also be levied and collected by the Centre. Centre should pass on SGST collection on imports to concerned States on the destination principle.

Sr. No.	Para No. of the Discussion Paper	Issues	Comments of the DoR
		chargeability, definition of taxable event and taxable person, measure of levy including valuation provisions, basis of classification etc. should be uniform across these statutes as far as practicable.	
4	3.2 (ii)	The Central GST and the State GST should be applicable to all transactions of goods and services made for a consideration except the exempted goods and services, goods are outside the purview of GST and the transactions which are below the prescribed threshold limits.	Agreed. There should be a common base for taxation between Centre and States.
5	3.2 (iii)	The Central GST and State GST are to be paid to the accounts of the Centre and the States separately. It would have to be ensured that account-heads for all services and goods would have indication whether it relates to Central GST or State GST (with identification of the State to whom the tax is to be credited).	Agreed. In addition, IGST should be paid to the accounts of the Centre.
6	3.2 (iv)	Since the Central GST and State GST are to be treated	Agreed.

Sr. No.	Para No. of the Discussion Paper	Issues	Comments of the DoR
		separately, taxes paid against the Central GST shall be allowed to be taken as input tax credit (ITC) for the Central GST and could be utilized only against the payment of Central GST. The same principle will be applicable for the State GST. A taxpayer or exporter would have to maintain separate details in books of account for utilization or refund of credit. Further, the rules for taking and utilization of Credit for the Central GST and the State GST would be aligned.	
7	3.2 (v)	Cross utilization of ITC between the Central GST and the State GST should not be allowed except in the case of inter-State supply of goods and services under the IGST model which is explained later.	Agreed.
8	3.2 (vi)	Ideally, the problem related to credit accumulation on account of refund of GST should be avoided both by the Centre and the States except in the cases such as of exports, purchase of capital	Agreed.

Sr. No.	Para No. of the Discussion Paper	Issues	Comments of the DoR
		goods, input tax at higher rate than output tax etc. where, again refund/adjustment should be completed in a time bound manner.	
9	3.2 (vii)	To the extent feasible, uniform procedure for collection of both Central GST and State GST may be prescribed in the respective legislation for Central GST and State GST.	Agreed.
10	3.2 (viii)	The administration of the Central GST to the Centre and for State GST to the States would be given. This would imply that the Centre and the States would have concurrent jurisdiction for the entire value chain and for all taxpayers on the basis of thresholds for goods and services prescribed for the States and the Centre.	Agreed. The threshold for goods and services should be common between Centre and State on one hand and between goods and services on the other.
11	3.2 (ix)	The present thresholds prescribed in different State VAT Acts below which VAT is not applicable varies from State to State. A uniform State GST threshold across States is desirable and, therefore, it is recommended	There should be a uniform threshold for goods and services for both SGST and CGST. This annual turnover threshold could be Rs.10 lakh or even more than that. The threshold exemption should not apply to dealers and

Sr. No.	Para No. of the Discussion Paper	Issues	Comments of the DoR
		that a threshold of gross annual turnover of Rs.10 lakh both for goods and services for all the States and Union Territories may be adopted with adequate compensation for the States (particularly, the States in North-Eastern Region and Special Category States) where lower threshold had prevailed in the VAT regime. Keeping in view the interest of small traders and small scale industries and to avoid dual control, the States also considered that the threshold for Central GST for goods may be kept Rs.1.5 Crore and the threshold for Central GST for services may also be appropriately high. It may be mentioned that even now there is a separate threshold of services (Rs. 10 lakh) and goods (Rs. 1.5 crore) in the Service Tax and CENVAT.	service providers who undertake inter-State supplies. The problem of dual control is better addressed through a compounding scheme as well as administrative simplification for small dealers through measures such as: • Registration by single agency for both SGST and CGST without manual interface • No physical verification of premises and no pre-deposit of security • Simplified return format • Longer frequency for return filing • Electronic Return filing through certified service centres / CAs etc. • Audit in 1-2% cases based on risk parameters • Lenient penal provisions There may not be any need to have direct link between compensation package, if decided for, and the threshold for registration for North-Eastern and special category States.
12	3.2 (x)	The States are also of the	Agreed. Centre may also have

Sr. No.	Para No. of the Discussion Paper	Issues	Comments of the DoR
		view that Composition / Compounding Scheme for the purpose of GST should have an upper ceiling on gross annual turnover and a floor tax rate with respect to gross annual turnover. In particular there will be a compounding cut-off at Rs.50 lakh of gross annual turnover and a floor rate of 0.5% across the States. The scheme should also allow option for GST registration for dealers with turnover below the compounding cut-off.	a Composition Scheme up to gross turnover limit of Rs. 50 lakh, if threshold for registration is kept as Rs.10 lakh. The floor rate of 0.5% will be for SGST alone, in case Centre also brings a Composition Scheme for small assesses. The Centre may consider leaving the administration of Compounding Scheme, both for CGST and SGST to the States.
13	3.2 (xi)	The taxpayer would need to submit periodical returns, in common format as far as possible, to both the Central GST authority and to the concerned State GST authorities.	In addition, taxpayers having inter-State transactions will require submission of returns to related Central IGST authority.
14	3.2 (xii)	Each taxpayer would be allotted a PAN-linked taxpayer identification number with a total of 13/15 digits. This would bring the GST PAN-linked system in line with the prevailing PAN-based system for Income tax facilitating data exchange and taxpayer compliance.	There should be a uniform registration system through-out the country and this registration system should enable easy linkage with Income Tax database through use of PAN number.

Sr. No.	Para No. of the Discussion Paper	Issues	Comments of the DoR
15	3.2 (xiii)	Keeping in mind the need of taxpayers convenience, functions such as assessment, enforcement, scrutiny and audit would be undertaken by the authority which is collecting the tax, with information sharing between the Centre and the States.	Since the tax base is to be identical for the two components, viz., CGST and SGST, it is desirable that any dispute between a taxpayer and either of the tax administrations is settled in a uniform manner. The possibility of setting up a harmonised system for scrutiny, audit and dispute settlement may be developed.
16	3.4	On application of the principle, it is recommended that the following Central Taxes should be, to begin with, subsumed under the Goods and Services Tax: (i) Central Excise Duty (ii) Additional Excise Duties (iii) The Excise Duty levied under the Medicinal and Toiletries Preparation Act (iv) Service Tax (v) Additional customs duty, commonly known as countervailing duty (CVD) (vi) Special Additional Duty of Customs - 4% (SAD) (vii) Surcharges, and	Agreed.

Sr. No.	Para No. of the Discussion Paper	Issues	Comments of the DoR
		(viii) Cesses.	
		Following State taxes and levies should be, to begin with, subsumed under GST: (i) VAT / Sales tax (ii) Entertainment tax (unless it is levied by the local bodies). (iii) Luxury tax (iv) Taxes on lottery, betting and gambling. (v) State Cesses and Surcharges in so far as they relate to supply of goods and services. (vi) Entry tax not in lieu of octroi.	Electricity duty, Octroi, purchase tax and taxes levied by local bodies should also be subsumed under GST.
		Purchase tax: Some of the States felt that they are getting substantial revenue from Purchase Tax and, therefore, it should not be subsumed under GST while majority of the States were of the view that no such exemptions should be given. The difficulties of the food grain producing States and certain other states were appreciated as substantial revenue is being earned by them from Purchase Tax and	Purchase tax is nothing but sales tax where the responsibility for collection of tax is with the purchaser (and not with the seller as in the case of sales tax). Keeping 'purchase tax' outside will give the loophole to the States to impose 'purchase tax' on any commodity (food-grains, agricultural / forest produce, minerals, industrial inputs etc.) over and above GST. Hence, purchase tax must be subsumed. The compensation

Sr. No.	Para No. of the Discussion Paper	Issues	Comments of the DoR
		it was, therefore, felt that in case Purchase Tax has to be subsumed then adequate and continuing compensation has to be provided to such States. This issue is being discussed in consultation with the Government of India.	package, if agreed, need not have any link to any particular tax being subsumed.
		Tax on items containing Alcohol: Alcoholic beverages may be kept out of the purview of GST. Sales Tax/VAT can be continued to be levied on alcoholic beverages as per the existing practice. In case it has been made Vatable by some States, there is no objection to that. Excise Duty, which is presently being levied by the States may not be also affected.	Alcoholic beverages should be brought under the purview of GST in order to remove the cascading effect on GST paid on inputs such as raw material and packaging material. Sales tax / VAT and State excise duty can be charged over and above GST. Similar dispensation should apply to opium, Indian hemp and other narcotic drugs and narcotics but medicines or toilet preparations containing these substances should attract only GST.
		Tax on Tobacco products: Tobacco products should be subjected to GST with ITC. Centre may be allowed to levy excise duty on tobacco products over and above GST without ITC.	Agreed.
		Tax on Petroleum Products: As far as petroleum products	Keeping crude petroleum and natural gas out of the GST net

Sr. No.	Para No. of the Discussion Paper	Issues	Comments of the DoR
		are concerned, it was decided that the basket of petroleum products, i.e. crude, motor spirit (including ATF) and HSD should be kept outside GST as is the prevailing practice in India. Sales Tax could continue to be levied by the States on these products with prevailing floor rate. Similarly, Centre could also continue its levies. A final view whether Natural Gas should be kept outside the GST will be taken after further deliberations.	would imply that the credit on capital goods and input services going into exploration and extraction would not be available resulting in cascading. Diesel, ATF and motor spirit are derived from a common input, viz., crude petroleum along with other refined products such as naphtha, lubricating oil base stock, etc. Leaving diesel, ATF and motor spirit out of the purview of GST would make it extremely difficult for refineries to apportion the credit on capital goods, input services and inputs. These products are principal inputs for many services such as aviation, road transport, railways, cab operators etc. As such, these may be levied to GST and in select cases credit of GST paid on these items may be disallowed in order to minimize the possibility of misuse.
		Taxation of Services: As indicated earlier, both the Centre and the States will have concurrent	The sub-working group of the Empowered Committee in its report has suggested two options each for B to B and B

Sr. No.	Para No. of the Discussion Paper	Issues	Comments of the DoR
		power to levy tax on all goods and services. In the case of States, the principle for taxation of intra-State and inter-State has already been formulated by the Working Group of Principal Secretaries/Secretaries of Finance / Taxation and Commissioners of Trade Taxes with senior representatives of Department of Revenue, Government of India. For inter-State transactions an innovative model of Integrated GST will be adopted by appropriately aligning and integrating CGST and SGST.	to C transactions. A decision is required to be taken by the Empowered Committee with respect to the option to be adopted. Such a decision may be taken and communicated to DoR.
17	3.5	**Inter-State Transactions of goods & services:** The Empowered Committee has accepted the recommendations of the Working Group of concerned officials of Central and State Governments for adoption of IGST model for taxation of inter-State transaction of Goods and Services The scope of IGST Model is that Centre would levy IGST	Agreed. It may however be noted that IGST model will work smoothly only when there is a common threshold for goods and services and for Centre and States. Having more than one rate either for CGST or SGST will complicate the working of IGST model.

Sr. No.	Para No. of the Discussion Paper	Issues	Comments of the DoR
		which would be CGST plus SGST on all inter-State transactions of taxable goods and services with appropriate provision for consignment or stock transfer of goods and services. The inter-State seller will pay IGST on value addition after adjusting available credit of IGST, CGST, and SGST on his purchases. The Exporting State will transfer to the Centre the credit of SGST used in payment of IGST. The Importing dealer will claim credit of IGST while discharging his output tax liability in his own State. The Centre will transfer to the importing State the credit of IGST used in payment of SGST. The relevant information is also submitted to the Central Agency which will act as a clearing house mechanism, verify the claims and inform the respective governments to transfer the funds. The major advantages of IGST Model are: (a) Maintenance of	

Sr. No.	Para No. of the Discussion Paper	Issues	Comments of the DoR
		uninterrupted ITC chain on inter-state transactions. (b) No upfront payment of tax or substantial blockage of funds for the inter-state seller or buyer. (c) No refund claim in exporting State, as ITC is used up while paying the tax. (d) Self monitoring model. (e) Level of computerization is limited to inter-state dealers and Central and State Governments should be able to computerize their processes expeditiously. (f) As all inter-state dealers will be e-registered and correspondence with them will be by e-mail, the compliance level will improve substantially. (g) Model can take 'Business to Business' as well as 'Business to Consumer' transactions into account.	
18	3.6	**GST Rate Structure:** The Empowered Committee has decided to adopt a two-rate structure – a lower rate for necessary items and goods of	There should be a single rate of SGST both for goods and services. A two rate structure for goods would pose the

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		basic importance and a standard rate for goods in general. There will also be a special rate for precious metals and a list of exempted items. For upholding of special needs of each State as well as a balanced approach to federal flexibility, and also for facilitating the introduction of GST, it is being discussed whether the exempted list under VAT regime including Goods of Local Importance may be retained in the exempted list under State GST in the initial years. It is also being discussed whether the Government of India may adopt, to begin with, a similar approach towards exempted list under the CGST.	following problems: (a) Likelihood of inversions in duty structure with raw materials and intermediates being at a higher rate and finished goods being at a lower rate, especially as the intention is to apply the lower rate to necessities. (b) Inversions would result in input credit accumulation and demand for refunding the same from time to time. (c) The general rate (RNR) would have to be higher than under a single rate structure. (d) Currently, services are chargeable to tax at a single rate. Adopting a dual rate for goods would generate a similar demand for services too. (e) Having different rates for goods and services would imply that the distinction between goods and services should continue. Around 99 items presently exempted under VAT may continue to remain exempted

Sr. No.	Para No. of the Discussion Paper	Issues	Comments of the DoR
			in GST regime. There should be no scope, with individual States, for expansion of this list even for goods of local importance. Efforts will be made by Centre to substantially reduce the number of items presently exempted under CENVAT regime. At the end, there must be a common list of exemptions for CGST and SGST.
		The States are of the view that for CGST relating to goods, the Government of India may also have a two-rate structure, with conformity in the levels of rate under the SGST. For taxation of services, there may be a single rate for both CGST and SGST.	There should be one CGST rate both for goods as well as services.
		The exact value of the SGST and CGST rates, including the rate for services, will be made known duly in course of appropriate legislative actions.	SGST and CGST rates are required to be put in public domain much before initiation of legislative action.
19	3.7	**Zero Rating of Exports:** Exports should be zero-rated. Similar benefits may be given to Special Economic Zones	Agreed.

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		(SEZs). However, such benefits should only be allowed to the processing zones of the SEZs. No benefit to the sales from an SEZ to Domestic Tariff Area (DTA) will be allowed.	
20	3.8	**GST on Imports:** The GST is proposed to be levied on imports with necessary Constitutional Amendments. Both CGST and SGST will be levied on import of goods and services into the country. The incidence of tax will follow the destination principle and the SGST amount will accrue to the State where the imported goods and services are consumed. Full and complete set-off will be available on the GST paid on import on goods and services.	Levy of GST on imports may be handled by Centre through a Central legislation either as a customs duty (as is being done now) or along the lines of IGST. SGST collected by Centre may be passed on to concerned State following the destination principle. Taxation of import of services may be on the basis of reverse charge model, as is being done at present.
21	3.9	**Special Industrial Area Scheme:** After the introduction of GST, the tax exemptions, remissions etc. related to industrial incentives and special industrial area schemes should be converted, if at all needed, into cash refund or	Agreed.

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		subsidy schemes after collection of tax, so that the GST scheme on the basis of a continuous chain of set-offs is not disturbed. Regarding Special Industrial Area Schemes, it is clarified that the benefits of such exemptions, remissions etc. would continue up to legitimate expiry time both for the Centre and the States. Any new exemption, remission etc. or continuation of earlier exemption, remission etc. would not be allowed. In such cases, the Central and the State Governments could provide reimbursement after collecting GST.	
22	3.10	**IT Infrastructure:** After acceptance of IGST Model for Inter-State transactions, the major responsibilities of IT infrastructural requirement will be shared by the Central Government through the use of its own IT infrastructure facility. The issues of tying up the State Infrastructure facilities with the Central facilities as well as further	Agreed.

Sr. No.	Para No. of the Discussion Paper	Issues	Comments of the DoR
		improvement of the States' own IT infrastructure, including TINXSYS, is now to be addressed expeditiously and in a time bound manner.	
23	3.11	**Constitutional amendments, legislations and rules for administration of CGST and SGST:** It is essential to have Constitutional Amendments for empowering the States for levy of service tax, GST on imports and consequential issues as well as corresponding Central and State legislations with associated rules and procedures. With these specific tasks in view, a Joint Working Group has recently been constituted (September 30, 2009) comprising of the officials of the Central and State Governments to prepare, in a time bound manner a draft legislation for Constitutional Amendment, draft legislation for CGST, a suitable Model Legislation for SGST and rules and procedures for CGST and SGST. Simultaneous steps have also been initiated for	The Joint Working Group (JWG) has held several meetings by now. Department of Revenue is closely working with Ministry of Law, Government of India, for finalisation of draft Constitutional amendment. The issue of empowering States to levy GST on imports has been deliberated by the JWG and the view which has emerged out of discussion is that the Centre shall collect GST on imports and pass on the SGST component of it to concerned State on destination principle.

Sr. No.	Para No. of the Discussion Paper	Issues	Comments of the DoR
		drafting of a legislation for IGST and rules and procedures. As a part of this exercise, the Working Group may also address the issues of dispute resolution and advance ruling.	
24	3.12	**Harmonious structure of GST and the States' autonomy in federal framework:** As a part of the exercise on Constitutional Amendment, there would be, as mentioned earlier, in para 3.2, a special attention to the formulation of a mechanism for upholding the need for a harmonious structure for GST along with the concern for the States' autonomy in a federal structure.	Agreed in principle.
25	3.13	**Dispute Resolution & Advance Rulings:** As a part of the exercise on drafting of legislation, rules and procedures for the administration of CGST and SGST, specific provisions will also be made to the issues of dispute resolution and advance ruling.	The provisions related to dispute resolution, advance rulings and other business processes need to be harmonised between Centre and States.
26	3.14	**Need for compensation during implementation of**	Empowered Committee has already referred the issue to

Sr. No.	Para No. of the Discussion Paper	Issues	Comments of the DoR
		GST: Despite the sincere attempts being made by the Empowered Committee on the determination of GST rate structure, revenue neutral rates, it is difficult to estimate accurately as to how much the States will gain from service taxes and how much they will lose on account of removal of cascading effect, payment of input tax credit and phasing out of CST. In view of this, it would be essential to provide adequately for compensation for loss that may emerge during the process of implementation of GST for the next five years. This issue may be comprehensively taken care of in the recommendations of the Thirteenth Finance Commission. The payment of this compensation will need to be ensured in terms of special grants to be released to the States duly in every month on the basis of neutrally monitored mechanism.	the Thirteenth Finance Commission (TFC). TFC is likely to submit its report shortly. A view on the subject will be taken after more clarity on the subject is available.
27	3.15	With this First Discussion	Empowered Committee may

Sr. No.	Para No. of the Discussion Paper	Issues	Comments of the DoR
		Paper and the Annexure on frequently asked Questions and Answers on GST, interaction with the representatives of industry, trade and agriculture would begin immediately at the national level, and then also simultaneously at the State levels. Similarly awareness campaign for common consumers would also be initiated at the same time. As a part of the discussion and campaign the views of the industry, trade and agriculture as well as consumer may be sought to be obtained in a structured and time bound manner.	prepare a plan with clear timelines for orientation of stakeholders so that required steps may be taken by all the States in time.

C-3
The IT Strategy for GST*

EMPOWERED GROUP ON IT INFRASTRUCTURE ON GST HEADED BY Shri Nandan Nilekani

PREFACE

The broad IT plan for enabling GST was presented to the Government of India and the Empowered Committee of State Finance Ministers under the Chairmanship of Dr. Asim Dasgupta on July 21, 2010. This document is a follow-up to that presentation and feedback thereon and describes the IT strategy for GST implementation.

This document is at the draft stage, and will evolve as various stakeholders and experts are consulted.

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* *Source:* http://finmin.nic.in/gst/IT_Strategy_for_GST_ver0.85.pdf

1. Introduction

1.1 The merits of GST

GST will bring about a change in the tax system by redistributing the burden of taxation equitably between manufacturing and services. GST will enable broadening of the tax base, which will further result in reduction in effective rate of tax. It will reduce distortions by applying the destination principle for levy of taxes. It will foster a common market across the country, reduce compliance costs and promote exports. It can provide a fiscal base for local bodies to enable them to fulfill their obligations. It will facilitate investment decisions being made on purely economic concerns independent of tax considerations.

1.2 Urgency

The broad framework of GST is now clear, with the model being approved by the Government of India and Empowered Committee of State Finance Ministers. The GST will be a dual tax with both Central and State GST component levied on the same base. The IGST framework will be used for goods and services that are exported across state boundaries. Thus, all goods and services, barring a few exceptions, will be brought into the GST base. For reasons of simplicity for the taxpayer, ease of tax administration, and bringing about a national common market, a common PAN-based taxpayer ID, a common return, and a common challan for tax payment have been agreed to by all stakeholders.

A number of issues still remain to be resolved. These are presently under the consideration of the Empowered Committee of State Finance Ministers under the Chairmanship of Dr Asim Dasgupta. Such issues include: the rates of taxation, the revenue sharing between States and Centre, and a framework for exemption, thresholds and composition.

On the IT front, there has been consensus that there will be a common portal providing three core services (registration, returns and payments). The broad services framework of the portal has been discussed with the Sub Working group for IT. Various technology issues have been addressed including solution architecture and selection of likely service provider. However many other related issues need to be addressed which are on the critical path for GST going live by April 2011. Some of these issues include incubation, ownership and governance structures, development, deployment, and integration of existing systems, and change management procedures, among others. An update on some of these issues is provided in Section 6 of this document.

Without a well-designed and well-functioning IT system, the benefits of GST will remain elusive. It is important that the design and implementation of the GST IT systems start without any further delay, and consensus is achieved on the unresolved policy issues in the earliest possible timeframe.

2. An IT infrastructure for GST

Figure 1: Desirable features of GSTN

2.1 Desirable features of Goods & Service Tax Network (GSTN)

Simplicity for taxpayers: The process of filing of tax returns and payment of tax should be simple and uniform and should be independent of taxpayer's location and size of business. In addition, the compliance process should not place any undue burden on the taxpayer and should be an integral part of his business process.

Respect autonomy of states: The design of the IT system should respect the constitutional autonomy of the states. Several business processes will be re-engineered as a new IT system for GST is put into place. There should be no dilution of the autonomy of states as a result of the IT system, or the re-engineering. On the contrary, it should strengthen the autonomy of states. This is a key factor in the design of the IT system presented in the rest of this document.

Uniformity of policy administration: The business processes surrounding GST need to be standardized. Uniformity of policy administration across states and centre will lead to a better taxpayer experience, and cut down costs of compliance as well as tax administration.

Enable digitization and automation of the whole chain: All the business processes surrounding GST should be automated to the extent possible, and all documents processed electronically. This will lead to faster processing and reconciliation of tax information and enable risk based scrutiny by tax authorities. For small taxpayers, facilitation centres can be set up to ease the migration.

Reduce leakages: A fully electronic GST can dramatically increase tax collections by reducing leakages. Tools such as matching the input tax credit, data mining and pattern detection will deter tax evasion and thus increase collections.

Leverage existing investments: Existing IT investments of states should be leveraged. The Mission Mode Project on Commercial Tax should be aligned with the GST implementation going forward.

2.2 Stakeholders

The design of an IT infrastructure should serve all stakeholders and their business processes. The various stakeholders in a GST IT implementation are as follows (Figure 2):

Figure 2: Stakeholders

Small taxpayers: Much of the economic activity in India is concentrated among small taxpayers. They may not have the skill or the resources to effectively migrate to GST. Thus, adequate preparations must be done to ensure smooth migration for small taxpayers to GST. This includes extensive consultations, setting up of facilitation centres, education and training.

Corporate taxpayers: Corporate taxpayers may operate across various states and typically have sophisticated IT systems for accounting, e-filing returns, payments etc. Common file formats and message specifications should be released early to allow IT vendors that provide software to corporate taxpayers to modify and release updated versions with GST support.

State tax authorities: The state tax authorities would be responsible for collecting SGST. Common file formats, interfaces, and policy administration will enable accurate and timely assessment, and risk-based investigations resulting in enhanced productivity and revenues.

CBEC: CBEC would be responsible for collecting CGST and IGST. Common file formats, interfaces, and policy administration will increase the productivity of CBEC. It will allow for accurate and timely assessment, risk-based investigations and facilitate IGST settlement by Centre at agreed time intervals.

RBI: The Reserve Bank of India will facilitate the interface with various banks to facilitate movement of states' and center's funds. The processes of funds settlements and documentary compliance are independent.

Banks: Banks will accept duty from the taxpayers and process challans. All tax collections (whether physical or electronic) will happen at bank branches, or through the banks' IT systems. Banks will route the tax collected to the concerned authorities through the RBI channel.

Other Stakeholders include CAG, GSTN, TRPs and facilitation agencies.

2.3 Workflows

The following three processes constitute the most important workflows of the GST administration and would be covered in the first phase:

Registration: A unique ID is necessary to identify each taxpayer. The PAN based ID should be common to both the states and the centre. A common PAN-based taxpayer registration has several benefits including a unified view of taxpayers for all tax authorities. A PAN based registration system has already been implemented in CBEC and several states are also capturing PAN data.

Returns: Both, the states and centre require taxpayers to file periodic returns to assess whether the taxpayers have computed, collected, and deposited their taxes correctly. ITC credit can also be verified on the basis of the returns filed and revenues reconciled against challan data from banks.

Challans: Challans are the payment instruments used by taxpayers to actually pay their taxes. Challans are deposited at collecting banks and are forwarded by them to the tax administrations.

IGST: Under GST, inter-state trade will be leviable to IGST. Under IGST, the tax paid by the selling dealer in the exporting state will be available as ITC to the purchasing dealer in the importing state. This requires verification of ITC claims and transfer of funds from one state to another. Further, in an interstate business to consumer transaction, tax collected in one state has to be transferred to another state as finalized by the business processes. Thus, periodic inter-state settlement is required.

In addition, there are several other workflows such as processing refunds, taxpayer audits, and appeals. It is reiterated that the **core services** envisaged through common portal are limited to registration, payments and returns in the first phase. Other value added services will be added subsequently based on the needs of the Stakeholders. The IT infrastructure should be designed taking into account all stakeholders (Figure 2), and all related workflows (Figure 3

Figure 3: Workflows

3. The Solution Architecture

3.1 A common GST portal

The solution architecture should be designed to meet the design goals for GSTN, described in the previous section. For the purpose of simplicity for taxpayers, uniformity of tax administration, digitization of all documents, and automation of related processes, it is necessary to have:

1. Common PAN-based registration
2. Common standardized return for all taxes (with different account heads for CGST, SGST, IGST)
3. Common standardized challan for all taxes (with different account heads for CGST, SGST, IGST)

Figure 4 shows the solution architecture, the role of the common GST portal, and its connections with other systems.

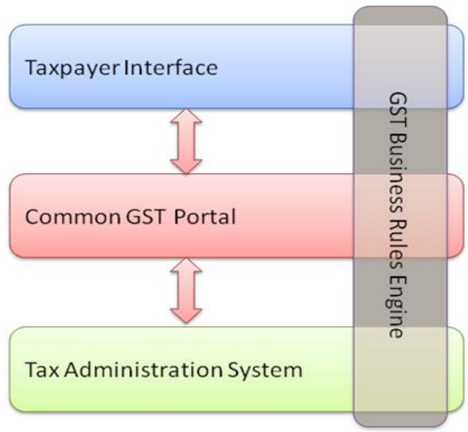

Figure 4: Solution Architecture

A common GST portal, operated by GSTN, is the fastest and most cost-effective way to provide common PAN-based registration, common returns, and common challans for all stakeholders. It can marry the taxpayers standard interface with the varied systems of the tax administrations. Each tax authority will have full flexibility in using this data for in-house automation, integration, and enforcement.

3.2 Basic solution architecture

Given the need for a common GST portal, the basic solution architecture is as follows:

1. Taxpayer files through a standardized taxpayer interface.
2. States and CBEC implement tax administration systems for assessments, audits, and enforcement within their domain. This is desirable but not a pre-condition since the GSTN can provide support for states that do not have the necessary IT systems in place.
3. The taxpayer and tax authority systems are connected with a Common GST Portal, operated by GSTN.
4. Policy decisions are captured in GST Business Rules Engine that defines the tax rates, revenue sharing rules, and exceptions for all parties.

The Business Rules Engine is a component of the solution architecture that spans all entities. It codifies policies and business rules such as the rates of taxation, the revenue sharing between states and centre, a framework for exemption, and thresholds, among other things. All systems in the rest of the solution architecture will be designed so that they load business rules from the Business Rules Engine. This decoupling of the business rules from the rest of the solution architecture allows for a great deal of flexibility. At a later date, if rates are changed or new items are added to the list of taxable items, or if existing items are exempted; these changes can be reflected in the Business Rules Engine, without affecting the rest of the system. This also makes it possible to start the design and implementation of all IT systems, even while policies and rates are debated. Once the policies and rates are fixed, they can simply be reflected in the Business Rules Engine.

In addition to common registration, returns, and challans, the Common GST portal will provision for selected information needs of states.

3.3 Information Flow

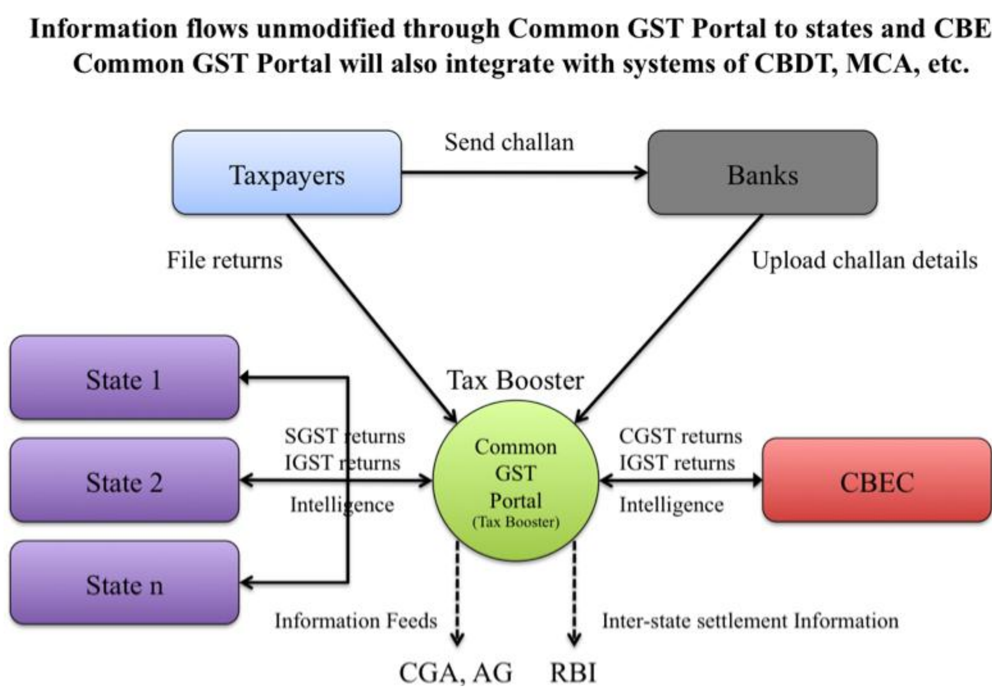

Figure 5: Information flow

The information flows are shown in Figure 5 are designed keeping the constitutional autonomy of states in mind, while simultaneously building intelligence in the system to plug leakages. The common GST portal is simply a pass-through device. The taxpayer files the return with GSTN, which keeps a copy of the return for analysis, and forwards it in near real-time to the respective state and CBEC. The taxpayer pays the actual duty in the bank, which uploads only the challan details into the GSTN. Actual funds never pass through the GSTN.

The common GST portal reconciles the returns and the challans. In addition to its pass-through role, the common GST portal also plays two other critical roles:

1. It acts as a tax booster, matching the input tax credits in the returns to detect tax evasion. It can also integrate with various other systems at MCA, CBDT for verification of PAN or other corporate information and perform data mining and pattern detection to detect tax fraud. It sends this information as alerts/ reports to the respective tax authorities.

2. It also computes inter-state settlement, netting IGST across states.

3.4 Funds flow

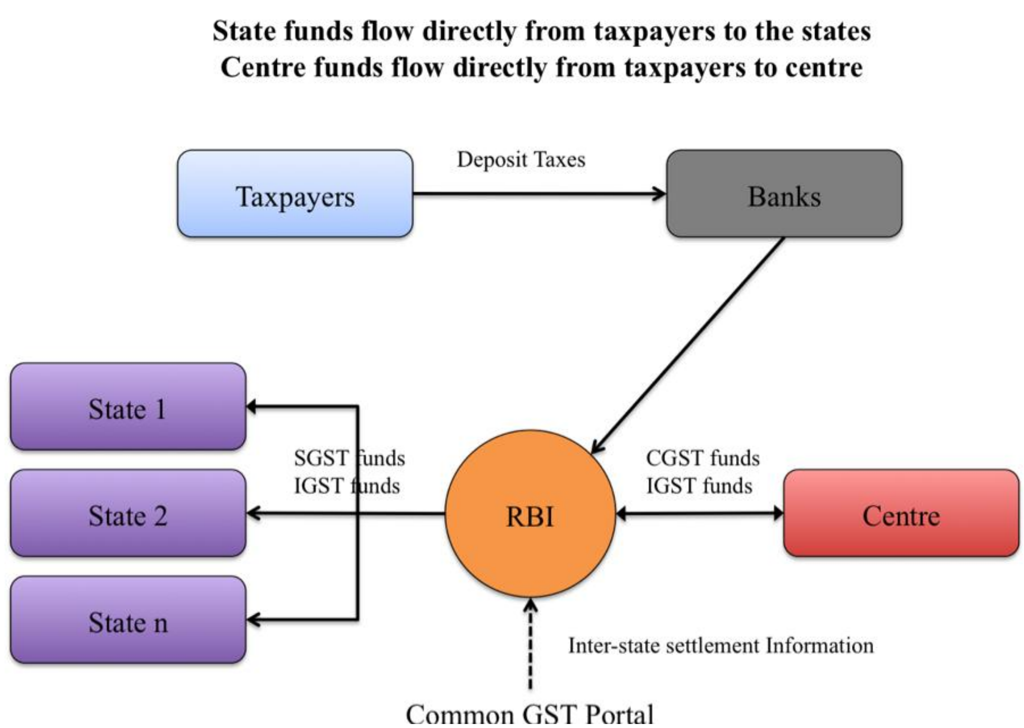

Figure 6: Funds flows

Just like the information flows, the funds flows (Figure 6) are also designed keeping the constitutional autonomy of states in mind. The design ensures smooth and timely availability of funds as soon as they are deposited. The SGST funds that are intended for the states directly go from the taxpayer to the state treasuries. Similarly, the CGST funds go directly to the centre. With the help of information from GSTN, IGST will be settled between states and centre by RBI.

4. Tax Booster

4.1 Tax computation and accounting

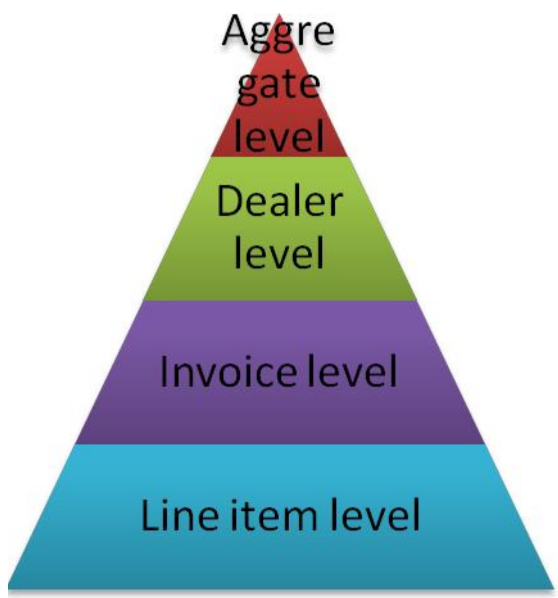

Figure 7: Levels of granularity for returns

The tax returns can be filed at various levels of granularity, as shown in Figure 7.

1. **Aggregate level:** A taxpayer aggregates all his sales and purchases made across all the customers/ vendors and files one return.
2. **Dealer level:** A taxpayer aggregates all his sales and purchases made across all the customers/ vendors and files one return along with the transactions consolidated customer/ vendor wise.
3. **Invoice level:** A taxpayer aggregates all his sales and purchases made across all the customers/ vendors and files one return along with the transactions details provided invoice wise.

4. **Line item level:** A taxpayer aggregates all his sales and purchases made across all the customers/ vendors and files one return along with the invoice wise transactions capturing item wise details as well.

Invoice level detail is necessary for the reconciliation of tax deposits, and the end-to-end reconciliation of ITC. An effective IGST implementation may also require invoice-level details. A number of states are capturing invoice details even in the existing VAT systems. It is proposed to follow a two-pronged approach with Dealer level granularity of returns in the first phase followed by invoice level in the next phase. This issue is currently being discussed in the IT sub-working group for evolving consensus.

There has been some concern around reconciliation of ITC at invoice-level detail due to the sheer volume of data. However, this scale is no different than what organizations such as NSE, NSDL, RBI, and banks handle on a daily basis. Experience at states that have implemented this also shows that match quality is low initially, but improves significantly over time.

4.2 Tax booster

Type of fraud	Common GST Portal: Intelligence based deterrence
Fraudulent bills	Matching
Improper Input Tax Credit	Matching
Fraudulent use of ‘exempt’ rules	Electronic returns
False payment proofs	Electronic challans
Unrecorded sales	Data mining
Misuse of composition method	Data mining
Wrongful application of lower tax	Data mining
Under-invoicing	Data mining
Non-existent dealers	Data mining

Figure 8: Types of frauds

As taxpayers start filing invoice level returns, the common GST portal can start analysing the data for tax evasion and fraud. Common formats for returns and payments, combined with electronic filing and electronic payments, and a standardized PAN-based registration makes the data consistent, and amenable to mining.

Some of the common frauds, and how they may be combated are shown in Figure 8. Assuming VAT collections of ₹ 1,50,000 crores across all states, and a potential for a 20% increase in collections, the common GST portal can lead to additional revenues of up to ₹ 30,000 crores.

5. Implementation plan

Owner	Component
Taxpayer	User registration (PAN-based) File returns Tax payments
GSTN	User registration (PAN-based) Acceptance and Consolidation of returns Challan reconciliation Matching of Input Tax Credit Dashboard and MIS Helpdesk and facilitation centres
Tax Authorities	Assessment, audits, and enforcement Refunds Dispute resolution Helpdesk and facilitation centres
Banks and RBI	Tax payments and reconciliation
Accounting Authorities	Reconciliation

Figure 9: Owners of various components

The GST IT implementation requires various stakeholders to implement new IT systems, or modify existing systems. All these stakeholders are on the critical path for GST readiness in April 2011. Implementation plans for various stakeholders, and interfaces between stakeholders should be frozen, and agreed to by all before implementation can commence. Figure 9 lists the components to be implemented by various stakeholders to go live in April 2011.

6. Current Status of GSTN implementation

The Ministry of Finance, with the concurrence of the Empowered Committee of

State Finance Ministers, has set up an *Empowered Group on IT Infrastructure for GST* with, inter alia, the mandate of approving the Solution architecture of the Common GST portal to be set up, Suggesting the modalities for setting up of a National Information Utility (NIU / SPV) and evaluating the suitability of the existing NIUs namely NSDL & NPCL for incubating the NIU/SPV for GST portal.

The 'Empowered Group on IT Infrastructure for GST' in its first meeting evaluated the feasibility of incubating the NIU, called GSTN, in NSDL and came to the conclusion that NSDL is well suited for this purpose. The scope of the project and implementation strategy is being worked out with the NSDL.

C-4

List of Countries Implementing VAT/GST*

- Currently, there are **160** countries in the world that have implement VAT/GST. Number of country based on region are as follows:-

No.	Region	No. of Country
1	ASEAN	7
2	Asia	19
3	Europe	53
4	Oceania	7
5	Africa	44
6	South America	11
7	Caribbean, Central & North America	19

- Out of 160 countries, eight countries are not United Nation (UN) Member States:

— Azores;

— Taiwan;

— Faroe Islands;

— Isle of Man;

— Jersey;

— Kosovo;

— Madeira; and

— Niue.

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* *Source:* http://gst.customs.gov.my/en/gst/Pages/gst_ci.aspx

- Number of UN Member States are **193** and out of the 193, only **41** Member States do **not** implement VAT/GST, as follows:

No.	**Region**	**No. of Country**
1	ASEAN – Malaysia – Brunei – Myanmar	3
2	Asia – Afghanistan – Bahrain – Bhutan – Iraq – Kuwait – Maldives – North Korea – Oman – Qatar – Saudi Arabia – Syria – Timor Leste – United Arab Emirates – Yemen	14
3	Europe	2
	– Andorra – San Marino	
4	Oceania	7
	– Kiribati – Marshall Islands	

No.	Region	No. of Country
	— Micronesia — Nauru — Palau — Solomon Islands — Tuvalu	
5	Africa	10
	— Angola — Comoros — Djibouti — Eritrea — Liberia — Libya — Sao Tome and Principe — Somalia — South Sudan — Swaziland	
6	Caribbean, South, Central & North	5
	— America — Bahamas — Cuba — Saint Lucia — Suriname — United States of America	

- Latest countries to implement VAT/GST *(for the last 5 years)* are:

Gambia - **2013**	Saint Kitts and Nevis - **2010**
Congo - **2012**	Laos - **2009**
Seychelles - **2012**	Niue - **2009**
Grenada - **2010**	Sierra Leone – **2009**

1.2 Country working towards a VAT/GST system:-

— Afghanistan, Bahamas, Bhutan, Kiribati, Marshall Islands, Micronesia, Palau, Sao Tome and Principe, Syria

— Gulf Cooperation Council (Bahrain, Kuwait, Qatar, Saudi Arabia, Oman and the United Arab Emirates)

— China & India – to have a uniformed GST system

1.3 The detailed list of country are attached.

ASEAN (7 Countries)

No	Country	GDP Per Capita (World Bank, 2011, USD)	Year of Implementation	Initial Rate (%)	Current Rate (%)
1	Indonesia	3,495	1984	10	10
2	Thailand	4,972	1992	7	7
3	Singapore	46,241	1993	3	7
4	Philippines	2,370	1998	10	12
5	Cambodia	897	1999	10	10
6	Vietnam	1,407	1999	10	10
7	Laos	1,320	2009	10	10

ASIA (19 Countries)

No	Country	GDP Per Capita (World Bank, 2011, USD)	Year of Implementation	
1	Bangladesh	743	1991	15.0
2	China	5,445	1994	17.0
3	India	1,509	2005	12.5
4	Iran	*NA*	2008	5.0
5	Japan	45,903	1989	5.0
6	Jordan	4,666	2001	16.0
7	Kazakhstan	11,357	1991	12.0
8	Kyrgyzstan	1,124	1999	20.0
9	Lebanon	9,413	2002	10.0
10	Mongolia	3,129	1998	10.0
11	Nepal	619	1997	13.0
12	Pakistan	1,189	1990	16.0
13	Papua New Guinea	1,845	2004	10.0
14	South Korea	22,424	1977	10.0
15	Sri Lanka	2,835	2002	12.0
16	Taiwan	*NA*	1986	5.0
17	Tajikistan	935	2007	20.0
18	Turkmenistan	5,497	1993	15.0
19	Uzbekistan	1,546	1992	20.0

EUROPEAN (53 Countries)

No	Country	GDP Per Capita (World Bank, 2011, USD)	Year of Implementation	Current Rate (%)
1	Albania	4,030	1995	20.0
2	Austria	49,581	1973	20.0
3	Armenia	3,305	1993	20.0
4	Azerbaijan	6,912	1992	18.0
5	Azores *(the autonomous region of Portugal)*	*NA*	1986	16.0
6	Belarus	5,820	1991	20.0
7	Belgium	46,608	1971	21.0
8	Bosnia Herzegovina	4,821	2006	17.0
9	Bulgaria	7,283	1994	20.0
10	Croatia	14,193	1998	25.0
11	Cyprus	30,670	1992	18.0
12	Czech Republic	20,677	1993	21.0
13	Denmark	59,889	1967	25.0
14	Estonia	16,534	1991	20.0
15	Faroe Islands	*NA*	1993	25.0
16	Finland	48,812	1994	24.0
17	France	42,379	1954	19.6
18	Georgia	3,203	1993	18.0
19	Germany	44,021	1968	19.0
20	Greece	25,630	1987	23.0
21	Hungary	14,043	1988	27.0
22	Iceland	43,967	1990	25.5

No	Country	GDP Per Capita (World Bank, 2011, USD)	Year of Implementation	Current Rate (%)
23	Ireland	47,478	1972	23.0
24	Isle of Man	*NA*	1973	20.0
25	Israel	31,281	1976	18.0
26	Italy	36,130	1973	21.0
27	Jersey	*NA*	2008	5.0
28	Kosovo	3,579	2001	16.0
29	Latvia	13,727	1995	21.0
30	Liechtenstein	*NA*	1995	8.0
31	Lithuania	14,100	1994	21.0
32	Luxembourg	114,232	1969	15.0
33	Macedonia	5,058	2000	18.0
34	Madeira *(the autonomous regions of Portugal)*	*NA*	1986	22.0
35	Malta	21,380	1999	18.0
36	Moldova	1,967	1998	20.0
37	Monaco	171,465	1954	19.6
38	Montenegro	7,111	2003	17.0
39	Netherlands	50,085	1969	21.0
40	Norway	98,081	1970	25.0
41	Poland	13,352	1993	23.0
42	Portugal	22,485	1986	23.0
43	Romania	8,874	1993	24.0
44	Russia	12,995	1991	18.0
45	Turkey	10,524	1984	18.0
46	Serbia	6,312	2004	20.0

No	Country	GDP Per Capita (World Bank, 2011, USD)	Year of Implementation	Current Rate (%)
47	Slovak Republic	17,782	1993	20.0
48	Slovenia	24,132	1999	20.0
49	Spain	31,985	1986	21.0
50	Sweden	57,114	1969	25.0
51	Switzerland	83,326	1995	8.0
52	Ukraine	3,615	1992	20.0
53	United Kingdom	38,974	1973	20.0

OCEANIA (7 Countries)

No	Country	GDP Per Capita (World Bank, 2011, USD)	Year of Implementation	Current Rate (%)
1	Australia	61,789	2000	10.0
2	Fiji	4,397	1992	15.0
3	New Zealand	36,254	1986	15.0
4	Niue	*NA*	2009	5.0
5	Samoa	3,485	1994	15.0
6	Tonga	4,152	2005	15.0
7	Vanuatu	3,094	1998	13.0

AFRICA (44 Countries)

No	Country	GDP Per Capita (World Bank, 2011, USD)	Year of Implementation	Current Rate (%)
1	Algeria	5,244	1992	17.0
2	Benin	802	1991	18.0
3	Botswana	8,533	2002	12.0
4	Burkina Faso	613	1993	18.0
5	Burundi	271	2009	18.0
6	Cameroon	1,260	1999	19.25
7	Cape Verde	3,798	2004	15.0
8	Central African Republic	489	2001	19.0
9	Chad	918	2000	18.0
10	Democratic Republic of the Congo	231	2012	16.0
11	Ethiopia	357	2003	15.0
12	Egypt	2,781	1991	10.0
13	Equatorial Guinea	27,478	2004	15.0
14	Gabon	11,114	1995	18.0
15	Gambia	506	2013	40.0
16	Ghana	1,570	1998	12.5
17	Guinea	498	1996	18.0
18	Guinea-Bissau	626	2001	15.0
19	Ivory Coast	1,195	1960	18.0
20	Kenya	808	1990	16.0

No	Country	GDP Per Capita (World Bank, 2011, USD)	Year of Implementation	Current Rate (%)
21	Lesotho	1,106	2003	14.0
22	Madagascar	465	1994	20.0
23	Malawi	365	2002	16.5
24	Mali	684	1991	18.0
25	Mauritania	1,190	1995	14.0
26	Mauritius	8,755	1998	15.0
27	Morocco	3,054	1986	20.0
28	Mozambique	533	2008	17.0
29	Namibia	5,383	2000	15.0
30	Niger	374	1994	19.0
31	Nigeria	1,502	1993	5.0
32	Republic of Congo	3,485	2012	16.0
33	Rwanda	583	2001	18.0
34	Senegal	1,119	2001	18.0
35	Seychelles	12,321	2012	15.0
36	Sierra Leone	496	2009	15.0
37	South Africa	8,070	1991	14.0
38	Sudan	1,435	2000	17.0
39	Tanzania	532	1998	18.0
40	Togo	588	1995	18.0
41	Tunisia	4,350	1988	18.0
42	Uganda	487	1996	18.0
43	Zambia	1,425	1995	16.0
44	Zimbabwe	757	2004	15.0

SOUTH AMERICA (11 Countries)

No	Country	GDP Per Capita (World Bank, 2011, USD)	Year of Implementation	Current Rate (%)
1	Argentina	10,942	1974	21.0
2	Bolivia	2,374	1986	13.0
3	Brazil	12,594	1964	10
4	Colombia	7,104	1983	16.0
5	Chile	14,394	1974	19.0
6	Ecuador	4,496	1981	12.0
7	Guyana	3,408	2007	16.0
8	Paraguay	3,629	1992	10.0
9	Peru	6,018	1991	18.0
10	Uruguay	13,866	1972	22.0
11	Venezuela	10,810	1993	12.0

CARIBBEAN, CENTRAL & NORTH AMERICA (19 Countries)

No.	Country	GDP Per Capita (World Bank, 2011, USD)	Year of Implementation	Current Rate (%)
1	Antigua and Barbuda	12,480	2007	15.0
2	Barbados	13,453	1997	17.5
3	Belize	4,059	2006	12.5
4	Canada	50,344	1991	5.0
5	Commonwealth of Dominica	7,154	2006	15.0

No.	Country	GDP Per Capita (World Bank, 2011, USD)	Year of Implementation	Current Rate (%)
6	Costa Rica	8,647	1982	13.0
7	Dominican Republic	5,530	1992	16.0
8	El Salvador	3,702	1992	13.0
9	Grenada	7,780	2010	15.0
10	Guatemala	3,178	1992	12.0
11	Haiti	726	1982	10.0
12	Honduras	2,247	1964	12.0
13	Jamaica	5,335	1991	12.5
14	Mexico	10,047	1980	16.0
15	Nicaragua	1,587	1984	15.0
16	Panama	7,498	1976	7.0
17	Saint Kitts and Nevis	13,144	2010	17.0
18	Saint Vincent and the Grenadines	6,291	2007	15.0
19	Trinidad and Tobago	16,699	1990	15.0

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Goods and Services Tax for India*

R. Kavita Rao

Working Paper 2008-57

November-2008

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* Source : http://www.empcom.gov.in

Goods and Services Tax for India

R. Kavita Rao*

Introduction

Indirect taxes on goods and services at the state level constitute 85 percent of own tax revenue of the state governments of which sales tax alone accounts for 61 percent. A change in regime in recent times from cascading types sales taxes to taxes based on input-tax credit within taxation of goods, as well as the adoption of a uniform rates of tax, has resulted in buoyant revenues. However, the reform agenda is far from complete. The proposed GST regime constitutes the next step towards comprehensive reforms of indirect taxes in India. It would be the final step or a step in the right direction, depending on how the country chooses to define the constituents of this new regime. Decisions on the design of the proposed tax are not yet in the public domain. In this context, the objective of this paper is twofold: First, to identify the likely form of the proposed tax and the contentious issues that need a resolution before the tax can be implemented effectively. Second, given the importance of indirect taxes in the portfolio of the states, since any change would not affect all states uniformly, an attempt would be made to project the likely impact of one particular design of GST on states. While these estimates can at best be tentative, they will highlight the fact that the impact is differential across states and these differences would have to be taken into account in designing the proposed assignment of tax powers between the centre and the states.

The paper is organised as follows. *Section 2* sets out the contours of a feasible design of VAT in India. It also takes on board the various alternatives proposed. *Section 3* looks at the issues that need resolution and the options available for resolving the same. *Section 4* provides estimates of the rates of tax that would ensure that the regime is revenue neutral. It also illustrates the differential impact across states, under one configuration. This section works

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with the assumption that there is only one rate of tax under the new regime. *Section 5* concludes.

II. Feasible Design of GST for India

Textbook discussions of VAT often present a case for a federal VAT with a broad base and few exemptions. Political compulsions and the need to maintain some degree of progressivity in the tax system induce deviations from the prescribed coverage. There are very few examples worldwide that incorporate a sub-national VAT.[1] Within the constitutional assignment of tax powers in India and the current political environment, however, purely federal VAT is not considered feasible, even though it may be considered desirable in a number of circles. The options left therefore are a dual VAT, an integrated VAT, or a state level VAT. Each of these regimes has certain advantages and some costs. It would be useful to look at these in some detail.

In contrast to a federal VAT, a state VAT transfers the entire power to tax to the provincial governments. The revenue balance in such a regime can be ensured by a reduction in the transfers to the provinces from the union government. However, there are two major difficulties in implementing such a regime. First, since one of the purposes of central transfers is to induce some redistribution of resources, a reduction in the transfers can reduce the leverage the union government has in effecting such regional redistribution. Second, since the strength of the Indian economy would lie in its forging a single common market, form of treatment and monitoring of inter-state transactions would be critical in determining the success of such a regime. While destination principle is considered appropriate, success of a pure zero-rating mechanism is contingent on a reliable and timely information system to record and monitor inter-state transactions. It is possible to find solutions to the second problem, however, the first would remain a constraint.

A dual VAT proposes two parallel taxes – one by the union government and the other by the state governments. In principle, the taxes can be completely unrelated to each other and can be run by two or more unrelated tax administrations. In the context of India, this would represent some improvement in the tax base for the governments, since both the union government and the state governments in India currently work with comparatively smaller tax bases. Cascading would be minimised provided provincial taxes are not levied on a base inclusive of central taxes.[2] However, the tax system would remain as complex as it is today, with 30 different tax laws and the corresponding administrations. The changes in coverage and the implied expansion in incidence of tax would induce a considerable resistance to such a change. Further, there remains the need to put in place a reliable system to monitor inter-state transactions, as in the case of the state VAT alternative.

An integrated VAT as opposed to the above, attempts to design an integration of the tax bases for the centre and the states so that together, the taxes cover a comprehensive base for VAT. This model would eliminate the duality of taxes on all segments of the tax base, however, it would retain the complexity of the dual VAT, provided the states are allowed to determine their own rates of tax and maintain separate administrations. Further, there would arise need for tax credit to flow across taxes, which would make tracking transactions essential and difficult. Another potential difficulty with any such design is, with differential growth rates for different segments of the economy, any assignment of tax powers would be perceived as unfair by one or the other level of government. For instance, if services are allocated to the union government, since this sector of the economy is known to grow faster than the other sectors, states would perceive this as an unfair assignment of tax powers.

Clearly, any model that is adopted needs to be modified to suit the needs of the hour. A dual VAT with corrections for the problems mentioned would provide a model closest to satisfying the needs of both levels of government. This is the model that has found support in academic circles and is now being endorsed by the Empowered

Committee of State Finance Ministers. The rest of the discussion therefore, focuses on this broad structure and attempts to identify the details of any model that can be adopted.

As the discussion above suggests, a dual VAT empowers both levels of government to tax the entire available tax base. In defining the tax base, there will arise some exemptions. A conservative picture of the likely exemptions in the proposed regime would be as follows: Unprocessed agricultural goods could remain exempt from taxes – for reasons of convenience and to present a picture of progressivity in the tax. In the present regimes, the central tax does not extend to the agricultural sector and the state regimes exempt a number of agricultural commodities – only crops considered to be of commercial nature are usually brought under tax.[3] Government services are likely to be exempt and so would personal and social services like education and health care. Given the rising demand for the latter category of services in India, where it is often perceived that the responsibility for the same rests with the government, introducing a tax on the same may not be acceptable, at least in the short run. Furthermore, given the well-documented difficulties in taxing financial services, to being with, it is fair to assume that this sector too would remain largely untaxed.[4] In order to ensure a level playing field, it is important that exports are zero-rated and imports are subject to GST, i.e., to both central and state VAT. The rest of the activities, it is expected, would come within the ambit of GST, at both levels of tax.

In implementing such a regime, it is important to clearly specify a regime for taxation of inter-state transactions. This is even more important in the context of services which span more than one state. The other important issue that needs to be discussed is the nature of administration of such a tax – if the tax base is synchronised/ homogenised across the taxes, there is great merit in exploring the options for a unified administration. These issues remain as yet unresolved. The options in the same are discussed in the following section.

The other major issue that remains to be discussed is the rate of tax that would make this regime revenue neutral. There are three distinct issues in any discussion on the rates of tax. First, should there be a single rate of tax or multiple rates. While it is generally accepted that a regime with a single rate of tax is easier to administer and comply with, multiple rates are introduced to address issues of progressivity. Apart from issues such as classification disputes and accounting difficulties in a multi-rate regime, such regimes introduce perverse incentives. In the present regime of state VAT for instance, inputs have been taxed at 4 percent while 12.5 percent is the regular rate on goods of final consumption. Such a big divergence between taxes on inputs and final products undermines the incentive mechanism of VAT – the manufacturer would not be induced to report all his sales since a substantial part of the tax is to be paid at this stage. A GST regime with an acceptable tax rate might provide the scope for moving away from a multi-rate regime to a single rate regime.

Second, since high rates would induce non-compliance, are there mechanisms available to ensure that the rates of GST rates remain modest and yet generate the required resources? It is often argued that any tax less than 20 percent would not raise the resources required. VAT is often complemented by some non-rebatable excises. These excises could be satisfying a number of other objectives like environmental issues, discouraging the consumption of tobacco and alcohol, and/or imposing a "luxury tax" on select goods associated with relatively higher incomes. In India, no specific emphasis has been placed on environmental issues in determining tax structures – however, for reasons of ease of collection, petrol and diesel have been subject to high rates of tax, especially at the state level.[5] The state VAT regimes have kept these two products outside the purview of VAT.[6] It is feasible therefore to construct regimes which integrate these commodities into the general VAT/GST structure and introduce a separate non-rebatable excise over and above this rate. In the case of tobacco products, especially, cigarettes and *bidis*, the state governments have now introduced a state VAT at 12.5 percent and the central government imposes specific taxes on these products. The central taxes alone contribute anywhere between 17 to 59 percent of the retail prices of these products. There is therefore, room to reorganise these regimes into a generalised GST and some non-rebatable excises. This would not disturb the government's overall concern to discourage the consumption of tobacco products. For luxury taxes, it is possible to identify a number of commodities which satisfy this description. However, in order to capitalise on the benefits of introducing a simple and comprehensive VAT, it is important to keep this list small. For illustration, we limit this list to include only passenger cars and multi-utility vehicles. With these three categories subject to non-rebatable excises, *Section 4* explores the rates of tax required to ensure revenue neutrality. Depending on the relative distribution of revenues within the new regime, the non-rebatable excises can be assigned to either the union government or the state governments.

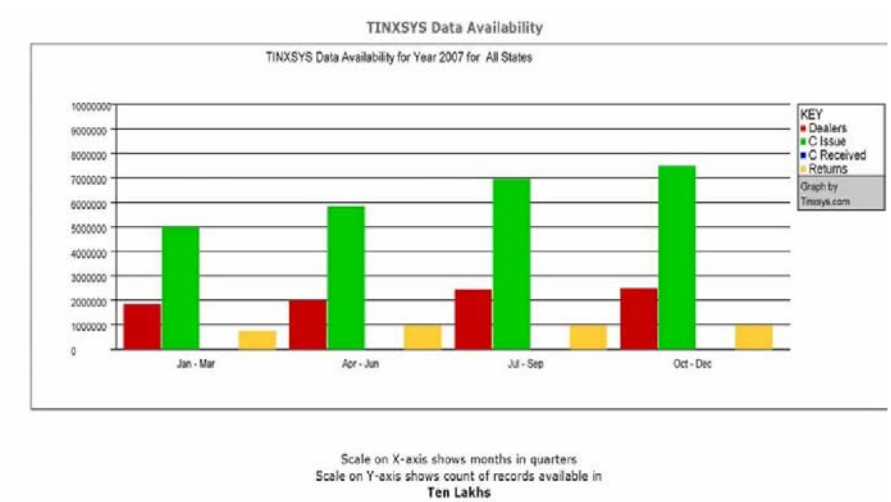
Third, would there be uniform taxes across all states? States, till now, have autonomy in determining tax rates on bases within their jurisdiction. Since 2000, some consensus has been worked out to ensure a degree of harmonisation in the rates. While complete harmonisation has not been achieved, it does not appear to be an impossible task. It may however, be worthwhile to allow for a degree of autonomy in rates within a narrow band so as to address local concerns of individual states. Harmonisation in the base however is essential and highly desirable.

III. Unresolved Issues and Options

1. Treatment of inter-state transactions:

The present regime of taxation of inter-state sales relates only to the taxation of goods and involves tax exportation from the producing states to the consuming states. An agreement has been reached to gradually phase out this levy called the Central Sales Tax.[7] The budget for the present year has proposed to reduce it from the existing 3 percent to 2 percent. Complete zero-rating − the result when this tax is reduced to zero − would however provide incentives for tax evasion, since there would be considerable difference between the taxes on local sales and those applicable on inter-state sales. It is imperative that a reliable mechanism for identifying inter-state transactions be introduced so as to place a curb on the incentives to evade. The Empowered Committee of State Finance Ministers has worked towards the creation of such a database in the form of TINXSYS. This system is now more than 2 years old. It captures data on C-forms issued by each of the state tax administrations.[8] However, there is no information on the C-forms received by the exporting states. The registered dealers are expected to report on C-forms every quarter. Unless this loop is completed, the information on inter-state transactions is not complete and hence not reliable.[9] The chart below provides a summary of the information captured in the database for the calendar year 2007.

This system, by providing information on C-forms issued, does allow the exporting state access to some data. However, the verification of information would remain a manual and individualised task, losing out on the potential gains from implementing a comprehensive system.



Source: TINXSYS website. www.**tinxsys**.com

In this context it is desirable to go back to the drawing board. The literature presents a number of models for treatment of inter-state transactions.[10] Both

Canada and the European Union use the zero-rating model while the Brazilian system is one central levy, bridging the gap. An adaptation of the zero-rating model has often been discussed in India – zero-rating with pre-payment, also referred to as zero-rating with reverse charge. The system can be broadly summarised as follows:[11]

> Zero-rating is made conditional on payment of tax in importing state. Importing dealer would account for all imports in the monthly return and pay taxes on the same. In practice, zero-rating can be reversed if the transactions are not reported in the importing state within prescribed time limit. It may be mentioned that this places local purchases and inter-state purchases on a level playing field since taxes would be payable on both these transactions.

The information on these transactions would therefore flow on a month by month basis. Information can be captured on individual transactions or on pairs of dealers. It is possible to extend this regime to dematerialise the C-forms and ensure that the details are captured online by the buyer and the seller as well, by self-issuing a C-form and validating the same. In the process, the information can be made more reliable.

While the above deals with transactions involving goods rather efficiently, some more details need to be worked out for dealing with services. In the case of services, the normal regime would dictate that the tax is payable where the service is rendered.

However, when services span more than one jurisdiction, special rules need to be spelt out and agreed upon. In defining these rules, it is important to keep in mind the potential for ensuring tax credit mechanisms work, if required.

The European Union provides some guidelines for dealing with services of such a nature:[12]

- **Passenger transport** services are taxed according to the distances covered.

  Example: the price of a bus ticket for a trip from Poland to Austria through Germany will include Polish, German and Austrian VAT, proportionate to the distances travelled in each of these countries.

- The **intra-Community transport of goods** is taxed at the place of departure. If the customer is identified for VAT purposes in another

Member State and provides the supplier with this VAT identification number, the service is however taxed in the Member State where the customer is identified.

Example: When goods are transported by a French company from Germany to France, German VAT must be paid on the transport. If this service is rendered to a customer who is identified for VAT in the Netherlands, Dutch VAT will have to be paid, and by the customer himself.

- The **ancillary services to an intra-Community transport of goods**, such as the loading and unloading services, are taxable in the Member State where those services are physically carried out. If rendered to a customer who is identified for VAT purposes in another Member State and he provides the supplier with this VAT identification number of that other Member State, the service is instead taxed in the Member State where the customer is identified.

  Example: A Danish company unloads a truck in Rotterdam. If this is done for a Dutch customer, the supplier will need to charge Dutch VAT. If, on the other hand, the customer is a Finnish company, the place of supply of the service rendered by the Danish company is not the Netherlands, where the unloading takes place, but Finland, where the customer is identified for VAT.

Chart A below provides a summary of the treatment of transactions in the case of telecom services.[13] All these cases illustrate systems for preserving the tax credit mechanism for registered taxpayers and at the same time define rules for sharing of revenues in all other cases. Some such rules need to be agreed upon, before comprehensive taxation of services can be contemplated. Further, clear definitions of what constitutes international export of services too need to be agreed upon since zero-rating at two levels is involved.

2. Administration of the tax

If the tax bases are successfully harmonised, even with some variation in the tax rates across states, it is possible to pool the resources of the tax administrations so as to improve tax administration. There is no significant advantage in implementing two completely disjointed tax administrations for such a tax regime. The important question however is to what extent can and should there be unification of administration. To begin with, it is important to understand the gains from unification or integration. Dealing with two tax administrations adds to compliance costs for the tax payer two returns, two sets of officials, and potentially two audits. Some unification therefore would make the transition more acceptable. From the point of view of tax administration, the information flowing from the taxpayer to a unified administration would be more reliable than to two separate administrations. Resources can be conserved by not duplicating routine tasks like registration and returns processing.

Having made a case of some unification in administration, it is useful to discuss what extent of unification is feasible and/or desirable. In principle, it is possible to imagine a single tax administration for this new regime. The regime can be in the form of an independent revenue administration which implements the tax laws of both levels of government. Or it could be a part of either level of government, which takes responsibility to collect revenues on behalf of the other and transfers the same. Such regimes exist in Canada for instance. Such a proposal would face one important question what happens to the existing tax administrations? Once again it is possible to subsume existing tax administrations within this new arrangement. Even with this problem out of the way, it is difficult to arrive at a consensus on such a proposal since there is some perceived autonomy with respect to tax administration as well.

The minimum desirable level of integration is one covering registration, returns filing, database generation, and management. This level of integration would allow the tax administrations to function efficiently and gain from each other's expertise. A further degree of integration could be one where there is a common audit for both the taxes. This, as argued earlier, would ensure that the compliance cost for the tax payer is minimised. Since the revenue interests of different tax administrations would be different, it is possible that some state governments would perceive a given case as a significant revenue risk which the central tax administration might not. To allow for these differences, the tax departments could have the autonomy to choose cases for audit, subject to the condition that the audit would cover both taxes and would therefore apply for both levels of government. A common procedure for choosing case for audit therefore would need to be developed.

Between these two extremes, any intermediate position should be acceptable to the taxpayer. It is however, important to mention that segregation of units by size or economic activity into groups to be administered by one or the other administration would hinder effectiveness of administration. It would constitute an artificial segregation, and depending on the perceived strength and weakness of the underlying administrations, there would evolve an incentive to align oneself to one or the other. This would give rise to definitional conflicts of turf between two levels of government, without contributing actively to taxes or improved administration or to improved economic environment. It is therefore desirable to develop schemes whereby the division of functions between the different tax administrations is not of immediate concern and relevance to the taxpayer.

Chart A

Liability to VAT on supplies of telecommunications services.

	Status and place of establishment or residence of customer	Supplier in Ireland	Supplier in OMS	Supplier outside EU
1	**business customer in Ireland**	Supplier accounts for Irish VAT	Customer accounts for Irish VAT	Customer accounts for Irish VAT
2	**private individual in Ireland**	Supplier accounts for Irish VAT	Supplier accounts for OMS VAT	Supplier must register and account for Irish VAT
3	**business customer in OMS**	Customer accounts for OMS VAT	Supplier/customer accounts for OMS VAT[1]	Customer accounts for OMS VAT
4	**private individual in OMS**	Supplier accounts for Irish VAT	Supplier accounts for OMS VAT[2]	Supplier must register and account for OMS VAT
5	**outside EU, whether business customer or private individual**	Outside the scope of Irish VAT - No VAT payable (but see column 6)	Outside the scope of Irish VAT	Outside the scope of EU VAT
6	**private individual resident outside EU but avails of service while in Ireland**	Supplier accounts for Irish VAT	Outside the scope of Irish VAT	Outside the scope of Irish VAT when mobile services, cards etc. are involved

OMS = other Member State of the EU

[1] If supplier and customer in the same Member State, supplier pays VAT.
If supplier and customer in different Member States, customer pays VAT in his/her Member State.

[2] Supplier pays VAT in his/her Member State, even if customer in a different State.

IV. Revenue Neutral Rates of Tax for GST

This exercise is based on the All-India Input-Output Matrices, 2003-04.[14] It is assumed that the structure of the economy captured by these matrices remains valid for the present day as well. Since complete and comprehensive information is available for 2005-06, the exercise reports results for this year, and follows it up with rough and ready estimates for subsequent years.

There are two alternative approaches used to estimate the revenue. Both the approaches use common assumptions regarding exemptions, which are listed below. The first approach works with overall GDP numbers.[15] The GDP from taxable sectors as well as the value of exempt inputs used in these sectors constitute the base for the tax. Since even for the taxable activities, imports exceed exports, this provides an acceptable estimate of the domestic base provided one assumes that tax credit for capital goods is not provided upfront. The second approach is based on estimates for private final consumption expenditure. For these estimates, the consumption of taxable goods and services and the taxable inputs used by all the exempt goods and services are taken together to determine the tax base. It may be recalled that the exempt transactions include the exempt goods/services as well as government final consumption expenditure.

Once the base is determined, the rate of tax is sought to be calibrated to ensure the same revenue as jointly obtained from the central excise and service tax of the union government and the state government's state VAT and associated taxes, electricity duty, passenger and goods tax, and entertainment tax. This exercise also assumes that there exist some non-rebatable excises on a few commodities – petroleum products, passenger cars and multi-utility vehicles, and tobacco products. This is in consonance with the conventional view of keeping VAT simple and addressing issues of externalities and inequality through the use of excises.[16]

Based on the discussions in the above sections, this exercise works on the following assumptions:

- all agricultural output are exempt – since some of these goods would actually be taxable, when used in final consumption, the present estimate provides a conservative estimate of the revenues. It may be mentioned that agricultural goods used as inputs by other sectors are already accounted in the estimates of the base.

- all banking and insurance services are assumed to be exempt – however, it is not very clear whether there are other heads of activities where some financial services may have been accounted for (FISIM as per the GDP estimates). The present regime of service tax does levy some taxes on financial services. To the extent some of these levies continue in the new regime, the present estimates would also continue to be conservative.
- "other services and personal and social services" are considered exempt – these include health and education services. While the present sentiment does not suggest taxation of these services, it is possible to imagine some segments of this broad category being brought under tax.
- all sales by government are exempt – holds for central and state governments. However, purchases by government are assumed to be taxed.
- exports are to be zero-rated and imports are to be taxed on par with domestic production.

GDP Based Estimates:

In this approach, the GDP, i.e., value added in sectors classified as taxable, as well as the value of exempt inputs used by these sectors, is considered the base for the tax. Value added in exempt sectors is by definition, not a part of the tax base, unless it returns to the taxable chain in a subsequent transaction. While the taxable inputs used by exempt sectors are subject to a tax, and since these would constitute output of the taxable sectors, there is no need to account for this component separately. Using this base and with a 7 percent non-rebatable excise on passenger cars and multi-utility vehicles, petroleum products and tobacco products, the revenue neutral rate for GST can be worked out. *Table 1* below provides the figures for three years. As can be noted, GST at 10 percent is adequate to raise the revenues required to replace CenVAT and Service tax at the central level and sales tax, passenger and goods tax, electricity duty and entertainment tax, at the state level. In 2007-08 for instance, the revenue raised from these taxes is Rs 3891 billion. Value added in taxable goods and services adds up to Rs 27755 billion and value of exempt inputs used by these sectors is Rs 5113 billion.[17] 10.5 percent tax on this base yields Rs 3426 billion. A 7 percent non-rebatable excise on passenger cars and multi-utility vehicles, petroleum products and tobacco products would generate Rs 526 billion[18], together generating Rs 3953 billion. Any assumption to extend the base to cover some of the personal services and privately provided health and education services or financial services can provide some further revenue.

Based on Private Final Consumption Expenditure:

Using the input-output transactions matrix, the share of taxable consumption expenditure in total private final consumption expenditure is computed to be 56 percent. Using this ratio on the actual figures for private final consumption expenditure for any given year, the taxable component of expenditure can be determined. For the exempt sectors and exempt transactions, taxable inputs used for all exempt output needs to be identified. For the exempt sectors, using the input-output coefficients matrix, the ratio of taxable inputs to gross value added can be obtained. Applying these ratios to GDP from each of the exempt sectors, the taxable base is estimated. Similarly, since gross domestic capital formation is considered final use in the input output transaction matrix, whenever the capital formation takes place in exempt sectors, there is a tax incurred. The extent of investment on which such a tax would accrue is estimated by applying the share of exempt sectors in total capital formation to the gross fixed capital formation levels for the respective years.[19] Further, since we assume that all government expenditure is exempt from taxes, the inputs used to fulfil government final consumption expenditure too would suffer a tax. The sectoral profile of government final consumption expenditure is approximated by the figures obtained from the input-output transactions matrix, and in using the input-output coefficients matrix, the corresponding demand for taxed inputs can be derived.[20]

TABLE 1: Revenue from GST: GDP based Estimates (Figures in Rs billion)

		2005-06	2006-07(R.E.)	2007-08(BE)
1. CenVAT		1112	1176	1279
2.	Service tax	231	371	506
3.	Sales tax	1356	1659	1921
4.	Electricity duty	77	86	91
5.	Passenger and goods tax	64	77	85
6.	Entertainment tax	7	8	9

Total Revenue (1-6)	2847	3377	3891
total revenue (1-3)	2699	3206	3706
Estimates of Revenue			
Rate of GST	10.5 percent	10.5 percent	10.5 percent
Revenue from GST	2553	2980	3426
Rate of non-rebatable excise	7 per cent	7 percent	7 percent
Revenue from excises	420	470	526
Total Revenue	2973	3450	3953

Notes: Revenue figures for the state taxes are revised estimates for 2006-07 and budget estimates for 2007-08. The GDP numbers are quick estimates for 2007-08.

Given the target of revenue, as discussed in *Table 1* , the rates of tax required can be worked out to about 14 percent GST and 10 percent non-rebatable excises on passenger cars and multi-utility vehicles, petroleum products, and tobacco products.

TABLE 2: Revenue from GST: Estimates based on consumption expenditure

(Figures in Rs billion)

	2005-06	**2006-07**	**2007-08**
Rate of GST (percent)	13.23	13.44	13.78
PFCE	20622	23241	26044
Taxable part	11512	12973	14538
Taxes from taxable activities	1522	1744	2003
Taxes from exempt activities	725	907	1075
Total	2247	2651	3078
Rate of excise	10 percent	10 percent	10 percent
non-rebatable excises	600	726	813
Total Revenue Estimated	2847	3377	3891
Target Revenue	2847	3377	3891
GST Rates with Informal Sector Corrections			
30 percent informal sector	18.9 percent	19.2 percent	19.7 percent
25 percent informal sector	17.6 percent	17.9 percent	18.4 percent

Since it is often argued that a significant component of the Indian economy is in the informal sector, which by definition is invisible to the tax system, it is essential to make corrections for this aspect as well. Informal sector can potentially assume two forms first, forms similar to unregistered manufacturing, where it is accounted for in the GDP estimates and second, forms where the GDP estimation procedure fails to capture the same. Since the latter does not affect our estimates, we attempt to correct for the former alone. For the former, since unregistered manufacturing accounts for close to 30 percent of total value added in the manufacturing sector, this proportion is assumed to be representative for the entire economy. Correcting on this basis, it can be shown that the rate of GST required to raise the same revenue as above would be 20 percent. It may be mentioned here that the share of unregistered manufacturing is seen to be declining in recent times – it has declined from over 34 percent in 1999-00 to 30.6 percent in 2006-07. If improved tax regimes, including improved tax administration induce further reductions in this ratio, a lower rate of GST would be able to ensure the same revenues. For instance, if the informal component of the economy is 25 percent of the total, a rate of 18 percent would be adequate.

An important question that emerges is whether the liability on the passenger cars, petroleum products and tobacco products would be raised beyond the present levels. *Table 3* below presents some comparison of the present and proposed liabilities. The proposed liability could be somewhat higher than the present liability in the case of passenger cars and multi-utility vehicles. For the other two categories, the differences do not appear significant, in general. Specific products however, may face some increases.

TABLE 3: Present and Proposed Tax Liabilities in Case of Excisable Goods

	Proposed Liability	**CenVAT**	**Sales Tax**
Passenger cars and multiutility vehicles	30 percent	16 percent	12.5 percent
Tobacco products	30 percent	17-50 percent	12.5 percent
Petroleum products	30 percent	16 percent + specific duties	10-33 percent

Notes: CenVAT is normally applicable as an ad *valorem* levy on ex-factory prices. It is however, a specific tax for cigarettes and *bidis*. The liability as a percentage of the retail price works out to be 17 percent for *bidis* and 26-59 percent for cigarettes.

The revenue neutral rate for GST appears rather modest and comfortable. Lower rates can be achieved by expanding the list of non-rebatable excises and/or hiking the rates of tax on these items. The former is not a desirable route since it would defeat the basic purpose of introduction of a comprehensive value added tax. An alternative route would be to compress the list of exempt activities.

It would in principle be useful to derive such numbers for individual states, based on state specific numbers. However, since expenditure based decomposition of GSDP is not available, nor have input output matrices at the state level been compiled, one cannot generate very reliable numbers for individual states. In what follows, an attempt is made to use some proxies to allocate the total revenue for states to individual states. Since the base for the new tax is different when compared to the taxes it seeks to replace, the revenue in the new regime would not be exactly equal to that in the old regime for each individual state.

The approach adopted to derive the share of each state in total revenue is as follows: Since there are two components to the tax regime, as a first step, some rule for assignment of the non-rebatable excises needs to be worked out. Since the levies are introduced partially to address revenue considerations, it is important that the rate of tax as well as the coverage of the tax in these cases be defined and frozen in time. Any change in either the base or the rate should require a consensus between all the concerned governments. If such rules can be established, the revenues from the above can be assigned to any of the two tiers of governments, without apprehensions of uneven access to tax bases. Table 4 below provides a comparison of the rates of tax under GST for centre and states under two alternative scenarios. For the sake of simplicity, for the purposes of this exercise, it is assumed that all the revenues from these levies are assigned to the union government. Since most indirect taxes are sought to be zero-rated for any exported commodity, such an assignment would allow for easy corrections in case the commodity is exported out of the country.

The base for the tax under GST, as discussed above, has two components private final consumption expenditure on taxable activities and taxable inputs used in exempt sectors and transactions. For the former, the share of states in total taxable consumption as per NSS reports is taken as the proxy. Per capita consumption expenditure by item for each state is segregated into taxable items of expenditure and exempt items of expenditure for rural and urban consumers separately.[21] Population estimates for 2005-06 were used to arrive at the state-wise figure for total private final-consumption expenditure, subject to taxation. [22] The share of each state in the sum of total consumption expenditure across states is taken as the proxy for share of the state in total revenue from taxing consumption. The rate of GST is assumed to be 14 percent.

TABLE 4: Rates of Tax for Centre and State: Alternative Scenarios (percent)

	2005-06	**2006-07**	**2007-08**	**2005-06**	**2006-07**	**2007-08**
Informal sector share		**30 percent**			**25 percent**	
Case 1: Non-rebatable excises assigned to the centre						
Centre	6.2	5.9	6.0	5.8	5.5	5.6
States	12.6	13.4	13.7	11.8	12.5	12.8
Case 2: Non-rebatable excises assigned to the states						
Centre	11.3	11.3	11.7	10.5	10.6	11.0
States	7.6	7.9	7.9	7.1	7.3	7.4

For the second component of the base, exempt activities are assumed to be closely related to overall GSDP in the state. Therefore, share of the state in sum of GSDP across all states is taken as the proxy. It is well recognised that GSDP estimates are not comparable across states and hence cannot in principle be added to generate an overall estimate. However, under a reasonable assumption that scale of economic activity is proportionate to the estimate of GSDP, in the absence of better alternatives, the above is used for purposes of illustration. *Table 5* summaries the results of this exercise. Interestingly, inspite of using rates of tax somewhat higher than the revenue neutral rate, the revenue accruing to some of the states falls short of the actual revenue collections. Most of the states with actual revenue higher than projected revenue are states with relatively higher per capita income. To the extent that NSS data underestimates consumption of the higher income categories, the estimates derived here would contain a *bias* in favour of the relatively lower income states. It should however, be pointed out that apart from this factor, tax bases focused more closely on consumption would tend to induce some redistribution when compared to the present systems, to the extent there is tax exportation on account of CST related provisions within the existing regimes. These two effects need to be segregated, so that a suitably designed assignment of tax powers can be implemented so as to protect the revenues of the states as well as the union government. However, reliable information on CST collections are not readily available, due to poor reporting standards. Some states which are known to derive revenue from CST actually report zero revenue in their budgets. This segregation therefore has not been attempted here.

TABLE 5: Comparison of Actual and Projected Revenue

(Rs crore)

	Actual Revenue		**Projected Revenue**		**Projected -actual**	
	2005-06	**2006-07**	**2005-06**	**2006-07**	**2005-06**	**2006-07**
Andhra Pradesh	**12800**	**17175**	12903	15227	103	-1949
Arunachal Pradesh	48	53	185	214	137	161
Assam	2646	2907	3082	3628	436	721
Bihar	2379	2998	7446	8692	5067	5694
Chhattisgarh	2850	3904	2755	3199	-95	-704
Goa	879	918	465	551	-414	-367
Gujarat	12662	15274	10751	12529	-1911	-2746
Haryana	6437	7682	5058	6115	-1379	-1567
Himachal Pradesh	859	883	1369	1602	510	719
Jammu and Kashmir	1409	1568	1844	2128	436	561
Jharkhand	2300	2648	3262	3817	962	1170
Karnataka	11276	13821	8731	10105	-2546	-3716
Kerala	7071	8920	7140	8331	70	-588
Madhya Pradesh	5938	6558	7746	8975	1807	2417
Maharashtra	22087	26479	21098	24438	-989	-2041
Manipur	72	86	265	313	193	227

Meghalaya	177	190	331	385	153	195
Mizoram	43	52	171	199	129	147
Nagaland	79	93	290	345	212	252
Orissa	3828	4228	3921	4679	93	451
Punjab	5302	5685	6561	7676	1259	1991
Rajasthan	6313	7404	9576	11160	3263	3756
Sikkim	57	51	80	95	23	45
Tamil Nadu	16647	20025	11412	13332	-5235	-6693
Tripura	203	247	389	456	186	209
Uttarakhand	1031	1436	5922	7358	4891	5922
Uttar Pradesh	11655	15810	16365	18528	4710	2719
West Bengal	6537	8090	11899	13778	5363	5688
Delhi	6535	7442	5046	5881	-1489	-1561
Puducherry	304	357	292	341	-13	-16

Note: Difference in the last two columns is projected-actual revenue.
Source: Data for actual revenue collections are taken from the RBI, State Finances, 2007-08.

V. Conclusion

The implementation of GST in India in the form of a comprehensive value added tax is contingent on several key decisions. While there is clarity that the tax would be in the form of a dual VAT, that is the only detail about the tax that is available in the public domain. Presuming that the country is going to witness considerable tax reform, it is only fair on the taxpayers that the details be worked out well in advance so that preparations for a smooth transition can be made.

This paper attempts to identify some of the potential contours of the tax. One of the key issues that needs to be resolved is the treatment of inter-state transactions in goods and services. The existing consensus of zero-rating by itself would not be adequate to address the potential concerns of evasion in such transactions. Zero-rating with pre-payment appears to be a superior alternative. The related issue concerns taxation of services which span more than one tax jurisdiction. International experience points towards self-assessment in the case of registered taxpayers and taxation in the jurisdiction of the supplier in other cases, with some revenue sharing among the member states. Some of the details need to be worked out before the tax on services can be implemented at the state level. A second concern relates to the need to integrate tax administration at the two levels in order to maximise on the efficiency of administration. While there are options available, a final choice needs to be made, once again

Apart from these design issues, one important concern relates to the rate of tax. It is believed and correctly so, that if the rate of tax is "too high", it induces non-compliance. In discussions on VAT in India, a rate of 20 percent has often been proposed as a feasible rate. *Section 4* demonstrates that with the informal sector accounting for 30 percent of economic activity in taxed transactions, a rate of 20 percent with non-rebatable excises of 10 percent on a few selected commodities would be required to generate the target revenue. If the non-rebatable excises are assigned to the union government, this translates into about 14 percent rate for the states and 6 percent for the centre. It may be mentioned that in deriving this rate, all agricultural commodities were considered to be exempt. This should mitigate the regressivity normally associated with VAT regimes. The above is however a conservative estimate since a number of activities currently taxed have been assumed to be exempt for the purposes of arriving at these estimates. Any expansion in the tax base to include some of the activities would allow for a lower rate of tax to be implemented. Further, as observed earlier, the share of informal activities in total as proxied by the share of unregistered manufacturing in total GDP from manufacturing is registering some decline in recent times. If this trend persists, there is scope for considering lower rates of tax.

Finally, the impact of the tax on different states would be different. Careful assignment of tax powers is crucial for the new regime to be acceptable. In the absence of the same, transition to the new regime would require some other revenue transfers. With the new regime, instruments for the same would be limited, and can generate perverse incentives and/or unstable finances for some of the governments involved.

Footnote

1 Canada and Brazil are two such cases. While the European Union is not a single country, the commitment to adhere to the 6th Directive simulates the case of a sub-national levy with no accompanying federal component.

2 The rates of tax can be adjusted to yield the same level of revenues.

3 There are however, exceptions to this general rule. In Punjab for instance, a *mandi* tax is imposed on food grains and the revenue from the same is assigned to local bodies.

4 It may be mentioned that in the present regime of service taxation, the union government does levy a tax on a number of financial services – especially where there is an explicit fee charged for the same. This regime may persist within GST as well. However, it is not clear how a tax credit mechanism can be designed effectively in such cases.

5 The Union government has dual interventions in this sector – on one hand there is a tax on petroleum products and on the other there is an attempt to control the prices of these products, especially in the context of rising crude prices in the international market. In order to moderate the impact of rising crude prices, the rates of tax on petrol and diesel too have been reduced. Petrol for instance, now faces a tax of 6 percent with some specific excises as against 16 percent plus specific excises till 2005-06.

6 This approach would enhance cascading in the economy and defeat the purpose of VAT. Andhra Pradesh is an exception in that it allow for tax credit at the refinery stage.

7 Central Sales Tax was introduced in 1956 with a rate of one percent to provide a mechanism for documenting inter-state transactions and to ensure that the domain of taxation of any state government remained limited to the dealers located within their geographical jurisdiction.

8 C-forms are issued by the importing state to an importing dealer. These are passed on to the exporting dealer who in turn submits them to the tax department of the exporting state as evidence of sales outside the state and hence would be liable to the preferential/concessional treatment.

9 It has been mentioned that since different states maintain their data in different formats, and differing degree of detail, comparable information is not uploaded to the system, making the system rather dysfunctional.

10 For an overview of some the key issues and the options discussed in the literature in the context of United States, *see* McClure (2005), "Coordinating Sales Taxes with a Federal VAT: Opportunities, Risks and Challenges", Paper presented at Symposium on ***Federal Tax Reform and the States***, National Press Club, Washington May 18.

11 The European model is technically one of zero-rating with reverse charge.

12http://ec.europa.eu/taxation_customs/taxation/vat/how_vat_works/vat_on_services/index_en.htm

13 Government of Ireland, Value Added Tax, Information Leaflet No.7, www.revenue.ie/leaflets/inforno7.pdf

14 Central Statistical Organisation, Input-Output Transactions Table, 2003-04, http://mospi.nic.in/rept%20_%20pubn/ftest.asp?rept_id=nad04_2003_2004&type=NSSO

15 Central Statistical Organisation, National Accounts Statistics, 2007, 2008. http://mospi.nic.in/rept%20_%20pubn/ftest.asp?rept_id=nad01_2007&type=NSSO

16 S. Cnossen (2004) "VAT in South Africa: What Kind of Rate Structure", International VAT Monitor, 19-24. For a discussion of the rationale for excise taxes, *see* McCarten, W.J. and J. Stotsky (1995), "Excise Taxes", in Shome P. (*ed*.) *Tax Policy Handbook,* International Monetary Fund, Washington DC.

17 These numbers are derived using the input-output coefficients matrix and the sector-wise GDP figures.

18 The turnover figures for the non-rebatable excise are available till 2006-07. For 2007-08,12 percent growth has been assumed, over a base of 2006-07.

19 Since the decomposition of Gross Fixed Capital Formation is available with a considerable lag, the above approach is used to obtain an approximation. In order to obtain a conservative estimate, the lowest share observed during 2000-05 is taken as the benchmark - 23 percent, in 2003-04.

20 Since there would be some overlap in the base as discussed above, some corrections are made government final consumption expenditure on otherwise taxable sectors only is taken into account for this exercise.

21 NSSO (2008): *Household Consumption Expenditure in India, 2005-06,* Report Number 523.

22 Office of the Registrar General and Census Commissioner (2006): *Population Projections for India and the States, 2006-2026,* Report of the Technical Group on Population Projections, constituted by the National Commission on Population.

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Working Paper No.1/2009-DEA

GST Reforms and Intergovernmental Considerations in India*

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March 2009
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Ministry of Finance Government of India

* Source : http://www.empcom.gov.in

Foreword

The Economic Division in the Department of Economic Affairs has initiated a Working Paper series with the objective of improving economic analysis and promoting evidence based policy formulation in its mandated areas of work. The themes to be covered in the series include macro-economic and sectoral issues of relevance for national policy, strategy for addressing emerging global and national development concerns and the agenda for economic policy reforms. While the issues identified for the Working Papers have relevance as inputs for the flagship publications of the Department, namely Economic Survey and the Mid-Year Review, issues that are related to the larger work responsibility of the Department of Economic Affairs, including the economic aspects of financial services, revenues and expenditure are also the subject matter of this initiative. Papers prepared by the staff or commissioned by the Economic Division as well as other Divisions in the DEA will be included in the Working Paper series on suitable peer review.

The paper by Mr.Satya Poddar and Mr. Ehtisham Ahmad on *GST Reforms and Intergovernmental Considerations in India* is the first Working Paper for 2009 and the third since the initiation of the series. This paper discusses the contractual issue of carrying forward the sub-national tax reform agenda and throws light on the principles, issues and procedures related to the objective of achieving a common goods and services market.

The introduction of the State level VAT in 2005 was the first sub-national tax reform that provided for greater competitiveness of Indian industry and trade. The goods and service tax first proposed in the Budget speech of 2006-07 and now under active discussions of the Empowered Committee of State Finance Ministers is the next logical step in this quest for a common market. The Paper by the authors raises certain key issues in the objective of the tax, its design with tradeoffs in the available choices, administrative infrastructure and the tax base and rates. The paper has references to international best practices and may prove useful in the context of evolving the broad design of the tax.

Arvind Virmani

(Arvind Virmani)

GST Reforms and Intergovernmental Considerations in India

Satya Poddar and Ehtisham Ahmad*

Content

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1. Introduction

The replacement of the state sales taxes by the Value Added Tax in 2005 marked a significant step forward in the reform of domestic trade taxes in India. Implemented under the leadership of Dr. Asim Dasgupta, Chairman, Empowered Committee of State Finance Ministers, it addressed the distortions and complexities associated with the levy of tax at the first point of sale under the erstwhile system and resulted in a major simplification of the rate structure and broadening of the tax base. The state VAT design is based largely on the blueprint recommended in a 1994 report of the National Institute of Public Finance and Policy, prepared by a team led by late Dr. Amaresh Bagchi (hereinafter, the "Bagchi Report").[1] In recommending a state VAT, the Bagchi Report clearly recognized that it would not be the perfect or first best solution to the problems of the domestic trade tax regime in a multi-government framework. However, the team felt that this was the only feasible option within the existing framework of the Constitution and would lay the foundation for an even more rational regime in the future.

Buoyed by the success of the State VAT, the Centre and the States are now embarked on the design and implementation of the perfect solution alluded to in the Bagchi Report. As announced by the Empowered Committee of State Finance Ministers in November 2007, the solution is to take the form of a 'Dual' Goods and Services Tax (GST), to be levied concurrently by both levels of government.

The essential details of the dual GST are still not known. Will it necessitate a change in the constitutional division of taxation powers between the Centre and the States? Will the taxes imposed by the Centre and the States be harmonized, and, if so, how? What will be treatment of food, housing, and inter-state services such as transportation and telecommunication? Which of the existing Centre and State taxes would be subsumed into the new tax? What will be the administrative infrastructure for the collection and enforcement of the tax? These are issues which ultimately define the political, social, and economic character of the tax and its impact on different sectors of the economy, and households in different social and economic strata.

It is some of these aspects of the proposed GST that are the subject matter of this paper. We focus on the essential questions relating to the Dual GST design, and first

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[1] Bagchi, Amaresh et al (1994).

discuss the need for, and the objectives of GST reform. We then describes alternatives to the Dual GST already endorsed by the Empowered Committee, not because they are superior in any way to the Dual GST, but to allow a fuller discussion of the trade-offs involved in the choice among them. Subsequent sections consider the question of tax base and rate, and proper treatment of various components of the tax base (e.g., food, housing, and financial services) in light of international best practices. The last section provides a discussion of the issues that arise in the taxation of cross-border transactions, both inter-state and international. An important question in this regard is the feasibility of, and the rules for, taxation of inter-state supplies of services.

2. The Current Taxes and Their Shortcomings

The principal broad-based consumption taxes that the GST would replace are the CENVAT and the Service Tax levied by the Centre and the VAT levied by the states. All these are multi-stage value-added taxes. The structure of these taxes today is much better than the system that prevailed a few years ago, which was described in the Bagchi Report as "archaic, irrational, and complex – according to knowledgeable experts, the most complex in the world". Over the past several years, significant progress has been made to improve their structure, broaden the base and rationalize the rates. Notable among the improvements made are:

the replacement of the single-point state sales taxes by the VAT in all of the states and union territories, reduction in the Central Sales Tax rate to 2%, from 4%, as part of a complete phase out of the tax,

the introduction of the Service Tax by the Centre, and a substantial expansion of its base over the years, and rationalization of the CENVAT rates by reducing their multiplicity and replacing many of the specific rates by ad valorem rates based on the maximum retail price (MRP) of the products.

These changes have yielded significant dividends in economic efficiency of the tax system, ease of compliance, and growth in revenues.

The State VAT eliminated all of the complexities associated with the application of sales taxes at the first point of sale. The consensus reached among the States for uniformity in the VAT rates has brought an end to the harmful tax competition among them. It has also lessened the cascading of tax.

The application of CENVAT at fewer rates and the new system of CENVAT credits has likewise resulted in fewer classification disputes, reduced tax cascading, and greater neutrality of the tax. The introduction of the Service Tax has been a mixed blessing. While it has broadened the tax base, its structure is complex. The tax is levied on specified services, classified into one hundred different categories. This approach has spawned many disputes about the scope of each category. Unlike goods, services are malleable, and can and are often packaged into composite bundles that include taxable as well as non-taxable elements. Also, there is no standardized nomenclature for services, such as the HSN for goods.

The design of the CENVAT and state VATs was dictated by the constraints imposed by the Constitution, which allows neither the Centre nor the States to levy taxes on a comprehensive base of all goods and services and at all points in their supply chain. The Centre is constrained from levying the tax on goods beyond the point of manufacturing, and the States in extending the tax to services. This division of tax powers makes both the CENVAT and the state VATs partial in nature and contributes to their inefficiency and complexity. The principal deficiencies of the current system, which need to be the primary focus of the next level of reforms, are discussed below.

A. Taxation at Manufacturing Level

The CENVAT is levied on goods manufactured or produced in India. This gives rise to definitional issues as to what constitutes manufacturing, and valuation issues for determining the value on which the tax is to be levied.[2] While these concepts have evolved through judicial rulings, it is recognized that limiting the tax to the point of manufacturing is a severe impediment to an efficient and neutral application of tax. Manufacturing itself forms a narrow base.

Moreover, the effective burden of tax becomes dependent on the supply chain, i.e., the taxable value at the point of manufacturing relative to the value added beyond this point.[3]

It is for this reason that virtually all countries have abandoned this form of taxation and replaced it by multi-point taxation system extending to the retail level.[4]

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[2] A detailed discussion of the problems can be found in the Bagchi Report.

[3] See Ahmad and Stern (1984) for the definition of effective taxes and applications to India. Bagchi (1994) provides estimates of effective excise tax rates, which are shown to vary from less than one percent to more than 22%.

[4] For example, these were precisely the reasons for the replacement of the federal manufacturers' sales tax by the Goods and Services Tax in 1991. See Canada Department of Finance (1987), and Poddar, Satya and Nancy Harley (1989).

Australia is the most recent example of an industrialized country replacing a tax at the manufacturing or wholesale level by the GST extending to the retail level. The previous tax was found to be unworkable, in spite of the high degree of sophistication in administration in Australia. It simply could not deal with the variety of supply chain arrangements in a satisfactory manner.

B. Exclusion of Services

The States are precluded from taxing services. This arrangement has posed difficulties in taxation of goods supplied as part of a composite works contract involving a supply of both goods and services, and under leasing contracts, which entail a transfer of the right to use goods without any transfer of their ownership. While these problems have been addressed by amending the Constitution to bring such transactions within the ambit of the State taxation[5] (by deeming a tax on them to be a tax on the sale or purchase of goods), services per se remain outside the scope of state taxation powers. This limitation is unsatisfactory from two perspectives.

First, the advancements in information technology and digitization have blurred the distinction between goods and services. Under Indian jurisprudence, goods are defined to include intangibles, e.g., copyright, and software, bringing them within the purview of state taxation. However, intangibles are often supplied under arrangements which have the appearance of a service contract. For example, software upgrades (which are goods) can be supplied as part of a contract for software repair and maintenance services. Software development contracts could take the character of contracts for manufacturing and sale of software goods or for rendering software development services, depending on the roles and responsibilities of the parties. The so-called 'value-added services (VAS) provided as part of telecommunication services include supplies (e.g., wallpaper for mobile phones, ring tones, jokes, cricket scores and weather reports), some of which could be considered goods. An on-line subscription to newspapers could be viewed as a service, but online purchase and download of a magazine or a book could constitute a purchase of goods. This blurring also clouds the application of tax to transactions relating to tangible property. For example, disputes have arisen whether leasing of equipment without transfer of possession and control to the lessee would be taxable as a service or as a deemed sale of goods.

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[5] The Constitution (46th Amendment) Bill 1982 amended Article 366 (29A) of the Constitution to deem a tax on six items to be a tax on the sale or purchase of goods.

The traditional distinctions between goods and services (and for other items such as land and property, entertainment, and luxuries) found in the Indian Constitution have become archaic. In markets today, goods, services, and other types of supplies are being packaged as composite bundles and offered for sale to consumers under a variety of supply-chain arrangements. Under the current division of taxation powers, neither the Centre nor the States can apply the tax to such bundles in a seamless manner. Each can tax only parts of the bundle, creating the possibility of gaps or overlaps in taxation.

The second major concern with the exclusion of services from the state taxation powers is its negative impact on the buoyancy of State tax revenues. With the growth in per capita incomes, services account for a growing fraction of the total consumer basket, which the states cannot tax. With no powers to levy tax on incomes or the fastest growing components of consumer expenditures, the States have to rely almost exclusively on compliance improvements or rate increases for any buoyancy in their own-source revenues. Alternatives to assigning the taxation of services to the states include assigning to the states a share of the central VAT (including the tax from services), as under the Australian model.

C. Tax Cascading

Tax cascading occurs under both Centre and State taxes. The most significant contributing factor to tax cascading is the partial coverage Central and State taxes. Oil and gas production and mining, agriculture, wholesale and retail trade, real estate construction, and range of services remain outside the ambit of the CENVAT and the service tax levied by the Centre. The exempt sectors are not allowed to claim any credit for the CENVAT or the service tax paid on their inputs.

Similarly, under the State VAT, no credits are allowed for the inputs of the exempt sectors, which include the entire service sector, real property sector, agriculture, oil and gas production and mining. Another major contributing factor to tax cascading is the Central Sales Tax (CST) on inter-state sales, collected by the origin state and for which no credit is allowed by any level of government.

While no recent estimates are available for the extent of tax cascading under the Indian tax system (although see Ahmad and Stern 1984 and 1991, and Bagchi for earlier work), it is likely to be significant, judging by the experience of other countries which had a similar tax structure. For example, under the Canadian manufacturers' sales tax, which was similar to the CENVAT, the non-creditable tax on business inputs and machinery and equipment accounted for approximately one-third of total revenues from the tax. The extent of cascading under the provincial retail sales taxes in Canada, which are similar to the State VAT, is estimated to be 35-40% of total revenue collections. A priori, one would expect the magnitude of cascading under the CENVAT, service tax, and the State VAT to be even higher, given the more restricted input credits and wider exemptions under these taxes.[6] The Service Tax falls predominantly on business to business (B2B) services and is thus highly cascading in nature.

Tax cascading remains the most serious flaw of the current system .It increases the cost of production and puts Indian suppliers at a competitive disadvantage in the international markets. It creates a bias in favor of imports, which do not bear the hidden burden of taxes on production inputs. It also detracts from a neutral application of tax to competing products. Even if the statutory rate is uniform, the effective tax rate (which consists of the statutory rate on finished products and the implicit or hidden tax on production inputs) can vary from product to product depending on the magnitude of the hidden tax on inputs used in their production and distribution. The intended impact of government policy towards sectors or households may be negated by the indirect or hidden taxation in a cascading system of taxes.

D. Complexity

In spite of the improvements made in the tax design and administration over the past few years, the systems at both central and state levels remain complex. Their administration leaves a lot to be desired. They are subject to disputes and court challenges, and the process for resolution of disputes is slow and expensive. At the same time, the systems suffer from substantial compliance gaps, except in the highly organized sectors of the economy. There are several factors contributing to this unsatisfactory state of affairs.

The most significant cause of complexity is, of course, policy related and is due to the existence of exemptions and multiple rates, and the irrational structure of the levies. These deficiencies are the most glaring in the case of the CENVAT and the Service Tax.

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[6] Kuo, C.Y., Tom McGirr, Saya Poddar (1988), "Measuring the Non-neutralities of Sales and Excise Taxes in Canada", Canadian Tax Journal, 38, 1988, provide estimates of tax cascading under the Canadian federal manufacturers' sales tax and the provincial retails sales taxes.

The starting base for the CENVAT is narrow, and is being further eroded by a variety of area-specific, and conditional and unconditional exemptions. A few years ago the Government attempted to rationalize the CENVAT rates by reducing their multiplicity but has not adhered to this policy and has reintroduced concessions for several sectors/products.

The key problem with the service tax is the basic approach of levying it on specified services, each of which generates an extensive debate as to what is included in the base. Ideally, the tax base should be defined to include all services, with a limited list of exclusions (the so-called "negative list").[7] The Government has been reluctant to adopt this approach for the fear that it could bring into the tax net many services that are politically sensitive.

The complexities under the State VAT relate primarily to classification of goods to different tax rate schedules. Theoretically, one might expect that the lower tax rates would be applied to basic necessities that are consumed largely by the poor. This is not the case under the State VAT. The lowest rate of 1% applies to precious metals and jewellery, and related products—hardly likely to be ranked highly from the distributional perspective. The middle rate of 4% applies to selected basic necessities and also a range of industrial inputs and IT products. In fact, basic necessities fall into three categories – exempted from tax, taxable at 4%, and taxable at the standard rate of 12.5%. The classification would appear to be arbitrary, with no well accepted theoretical underpinning. Whatever the political merits of this approach, it is not conducive to lower compliance costs. Most retailers find it difficult to determine the tax rate applicable to a given item without referring to the legislative schedules. Consumers are even less aware of the tax applicable to various items. This gives rise to leakages and rent seeking.

Another source of complexity under the State VAT is determining whether a particular transaction constitutes a sale of goods. This problem is most acute in the case of software products and intangibles such as the right to distribute/exhibit movies or time slots for broadcasting advertisements.

Compounding the structural or design deficiencies of each of the taxes is the poor or archaic infrastructure for their administration. Taxpayer services, which are a lynchpin of a successful self-assessment system, are virtually nonexistent or grossly

[7] For a detailed discussion of the flaws of the current approach to taxation of services, see Rao (2001), which recommended replacement of taxation of selected services by a general tax on all services (other than excluded services).

inadequate under both central and state administrations. Many of the administrative processes are still manual, not benefiting from the efficiencies of automation. All this not only increase the costs of compliance, but also undermines revenue collection.

3. Objectives of Tax Reform

A. Basic Objectives

The basic objective of tax reform would be to address the problems of the current system discussed above. It should establish a tax system that is economically efficient and neutral in its application, distributionally attractive, and simple to administer.

As argued in Ahmad and Stern (1991), distributional or sectoral concerns have been at the heart of the excessive differentiation of the Indian tax system—but that the objectives are negated by the cascading effects of the taxes. While an optimal design of the consumption tax system, taking into account both production efficiency and distributional concerns, would not imply uniformity of the overall tax structure, the desired structure can be achieved by a combination of taxes and transfers.

Ahmad and Stern (1991) analyze the optimal pattern of tax rates implied by a given degree of aversion to poverty and concern for the poor. At high levels of concern for the poor, one would reduce the tax on cereals (but not dairy products) and increase the taxes on non-food items (durables). Thus, a differentiated overall structure appears desirable for a country in which the government has consistently expressed a concern for the poor. However, individual taxes should not be highly differentiated, as that complicates administration and makes it difficult to evaluate the overall effects of the tax design. This applies particularly to value-added type of taxes. In principle, a single rate (or at the most two-rate) VAT, together with excises and spending measures could achieve the desired distributional effects, for reasonable degrees of inequality aversion of policy makers.

In particular, it is important from an administrative perspective that close substitutes should not be taxed at very different rates—to avoid leakages and distortions. Revenue considerations suggest that the tax base should be broad, and comprise all items in the consumer basket, including goods, services, as well as real property.

The neutrality principle would suggest that:

- the tax be a uniform percentage of the final retail price of a product, regardless of the supply-chain arrangements for its manufacturing and distribution;
- the tax on inputs be fully creditable to avoid tax cascading; and
- the tax be levied on the basis of the destination principle, with all of the tax on a given product/service accruing in the jurisdiction of its final consumption.

Multiple VAT rates become a source of complexity, and disputes, for example, over borderlines, adding to the costs of tax administration and compliance. It is for this reason that countries like New Zealand, Singapore, and Japan have chosen to apply the tax at a low and uniform rate, and address any concerns about vertical equity through other fiscal instruments, including spending programs targeted to lower-income households.[8]

Another important objective of tax reform is simplification of tax administration and compliance, which is dependent on three factors. The first determining factor for simplicity is the tax design itself. Generally, the more rational and neutral the tax design, the simpler it would be to administer and encourage compliance. If the tax is levied on a broad base at a single rate, there would be few classification disputes and the tax-specific record keeping requirements for vendors would be minimal. The tax return for such a system can be as short as the size of a postcard. It would simplify enforcement, and encourage voluntary compliance.

The second factor is the infrastructure for tax administration, including the design of tax forms, data requirements, system of tax rulings and interpretations, and the procedures for registration, filing and processing of tax returns, tax payments and refunds, audits, and appeals. A modern tax administration focuses on providing services to taxpayers to facilitate compliance. It harnesses information technology to enhance the quality of services, and to ensure greater transparency in administration and enforcement.

The third factor in a federation such as India is the degree of harmonization among the taxes levied by the Centre and the States. The Empowered

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[8] Canada provides a refundable tax credit, GST Credit, lower-income households through the personal income tax system. The credit is paid in quarterly installments and income-tested for higher-income households.

Committee has already indicated a preference for a dual GST, consisting of a Centre GST and a State GST. Under this model, harmonization of the Centre and State GSTs would be critical to keep the overall compliance burden low. Equally important is harmonization of GSTs across the states.

B. Fiscal Autonomy and Harmonization

An important consideration in the design of reform options is the degree of fiscal autonomy of the Centre and the States. It goes without saying that the power to govern and to raise revenues go together. The Constitution of India lays down a clear division of powers between the Centre and the States, including the power to levy taxes. Should the Centre and the States then have complete autonomy in levying and collecting the taxes within the parameters specified in the Constitution, or should they voluntarily or otherwise conform to certain common principles or constraints? Should they collectively agree to have their individual taxes consolidated into a single national tax, the revenues from which get shared in some agreed manner among the constituent units? Such a system would have much to commend itself from the perspectives of economic efficiency and the establishment of a common market within India. Indeed, such political-economy compromises have been adopted by China and Australia. China moved to a centralized VAT with revenue sharing with the provinces — ensuring that provinces got as much revenues as under the prior arrangements, plus a share of the increment. In Australia, the GST is a single national levy and all the GST revenues collected by the center are returned to the states. However, such a compromise is unlikely to find much favor with the States in India, as is already revealed in their preference for the Dual GST.

To give political substance to the federal structure in India, the States (as well as the Centre) are likely to insist that they have certain autonomy in exercise of their taxation powers. Full autonomy would mean that:

retain the power to enact the tax,

enjoy the risks and rewards of 'ownership' of the tax (i.e., not be insulated from fluctuations in revenue collections),

be accountable to their constituents, and

be able to use the tax as an instrument of social or economic policy.

Notwithstanding the above, there is a clear recognition of the need for harmonization of the Centre and State Taxes. Fiscal autonomy is important to allow the Centre and the States to set the tax rates according to their revenue needs. Harmonization of tax laws and administrative procedures is needed to simplify compliance and enforcement. It is also necessary to ensure that inter-state differences in policies and procedures do not generate additional economic distortions. An important question then is the desired degree of harmonization and the mechanism for achieving it.

The elements of harmonization can be divided into three broad sets: tax rates, tax base and tax infrastructure, i.e., the administration and compliance system. The first two elements could be viewed as important levers on which States would want to have some degree of control to achieve their social, economic, and fiscal policy objectives. However, the experience of other countries as well as the ir sub-national governments suggests that changes to the GST base are not a suitable instrument for social and economic policy (as discussed in greater detail in a later section in considering the treatment of food). While the tax base is a subject of intense debates at the time the tax is introduced, changes in the base after its introduction have been infrequent. This has especially been the case where the tax was initially levied on a broad and comprehensive base. Where the tax was initially levied on a narrow base, subsequent changes in the base have then been felt necessary to minimize anomalies, distortions, and revenue leakages created by the narrow base. Achieving such changes once the tax has been brought in, however logical, is invariably politically contention because of vested interests. It is thus important to get the structure right at the outset, as the base (and quite often the rate) cannot be easily changed, ex post facto.

The VAT in the European Union is an example reflecting these policy considerations. The base for the EU VAT is uniform, as codified in the EU Directive[9], which is binding in all Member States. There are important variations in the base, but these are essentially in the form of derogations granted for the arrangements existing at the time of introduction of the tax, and were intended to be temporary (though this has not always been the case). The tax rates are specified as floor rates (with some provision for reduced rates and maximum rates), below which Member States cannot set their rates.

[9] The Commission Directive on the Commo n System of Value Added Tax, which replaced the Sixth Directive.

Administration and compliance is an area where the need for harmonization is the greatest, and where Centre-State or inter-state variations are unlikely to serve any social or economic policy objective. This includes items such as the taxpayer registration system, taxpayer identification numbers, tax forms, tax reporting periods and procedures, invoice requirements, cross-border trade information systems and IT systems. Harmonization of these elements would result in significant savings in costs of implementing the GST (by avoiding duplication of effort in each government), as well as recurring savings in compliance costs. Harmonization would also permit sharing of information among governments, which is essential for effective monitoring of cross- border transactions. A common set of tax identifier numbers across states and the central government is a key element in the efficient exchange of information.

Harmonization of tax laws is also critical. Variation in the wording and structure of tax provisions can be an unnecessary source of confusion and complexity, which can be avoided by having the Centre and the States adopt a common GST law. An alternative is to agree on the key common elements if separate laws are chosen. Some of the critical elements for harmonization include common time and place of supply rules, as well as common rules for recovery of input tax, valuation of supplies and invoicing requirements. There would then be merit in harmonizing the system of tax interpretations and rulings as well (e.g., about classification of goods and services, determination of what constitutes taxable consideration, and definition of export and import).

These considerations suggest that harmonization of virtually all major areas of GST law and administration would be desirable. There is merit in keeping even the GST rate(s) uniform, at least during the initial years until the infrastructure for the new system is fully developed (see Ahmad, Poddar et al, 2008 for the GCC proposals). Harmonized laws would mean lower compliance costs for taxpayers and may also improve the efficiency of fiscal controls.

The Central Sales Tax (CST) in India provides a very useful for model for such harmonization. The CST is a state-level tax, applied to inter-state sales of goods, based on the origin principle. The tax law (including the base, rates, and the procedures) is enacted by Parliament, but the States collect and keep the tax. It is a perfect example of absolute harmonization, with the States enjoying the risks and rewards of ownership of the tax.

It is worth emphasizing that harmonization should not be viewed as constraining the fiscal autonomy of the Centre or the States. Rather, this is a framework that facilitates more efficient exercise of taxation powers, and all jurisdictions would be worse off without harmonization. This was the case under the previous State sales tax system, under which inter-state tax rate wars became a race to the bottom. Even today, they all suffer because of lack of harmonization of information and technology architectures, as a result of which they are unable to share information on inter-state trade. Harmonization should allow greater exploitation of the benefits of a common market.

C. Centre and State Taxation Powers

As noted earlier, the current division of taxation of powers under the Constitution is constraining for both the Centre and the States. Neither is able to design a comprehensive and neutral tax on goods and services of the type found in modern tax systems. The Constitution divides taxation powers between the Centre and the States by sector (e.g., agriculture, manufacturing, and land and property) or type of taxes (e.g., luxury tax, tax on the sale or purchase of goods, and excise duty). A notable feature of the current division is that the two levels of government have no area of concurrent jurisdiction, with the exception of stamp duties. This approach, while it may have served the country well in the past, is no longer optimal for modern economies where the traditional dividing lines between sectors are blurred, and new social, environmental, and economic issues emerge which require new forms of taxation instruments. The need for a substantial realignment of taxation powers is also emphasized by Rao (2008):

> "Paradigm shift in tax policy is necessary to recognise that tax bases of central and state governments are interdependent. The principle of separation of tax bases followed in the Constitutional assignment does not recognise the interdependence. It is therefore desirable to provide concurrent tax powers to Centre and States in respect of both income and domestic consumption taxes. In the case of personal income tax, separation of tax powers between the centre and states based on whether the income is from agricultural or non-agricultural sector has been a major source of tax evasion. As agriculture is transformed into a business it is important to levy the tax on incomes received from all the sources both for reasons of neutrality and to minimise tax evasion. At the same time, both centre and states could be allowed to levy the tax with the latter piggybacking the levy on the central tax subject to a ceiling rate. Similarly, it is important to unify multiple indirect

> taxes levied by the central and state governments into a single goods and services tax (GST) preferably with states piggybacking on the central levy with clearly defined tax rooms for the two levels of government. The transition to such a concurrent tax system requires integrating the existing CENVAT and service taxes and extending the tax to the retail level which would, inter alia, entail amendment of the Constitution. The states could piggyback on the levy."

Thus, the current search for options for tax reform warrants a review of the existing Constitutional arrangements, which may well require a substantial realignment. For example, the dual GST would require giving the Centre and the States concurrent indirect taxation powers, subject to prohibition on extra-territorial taxation, i.e., that the incidence of tax be restricted to consumption within the territory of the taxing jurisdiction.[10]

While such a review is beyond the scope of this paper, our discussion of alternative options in the next section proceeds with the assumption that suitable constitutional amendments would be made to enable the implementation of the chosen option.

4. Options for the Centre and State GSTs

In defining options for reform, the starting point is the basic structure of the tax. For purposes of this discussion, we start with the assumption that any replacement of the current taxes would be in the form of a classical VAT, which is consumption type (allowing full and immediate credit for both current and capital inputs attributable to taxable supplies) and destination based (i.e., the tax levied

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[10] The division of taxation powers between federal and provincial governments in Canada provides an interesting example of such concurrent powers. Under the Canadian Constitutions, the federal government can levy any tax, and the provinces have the power to levy any direct tax within the province. A tax is considered to be a direct tax if its incidence falls on the person on whom it is levied. Thus, it includeds all forms of income and wealth taxes. A sales tax or VAT is also viewed to be a direct if it is levied on the buyer/consumer, but not on the vendor. The tax can be collected and remitted by the vendor, acting as an agent of the government, but it has to be levied on the buyer. As a result, the two levels of concurrent powers for all types of taxes, subject to the condition that the provincial taxes can only be levied on persons within the geographical boundary of the provinces.

on the basis of the place of consumption of the goods and services, not the place of production). Under this system, credits for input taxes are allowed on the basis of invoices issues by the vendors registered for the tax. This is the most common type of structure adopted around the world. Its superiority over other forms of consumption taxes is well accepted in India as well as other countries.

The choices that remain then relate essentially to the assignment of powers to levy the tax to the Centre and the States, and the tax base and rates. In the remainder of this section we deal with the question of assignment, and then turn to the question of tax base and rates in the next section.

The main options for the VAT assignments include:

Concurrent Dual GST,

National GST, and

State GSTs.

All these options require an amendment to the Constitution. For the sake of completeness of discussion, we also consider an additional option, Non-concurrent Dual VAT, that does not require an amendment to the Constitution. We now discuss each of these options in turn below.

A. Concurrent Dual GST

Under this model, the tax is levied concurrently by the Centre as well as the States. Both the Central Government and the Empowered Committee appear to favor this model.

While full details of the model are still awaited, two variants have been identified in public discussions so far. The initial variant, discussed in November, 2007, entailed both the Centre and the States levying concurrently the GST on goods, but most of the services (except services of a local nature) remaining subject to the Centre GST only. The Central GST would thus apply to both goods and services, extending to the entire supply chain, including wholesale and retail trade. The State GSTs would largely be confined to goods only, with minor changes from the current State VATs.

Under the more recent variant,[11] both goods and services would be subject to concurrent taxation by the Centre and the States. This variant is closer to the model

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[11] See Empowered Committee of State Finance Ministers (2008).

recommended by the Kelkar Committee in 2002.[12]

The main difference between the two variants is in the treatment of services, reflecting apprehensions about the feasibility of defining the place of supply (i.e., destination) of inter-state services. Even the more recent variant recognizes that there would be a set of inter-state services for which the place of destination would be difficult to determine. The State tax on these services would be collected by the Centre, and then apportioned among the States in some manner.

Other notable features of this variant are as follows:

> There would a single registration or taxpayer identification number, based on the Permanent Account Number (PAN) for direct taxation. Three additional digits would be added to the current PAN to identify registration for the Centre and State GSTs. States would collect the State GST from all of the registered dealers. To minimize the need for additional administrative resources at the Centre, States would also assume the responsibility for administering the Central GST for dealers with gross turnover below the current registration threshold of Rs 1.5 crores under the central Excise (CENVAT). They would collect the Central GST from such dealers on behalf of the Centre and transfer the funds to the Centre. Procedures for collection of Central and State GSTs would be uniform. There would be one common tax return for both taxes, with one copy given to the Central authority and the other to the relevant State authority.
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> Other indirect taxes levied by the Centre, States, or local authorities at any point in the supply chain would be subsumed under the Central or the State GST, as long as they are in the nature of taxes on consumption of goods and services.

At a broad conceptual level, this model has a lot to commend itself. It strikes a good balance between fiscal autonomy of the Centre and States, and the need for harmonization. It empowers both levels of government to apply the tax to a comprehensive base of goods and services, at all points in the supply chain. It also eliminates tax cascading, which occurs because of truncated or partial application of the Centre and State taxes.

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[12] Kelkar, Vijay, et al (2004).

The apprehension about feasibility of application of State GST to inter-state services is understandable, given the complete absence of any framework in India for determining their place of supply. However, the task of developing of such a framework is not insurmountable. In fact, such frameworks do already exist for application of national VAT to international cross-border services, which could be adapted for inter-state services. Canada has developed such a framework for application of provincial sales taxes or GST to services.

Another point to note is that inter-state services are provided predominantly by the organized sector (e.g., telecom and transportation services), which is generally tax compliant. Once the rules are framed, they would program their accounting and invoicing systems to collect and remit the tax accordingly.

Admittedly, there are inter-state services which have no unique place of supply. Take for example the supply of group health insurance to a corporation with employees throughout India, or auditing or business consulting services provided to a corporation or conglomerate with business establishments in several States. The determination of place of supply of such services is going to be somewhat arbitrary. However, such services are almost entirely B2B supplies, the tax on which is fully creditable to the recipient under a comprehensive taxation model. The arbitrariness in the rules would thus have no impact on the final tax collections of the Centre or the States.

The Empowered Committee proposal is silent on the treatment of land and real property transactions in the description of this option. Assuming this omission is deliberate, it is a major drawback of the option. As discussed further in the next section, modern VATs apply to all supplies, including supplies of land and real property. The Service Tax has already been extended to rentals of commercial property and construction services. There are no compelling social or economic policy reasons for excluding these services from the scope of the GST.

B. National GST

Under this option, the two levels of government would combine their levies in the form of a single national GST, with appropriate revenue sharing arrangements among them. The tax could be controlled and administered by the Centre, States, or a separate agency reporting to them. There are several models for such a tax. Australia is the most recent example of a national GST, which is levied and collected by the Centre, but the proceeds of which are allocated entirely to the States.[13]

In China, the VAT law and administration is centralized, but the revenues are shared with the provinces. In going to this model, the Centre had assure the provinces that they would continue to get what they did under the previous arrangement and that changes in revenue shares would be phased in over an extended period of 15 years—see Ahmad 2008.

Under the Canadian model of the Harmonized Sales Tax (HST), the tax is levied at a combined federal and provincial rate of 13 percent (5% federal rate, 8% provincial rate) in the three participating provinces. Tax design and collection are controlled by the Centre, but the provinces have some flexibility to vary their tax rate. The revenues from the tax are shared among the participating provinces on the basis of consumer expenditure data for the participating provinces.

In Austria, and Germany, the tax design is controlled by the Centre, but states collect the taxes. This has led to incentive problems, as some of the Länder have begun to use tax administration measures to achieve tax policy goals. In Mexico, the establishment of a VAT at the center replaced state sales taxes, but had to be part of a political-economy compromise that assured the states an automatic share of the revenues generated from all federal taxes.

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[13] The Australian constitutional situation is that both the States and the Commonwealth (the Federal Government) have power to tax supplies of goods and services. The constitution prevents laws interfering with interstate trade (including tax laws) and gives the power to collect Customs and excise taxes exclusively to the Federal Government. It is forbidden for the Commonwealth to tax State Property. To meet this requirement, the GST implementation laws, of which there are 6, simply state that they do not impose tax on State properties and the States accept that view, at least at the moment. The GST was introduced on the pretence that it was a State tax being collected by the Commonwealth in order to (a) secure the States' agreements to abolish some of their preexisting transaction taxes, in particular certain stamp duties, financial institutions duties, etc and (b) to ensure that the States wouldn't start a round of attempts to challenge the constitutional validity of the law (as was done, unsuccessfully, in the past with income tax, which both States and Commonwealth also have power to collect. The current Government has acknowledged that GST is in fact simply a Federal Tax that it uses to make grants to the States and as a result of this acknowledgement, the Auditor General has for the first time since 2000 agreed to approve the Commonwealth accounts.

A single national VAT has great appeal from the perspective of establishment and promotion of a common market in India. However, the States may worry about the loss of control over the tax design and rates. Indeed, some control over tax rates is a critical issue in achieving accountable sub-national governance and hard budget constraints (Ambrosiano and Bordignon, 2006). The States may also be apprehensive that the revenue sharing arrangements would over time become subject to social and political considerations, deviating from the benchmark distribution based on the place of final consumption. The Bagchi Report also did not favor this option for the fear that it would lead to too much centralization of taxation powers.

These concerns can be addressed partially through suitable administrative arrangements and centre-state agreements. The tax design could be made subject to joint control of the Centre and the States. The States would necessarily lose the flexibility of inter-state variation in tax design, but that is also the perceived strength of this option. Given that the Centre does not have the machinery for the administration of such a tax, the States would presumably play a significant role in its administration. The revenue sharing formula could also be mandated to be based on the destination principle, as under the Canadian HST.

The key concerns about this option would thus be political. Notwithstanding the economic merits of a national GST, will it have a damaging impact on the vitality of Indian federalism? With no other major own-source revenues, will individual States become too dependent on collective choices and feel disempowered to act on their priorities? Will it be possible for the governments with such diverse political interests and philosophies to reach a consensus and adhere to it?

While one can have a healthy debate on each of these issues, international experience suggests that discretionary use of broad-based consumption taxes for social, political, or economic policy purposes tends to be limited. The dominant consideration in their design is their neutrality and efficiency in raising revenues. This is also reflected in the design of the State VATs in India. In spite of vast political and economic differences among them, States have been able to forge a consensus on a common VAT design. A national GST would extend this consensus to the Centre. But participation of the Centre could fundamentally alter the delicate balance of interests that currently prevails in the Empowered Committee and make the consensus harder to achieve.

C. State GSTs

Under this option, the GST would be levied by the States only. The Centre would withdraw from the field of general consumption taxation. It would continue to levy income taxes, customs duties, and excise duties on selected products such as motor fuels to address specific environmental or other policy objectives. The loss to the Centre from vacating this tax field could be offset by a suitable compensating reduction in fiscal transfers to the States. This would significantly enhance the revenue capacity of the States and reduce their dependence on the Centre. The USA is the most notable example of these arrangements, where the general sales taxes are relegated to the states.

There would be significant hurdles in adopting this option in India. First, it would seriously impair the Centre's revenues. The reduction in fiscal transfers to the States would offset this loss, but still the Centre would want to have access to this revenue source for future needs. Second, the option may not be revenue neutral for individual States. The incremental revenues from the transfer of the Centre's tax room would benefit the higher- income states, while a reduction in fiscal transfers would impact disproportionately the lower- income states. Thus the reform would be inequality enhancing—and against the traditions of successive governments in India (of all political shades). Third, a complete withdrawal of the Centre from the taxation of inter-state supplies of goods and services could undermine the States' ability to levy their own taxes on such supplies in a harmonized manner. In particular, it would be impractical to bring inter-state services within the ambit of the State GST without a significant coordinating support from the Centre.

D. Non-concurrent Dual VATs

Under the concurrent dual GSTs, the Centre and State taxes apply concurrently to supplies of all goods and services. It poses two challenges. First, it requires a constitutional amendment. Second, a framework is needed for defining the place of supply of inter-state services and for the application of State GST to them. Both of these hurdles can be circumvented if the GST on goods were to be levied by the States only and on services by the Centre only. The States already have the power to levy the tax on the sale and purchase of goods (and also on immovable property), and the Centre for taxation of services. No special effort would be needed for levying a unified Centre tax on inter-state services.

This option would not address any of the deficiencies of the current system identified in Section 2 above, if the taxes on goods and services were to be levied in an uncoordinated manner as two separate partial taxes. It would perpetuate the difficulties in delineating supplies of goods and services, and compound tax cascading.

The main appeal of this option is as a variant of the State GST option discussed immediately above. In levying the VAT on services, the Centre would essentially play the coordinating role needed for the application and monitoring of tax on inter-state services. The Centre would withdraw from the taxation of goods. Even the revenues collected from the taxation of services could be transferred back to the States, partially or fully.

Within this framework, cascading could be completely eliminated by the States agreeing to allow an input credit for the tax on services levied by the Centre. Likewise, the Centre would allow an input credit for the tax on goods levied by the States.

The discussion above suggests that the design of a GST is going to be a challenge, regardless of the option chosen. All options require significant Centre-State coordination and harmonization, and there may be very little room for variance in rate setting by States at least in the near future. The best option would appear to be a national GST (either through the constitution or on a voluntary basis), with an appropriate Centre-State and inter-State revenue sharing arrangement. If a framework for taxation of inter-state services can be devised, then the concurrent dual VAT could be the most supportive of the objective of fiscal autonomy. To ensure harmonization of tax base, rules and procedures, it would be desirable to have a single common legislation enacted by Parliament, following the model for the CST. The law would delegate the collection of tax to the Centre and States on their respective tax bases, i.e., the Centre to collect the central GST on supplies of goods and services anywhere in India, and the States to collect the state GST on supplies within their states (as per the place-of-supply rules specified in the legislation).

5. Tax Base and Rates

We turn now to the question of the tax base and rates, within the broad structure of a consumption-type, destination-based, credit-invoice GST. Ideally, the tax should be levied comprehensively on all goods and services at a single rate to achieve the objectives of simplicity and economic neutrality. However, governments often deviate from this ideal either because of concerns about distribution of tax burden (e.g., food), or because of administrative and conceptual difficulties in applying the tax to certain sectors of the economy (e.g., health care, education, and financial services). These concerns are likely to be paramount at both Centre and State levels and there will inevitable be calls to exempt, or tax at a reduced rate, items of importance to the poor or other particular groups.

As noted earlier, reduced rates or exemptions for basic necessities may not be an efficient way of helping the poor, because of a significant spillover of their benefits to the rich. Although the rich spend a smaller *proportion* of their income on such goods than do the poor, because their income is higher they are also likely to spend a larger *absolute* amount. As a result, the rich might gain most from applying a reduced tax rate to such goods. The needs of the poor could be more effectively addressed through spending and transfer programs. Distributional concerns should be seen as part of the overall balance of all fiscal instruments and not solely for the GST. Moreover, multiple rates and exemptions increase the costs of administration and compliance. They give rise to classification disputes, necessitate additional record keeping, and create opportunities for tax avoidance and evasion through misclassification of sales.

Notwithstanding the virtues of a single-rate and comprehensive base, debates about the proper treatment of food and a variety of other items are inevitable. In what follows, we discuss some of the most critical aspects this debate, starting with a discussion of the revenue neutral tax rates in the absence of any exemptions or other preferences.

A. Tax Rates

In discussions on the GST design for India, it has been suggested that the tax would need to be levied at a combined Centre-State tax rate of 20 percent, of which 12% would go to the Centre and 8% to the states (vide, for example, the Kelkar Task Force Report). While they fall below the present combined Centre and State statutory rate of 26.5% (Cenvat of 14%, and VAT of 12.5%), GST at these rates would encounter significant consumer resistance, especially at the retail level, and would give rise to pressures for exemptions and/or lower rates for items of daily consumption. With the notable exception of Scandinavian countries, where the tax is levied at the standard rate of 25%, few countries have been successful in levying and sustaining a VAT/GST at such high rates.

Successful GST models adopted by other countries had a very broad base and a relatively modest tax rate, especially at the time of inception. For example, the New

Zealand GST was introduced at the rate of 10%, with a base consisting of virtually all goods and services (with the exception of financial services). The Singapore GST was introduced at 3%, but the rate has now been raised to 7% as inefficient excises and customs duties have been progressively eliminated.

Table 1 provides a comparison of the tax base and rates in selected international jurisdictions with 'modern' VAT/GST. It provides data on C efficiency, which is a widely- used measure of the comprehensiveness of the tax base. It is calculated as the ratio of the share of GST revenues in consumption to the standard rate. Any deviation from a 100 percent C-efficiency indicates deviatio n from a single tax rate on all consumption. Zero-rating of some consumption items would lead to a C-efficiency of less than 100 percent while inclusion of investment or a break in the GST chain could lead to a C-efficiency higher than 100 percent. While a C-efficiency of 100 does not imply a perfect VAT, it can serve as a useful indicator of the productivity of GST revenue per percentage point of GST rate. The last column in the table shows revenue productivity of GST in these countries, measured as GST revenues per point of the standard rate divided by the GDP (i.e., (Aggregate Revenues/Standard Rate)/GDP).

TABLE 1

Comparison of GST Base and Rates, Selected Jurisdictions					
Country	**Year**	**Standard Rate %**	**Consumption % of GDP**	**C Efficiency**	**Revenue Productivity**
Canada	2005	7	74.8	0.46	0.34
Japan	2004	5	75.5	0.67	0.50
New Zealand	2005	12.5	76.0	0.94	0.73
Singapore	2004	5	54.2	0.70	0.40

Source: Various IMF reports and authors' own estimates

As shown in Table 2, the New Zealand GST, which is levied at a single rate on virtually all goods and services, has the highest C efficiency. The Canadian GST, also levied at a single rate, has low C efficiency because of zero-rating of food and medicines, and rebates for housing and non-profit sector. Japan and Singapore levy tax at a single rate to a comprehensive base, including food. Yet, their C efficiency is lower than in New Zealand mainly on account of exemptions for supplies by non-profit organizations. The C efficiency of European VATs is generally much lower, in the range of 50%, as these taxes are levied at multiple rates, and with exemption for land and housing, financial services, and supplies by public bodies. In general, VATs that have been introduced around the world in the last few years have a higher C efficiency than the 'old' VATs.

A low C efficiency translates into lower revenue productivity of tax, as shown in the last column of the table.

With this background, we turn to an estimation of the size of the GST base in India and the GST rates that would be required to replace the current indirect tax revenues of the Centre and the States.

Poddar and Bagchi (2007) calculations show that if the GST were to be levied on a comprehensive base, the combined Centre-State revenue neutral rate (RNR) need not be more than 12%. This rate would apply to all goods and services, with the exception of motor fuels which would continue to attract a supplementary levy to maintain the total revenue yield at their current levels.

Here are some basic ingredients of the RNR calculations for 2005-06, the latest year for which the necessary data are available. The total excise/service tax/VAT/sales tax revenues of the Centre and the States in that year was Rs.134 thousand crore and Rs.139 thousand crore respectively. Assuming that approximately 40% of the central excise revenues and 20% of the state VAT/sales tax revenues are from motor fuels, the balance of the revenues from other goods and services that need to be replaced by the GST are Rs 89 thousand crore for the Centre and Rs 111 thousand crore for the states, making up a total of Rs 200 thousand crore.

In 2005-06, the total private consumer expenditure on all goods and services was Rs.2,072 thousand crore at current market prices. Making adjustments for sales and excise taxes included in these values and for the private consumption expenditure on motor fuels, the total tax base (at pre-tax prices) for all other goods and services is Rs 1763 thousand crore.

These values yield a revenue neutral GST rate of approx. 11% (200 as percent of 1763 is 11.3%). The RNR for the Centre is 5% and for the states 6.3%. Allowing for some leakages, the combined RNR could be in the range of 12%. The Centre excise duty rates have been reduced substantially (the standard rate reduced from 16% to 10%) since 2005. At the current duty rates, the Centre RNR is likely to be in the range of 3%, bringing the combined RNR to below 10%.

These estimates are by no means precise. Even so, they give a broad idea of the levels at which the rate of a national GST could be set to achieve revenue neutrality for both levels of government. An important question for policy makers is the costs and benefits of deviating from this benchmark of single rate GST. While there would be pressing calls for all kinds of exemptions and lower rates, the economic benefits of a single rate are enormous. The experience of countries like New Zealand, Japan and Singapore suggests that it is feasible to resist such calls by keeping the tax rate low. There is increasing political support for such an option. It would mark a clean break from the legacy structures and herald a new era of simple and transparent tax administration.

There is virtue in keeping the GST rate in the 10% range, especially at inception. Any revenue shortfall at this rate could be made up by the use of supplementary excises on select demerit goods (e.g., tobacco, and alcohol), besides motor fuels. Excises could also be used for select luxury items which do already attract tax at higher rates. This would help minimize undesirable shifts in the distribution of tax burden (see the discussion in Ahmad and Stern, 1984 and 1991). Clearly, such excises should be limited to a very small list of items which are discrete and not amenable to tax avoidance and evasion.

B. Food

The main issue in the application of GST to food is the impact it would have on those living at or below subsistence levels. In 2005, data, food accounted for one-third of total private final consumer expenditures. For those at the bottom of the inco me scale, it doubtless accounts for an even higher proportion of total expenditures and incomes. Taxing food could thus have a major impact on the poor. By the same token, a complete exemption for food would significantly shrink the tax base.

There are additional considerations that are pertinent to the treatment of food.

> Food includes a variety of items, including grains and cereals, meat, fish, and poultry, milk and dairy products, fruits and vegetables, candy and confectionary, snacks, prepared meals for home consumption, restaurant meals, and beverages. In most jurisdictions where reduced rates or exemptions are provided for food, their scope is restricted to basic food items for home consumption. However, the definition of such items is always a challenge and invariably gives rise to classification disputes. In India, basic food, however defined, would likely constitute the vast bulk of total expenditures on food.

> In India, while food is generally exempt from the CENVAT, many of the food items, including food grains and cereals, attract the state VAT at the rate of 4%. Exemption under the state VAT is restricted to unprocessed food, e.g., fresh fruits and vegetables, meat and eggs, and coarse grains. Beverages are generally taxable, with the exception of milk.
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> In the rural sector, the predominant distribution channel for unprocessed food would be either a direct sale by the farmer to final consumers or through small distributors/retailers. Even where food is within the scope of the GST, such sales would largely remain exempt because of the small business registration threshold. Given the large size of farm community in India, which is mostly unorganized, consideration needs to be given to whether it is advisable to exempt (with no right of input tax deduction) all unprocessed farm produce sold by them at the farm gate. In the case of cash crops (produce for further manufacturing or processing, e.g., cotton, coffee beans, and oil seeds), it would not be in the interest of the farmers to be exempted from tax. They should thus be allowed the option of voluntary registration to pay the tax. It is recognized that an exemption for first sale at the farm gate would be difficult to administer and create inefficiencies in distribution and marketing of farm produce.

These considerations pose some difficult policy issues. Given that food is currently exempt from the CENVAT, the GST under a single-rate, comprehensive-base model would lead to at least a doubling of the tax burden on food (from 4% state VAT to a combined GST rate of 10-12%). It would call for some tangible measures to offset the impact on the lower-income households. One would be to limit the exemption only to cereals (see Table 1) as some of the other food items have lower distributional characteristics.

The alternative of exempting food altogether (or zero rating) would not be any better. First, the revenue neutral rate would jump from 10-12% to 18%. While the poor would pay less tax on food, they would pay more on other items in their consumption basket. Whether and to what extent they would be better off would depend on the composition of their consumption basket. The higher standard rate would, in turn, lead to pressures for exempting other items (e.g., medicines, books, LPG, and kerosene). Third, it could preclude unification of the tax rate on goods with that on services, which are currently taxable 12.36%. Imposition of tax rate at 18% on hitherto exempt services (e.g., passenger travel, health, and education) would encounter significant political resistance. Fourth, one cannot expect any improvement in taxpayer compliance at such high rates. To the contrary, greater visibility of the Centre tax at the retail level could have a negative impact on compliance. Thus, an exemption for food has the potential to totally unravel the simplicity and neutrality of GST.

One could consider a lower rate for food, instead of complete exemption. If the lower rate were to be 5%, the revenue neutral standard rate (based on 2005 rate structure) would be pushed up to 16%. This may be a reasonable compromise, provided all other goods and services are made taxable at the single standard rate of 16%. The risk is that the lower rate for food would become the thin edge of the wedge which would create irresistible demands for the opening the door wider.

An important question is the definition of food that would be eligible for the lower rate. To keep the base broad, and limit the preference to items of consumption by the lower- income households, the lower rate should be confined to 'unprocessed' food items (including vegetables, fruit, meat, fish, and poultry). Its scope can be further restricted by excluding from the preference food pre-packaged for retail sale. This definition would not be without problems, especially where the processing value added is small. For example, if wheat were taxable at 5% as unprocessed food, but flour taxable at 16% as processed food, it would encourage consumers to buy wheat and then have it processed into flour.

Overall, the preferred option would appear to be a single-rate, comprehensive-base GST. While no option is perfect, it has the advantage of simplicity and neutrality. As noted earlier, sales of unprocessed food in rural India would largely remain exempt under this option because of the small business exemption. The poor can be further insulated from its impact through direct spending programs, and/or exempt from tax any sales under the Public Distribution System (PDS).

C. Land and Real Property

Under the 'old' VATs (such as those in Europe), land and real property supplies are excluded from the scope of the tax. To minimize the detrimental impact of an exemption under a VAT, business firms are given the option to elect to pay tax on land real property supplies.

Under a modern GST/VAT (e.g., in Australia, New Zealand, Canada, and South Africa), housing and construction services are treated like any other commodity. Thus, when a real estate developer builds and sells a home, it is subject to VAT on the full selling price, which would include the cost of land[14], building materials, and construction services. Commercial buildings and factory sales are also taxable in the same way, as are rental charges for leasing of industrial and commercial buildings. There are only two exceptions: (1) resale of used homes and private dwellings, and (2) rental of dwellings:

> A sale of used homes and dwellings is exempted because the tax is already collected at the time of their first purchase, especially for homes acquired after the commencement of the tax. If the sale were to be made taxable, then credit would need to be given for the tax paid on the original purchase and on any renovations and additions after the purchase. Except where the prices have gone up, the net incremental tax on resale may not be significant. Theoretically, this system does create a windfall for the existing homes build and acquired prior to the commencement of the tax. In practice, the windfall is not significant as the home construction would have attracted other taxes on construction materials and services that prevailed at the time.
>
> Residential rentals are also exempted for the same reason. If rents were to be made taxable, then credit would need to be allowed on the purchase of the dwelling and on repairs and maintenance. Over the life of the dwelling, the present value of tax on the rents would be approximately the same as the tax paid on the purchase of the dwelling and on any renovation, repair, and maintenance costs. In effect (and as with other consumer durables), payment of VAT on the full purchase price at acquisition is a prepayment of all the VAT due on the consumption services that the house will yield over its full lifetime. A resale of a dwelling is exempted for the same reason: the tax was pre-paid when the dwelling was initially acquired.

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[14] Actually, in Australia and New Zealand, this is not always the case. In New Zealand, land (like any other "goods") is the subject of a deemed input tax credit under the "second hand goods" scheme, which has the effect that the tax on a development of land acquired from an unregistered person is the margin of the supplier. This provision affects mainly the land held by individuals outside a business at the commencement of the GST. Such land is permanently sheltered from tax, even where it subsequently enters a commercial supply chain. In Australia, a margin scheme for land is used to work out the taxable value in similar circumstances: the margin scheme operates as a second hand scheme and as a transitional rule to prevent the value of most (but not all) of the value of land as at 1 July 2000 entering into the tax base.

> Many private individuals and families own residential dwellings (including their homes and summer residences) which they may rent to others. They are generally not in the VAT system, so do not get a credit for the VAT paid when they initially to tax, owners should also be given a credit for the taxes paid on such costs—which would be complex, and difficult to monitor.

Thus, virtually all countries exempt long-term residential rents and resale of used residential dwelling. However, short-term residential accommodation (in hotels, for example) is normally subject to VAT. Any commissions charged by the agents and brokers for the sale or rental of a dwelling are treated as a service separate from the sale or rental of the dwelling and attract tax regardless of whether paid by the buyer or the seller.[15]

Sale or rental of vacant land (which includes rental of car parking spaces, fees for mooring of boats and camping sites) is also taxable under the 'modern' VAT system.

It would make sense to incorporate these concepts in the design of GST in India as well.

Conceptually, it is appropriate to include land and real property in the GST base. To exclude them would, in fact, lead to economic distortions and invite unnecessary classification disputes as to what constitutes supply of real property.

In the case of commercial and industrial land and buildings, their exclusion from the base would lead to tax cascading through blockage of input taxes on construction materials and services. It is for this reason that even under the European system an option is allowed to VAT registrants to elect to treat such supplies as taxable. Housing expenditures are distributed progressively in relation to income and their taxation would contribute to the fairness of the GST.

The State VAT and the Service Tax already apply to construction materials and services respectively, but in a complex manner. For example, there is significant uncertainty whether a pre-construction agreement to sell a new residential dwelling is a works contract and subject to VAT. Where the VAT does apply, disputes arise about the allocation of the sale price to land, goods, and services. While land is the only major element that does not attract tax, the tax rates applicable to goods and services differ, necessitating a precise delineation of the

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15 Poddar(2009) provides a more detailed discussion of the options for taxation of housing under VAT/GST.

two. Extending the GST to all real property supplies, including construction materials and services, would bring an end to such disputes, simplify the structure, and enhance the overall economic efficiency of the tax.

One potential argument against the levy of GST to land and real property would be that they already attract the stamp duty. This argument can be quickly discarded as the purpose and structure of the stamp duty is quite different from that of the GST. Stamp duty is a cascading tax on each conveyance of title to real property, whereas the GST is a tax on final consumer expenditures. The GST does not impinge on commercial property transactions, after taking into account the benefit of input tax credits. It does not result in tax cascading. Under the model described above, in the case of residential dwellings, the GST would apply to the first sale only. Thus, the two taxes cannot be viewed as substitutes. However, the application of GST to real property transactions does warrant a review of the structure and rates of stamp duties and registration fees. The rates should be lowered and the structure rationalized when the GST is introduced.

D. Non-profit Sector and Public Bodies

Historically, supplies made by governmental bodies and non-profit organizations (including religious institutions, social welfare agencies, and sports and cultural organizations) have been exempted from VAT on the grounds that such bodies are not engaged in a business and their activities are not commercial in nature. But this is often, and increasingly, not the case. Public enterprises are involved in a wide range of industrial and commercial activities. As deregulation proceeds, the dividing line between public administration and industrial/commercial activities becomes increasingly blurred. For example, postal and telecommunication services were historically viewed as public administration, but this is no longer the case. Government agencies/enterprises provide such services in competition with private firms. The same is true for other activities such as local and inter-city transit, operation of airports, radio and television broadcasting, and provision of water, sewer, and sanitation services. Moreover, the public sector in India, as in many other countries, is large and pervasive.

Under the EU VAT Directive, activities of the public sector are divided into three categories: non-taxable, taxable, and exempt. A public body is in principle eligible to claim input tax deductions only in respect of the VAT paid on inputs acquired for use in making taxable supplies (though a number of member states pay refunds of VAT by matching grant). While this approach may have provided the EU Member

States with the needed flexibility in dealing with their domestic environment, it falls short of achieving the principal criteria of an efficient VAT system identified above. The exempt or non- taxable status of a wide range of supplies by public bodies violates the criterion of economic neutrality. Biases are created in favor of the self-supply of services within the public sector to minimize the amount of non-deductible VAT on inputs. Consumers may be influenced in their purchasing decisions by the fact that the VAT does not apply to certain public sector goods and services. The non-deductible input VAT embedded in the prices of public sector goods and services is passed along to persons in the production- distribution chain who are not final consumers.

The application of a value added tax requires identification of a supply and the consumer or buyer to whom the supply is made, and valuation of consideration for the supply. Determination of each of these elements gives rise to issues in the public sector due to the nature of the way services are delivered by governments and the manner in which the services are funded. For example, a public body may provide its services for no explicit charge (e.g., museum admissions, water, health, and education) and there may not be any identifiable buyer or consumer for certain services provided on a collective basis (e.g., sanitation, and police protection). In addition, the political sensitivity to the taxation of certain services, and the methods of inter-governmental funding may detract from a neutral application of tax to the public sector activities. As a result, the public sector is subject to special rules in almost all VAT systems currently in place throughout the world.

This is a matter that cannot be dealt with satisfactorily without a systematic review of all of the activities of the governmental bodies and non-profit organizations. However, at this stage it is useful to describe the two broad approaches that other countries have followed.

First, the highly- regarded VAT system in New Zealand (and later Australia[16]) treats all activities of public sector and non-profit bodies as fully taxable.[17] They

[16] The Australian system is structured quite different from the New Zealand one, even though the net outcome is similar. New Zealand's GST is designed to tax all flows of money through the Government, whereas Australia's is complicated by the Federal Structure. The Commonwealth does not in fact pay GST or claim ITCs -- it just does so notionally --, whereas the States actually do pay and claim. New Zealand taxes appropriations, whereas Australian says that they are not taxed. In addition, a range of Government provided services are GST-free or exempt.

[17] See Peter Barrand (1991), for a description of the New Zealand system. Aujean, Michel, Peter Jenkins and Satya Poddar provide an analytical framework for such a system .

thus collect the VAT on all of their revenues, with the sole exception of revenues from taxes, interest and dividends, and gifts and charitable donations. Under this broad and comprehensive approach, no distinction is made between public administration and commercial/ industrial activities of the state or non-profit organizations. By the same token, these bodies are eligible to claim a full credit for their input VAT in the same manner as private enterprises. This system is conceptually simple, and consequently is in some respects easy to operate. And—by putting public and private sectors on an equal footing—it minimizes potential distortions of competition. In Australia, certain basic medical and educational supplies, and supplies by non-profit organizations below market value (i.e., subsidized supplies) are zero-rated.[18] Other supplies are taxable under the standard GST rules, as in New Zealand.

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[18] Zero-rated (called GST-free) supplies are defined as follows:
38-7 Medical services
(1) A supply of a medical service is GST-free.
(2) However, a supply of a medical service is not GST-free under subsection (1) if:
(a) it is a supply of a professional service rendered in prescribed circumstances within the meaning of regulation 14 of the Health Insurance Regulations made under the Health Insurance Act 1973 (other than the prescribed circumstances set out in regulations
14(2)(ea), (f) and (g)); or
(b) it is rendered for cosmetic reasons and is not a professional service for which medicare benefit is payable under Part II of the Health Insurance Act 1973.
[medical services are defined by cross-reference to services covered by a health and health insurance law]
38-85 Education courses
A supply is GST-free if it is a supply of: (a) an education course; or
(b) administrative services directly related to the supply of such a course, but only if they are supplied by the supplier of the course. [education course defined as a course leading to a diploma or degree from a primary, secondary or tertiary school with cross-references to recognition by the appropriate state education authority]
38-250 Nominal consideration etc. (1) A supply is GST-free if:
(a) the supplier is a charitable institution, a trustee of a charitable fund, a gift-deductible entity or a government school; and
(b) the supply is for consideration that:
(i) if the supply is a supply of accommodation – is less than 75% of the GST inclusive market value of the supply; or
(ii) if the supply is not a supply of accommodation – is less than 50% of the GST inclusive market value of the supply.

The second is the traditional approach followed in most other countries. Under this approach, the activities of public and non-profit bodies are divided into two lists: taxable and exempt. There are no simple or mechanical rules for this division, which in practice is based on a variety of economic, social, and practical considerations. For example, public enterprises engaged in industrial or commercial activities are generally taxable, especially if their revenues from their clients are expected to exceed their costs. Some countries exempt all other fees and charges, while others tax them on a selective basis (including postal charges, airport landing fees, port loading and unloading charges, sale of statistical and other publications, and fees fo r licenses and permits). Given that not all of the activities of an organization are considered taxable under this approach, an input tax credit is allowed for only those inputs that relate to the taxable activities of the organization.

This latter approach creates difficulties in determining what is taxable and what is exempt, and also in allocating the input taxes between the two (since credit would be given only in respect of taxable activities). It also creates a distortion in the form of a bias against the use of outside contractors by public bodies in their exempt activities. For example, if a municipality used a contractor for construction of a road or a bridge, it would pay the VAT on the contractor's fees, and not be eligible to claim a credit for the tax. However, it could avoid the tax if it hired its own employees to do the construction work. As noted above, some countries provide a full or partial rebate of the tax related to minimize this 'self-supply' bias.

There is little doubt that the New Zealand approach is conceptually superior. It does, however, lead to a larger number of taxpayers, many of which will be entitled to refunds. Since the management of refunds is an especially problematic aspect of the VAT, particularly in developing countries, the control issues may be a significant drawback.

If governments and public bodies are partially exempted, then one other issue that needs to be considered is the treatment of supplies to governments. This is especially important in a federation. Should one government apply its non-creditable tax to supplies to another government? Or should all governments be immune from taxation as sovereign bodies? In India, CENVAT and State VAT currently apply to government procurement.

Likewise, the GST could be made applicable to supplies to governments with no special rules. However, as noted earlier, this then would create a self-supply bias for public bodies where they buy inputs for an exempt activity.

E. Financial Services

Financial services are exempted from VAT in all countries. The principal reason is that the charge for the services provided by financial intermediaries (such as banks and insurance companies) is generally not explicit- a fee- but is taken as a margin, that is hidden in interest, dividends, annuity payments, or such other financial flows from the transactions. For example, banks provide the service of operating and maintaining deposit accounts for their depositors, for which they charge no explicit fee. The depositors do, however, pay an implicit fee, which is the difference between the pure interest rate (i.e., the interest rate which could otherwise be earned in the market without any banking services) and the interest actually received by them from the bank on the deposit balance. The fee is the interest foregone. Similarly, the charge for the services provided by banks to the borrowers is included in the interest charged on the loan. It is the excess of the interest rate on the loan over the pure rate of interest or cost of funds to the bank for that loan.

It would be straightforward to levy the tax on this implicit fee if the reference 'pure rate' were easily observable—but it is not. The spread between borrowing and lending rates, could be measured, and taken as measuring the *total* value added by the intermediary. But in order for the crediting mechanism to work properly, it is necessary to go further and *allocate* this value-added to borrower and lender (with a credit on the tax paid due only to registered taxpayers)—which again raises the problem of identifying a reference pure interest rate.[19]

Some financial services are, of course, charged for by a direct and explicit fee, examples being an account charge or foreign exchange commission. Services provided for an explicit charge could be subjected to VAT in the normal way with the taxable recipient having a right of deduction, and a growing number of countries do this. Nevertheless, some countries exempt them all, while others limit the exemption to banking and life insurance. The exemption avoids the need to measure the tax base for financial transactions, but gives rise to other distortions

[19] These concepts are discussed in greater detail in Poddar, S. and M. English (1997) and Poddar, Satya (2003).

in the financial markets. The denial of credit to the exempt financial institutions for the VAT charged on their inputs creates disincentives for them to outsource their business process operations. Where they render services to business clients, the blockage of input tax credits results in tax cascading, adversely affecting their competitive position in the international markets.

Taxing explicit fees for financial services, but treating margin services as exempt, is a possible answer, but it is conceptually flawed (as the same service will be treated differently for VAT purposes depending on how the remuneration for it is taken) and runs the risk that there will be some arbitrage between the two methods of charging to lessen the VAT charge (particularly in the case of supplies to final consumers with no right of deduction).

In China, financial services are taxable under their business tax, which is a tax on turnover with no tax credits allowed on inputs. Because it is a turnover tax, it can be applied to the total spread for margin services, with no need to allocate the spread between borrowers and depositors. Israel, and Korea also apply tax in such alternative forms.

Under the Service Tax, India has followed the approach of bringing virtually all financial services within the ambit of tax where the consideration for them is in the form of an explicit fee. It has gone beyond this by bringing selected margin services (where the consideration is the spread between two financial inflows and outflows) within the Service Tax net. The following are principal examples of such taxable margin services:

> Merchant discounts on credit/debit card transactions are taxable as a consideration for credit card services, as are any explicit fees or late payment charges collected from the card member.
>
> In foreign currency conversion transactions without an explicit fee, tax applies to a deemed amount of consideration equal to 2% of the amount converted. The tax applies to that portion of life insurance premiums that represents a cover for risks.

As there are no compelling economic or social policy reasons for exempting financial services (other than the practical difficulties of defining the consideration for margin services), it would be appropriate to continue this approach under GST. There are, however, certain technical flaws in the measurement of consideration that need to be addressed when switching over to GST. For example, in the case of insurance, the tax applies to the gross amount of risk premium, while a proper measure would be the premiums net of any claims (whether the claim is settled in cash or in kind). This can be accomplished by allowing a credit in respect of any claims paid.

Consideration could also be given to bringing interest margin on non-commercial loans and deposits within the next net on an aggregate basis, as opposed to for each transaction separately.[20] This could be done by computing the aggregate interest margin and apportioning it between the margin from B2B and B2C transactions. The B2B margin could then be zero-rated, and the tax applied to the B2C margin.

In some countries, transactions in gold, silver and other precious metals are also treated as part of the financial sector, given that these metals are often bought as investments, and not for consumption. They are exempted from tax. However, unlike the approach followed in India of applying a reduced rate of 1% to such metals and articles made of such metals, the exemption is confined to only metals of investment-grade purity levels. Jewellery and other articles made of such metals remain taxable at the standard rate.

6. Treatment of Inter-State and International Trade

Treatment of inter-state and international supplies of goods and services is one of the most crucial elements of the design of a Dual GST. A set of rules is needed to define the jurisdiction in which they would be taxable under the destination principle. Further a mechanism is needed for enforcing compliance to those rules.

The rules can be relatively straightforward for the application of the Central GST. However, there is a concern that, under a sub- national destination-based VAT, taxation of cross-border transactions could be a significant challenge in the absence of any inter-state fiscal border controls. Even if such border controls were to exist, they would be ineffective for taxation of services, which entail no physical inter-state movement. This concern has been a topic of increased discussion over the recent years due to the growth in internet sales and transactions. Cross-border VAT leakage is also a growing concern in the EU because of the removal of border controls between member countries.

[20] For a more complete discussion of the system in India and how it can be modified and extended, seePoddar, Satya (2007).

In what follows, we first start with the basic framework for defining the place of supply, then look at the policy options for ensuring proper compliance. This discussion draws on Ahmad, Poddar et al (2008) for the GCC Secretariat.

A. Place of Taxation, International Transactions

In virtually all countries, VAT is levied on the basis of the destination principle. For this purpose, some countries follow the practice of prescribing a set of rules for defining the place of taxation or place of supply. A supply is taxable in a given jurisdiction only if the supply is considered to take place in that jurisdiction. An alternative approach followed by other countries is to first define what supplies are potentially within the scope of the tax, and then provide criteria for determining which of those supplies would be zero-rated as exports. The two approaches yield the same result, even though one excludes exports from the scope of the tax, while the other zero-rates them, having first included them in the scope. The Service Tax in India follows the second approach.

While the rules and approaches vary from country to country, the basic criteria for defining the place of taxation are as follows (approaches for taxation of services depicted in Chart 1):[21]

A sale of goods is taxable if the goods are made available in or delivered/shipped to that jurisdiction (i.e., on the basic of place of delivery or shipment to the recipient) A sale of real property is taxable if the property is located in that jurisdiction (i.e., on the basis of place of location of the property). Services directly connected with real property are also taxable on this basis (e.g., services of estate agents or architects).

A supply of other services or intangible property is taxable in that jurisdiction depending on one or more of the following factors:

- Place of performance of the service
- Place of use or enjoyment of the service or intangible property
- Place of residence/location of the recipient
- Place of residence/location of the supplier

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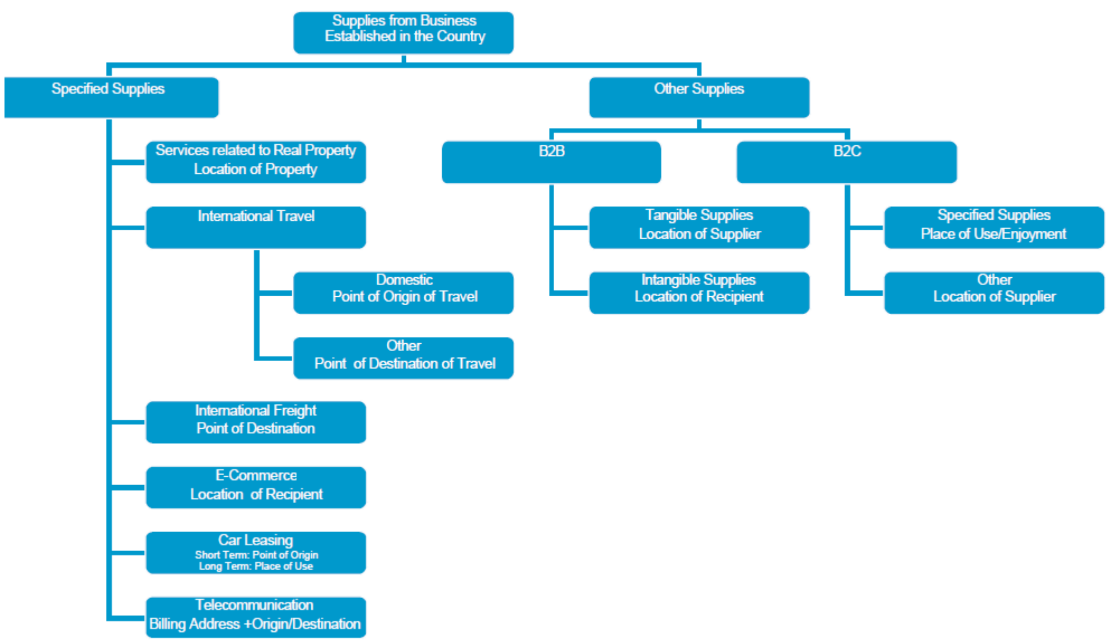
[21] What are discussed below are only the basic concepts. The actual rules can be complex, and highly varied from one jurisdiction to the next. For a more rigorous discussion of the approaches being followed in selected international jurisdictions, see Millar, Rebecca (2007).

Special rules apply for certain supplies (also referred to as mobile services) for which there is no fixed place of performance or use/enjoyment, such as:

- Passenger travel services
- Freight transportation services
- Telecommunication Services o Motor vehicle leases/rentals o E-commerce supplies

Chart 1
Place of Taxation
(of supplies other than goods)



In defining the place of taxation of services and intangible property, a distinction is often made between supplies made to businesses (B2B) and final consumers (B2C). B2B supplies are generally defined to be made where the recipient is located or established, regardless of where the services are performed or used. This is particularly the case for the so-called intangible services (e.g., advisory or consulting services) for which the place of performance is not important. Thus, all such services rendered to nonresidents become zero-rated, and subject to a reverse charge in the country of the recipient, which charge is deductible as long as the recipient is fully taxable. This avoids tax cascading, which would otherwise occur.

By contrast, B2C services are deemed to be made in the jurisdiction where the supplier is located. Many B2C services tend to be tangible or physical in nature, e.g., haircuts, and admissions to place of amusement, which are used/consumed at the place of their performance. In some countries, B2C intangible services are treated in the same manner as B2B services, i.e., they are zero-rated when rendered to nonresident customers.

Special rules apply to the so-called mobile services. For transportation services, the place of supply is defined by reference to the point of origin or destination. In Europe, rail passenger transportation is taxed based on distance traveled in the taxing jurisdiction. For telecommunication, e-commerce and satellite broadcasting services, the origin rule (taxation in the country of the supplier) can lead to non-taxation, and various solutions have been followed to prevent this. For example, in the EU, e-commerce suppliers to EU final consumers are required to register and account for tax in the country of their customer, using a 'one stop shop' registration facility, if they wish. This rule is being extended to intra-EU supplies of telecommunications, e-commerce and satellite broadcasting from 1/1/2015 to present suppliers obtaining an arbitrage advantage by setting up their business in a low rate member state. In Canada, a two-out-of-three rule is followed, i.e., the supply is made in the jurisdiction if the points of origin and termination are in that jurisdiction, or if one of the points is in the jurisdiction and the supply is billed to an account in the jurisdiction. The rules for e-commerce are varied, but generally follow the rules for telecommunication services. Internet connectivity services are in fact telecommunication services. Goods and services bought and sold online are generally taxed on the same manner as those bought offline.

For short-term car rentals, in Europe the place of supply is where the car is first made available to the customer, regardless of the place of its subsequent use. For long-term leases, place of supply could depend on the place of use of the vehicle or the residence of the customer; the EU is adopting such a rule from 1/1/2010 to prevent 'rate shopping'. Often, similar rules are adopted for leases and rentals of other goods also.

In addition to the above, there are a variety of other complex cross-border transactions' for which supplementary rules are required. They relate to global transactions (or master service agreements) for individual supplies to legal entities of a corporate group around the world, triangular transactions, supplies among branches and between branches and head office, and cost reimbursement/ allocation arrangements. The complexity of the rules for such transactions has been an issue under discussion by working groups at the OECD, with a view to developing a framework or guidance for uniformity and consistency in the treatment of international services and intangibles in different jurisdictions.[22]

It is recognized that under these rules tax could be charged to nonresident business customers on supplies of an intermediate nature (i.e., not for final consumption) which would lead to cascading and create competitive distortions. To address this concern, many countries have provisions to provide a rebate of the tax charged to business customers.[23] Such rebates can also be extended to non-business customers, e.g., rebates to foreign tourist for the tax paid on goods bought locally for subsequent export when they return back.

Generally, these rules apply in a symmetrical manner to define exports and imports. Thus, where the supply of, say, consulting services by a domestic supplier is zero-rated because it is supplied to a business located outside the country, the supply of such services by a foreign supplier to a business located in the country would be taxable as an imported service. Imports generally attract tax at the customs border. For services and intangibles, the tax is self-assessed by the recipient under the reverse-charge mechanism.

The combined result of these rules (including the system of rebates for nonresident customers) is to define the place of destination of services and intangibles as follows:

For B2B supplies, the place of destination is the place where the recipient is established or located.

For B2C supplies of a tangible/physical nature (e.g., hair cuts, hotel accommodation, local transportation, and entertainment services), the place of destination is the place where the supplier is established or located, which is generally also the place where the service is performed. For highly mobile B2C supplies of an intangible nature (e.g., telecommunication, e-commerce and

[22] For discussion of the issues and approaches, see OECD (2004).

[23] For example, such rebates are provided under Article XXX. of the EU VAT Directive.

satellite broadcasting services, for which the place of performance is not linked to the rendering of the service), the place of supply could be the place of residence of the customer (as for B2B supplies), or the place where the services are used or enjoyed. But, because it is wholly impractical to subject final consumers to the reverse charge, in Europe the non-resident supplier is required to register and account for VAT to customers resident in the European Union.

Special rules for specific supplies are generally designed to yield a result similar to that for other supplies. They serve the purpose of providing greater certainty and clarity in situations where the place of location or residence of the supplier or the recipient may not be well defined or easily ascertainable at the time of the supply.

B. Place of Taxation, Inter-State Transactions

An important question in the context of the Dual GST is whether these rules for international cross-border supplies can be adopted for domestic inter-state supplies also. Conceptually, there are no compelling reasons to deviate from them for defining the place of supply at the sub- national level. The only precedent available of a destination- based VAT at the sub-national level is that of Harmonized Sales Tax (HST) in Canada. (The precedent of the EU is different because it is a community of 27 sovereign member states rather than a single nation made up of a union of states in a federation. The EU solution of taxing intra-EU B2B supplies of goods and services by means of zero-rating and then reverse charge accounting in the member state of the taxable recipient may not be the right answer—and has led to the problem of carousel fraud). Surprisingly, Canada deviated from these rules in defining the place of supply in a province in one important respect. In defining the place of supply of services at the provincial level, the primary criterion used in Canada is the place of performance of the service. Thus, if all or substantially all of a service is performed in a province, then the place of supply of the service is considered to be that province, regardless of whether it is a B2B or B2C supply, and where it is used or enjoyed. There appear to be two reasons for it, which are also relevant for the design of the Dual GST in India.

First, it is recognized that the place where the supplier or the recipient is established cannot be defined uniquely at the sub-national level within a common market. A supplier may have establishments/offices in several States and one or more of them could be involved in rendering the service. At the national level, the country of residence of the counter parties to a transaction needs to be determined for direct tax as well as other regulatory purposes. However, at the sub-national level, such determination is not necessary, especially where there is no direct tax at that level. The basic rules outlined above for international supplies cannot be applied in the absence of supplementary rules for defining the place where the supplier and the recipient are located or established. Take, for example, an HR consulting firm with offices in several States providing recruitment services to a corporate entity with operations through India. In this case, the basic rule of defining the place of supply of the service to be where the recipient is established cannot be applied as the recipient is established in more than one State.

Second, under the Canadian HST, any input tax paid by a business can be claimed back as an input credit under the federal GST or the HST regardless of where it is established, as long as the inputs are used in a taxable activity. Thus, there is no adverse consequence of collecting the HST on services rendered to businesses located in other provinces. The HST is integrated with the GST to such an extent that it best fits the description of as a national GST, not a Dual GST.

Given these considerations, Canada defines the place of supply of services (other than those subject to special rules) to be the place where they are performed. If they are performed in more than one province, supplementary rules are employed to determine the place of supply. The main supplementary rule defines the place of supply/taxation to be the place to which the employee/officer of the supplier, who had responsibility for negotiating the service contract with the recipient, reports. In effect, under these rules the sub- national tax on services is applied on the basis of the origin principle, i.e., where the services are performed.

The Canadian approach does not appear to be suitable for the Dual GST in India where the Centre and State GSTs would be harmonized, but not integrated. It would be desirable to tax B2B supplies of services (and intangibles) in the State of destination, and not of origin.

Given that any tax on B2B supplies would generally be fully creditable, excessive sophistication would not be warranted for defining the place of destination of such supplies. For multi-establishment business entities, the place of destination could be defined simply as the place of predominant use of the service. Where there is no unique place of predominant use, the place of destination could be simply the mailing address of the recipient on the invoice, which would normally be the business address of the contracting party. The risk of misuse of this provision would be minimal if it is limited to B2B supplies where the tax is fully creditable.

For B2C services, the tax should apply in the State where the supplier is established, which, in turn, could be defined as the place where the services are performed. Where there is no unique place of performance of the service, the place of taxation could be defined to be the State where the supplier's establishment most directly in negotiations with the recipient is located. This would be similar to the Canadian rule.

C. Taxation of Imports by the States

In most countries, imports attract the VAT/GST at the time of entry into the country. The tax is generally applied on the value of goods declared for customs purposes, including the amount of the customs duty. However, there are no well-established precedents for the application of sub-national taxes to imports. In India, the Centre levies an additional duty (called the special additional duty) on imports at the rate of 4%, which is meant to be in lieu of the state VAT. This duty is allowed as a credit against the central excise duty on manufacturing or refunded where the imports are resold and the State VAT is charged on them.

In Canada, the provincial HST is collected by the Customs authorities on non-commercial importations of goods. The tax is collected at the time of importation on the basis of place of residence of the person importing the goods, regardless of where the goods enter the country. Commercial importations do not attract the provincial HST because of difficulties in determining their destination within the country. For example, a large consolidated commercial shipment could contain goods that are initially destined to a central warehouse, for subsequent distribution to various parts of the country.

The Canadian system is conceptually appealing and could be considered for the application of State taxes under the Dual GST in India.

D. Monitoring of Inter-State Supplies

We turn now to the design of a suitable mechanism for payment and collection of tax on inter-state supplies. As noted earlier, there is a concern that a sub-national destination-based VAT could be subject to substantial leakages in the absence of effective inter-state border controls. Many policy prescriptions have been made to deal with the issue, but none implemented so far at the sub-national level.[24]

In our view, these concerns are exaggerated, especially under a dual GST,

[24] See, for example, McLure, Charles (2000):, Keen, Michael and Stephen Smith (2000), and Poddar, Satya(1990).

harmonized between the Centre and the States and across the States. It is possible to design suitable mechanisms for proper application of tax on inter-state supplies, without resorting to border controls. The current border controls for goods, in the form of inter-state check posts have not been effective in the past. Border controls would not even be feasible for services and intangibles, which involve no physical inter-state movement.

As noted by Bird and Gendron[25], under a dual GST, the application of the Centre GST to all domestic supplies would automatically serve as an audit control for reporting of inter- State supplies for purposes of the State GST. The aggregate of the turnovers reported for the State GSTs must equal the total turnover reported for the Centre GST. Dealers can misclassify the turnover to different States, but would not be able suppress the turnover for State GST below the level reported for the Centre GST. Where the GST design, rate and the base is harmonized across the States, the dealers would have little incentive to misclassify the turnover. Under such a system, the focus of the authorities should be on proper reporting of the total turnover, not inter-State turnover.

Notwithstanding the above, a mechanism is needed for proper application of sub-national tax on inter-State supplies of goods as well as services. For reasons outlined elsewhere[26], zero-rating of inter-State supplies is not advisable. Instead, the preferred approach would be to require the vendors to collect the destination state GST on inter-State supplies (of goods and services) and remit the tax directly to the destination state. The tax would then be creditable in the destination state under the normal rules, i.e., if it relates to inputs for use in making taxable supplies.

This mechanism, referred to as Prepaid VAT (PVAT), is similar to the mechanism of the CST. Under the CST, the tax on inter-state sales is charged and remitted to the origin state. Under PVAT, the tax on inter-state supplies would be charged and remitted to the destination state.[27] It preserves the destination principle of VAT.

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[25] See Bird and Gendron (1998).

[26] See Poddar, Satya, Eric Hutton, (2001).

[27] The PVAT mechanism as originally developed by the authors entailed a prepayment of the destination state VAT before the goods are shipped. However, under a harmonized Dual GST, such prepayment may not be necessary. There would be enough safeguards in the system to enforce payment of tax on inter-state supplies at the same time as on intra-state supplies

Vendor in the origin state collect tax on all of their domestic supplies, whether intra-State or inter-State. The tax collected on inter-state supplies would be that of the destination state and remitted to that state by the vendor. On intra-state supplies, the tax collected would be that of the origin state and paid to that state.

Buyers who are GST registrants (in B2B transactions) would have a strong incentive to ensure that the vendor properly applies the destination tax, which would then be creditable against their output tax in the state of destination. Otherwise, the goods would be subject to the tax of the origin state, which would not be creditable in the state of destination.

Most supplies of services and intangibles to consumers and other exempt buyers (in B2C transactions) would be taxable in the state of origin, without the benefit of zero-rating. However, inter-state shipments of goods to consumers would be zero-rated in the state of origin and attract the tax of the destination state (including, for example, mail order supplies of goods). An inducement could be created for consumers also to ensure that the vendor charges the destination state tax on such shipments. This could be done by imposing a self-assessment requirement in the destination state on any inter-state purchases on which the vendor has not charged and remitted the destination state tax.

The PVAT mechanism establishes the output-tax-and- input-credit chain for inter-state transactions and, thereby, strengthens the audit trail property of the VAT system. Unlike the system of zero-rating, it creates strong incentives for both the origin and the destination states to monitor compliance independently of each other, as revenues of both are affected by the zero-rated sales declared by the vendor. This is a unique feature of PVAT, and perhaps it is most significant. Under the traditional system of zero-rating, the quantum of zero-rated sales reported by the vendor affects the revenues of the origin state, but not of the destination state. PVAT creates a simple and effective link between the two.

7. Harmonization of Laws and Administration

The need for Centre-State and inter-State harmonization is paramount under the Dual GST. The ultimate goal would be a unified base and one set of rules for the two taxes.

What should be the mechanism for achieving this harmonization? Different options have been adopted in other federations or trading blocks. At one extreme is the example of Australia where the GST is imposed and administered as a single unified tax levied by the national government. All the revenues from the tax are then distributed to the states. Another such example is that of Harmonized Sales Tax (HST) in Canada, which is levied in three of the ten provinces. The tax is levied and administered under a unified law by the national government, much like the Australian GST. The key difference is in the revenue allocation system. Under the Canadian system, provincial participation in the HST is elective, not mandatory. The tax is levied at the national rate of 7 percent (now reduced to 5%), which is increased by 8% percent in those provinces which have elected to participate in it. The revenues attributable to the supplementary rate of 8 percent are then distributed among the participating provinces on the basis of a statistical calculation of the tax base in those provinces (which approximates the revenues they would have collected if they had levied a separate tax of their own). In Australia, there is no State "participation". The tax is a federal tax that is distributed to the States under a political agreement. The revenues are distributed as grants to the States, taking into account factors such as fiscal capacity and need of individual States. In terms of the operation of the law, the enactment of the law, and the jurisdiction of law, it is exclusively a federal tax.

The system in the Province of Quebec in Canada offers another model of harmonization of the national and sub-national taxes. Quebec levies a goods and services tax, called Quebec Sales Tax (QST), the legislation for which follows very closely the model for the federal GST. The two taxes have the same base, definitions, and rules, but levied under two separate statutes. To ensure harmonization of administration, the two governments have entered into a tax collection agreement under which the collection, administration and enforcement of the federal GST is delegated to the provincial government. The agreement defines the role and responsibilities of the two governments and the policies and procedures to be followed in administering the tax. The federal government retains the power to make any changes in the legislation and to issue rulings, and interpretations, which are adhered to by the province in administering the federal GST. In practice, the province accepts the federal rulings and interpretations for both GST and QST, given the similarities in the two statues.

The EU model is yet another example. This model is quite distinct from the Australian and Canadian models. The focus in the EU model is on minimization of distortions in trade and competition, and not on harmonization of administration. Thus, the VAT base (subject to continuing derogations) is harmonized, as are the basic rules governing the mechanism and application of

VAT (time of supply, valuation, place of supply etc). The rates are harmonized only within broad bands (e.g., the standard rate may not be less than 15%) and administration is largely a matter for the member states to decide (but must respect basic principles such as neutrality).

As noted earlier, the CST in India also offers an interesting model of the harmonization mechanism. The CST law is central, but the tax is administered and collected by the States. Indeed, this appears to be most suitable model for India. The GST law for both the Centre and the States would be enacted by Parliament under this model. It would define the tax base, place of taxation, and the compliance and enforcement rules and procedures. The rates for the State GST could be specified in the same legislation, or delegated to the State legislatures. The legislation would empower the Centre and the States to collect their respective tax amounts, as under the CST.

If the governments fail to reach a political compromise on the CST model, the Quebec model would appear to be the next best alternative. It respects fiscal autonomy of the two levels of government, yet facilitates harmonization through the mechanism of binding tax collection agreements between the Centre and the States. These agreements would, in turn, encourage adoption of a common GST law.

The Centre can play an important role of providing a forum to discuss and develop the common architecture for the harmonized administration of the two taxes. It would have responsibility to develop policies and procedures for GST, in consultation with the Empowered Committee, e.g., on the place of supply rules, taxpayer registration and identification numbers, model GST law, design of tax forms and filing procedures, data requirements and computer systems, treatment of specific sectors (e.g., financial services, public bodies and governments, housing, and telecommunications), and procedures for collection of tax on cross-border trade, both inter-State and international. The proposal made by the Empowered Committee (for delegation of administration of the Centre GST for smaller dealers to the States) is very similar, even though the contractual framework for it is yet to be developed.

8. Conclusion

The Empowered Committee describes the GST as "a further significant improvement – the next logical step - towards a comprehensive indirect tax reforms in the country." Indeed, it has the potential to be the single most important initiative in the fiscal history of India. It can pave the way for modernization of tax administration - make it simpler and more transparent – and significant enhancement in voluntary compliance. For example, when the GST was introduced in New Zealand in 1987, it yielded revenues that were 45% higher than anticipated, in large part due to improved compliance. Its more neutral and efficient structure could yield significant dividends to the economy in increased output and productivity. The Canadian experience is suggestive of the potential benefits to the Indian economy. The GST in Canada replaced the federal manufacturers' sales tax which was then levied at the rate of 13% and was similar in design and structure as the CENVAT in India. It is estimated that this replacement resulted in an increase in potential GDP by 1.4%, consisting of 0.9% increase in national income from higher factor productivity and 0.5% increase from a larger capital stock (due to elimination of tax cascading)

However, these benefits are critically dependent on a neutral and rational design of the GST. The discussion of selected issues in this paper suggests that there are many challenges that lie ahead in such a design. The issues are not trivial or technical. They would require much research and analysis, deft balancing of conflicting interests of various stakeholders, and full political commitment for a fundamental reform of the system.

Opportunities for a fundamental reform present themselves only infrequently, and thus need to be pursued vigorously as and when they do become available. As the choices made today would not be reversible in the near future, one needs a longer-term perspective. Achieving the correct choice is then a political economy balancing act that takes into account the technical options and the differing needs and constraints of the main partners. Fortunately, there is a very substantial consensus among all stakeholders in the country for a genuine reform. In the circumstances, an incremental or timid response would be neither politically expedient, nor would it serve the needs of India of the 21st century. Experience of countries with modern VATs, such as New Zealand, Singapore, and Japan suggests that a GST with single-rate and comprehensive base can be a win-win proposition for taxpayers and the fiscal like.

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