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Executive Summary

1. The taxation of goods and services in India has, hitherto, been characterised as a cascading and distortionary tax on production resulting in mis-allocation of resources and lower productivity and economic growth. It also inhibits voluntary compliance. Therefore, it is necessary to replace the existing indirect tax system by a new regime which would foster the achievement of the following objectives:

- (a) The incidence of tax falls only on domestic consumption;
- (b) The efficiency and equity of the system is optimized;
- (c) There should be no export of taxes across taxing jurisdictions;
- (d) The Indian market should be integrated into a single common market;
- (e) It enhances the cause of cooperative federalism. **(Para 2.1)**

2. A well designed 'value added tax on all goods and services (GST) is the most elegant method of eliminating distortions and taxing consumption. Under this structure, all different stages of production and distribution can be interpreted as a mere tax pass-through, and the tax essentially 'sticks' on final consumption within the taxing jurisdiction.

(Para 2.2)

3. The 'flawless' GST recommended by us comprises of the following elements:

- i. It should be a dual levy imposed concurrently by the Centre and the States, but independently to promote cooperative federalism. **(Para 2.4)**
- ii. Both the Central Goods and Services Tax (CGST) and the State Goods and Services Tax (SGST) should be levied on a common and identical base. **(Para 2.4)**
- iii. The Centre and the States should adopt a consumption-type GST¹, that is, there should be no distinction between raw materials and capital goods in allowing input tax credit. **(Para 2.7)**

¹ Reference to GST in this Report includes both CGST and SGST

- iv. The tax base should comprehensively extend over all goods and services upto the final consumer point. **(Para 2.7)**
- v. There should be no classification between goods and services in law so as to ensure that there is no classification dispute. **(Para 2.7)**
- vi. The GST should be structured on the destination principle. As a result, the tax base will shift from production to consumption whereby imports will be liable to both CGST and SGST and exports should be relieved of the burden of goods and service tax by zero rating. Consequently, revenues will accrue to the State in which the consumption takes place or is deemed to take place; **(Para 2.13)**
- vii. The computation of the CGST and SGST liability should be based on the invoice credit method i.e., allow credit for tax paid on all intermediate goods or services on the basis of invoices issued by the supplier. As a result, all different stages of production and distribution can be interpreted as a mere tax pass-through, and the tax will effectively 'stick' on final consumption within the taxing jurisdiction. This will facilitate elimination of the cascading effect at various stages of production and distribution. **(Para 2.16)**
- viii. The CGST and SGST should be credited to the accounts of the Centre and the States separately. Since the CGST and SGST are to be treated separately, taxes paid against the CGST should be allowed to be taken as input tax credit (ITC) for the CGST and could be utilized only against the payment of CGST. The same principle will be applicable for the SGST. Cross utilization of ITC between the CGST and the SGST should not be allowed. **(Para 2.16)**
- ix. Full and immediate input credit should be allowed for tax paid (both CGST and SGST) on all purchases of capital goods (including GST on capital goods) in the year in which the capital goods are acquired. Similarly, any kind of transfer of the capital goods at a later stage should also attract GST liability like all other goods and services. **(Para 2.18)**
- x. Ordinarily, there should not be any exemption from CGST or SGST. However, if for some reason, it is considered necessary to provide exemption, the Centre and the

States should draw up a common exemption which should be restricted to the following:-;

- a. All public services of Government (Central, State and municipal/panchayati raj) including Civil administration, health services and formal education services provided by Government schools and colleges, Defence, Para-military, Police, Intelligence and Government Departments. However, public services will not include Railways, Post and Telegraph, other commercial Departments, Public Sector enterprises, banks and Insurance, health and education services;
 - b. Any service transactions between an employer and employee either as a service provider, recipient or vice versa;
 - c. any **unprocessed food article** which is covered under the public distribution system should be exempt regardless of the outlet through which it is sold; and
 - d. **education services** provided by non-Governmental schools and colleges; and
 - e. **health services** provided by non-Governmental agencies. **(Para 2.26)**
- xi. The SIN –goods comprising of emission fuels, tobacco products and alcohol should be subject to a dual levy of GST and excise. No input credit should be allowed for excise. However, industrial fuels should be subjected only to GST (both Central and State) with the benefit of input credit like any other intermediate good.
(Paras 2.27 to 2.32)
- xii. all inter-state transactions in goods and services should be effectively zero rated by adopting the Modified Bank Model. **(Paras 3.1 to 3.19)**
- xiii. the consignment sales and branch transfers across states should be subject to treatment in the same manner as if it was a inter-state transaction in the nature of sale between two independent dealers. **(Para 3.20)**

- xiv. the function of all state border check posts should be reduced to checking contrabands by setting up large scanners for trucks to pass through without any need for physical verification. The cost of the scanners should be entirely borne by the Central Government. All check-posts should be jointly manned by both States so as to reduce the number of check-posts and enhance efficiency in the road movement of goods. **(Para 3.20)**
- xv. Keeping in view the compliance cost and administrative feasibility, small dealers (including service providers) and manufacturers should be exempted from the purview of both CGST and SGST if their annual aggregate turnover (excluding both CGST and SGST) of all goods and services does not exceed Rs.10 lakh. However, like in most other countries, those below the threshold limit may be allowed to register voluntarily to facilitate sales to other registered manufacturers/dealers, limit competitive distortions and avoid inequities. Further, the threshold exemption limit should be uniform for both CGST and SGST and across States. **(Paras 2.61 and 2.62)**
- xvi. Further, with a view to reduce administrative and compliance burden, small dealers with annual aggregate turnover of goods and services between Rs.10 lakh to Rs.40 lakh² may be allowed to opt for a compounded levy of **one percent**, each towards CGST and SGST. However, no input credit should be allowed against the compounded levy or purchases made from exempt dealers. **(Para 2.63)**
- xvii. Certain high value goods comprising of (i) gold, silver and platinum ornaments; (ii) precious stones; and (iii) bullions (hereafter referred to as “high value goods”) are prone to smuggling due to high tax incidence thereby generating negative externalities in terms of social and economic disorder. Therefore, we recommend that dealers in such high value items may, subject to the threshold exemption but without the ceiling of Rs. 40 lakh, also be allowed to opt for the compounded levy of **one percent**, each towards CGST and SGST. **(Para 2.64)**

² The limit of Rs 40 lakh is based on the consideration that dealers with turnover of Rs 40 lakh or more are subject to tax audit under the Income Tax Act, 1961 and therefore they would suffer from any additional burden in terms of documentation under the GST.

- xviii. The existing **exemption upto Rs.1.5 crores of turnover for small-scale industries should not be continued under the GST framework**. However, in order to inspire confidence of the small scale industry in the new GST framework, the scrutiny/audit of the small scale industry should be conducted only by the state tax administration. The enforcement by the State tax administration would be adequate to even deal with CGST evasion. **(Paras 2.66 and 2.67)**
- xix. The area based exemption in respect of CENVAT **should not be continued** under the GST framework. In case it is considered necessary to provide support to industry for balanced regional development, it would be appropriate to provide direct investment linked cash subsidy. **(Para 2.74)**
- xx. Since the GST is designed to ensure that all producers and distributors are treated as complete pass-through and exports are zero-rated, there **should be no exemption for the developers of, or units in, the Special Economic Zones**. **(Para 2.75)**
- xxi. The tax regime for power sector, vehicles, goods and passengers, financial services and the real estate and housing services sector should be reformed and integrated into the GST framework along the lines summarized in the paragraphs 4 to 7 and explained in detail in Chapter-II.
- xxii. The rate of CGST and SGST on all non-SIN goods and services should be fixed at a single positive rate of 5 per cent and 7 per cent, respectively. In addition, there should be a zero rate applicable to all goods and services exported out of the country. **(Paras 5.9 and 5.79)**
- xxiii. The following central taxes should be subsumed in the CGST³:
- a. Central Excise Duty (including Additional Excise Duties);
 - b. Service Tax;
 - c. Additional Customs Duty (commonly referred to as 'CVD');
 - d. Surcharges and all cesses
- (Para 2.11)**

³ This is consistent with the proposal of the EC in their Discussion paper dated 30th April, 2008.

xxiv. The following State level taxes, as also recommended by the Empowered Committee (EC) in its discussion paper dated 30th April, 2008, should be subsumed in the SGST:-

- a. VAT/Sales Tax (including Central Sales Tax and Purchase tax);
- b. Entertainment tax (other than levied by local bodies);
- c. Entry taxes not in lieu of Octroi;
- d. Other Taxes and Duties (includes Luxury Tax, Taxes on lottery, betting and gambling, and all cesses and surcharges by States);

Since all taxes on goods and services, levied by the Centre or the States, should be subsumed in the GST, the following other taxes levied by the States on goods and services should also be subsumed:

- i. Stamp duty;
- ii. Taxes on Vehicles;
- iii. Taxes on Goods and Passengers; and
- iv. Taxes and duties on electricity. **(Para 2.11)**

xxv. Any amount collected through these taxes on the SIN goods should not be subsumed either in the CGST or the SGST. Similarly any amount which is collected as tax/fee/charge/cess which is essentially in the nature of a user charge for supply of goods and services (including environmental goods and services) also should not be subsumed under the CGST or SGST. Further, both Centre and the States should take steps to consolidate all taxes (other than proposed GST) on the SIN goods as a single levy termed as Central Excises and State Excises, respectively. **(Para 2.11)**

xxvi. All entry and Octroi duties levied by the third-tier of Government must be abolished. **(Para 2.11)**

4. The **power sector** must form an integral part of the comprehensive GST base recommended by us over which both the Central and State Governments would have concurrent jurisdiction. The tax regime for the power sector should be the same as in the case of any other normal good. The electricity duty levied by the States should be subsumed

in the SGST. Article 278 and Article 288 of the Constitution should be amended to enable levy of GST on supply of electricity to Government at all levels like any other normal goods.

(Para 2.35)

5. The **tax on vehicles and the tax on goods and passengers** levied by the State Governments should be subsumed in the GST. All transport equipments and all forms of services for transportation of goods and services by railways, air, road and sea must form an integral part of the comprehensive GST base recommended by us over which both the Central and State Governments would have concurrent jurisdiction. The tax regime for the transport equipments and transport services should be the same as in the case of any other normal goods.

(Para 2.38)

6. The **consumption of financial services** should be comprehensively taxed under the GST framework on the basis of the full taxation method.

(Paras 2.39 to 2.41)

7. The **real estate sector** should be integrated into the GST framework by subsuming the stamp duty on immovable properties levied by the States to facilitate input credit and eliminate cascading effect. The new GST regime for immovable property transactions and real estate services should be designed on the lines of the comprehensive taxation method. Therefore, the new regime would comprise of the following elements: -

- a. The GST should apply for all newly constructed property (both residential and commercial). If it is self-used by the person who constructed it, the GST should be applied on the cost of construction. If it is sold or transferred, the GST should be applied on the consideration received at first transfer or sale. In both cases, credit should be allowed in respect of input tax paid on raw materials used in construction.
- b. Rental charges received (excluding imputed rental values) in respect of leasing of immovable property used for both residential and commercial purposes should be charged to GST. Input tax credit would be allowed only in

respect of input tax paid on goods and services used for maintenance. No input tax credit should be allowed in respect of tax paid on construction or acquisition of the property or tax paid on improvements thereto. All secondary market transactions in immovable properties (whether constructed before or after the introduction of GST) should be liable to GST. However, if the property has been constructed after the introduction of GST, the GST should be levied on the resale value and input tax credit should be allowed in respect of the GST paid upon construction or purchase of the property after making adjustment for inflation. If the property has been acquired by the seller before the introduction of GST, the GST should be levied on the difference between the sale price and the cost of acquisition and improvements thereto. In such cases, no input tax credit would be allowed.

- c. The adjustment for inflation may be made on the basis of the same inflation index as provided for the purposes of determination of capital gains under the Income-tax Act, 1961.
- d. The new regime will also be subject to the threshold exemption of Rs.10,00,000/- for small businesses thereby eliminating the problem of excessively large number of landlords seeking GST registration.
- e. Immovable property will also include land and, therefore, the new regime will also be applicable to land transactions. However, where land is used for construction of a property, it will be treated as an input. In such cases, the GST paid in respect of land will be allowed as input tax credit in the same manner as other inputs used in construction.
- f. The State Governments would continue to perform essential asset registry functions, and enforces property rights associated with them. These functions are comparable to those of a depository on the markets. The registration fees can be interpreted as user charges for these records keeping functions – which justify small charges. The imposition of large scale

indirect taxes through registration and stamp duties constitutes a case of erroneous tax policy. Therefore, States may continue to levy a registration fee at a specific rate not exceeding Rs 1000 per transaction in immovable property, which is merely a user charge for the IT systems used in property registration.

Since the new regime will impart greater transparency through market mechanism, it will also strike a major blow to the underground economy. Therefore, it is imperative that the reform of the present system of taxation of immovable property transaction and real estate services forms an integral part of the proposed GST design. **(Paras 2.42 to 2.48)**

8. In the context of the GST, it is necessary to resolve the problem relating to the **treatment of inter-state sales/transfers** in a manner that the incidence of the tax falls on the consumption of commodities without any distortionary cascading effect and the revenue accrues to the State where the final consumer is located. After analysing the various Models, we recommend a Modified Bank Model, which comprises, inter alia, of the following functional components:-

- (i) In the course of inter-state B2B supply, the seller in the origin State shall collect the SGST leviable on the transaction from the buyer in the destination State as if the sale was within the origin State.
- (ii) The seller would issue an invoice to the buyer indicating the details of the transaction (including the date of the transaction) and his business identification number (BIN).
- (iii) The seller shall use the input SGST for payment of the output SGST on both intra-state and inter-state transactions. To the extent total output SGST is in excess of the input SGST, the same shall be paid into any of the authorised bank in the prescribed manner. This will ensure a self-adjustment mechanism for input credit thereby minimizing the need for issue of refunds.

- (iv) The buyer in the destination State shall make use of the SGST so paid in the State of origin for making payment of output SGST in the destination State.
- (v) All registered dealers across the country shall pay the sum due as CGST and SGST to the credit of the Central Government and all other States within one week from the end of the month to which the sale transactions relate.
- (vi) The Central Government and State Governments shall jointly identify a nodal bank to receive the collection of CGST and SGST by collecting banks. The nodal bank will also receive all information relating to purchase and sale by registered dealers.
- (vii) The nodal bank shall host the IT infrastructure, provide payment gateway to all banks in India and provide screen-based upload or file upload facility for receiving payment and transaction information.
- (viii) It would be mandatory for all registered dealers to make the payment by electronically furnishing Form No. GST-I, which would be a combined monthly payment and return form for all intra-state and inter-state transactions..
- (ix) As far as the registered dealer is concerned, he would be required to make a **single payment** of the aggregate of all sums due to the Centre and all other States. Even though he would have collected tax in the Origin State for inter-state transactions with buyers in a number of destination States, he can fulfil his obligation of directly remitting the tax so collected to all the destination states through a single payment made along with the electronic furnishing of Form No. GST-I. This mechanism will have the benefit of extremely low compliance cost.
- (x) It would be mandatory for all registered dealers to make electronic payment of CGST and the SGST by electronically remitting it in to the RBI, SBI or any authorized bank.

- (xi) The procedure for making payment of CGST and SGST **and** furnishing information relating to transactions of both purchases from and sales to registered dealers in Form No. GST-I shall be as explained in para 3.12.

9. It is now well-recognised that **tax administration** is tax policy. An inefficient tax administration will not be able to provide the requisite level of deterrence thereby leading to non-compliance and under performance of the tax regime. Therefore, the full potential of the pure tax regime will remain unrealised. Hence, the structure, design and the business process of the tax administration is an important factor in the determination of the revenue performance. The Central Board of Excise & Customs (CBEC) shall be responsible for implementing the CGST and the State Tax administrations will be separately responsible for implementing the SGST. The various tax administrative functions such as assessment, enforcement, scrutiny and audit should be undertaken by the CBEC in respect of the CGST and by the State tax administration in respect of the SGST subject to our recommendation on small-scale industries. However, from a taxpayer's perspective all compliance and enforcement procedures under CGST and SGST should be uniform. The Central Government shall establish a common IT infrastructure which will serve the needs of both CGST and SGST. **(Para 4.8)**

10. The jurisdiction between the CBEC and the State Administration may be divided between the two in such manner that the interface of the taxpayer is confined to one tax administration only. The basis for division could be turnover or any other criteria which is considered reasonable so that the compliance and administrative burden is minimized. **(Para 4.8)**

11. All persons with annual aggregate turnover of goods and services exceeding Rs.10 lakh (excluding CGST and SGST) should be required to register and obtain a GST registration number. Persons with lower turnover may be allowed an option to register. The GST registration number should be a twelve digit alpha numeric number. The first ten digits should be the alpha-numeric Permanent Account Number (PAN) followed by a space and

two more digits indicating the state code. This number scheme should be publicised widely and should be self-generated after obtaining a PAN. **(Para 4.4)**

12. The unit of taxation for the purposes of GST should be persons as defined under the Income Tax Act. Consequently, for the purposes of CGST, all production units/branches of a person located anywhere in the country will be treated as a single taxable entity eligible for CGST input credit across units/branches. Similarly, for the purposes of SGST, all production units/branches of a person located anywhere within the State will be treated as a single taxable entity eligible for SGST input credit across units/branches in that State.

13. The payment of tax and the transaction reporting should be made through a combined payment and transaction reporting statement in Form No. GST-I. This statement should detail all business to business transactions relating to sales. This statement should be common for both CGST and SGST compliance and it should be mandatory to file this statement electronically on a monthly basis while making payment of taxes. The VAT period should be a calendar month. **(Para 4.8)**

14. The administration of this **levy should be based on audited accounts** and not on the basis of any form of physical controls. Since the tax base will be common, there should be a **common appellate authority**. Similarly, the Authority for Advance Ruling should also be common. Best international practices should be embedded in the Central-GST, particularly in respect of laws relating to levy of penalties, and circumstances and method of prosecution. No authority should have any power to make preventive detention for the purposes of CGST and SGST. Procedures for collection of both the CGST and SGST should be uniform. **(Para 4.8)**

15. Another important element of the taxpayer information base is the **VAT invoice**, which forms the primary source of information and therefore a crucial control document of VAT. In an invoice based VAT system, the issue of invoices in the proper form is an essential part of the procedure for imposing and enforcing the VAT. Therefore, it should be mandatory for a supplier making a taxable supply to another taxable person to provide a

VAT invoice with that supply or the payment for it. The requirement should be enforceable by some penalty. The VAT invoice should be standardised across all states so as to contain a minimum of information about the supply being invoiced. **(Para 4.6)**

16. The choice of a single or a multiple VAT rates is extremely critical to the efficiency and performance of the GST. In terms of best international practice, recent experience shows that the preference of the policymakers is for adoption of a single rate as it is more efficient. Therefore, we recommend one **positive rate**, each for CGST and SGST on all goods and services. In addition, there should be a **zero rate** applicable to all goods and services exported out of the country. **(Para 5.9)**

17. One of the crucial issues relates to the determination of the rate of CGST and SGST. Since the GST is primarily intended as an exercise in reforming the consumption tax in India and not an exercise for additional resource mobilisation through discretionary changes, the CGST and SGST rates should be such rates which would yield the same revenue as collected from the various taxes which will be subsumed in the CGST and SGST, that is, it should be a '**revenue neutral rates**' or '**RNR**'). **(Para 5.17)**

18. Using **the fiscal year 2007-08 as the base year for calculation of the RNR, we first estimate the GST base under five different methods**. These methods are (i) Subtraction-Indirect Method; (ii) Consumption Method-Task Force Estimate; (iii) Consumption Method-NCAER Estimate; (iv) Shome Index Method; and (iv) Revenue Method. The various estimates of the GST Base for 2007-08 are summarized in Table-10. The Task Force estimate of the GST Base using the Consumption method is the highest (Rs.37,43,077 crores) whereas the Shome Index method provides the lowest estimate. All other estimates fall within this range. Since the five estimates are different, we use their average (Rs 31,25,325 crores) as the size of the comprehensive GST base for 2007-08 for the purposes of estimating the RNR. Since the tax base for both the CGST and the SGST are proposed to be identical, we use the same tax base for calculating the RNR for both levies. **(Paras 5.22 to 5.75)**

19. Given the estimate of the GST Base and the level of central taxes which are intended to be subsumed in the GST, we estimate the RNR for the CGST at 5.0 percent. Similarly, the RNR in respect of the state level TF-taxes which are proposed to be subsumed in the SGST is estimated to be 6.0 percent. **Therefore, the combined RNR is estimated to be 11 percent.** Incidentally, this estimate is the same as estimated by Poddar and Bagchi in their pioneering study published in November, 2007. These estimates do not factor in the revenue gains from increased compliance and GDP. To the extent, the flawless GST will reduce cascading effect, there will be significant increase in the corporate profits and hence corporate tax collections. Hence, in actual practice, the RNR of 11 percent will be revenue positive. However, all entry and Octroi taxes by state governments and other sub-national Governments are also proposed to be abolished. Accordingly, it is imperative to provide for an alternate buoyant source of revenue to the third-tier of Government. Hence, we recommend the following:-

- i. The rate of CGST and SGST on all non-SIN goods should be fixed at the **single rate of 5 percent and 7 percent, respectively;**
- ii. A formula-based devolution of an amount equivalent to collection of SGST at **2 percentage points** should be made to the third-tier of Government after an appropriate Constitutional Amendment;
- iii. The formula should be based on the recommendations of the State Finance Commission.
- iv. Pending Constitutional Amendment, the collection from 7 percent SGST shall accrue to the State Government and devolution to the third-tier Government should continue to be made on the basis of the recommendations of the State Finance Commission.
- v. Both the Central and the State Governments may continue to levy taxes, in addition to the CGST and SGST, on the various non-SIN goods as at present.

(Paras 5.76 to 5.79)

20. High import tariffs, excises and turnover tax on domestic goods and services have enormous cascading effects, leading to a distorted structure of production, consumption and exports. The existing tax system introduces myriad distortions which favour some goods and services at the expense of others. These distortions yield inefficient resource allocation and consequently, inferior GDP growth. The introduction of the GST will bring about a macroeconomic dividend by reducing what have been called the “negative grey area dynamic effects” of cascading taxation. As a result it reduces the overall incidence of indirect taxation by removing the many distortionary features of the present indirect tax system. The switchover to a flawless GST will have significant macroeconomic effects. The overall macroeconomic effect of reduction in economic distortions due to GST would be to It would provide an impetus to economic growth. Using CGE Model, the NCAER study commissioned by the Thirteenth Finance Commission estimates the impact of the introduction of a GST which would eliminate all taxes on production and distribution and rest on final consumption only. The study is based on two important assumptions of full employment and that 50 percent of indirect taxes remain embedded and ‘stick’ on production and distribution. The study concludes that ‘implementation of a comprehensive GST in India will lead to efficient allocation of factors of production thus leading to gain in GDP and exports. This would translate into enhanced economic welfare and returns to the factors of production, i.e. land, labour and capital. The gains in real returns to land range between 0.42 and 0.82 per cent. Wage rate gains vary between 0.68 and 1.33 per cent. The real returns to capital would gain in the range of 0.37 and 0.74 percent.’ Further, the study also shows that ‘implementation of GST across goods and services is expected, ceteris paribus, to provide gains to India’s GDP somewhere within a range of 0.9 to 1.7 per cent. The corresponding change in absolute values of GDP over 2008-09 is expected to be between Rs. 42,789 crore and Rs. 83,899 crore, respectively. **(Paras 7.1 to 7.5)**

21. These additional gains in GDP, originating from the GST reform, would be earned during all years in future over and above the growth in GDP which would have been achieved otherwise. The present value of the GST-reform induced gains in GDP may be computed as the present value of additional income stream based on some discount rate.

Assuming the long-term real rate of interest of about 3 per cent as the discount rate, the present value of total gain in GDP is computed as between Rs. 1,469 thousand crores and 2,881 thousand crores. The corresponding dollar values are \$325 billion and \$637 billion or as much as one-third to one-half of the country's GDP for the year 2009-10. **(Para 7.6)**

22. Gains in exports are expected to vary between 3.2 and 6.3 per cent with corresponding absolute value range as Rs. 24,669 crore and Rs. 48,661 crore. Imports are expected to gain somewhere between 2.4 and 4.7 per cent with corresponding absolute values ranging between Rs. 31,173 crore and Rs. 61,501 crore. **(Para 7.11)**

23. The benefit to the poor from the implementation of GST will flow from two sources: first through increase in the income levels and second through reduction in prices of goods consumed by them. The proposed switchover to the 'flawless' GST should, therefore, be viewed as pro-poor and not regressive. Hence, the switchover will improve the vertical equity of the indirect tax system. Similarly, to the extent it will impose a higher burden on the informal economy by reducing the cascading effect, the switchover will also improve horizontal equity. **(Para 7.22 and Para 7.29)**

24. Prices of agricultural commodities and services are expected to rise. Most of the manufactured goods would be available at relatively low prices especially textiles and readymade garments. The prices of agricultural goods would increase between 0.61 and 1.18 percent whereas the overall prices of all manufacturing sector would decline between 1.22 and 2.53 percent. Consequently, the terms of trade will move in favour of agriculture between 1.9 to 3.8 percent. The increase in agricultural prices would benefit millions of farmers in India. Similarly, the urban poor will also benefit from new employment opportunities. With regard to the food crops the poor would continue to remain secured through the public distribution system. The prices of many other consumer goods are expected to decline. These include sugar; beverages; cotton textiles; wool, silk and synthetic fibre textiles; and textile products and wearing apparel. **(Paras 7.24, 7.27 and 7.28)**

25. The changeover to GST is designed to be revenue neutral at existing levels of compliance. Given the design of the 'flawless' GST, the producers and distributors will only be pass through for the GST. Therefore, this policy initiative should witness a higher compliance and an upsurge in revenue collections. This will also have an indirect positive impact on direct tax collections. Further, given the fact that GST will trigger an increase in the GDP, this in turn would yield higher revenues even at existing levels of compliance. Another important source of gain for the Government would be the savings on account of reduction in the price levels of a large number of goods and services consumed by the Government. However, to the extent, the Central Government will be required to incentivise the states to adopt the GST, there will be an increase in the budgetary outgo. Given the smallness of the size of the compensation, it is expected that there would be a net gain in the tax revenues. This should enable the Central Government to better manage its finances. **(Para 7.31 and 7.32)**

26. As regards the State Governments, in the first year of implementation of GST and phasing out of the Stamp duty, the States should expect additional revenues to the extent of Rs 70,000 crores (excluding the incentive amount). However, in the subsequent years this gain would diminish on account of the phasing out of stamp duty but will be more than adequately compensated as compliance starts improving. **(Para 7.33)**

27. Under the proposed GST, the expansion in the power of the States is significantly larger than the Centre. Therefore, the proposed GST will alter the balance of power in favour of the states thereby reducing the vertical imbalance. **(Para 7.36)**

28. The GST envisages a mechanism whereby both the Centre and the States will cease to have any independent power to make changes in the design and structure once agreed upon. The existing mechanism for arriving at a collective decision on the structure of the GST should be permanently institutionalised so that changes in the initial design of the GST are collectively agreed and implemented by both the Centre and the States. The Empowered Committee of State Finance Ministers may, upon the introduction of the GST, be transformed into a permanent constitutional body known as the Council of Finance

Ministers. This Council shall comprise of the Union Finance Minister and all State Finance Ministers. The Union Finance Minister would be the Chairman of this Council.

(Paras 8.11 and 8.12)

29. The Council should be responsible for any modification in the initial design of the dual GST and regulating the indirect tax system in the country. The initial design of the dual GST should be approved by the Chairman and three-fourth of the State Finance Ministers. Thereafter, any change in the structure of the GST (both base and the rates) should be allowed to be carried out only if the Chairman **and** two-thirds of the State Finance Ministers agree to do so. Consequently, neither the Centre nor any State will have the authority to unilaterally make any change in the agreed design of the GST. However, in the event of a crisis, the Member State or the Centre may take immediate steps to impose a surcharge subject to ex-post facto approval by the Council within one month. Further, such surcharge should not be allowed to remain in force beyond a period of one year. **(Para 8.13)**

30. We do not expect any revenue loss to the States on account of the switch-over to GST. However, with a view to incentivising the States and establishing a credible mechanism for deciding on compensation claims, if any, we recommend the following:-

- i) A GST Compensation Fund should be created under the administrative control of the **Council of Finance Ministers**.
- ii) The Central Government shall transfer to the GST Compensation Fund a minimum sum of Rs 6000 crores per annum over the next five years (i.e. a total amount of Rs 30,000 crores) if, and only if, the States-
 - a. introduce the 'flawless' GST as recommended by us; and
 - b. follow the road map, as suggested by us, for its introduction;
- iii) The amounts in the Fund should be used only for the following purposes:-
 - a. To compensate the states for any revenue loss on account of the adoption of the 'flawless' GST;
 - b. The balance, if any in the Fund, to be carried forward to the subsequent year;

- c. The balance, if any remaining at the end of the fifth year, to be distributed amongst the states on the basis of the same formula used for distributing resources in the divisible pool.
- iv) The amount will be transferred in quarterly instalments.
- v) The amounts shall be disbursed by the Council on the basis of the recommendations by a three member Compensation Committee comprising of the Secretary, Department of Revenue, Government of India, Secretary to the Council and any fiscal expert appointed by the Central Government for this purpose.
- vi) No contribution to the Fund shall be made by the Central Government in any year in which the States fail to adhere to the roadmap for implementation of the GST.
- vii) The methodology to be used for estimating the revenue loss and the compensation shall be decided by the Council.

(Paras 9.3 to 9.6)

31. The States should also be liable to a penalty in case they deviate from the agreed design and structure of the GST. **(Para 9.8)**

32. Since the design of the GST will also impact the indirect tax system of the Central Government, it is necessary for the Central Government to play a more proactive role in this effort. Towards this, the leadership of the Union Finance Minister would be vital. This will provide the necessary impetus to the process of 'grand bargaining' for the GST. **(Para 10.4)**

33. On account of lack of adequate preparedness, the implementation of the GST scheduled for 1st April, 2010 should be postponed by six months to 1st October, 2010. However, the Council should release a timeline of various activities for introduction of GST simultaneously with the announcement for postponement. **(Para 10.6)**

34. All taxes on goods and services including cesses and surcharges levied at the State and sub-national level should be subsumed in the SGST. However, if for some political

economy reasons it is considered expedient to introduce the GST in a phased way, we recommend the phasing in the following manner:-

- a) In the year 2010-11, all elements of the Flawless GST recommended by us whereby
 - i. the single CGST rate should be 5 percent and the corresponding SGST rate should be 7 percent; and
 - ii. Transactions in immoveable property (i.e real estate and housing services) should be brought within the fold of GST; and
 - iii. Stamp duty **may** not be subsumed but the rate of stamp duty in all states should be calibrated so as not to exceed 4 percent. As a result, transactions in real estate will be subject to a dual levy like in the case of SIN-goods;
- b) In the year 2011-12, same as (a) above, with the modification that the rate of stamp duty should be reduced to 2 percent; and
- c) In the year 2012-13, same as (a) above, with the modification that-
 - i. Stamp duty should be eliminated and replaced by a Registration Fee at a specific rate;
 - ii. the revenues attributable to 2 percentage point out of the 7 percentage point of SGST should be set apart for devolution to the third-tier of Government and the revenues from the balance 5 percentage points will remain with the State Government so that the third-tier of Government have a interest in the efficient functioning of the GST and do not have to impose any cascading taxes like cess, entry tax or Octroi.

(Paras 10.3 to 10.10)

CHAPTER – I

Introduction

1.1 In 2004, analysing the structure of the prevailing indirect tax system both at the Central and State level, the Task Force on Implementation of the Fiscal Responsibility and Budget Management Act, 2003 observed that “high import tariffs, excises and turnover tax on domestic goods and services have enormous cascading effects, leading to a distorted structure of production, consumption and exports. This problem can be effectively addressed by shifting the tax burden from production and trade to final consumption, and from savings to consumption. The existing tax system introduces innumerable distortions resulting in inefficient resource allocation and adversely impacting GDP growth. It also provides an incentive to firms to engage in political lobbying for exemptions and favourable modifications in the tax schedule. The Indian consumer is known to be remarkably sensitive to apparently small changes in relative prices. The goal of a rational tax system is to *empower households* to engage in undistorted decision making, driven by their own needs and preferences.”. Accordingly, the Task Force recommended that “a well designed destination-based value added tax on all goods and services is the most elegant method of eliminating distortions and taxing consumption. Under this structure, all different stages of production and distribution can be interpreted as a mere tax pass-through, and the tax essentially ‘sticks’ on final consumption within the taxing jurisdiction⁴. Therefore, the Task Force recommended the introduction of a destination based VAT type dual Goods and Services Tax (hereafter referred to as ‘GST’).

1.2 In general, the recommendation was viewed as the ultimate goal but there was certain degree of scepticism about whether India should immediately move to a ‘flawless’

⁴ Report of the Task Force on Implementation of Fiscal Responsibility and Budget Management Act, 2003, Government of India (July, 2004)

GST⁵. Experts, in particular, were of the view that the dual GST was an idea whose time had not come.

1.3 By mid-2004, the State Governments were already at an advance stage of preparation for a switch over from the cascading type sales tax to a partial VAT regime which was eventually introduced with effect from the 1st April, 2005⁶. The VAT has two basic rates of 4 percent and 12.5 percent. There is an exempted category and a special rate of 1 percent for a few selected items. The items of basic necessities and goods of local importance are put under the exempted category. Special rate of 1 percent is applicable for Gold, silver and precious stones. The 4 per cent rate applies to other essential items and industrial inputs. The 12.5 percent is residual rate of VAT applicable to commodities not covered by other schedules. There is also a category with 20 percent floor rate of tax, but the commodities listed in this schedule will not be subjected to VAT. This category covers items like motor spirit (petrol, diesel, and aviation turbine fuel), liquor, etc. While input-credit is available for intra-state transactions, no such credit is available for inter-state transactions. Therefore, the VAT, like its predecessor the Sales tax, continues to be characterised by narrow base, plethora of exemptions, multiple rate structure and cascading effect on account of break in the input-credit chain. The introduction of VAT is, at best, a toddler's tentative step towards indirect tax reform.

1.4 As a step towards the eventual introduction of the GST, the Centre also took immediate steps to integrate the CENVAT and the services tax and expand the scope of the service tax in a phased manner. Recognising the need for a giant leap to cleanse the indirect tax system of its distortionary impact on the economy, the Finance Minister, while presenting the Union Budget 2006-07, set April 1, 2010 as the date for introducing GST and requested the Empowered Committee of State Finance Ministers to work with the Central Government to prepare a road map for introduction of GST in India.

⁵ "Flawless" GST means a GST which has all the elements described in para 3 of the Executive Summary.

⁶ Haryana was the first State to introduce the partial VAT regime in 2003.

1.5 The Thirteenth Finance Commission has been mandated to make recommendations after considering the impact of the proposed implementation of the GST with effect from the 1st April, 2010 including its impact on foreign trade. For this purpose, it is necessary to know the structure of the Goods and Services Tax which will be in place. The authority to design the structure of the GST Model jointly vests in the Empowered Committee of States' Finance Ministers and the Central Government. The Empowered Committee brought out its preliminary views on the design of the GST in a paper⁷ of April, 2008 and the Union Government gave its response to these proposals. After further consultations, the Empowered Committee presented the first discussion paper in November, 2009. The contours outlined in this paper do not adequately advance the cause of indirect of tax reforms due to a number of infirmities. This initiative seems to be an amalgam of compromises and continued fear of possible revenue losses and adverse impact on the low income groups. Clearly, there are a number of important unresolved issues relating to the design of the GST and resolving these will need further discussions between Central and State Governments. Hopefully, by providing comprehensive discussion of the issues, this Report of the Task Force will make useful contribution towards the Union and the State Governments reaching such a 'grand bargain' so that we have a world class GST regime in India.

⁷ "A Model and Road Map for Goods and Services Tax in India-Views of the Empowered Committee of State Finance Ministers", New Delhi, April 30, 2008.

CHAPTER-II

Goods and Services Tax: The Model

2.1 In the absence of a firm Model of the GST, it is necessary for us to construct a comprehensive Model in the light of the roadmap prepared by EC, the views expressed by the Central Government, the ongoing discussion on unresolved issues and best international practice. Therefore, the Group seeks to design the Model in such manner as would foster the achievement of the following objectives:

- (a) The incidence of tax falls only on domestic consumption;
- (b) The efficiency and equity of the system is optimized;
- (c) There should be no export of taxes across taxing jurisdictions;
- (d) The Indian market should be integrated into a single common market;
- (e) It enhances the cause of cooperative federalism.

2.2 With a view to attaining the objectives set out above, we recommend a VAT type Goods and Services Tax (GST). In the context of the design of the GST, some of the important issues are discussed in the following paragraphs.

a. Single GST versus Dual GST

2.3 In a federal country like India where the power to tax domestic trade is divided between the Central Government and the State Government, the designing of a destination based GST becomes extremely complicated. A conventional national GST⁸ cannot be implemented without the States losing their fiscal autonomy. However, this is not feasible since revenues from State VAT account for substantial proportion of State's revenues. Therefore, the solution has to be found within the existing federal framework where both levels of Governments have the concurrent powers to tax domestic trade in goods and services.

⁸ This refers to a single National level GST to be levied and collected by the Central Government.

2.4 In view of the above, we recommend the following:-

- (a) The GST will be a dual levy imposed concurrently by the Centre and the States, but independently. It will have two components: one levied by the Centre (hereinafter referred to as CGST), and the other levied by the States and Union Territories (UTs) [hereinafter referred to as SGST].
- (b) Both the CGST and SGST will operate over a common base. That is, the base will be identical.

b. Type of GST – Consumption, income or production

2.5 There are three possible variants of VAT, depending upon what macro-aggregate the government wants to tax: gross income, net income or consumption. A **gross product type VAT** treats both consumption and capital formation as final uses of the good; hence capital goods purchased by the dealer would not be treated as inputs. Input tax credit will not be available on taxes paid on capital goods. A **income type VAT** would give credit for tax paid on current inputs and tax paid on capital goods to the extent attributable to depreciation of capital goods, in any given year. Credit for tax on capital goods will therefore be spread over the life of the capital good. A **consumption type VAT** goes a step further in that only final consumption is treated as the final use of a good; full credit, therefore, is given for taxes paid on capital goods as well, in the year of purchase.

2.6 The consumption base has been a much favoured tax base from both the perspective of economic neutrality and ease of administration. It is also the only VAT that is equivalent to a retail sales tax, in that it restricts the burden of the tax to final consumption goods. In effect, the tax is only on the pure value added within the production stage in question. Consumption VATs are also the easiest to compute—all taxes previously paid on purchases from other firms to be simply subtracted from taxes due on sale. No distinction needs to be drawn between capital goods and other inputs, and no depreciation need be computed. Consumption, it is argued, is also a broad measure of the ability to pay taxes, much like income. Furthermore, it excludes savings from the base, hence does not discourage investment.

2.7 From an economic growth perspective, both the income and gross product VAT have an anti-investment bias. This is all the more significant in countries that impose substantial income taxes. An income tax taxes saved income and hence investment twice—one as the income is being earned and again as the rewards for saving appear as interest and profit, which are again taxed. Since income tax is fairly well established in India, we recommend that-

- (a) The Centre and the States should adopt a consumption type GST, i.e. there should be no distinction between raw materials and capital goods in allowing GST credit. Only this GST variant is equivalent to a retail sales tax.
- (b) The tax base of both CGST and SGST should comprehensively extend over **all goods and services** going up to the final consumer (retail level), reflecting the tax base of a typical consumption VAT.
- (c) Since the tax base will extend to all goods and services, no distinction will be maintained between goods and services. A registered dealer will be required to collect taxes on every invoice irrespective of whether the supply is for goods or services. Therefore, no classification of goods and services should be provided for in law. This will eliminate all classification disputes.

2.8 In the course of discussion with officials in the Department of Revenue a view was expressed that in the context of service tax, it should be levied on all services but there should be a positive list of such services. This view was based on the consideration that the assessing officer feels comfortable in levy and collection of tax if he knows exactly on which service the levy is being imposed.

2.9 In this context, we would like to point out that **firstly**, it is not possible to draw up a positive list which is all comprehensive. Invariably there would be gaps in the base. **Secondly**, it would lead to classification disputes thereby imposing higher compliance and administrative burden. **Thirdly**, with the introduction of the GST no distinction is required to be made between goods and services. Therefore, the issue relating to separate taxation of

services does not arise. **Fourthly**, under the GST regime, it is not necessary for the assessing officer to know what he should be taxing. The design should be so structured that he would need to know that all supply transactions will attract GST except those prescribed. Since the negative list is intended to be a very small list, it would not be difficult for him to administer. In the case of a positive list, the assessing officer must familiarize himself with a much longer list and any gap in his knowledge base could lead to erroneous judgement. Therefore, we are not inclined to agree with the view of the Department of Revenue officials that the taxation of services should be based on a positive list. Accordingly, we recommend that all goods and services should be subject to tax other than those specified in the negative list.

2.10 In view of the fact that the CGST and SGST are intended to be levied on consumption of all goods and services, these two taxes must subsume all taxes presently levied on various goods and services by the Centre and the States, respectively. For the purposes of identifying the taxes which needs to be subsumed in the CGST and SGST, we recommend that the following principles⁹ should be adopted:-

- (a) 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.
- (b) 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.
- (c) The sub-summation should result in free flow of tax credit at the intra and inter State levels.
- (d) Any tax/fee/charge which is in the nature of a user charge for supply of goods & services should not be subsumed under the GST.

⁹ In general, these principles are consistent with the principles laid down by the EC in their Discussion Paper dated 30th April, 2008.

2.11 Based on the aforesaid principles, we recommend the following:-

- a. The following central taxes should be subsumed in the CGST¹⁰:
 1. Central Excise Duty (including Additional Excise Duties);
 2. Service Tax;
 3. Additional Customs Duty (commonly referred to as 'CVD');
 4. Surcharges and all cesses
- b. The following State level taxes, as also recommended by the Empowered Committee (EC) in its discussion paper dated 30th April, 2008, should be subsumed in the SGST:-
 - i. VAT/Sales Tax (including Central Sales Tax and Purchase tax¹¹);
 - ii. Entertainment tax (other than levied by local bodies);
 - iii. Entry taxes not in lieu of Octroi;
 - iv. Other Taxes and Duties (includes Luxury Tax, Taxes on lottery, betting and gambling, and all cesses and surcharges by States)¹²;
- c. Since all taxes on goods and services, levied by the Centre or the States, should be subsumed in the GST, the following other taxes levied by the States on goods and services should also be subsumed:
 - i. Stamp duty;
 - ii. Taxes on Vehicles;
 - iii. Taxes on Goods and Passengers; and
 - iv. Taxes and duties on electricity.

¹⁰ This is consistent with the proposal of the EC in their Discussion paper dated 30th April, 2008.

¹¹ The Discussion Paper dated 30th April, 2008 released by the Empowered Committee indicates that Purchase Tax will be subsumed by the SGST. However, the Discussion Paper released on 10th November, 2009 indicates that Purchase Tax will not be subsumed by the SGST. This does not advance the cause of a 'flawless' GST and is a retrograde step in the reform of indirect taxes. We recommend that the purchase tax should be subsumed in the SGST.

¹² This does not include (i) Stamp Duty, (ii) Taxes on Vehicles, (iii) Taxes on Goods and Passengers, and (iv) Taxes and Duties on electricity.

- d. Any amount collected through these taxes on the SIN goods should not be subsumed either in the CGST or the SGST. Similarly any amount which is collected as tax/fee/charge/cess which is essentially in the nature of a user charge for supply of goods and services (including environmental goods and services) also should not be subsumed under the CGST or SGST. Further, both Centre and the States should take steps to consolidate all taxes (other than proposed GST) on the SIN goods as a single levy termed as Central Excises and State Excises, respectively.
- e. All entry and Octroi duties levied by the third-tier of Government must be abolished.¹³

2.12 For the purposes of this Report, the set of taxes which the EC has recommended for being subsumed in the SGST will be referred to as “**EC-taxes**”. Similarly, the larger set of taxes which we have recommended for being subsumed in the SGST will be referred to as “**TF-taxes**”.

c. Origin versus Destination Principle

2.13 A GST can be implemented under either the origin or the destination principle. Under the former, the GST is imposed on the value added of all taxable products that are produced domestically; under the latter, the GST is imposed on the value added of all taxable products that are consumed domestically. Obviously, the two principles are identical in a closed economy. In an open economy, the difference between them lies solely in their treatment of imports and exports: exports are taxed but imports are not under the origin principle, while just the converse holds under the destination principle. It is important to note that the distinction between the two principles is based on the location of production and consumption. In view of our recommendation for a consumption type GST and the need for increased international competitiveness, we recommend that -

¹³ This has already been done by all States other than Maharashtra.

- a. the GST should be structured on the destination principle. As a result, the tax base will shift from production to consumption whereby imports will be liable to tax and exports will be relieved of the burden of goods and service tax. Consequently, revenues will accrue to the State in which the consumption takes place or is deemed to take place;
- b. international exports should be zero rated;
- c. international imports should be subject to both CGST and SGST at the time of importation irrespective of whether or not the imported goods are produced domestically;
- d. SGST on B2B imports should be collected by the same agency which collects the CGST and should be remitted to the state in which the place of destination of the imports is located regardless of where the goods enter the country. However, the place of destination may be defined to mean the address of the importer on the import invoice; and
- e. SGST on B2C imports should be collected by the same agency which collects the CGST and should be remitted to the state in which the place of residence of the person importing the goods is located regardless of where the goods enter the country.

d. Method of Computation

2.14 There are essentially three methods of computing VAT liability: addition method, subtraction method and the credit method (also known as the invoice method). The principal debate concerning choice of methods in computing VAT liability is normally restricted to the credit and subtraction methods. The credit method requires that the amount of VAT charged be explicitly stated on the invoice associated with any taxable transaction. The amount of tax a dealer submits to tax authorities is simply the difference between the tax he collected on his sales and the tax he paid on his purchases. Under the subtraction method, each dealer's tax liability is computed by applying the applicable VAT rate to the difference between his total sales (inclusive of the VAT element in his sales price)

and his total purchases (inclusive of the VAT element in his purchase price). Hence, unlike the credit method, the amount of VAT connected with a taxable transaction is not required to be explicitly stated on the associated invoice.

2.15 The credit method therefore, is more transparent, whereby the effective tax rate on any commodity is easily identifiable as the rate applicable to the last transaction in that commodity. In the case of the subtraction method, the rate of VAT is not separately indicated and to this extent there is a loss of transparency. Further, since the effective rate under the subtraction method is a weighted average of the rates at the various stages, there could exist an incentive to shift value added to the stages with the lower tax rate. This kind of tax distortion needs to be avoided.

2.16 In view of the above, we recommend that-

- i. the credit method should be adopted for computation of the VAT liability.
- ii. The computation of the CGST and SGST liability will be based on the invoice credit method i.e., allow credit for tax paid on all intermediate goods or services on the basis of invoices issued by the supplier. As a result, all different stages of production and distribution can be interpreted as a mere tax pass-through, and the tax will effectively 'stick' on final consumption within the taxing jurisdiction. This will facilitate elimination of the cascading effect at various stages of production and distribution.
- iii. The CGST and SGST are to be credited to the accounts of the Centre and the States separately.
- iv. Since the CGST and SGST are to be treated separately, taxes paid against the CGST should be allowed to be taken as input tax credit (ITC) for the CGST and could be utilized only against the payment of CGST. The same principle will be applicable for the SGST.

- v. Cross utilization of ITC between the CGST and the SGST should not be allowed.

e. Treatment of capital goods

2.17 In the past, a number of countries, introduced accelerated depreciation or investment allowance to compensate for domestic trade taxes paid on capital goods. With the gradual introduction of VAT and the feasibility of extending credit for VAT on fixed assets,¹⁴ depreciation rates were rationalised. Later in some countries, VAT was used to slow down the development of capital intensive production processes. To this end, they disallowed the credit for the VAT on fixed assets (defined as all assets which are subject to depreciation) and non-material assets, like technical know-how. The case for allowing full and immediate credit for the VAT on capital goods rests on several arguments:

1. Depending on the capital intensity of the production process, the VAT on fixed assets enters into the price, causing uneven effects on consumer prices.
2. Any kind of restriction on full and immediate credit for VAT on fixed assets deters investment and hampers technological change, unless it can be fully shifted forward to consumers¹⁵.
3. Limiting the credit for VAT on fixed assets in any manner results in increased cost of exports thereby undermining international competitiveness. Hence, it serves as a disincentive to exports.
4. Capital goods need to be defined thereby creating scope for considerable disputes.
5. Denial of immediate credit for VAT on capital goods leads to implicit taxation. This is further aggravated if excess credits are not refunded but must be

¹⁴ Other reasons for rationalizing the depreciation rates were significant control over rate of inflation in the price of capital goods and reduction in corporate tax rates.

¹⁵ However, forward shifting is unlikely if competing imports can be sold without the element of tax on capital goods.

applied against VAT on future sales. Further, in the face of inflation, the real value of the tax credits carried forward declines rapidly becoming equivalent in effect to a tax on fixed assets. Any denial of full and immediate credit for the VAT on capital goods violates the neutrality of VAT.

2.18 Therefore, in recent years, most countries have introduced a full and immediate credit for the VAT on capital goods applied for the purpose of registered businesses. Under the Central Excise Act, credit for CENVAT paid on capital goods or CVD on imported capital goods is spread over two years resulting in the kind of distortions discussed above. The rationale for this spread over is essentially loss in revenues. The estimated total credit for CENVAT paid on capital goods and CVD on imported capital goods in 2002-03 was Rs. 8,500 crore and could be expected to increase to about Rs. 9,000 crore in 2004-05. Since the credit is allowed over a period of two years, the loss in revenues is, therefore, estimated to be Rs.4,500 crore and restricted to the transitional year only. However, in the context of revenue gain from reduction in depreciation rates proposed in the section on corporate tax, the impact on revenue could be fully absorbed. In the light of the arguments in support of full and immediate credit for VAT on capital goods and the revenue implications thereof, we recommend that-

- i. Full and immediate input credit should be allowed for tax paid (both CGST and SGST) on all purchases of capital goods (including GST on capital goods) in the year in which the capital goods are acquired; and
- ii. any kind of transfer of the capital goods at a later stage should also attract GST liability like all other goods and services.

f. Exemption from GST

2.19 Suppliers of goods and services are either taxable or tax exempt. By definition, exemption relieves the exempt trader's value added from the tax, but all his purchases including capital goods are taxed. Exemption will therefore increase the amount of tax finally paid on intermediate goods—the opposite effect that the exemption was supposed

to provide. In the case of final goods, exemption eliminates the tax on value added in the final stage only. In other words, if a commodity is exempt only at the retail level, then only the retail level is freed of VAT. Although the retailer would not charge VAT on its sale, the retailer would not be entitled to a credit for tax paid on the purchase of an exempt item. If a commodity or service is zero rated, the zero rated trader's value added is not taxed and the trader receives a credit for the tax paid on the purchase of materials and other inputs used. Zero rating, in theory, is the only way to ensure that a product is truly free of VAT, since any tax paid would be credited on the last sale. The considerations influencing the choice between zero rating and exemption are:

- (1) The desirability of freeing users of specific goods or services completely from VAT (as with zero rating), or only partially (as with exemption);
- (2) The merits of excluding certain firms from the registration and filing of returns. Even from the perspective of firms themselves, there are conflicting considerations. If a firm's goods are completely exempt, it is not required to register or file a return, but the prices of the goods sold by the exempt firm will include the tax incurred by the exempt firm on its purchases.

2.20 This may be particularly objectionable to the exempt firm's customers who cannot receive credit for the embedded tax. In this case, exemption would place the exempt firm at a competitive disadvantage.

2.21 If the objective is to have a broader tax base, however, exempting certain goods may become preferable to zero rating them. In addition, the administrative burden of the zero rating procedure can be onerous. Zero-rating implies build up or payout of refunds, which may entail huge administrative costs, requiring verification and disbursement of refund cheques. Furthermore, there is the issue of controlling evasion or fraud. Zero rating creates an incentive for sellers to exaggerate the values of their final sales and to correspondingly inflate the value of taxable inputs purchases, in order to avail themselves of the refund of a

larger input tax element. The resources needed to cross-check such claims can impose additional and perhaps unsustainable demands on prevailing systems.

2.22 Further, tax exemptions are economically inefficient, inequitable, lead to revenue loss, breed rent-seeking behaviour, increase compliance cost and enhance administrative burden. The case for tax incentives is further weakened in the existing tax regime of moderate tax rates.

2.23 In general, a case is often made for exempting **food** on the consideration that the levy of GST would have a significant impact on those living at or below the subsistence levels. Food constitutes a large variety of items and attempt at any definition will lead to complexity in legislation. If the exemption is extended to all categories of food items, the revenue base will shrink significantly and the standard rate would need to be substantially higher. This would trigger demands for other goods which form the consumption basket of the poor. To the extent the poor consume other goods also, any increase in the standard rate will also adversely affect them. Contrary to popular perception, food items are indeed subject to tax at the state level though at lower rates. As stated in earlier paragraphs, the distribution channel for unprocessed food in the rural sector is either a direct sale by the farmer to the final consumer in village hats or through small retail stores who would even otherwise remain exempt because of the threshold exemption for dealer registration. A lower rate for food in contrast to the relatively high standard rate would mean a two rate structure and gradual expansion of the lower rate category as is the international experience. As a compromise, we recommend that any food item which is covered under the public distribution system should be exempt regardless of the outlet through which it is sold. This principle may be applied to other non-food items also.

2.24 In the case of **health services**, there are two approaches. The first approach is the full taxation model whereby the health services form part of the comprehensive GST base. As a result, there is effectively zero tax liability in the case of publicly funded subsidised

health care facilities since input tax credit will be more than the output tax. As regards, health care availed in other health care facilities covered by insurance, there would be no additional burden on the consumer since the expenditure would be borne by the insurance company and can be claimed as input credit. Essentially, there would be zero incidence of GST on health care. Consequently, there would be opportunities for reduction in the price of health care. The second approach is the exemption approach which does not allow for full rebating of input taxes and therefore, effectively there is a significant element of GST embedded in the price of the final health care. Therefore, while public may prefer exemption, in reality it imposes a higher tax burden particularly on the publicly funded health care and for care provided in facilities covered by insurance. Since health services do not form part of our sample used for calculation of our RNR in the later part of this Report, the choice of the method of treatment of health services will not impact the estimation of the GST base and hence the RNR rate. Accordingly, we recommend that the choice may be made keeping in view the considerations discussed above.

2.25 The considerations discussed in the context of health services similarly apply to education services except that these services are not covered by insurance. In fact, the problem is more complex since the sector is more diverse covering child care facilities, formal education (both school and college levels), professional education, occupational programs, diploma programs and recreational programs. Therefore, defining educational services is more complex. However, given the multitude of schools and colleges in the country and the disproportionately large administrative burden, we recommend that the educational services may be exempted from the levy of GST and such exemption should be limited to formal education services provided by schools and colleges.

2.26 Keeping in view the above-mentioned economic and administrative implications of exemptions and zero rating, we summarize our recommendations on exemption from GST as under:-

- a. Ordinarily, there should not be any exemption from CGST or SGST. If for some reason, it is considered necessary to provide exemption, the Centre and the States should draw up a common exemption;
- b. The common list of exemption should be restricted to the following:-
 - i. All public services of Government (Central, State and municipal/panchayati raj) including Civil administration, health services and formal education services provided by Government schools and colleges, Defence, Para-military, Police, Intelligence and Government Departments. However, public services will not include Railways, Post and Telegraph, other commercial Departments, Public Sector enterprises, banks and Insurance, health and education services;
 - ii. Any service transactions between an employer and employee either as a service provider, recipient or vice versa;
 - iii. any **unprocessed food article** which is covered under the public distribution system should be exempt regardless of the outlet through which it is sold; and
 - iv. **education services** provided by non-Governmental schools and colleges; and
 - v. **health services** provided by non-Governmental agencies.

g. Treatment of petroleum products

2.27 One of the classes of products whose consumption needs to be checked to restrict negative externalities is petroleum products. The entire range of petroleum products is subject to multiple taxation at both the Central and State level. As a result, the incidence of tax on products essentially used as intermediate inputs cannot be estimated and leads to a cascading effect on downstream products. Consequently, it is necessary to rationalise the tax treatment of petroleum products.

2.28 The petroleum products can essentially be classified into two categories: (i) industrial inputs or fuels such as crude oil; (ii) transportation fuels comprising of HSD, MS and ATF; and (iii) household fuels comprising of kerosene and Liquefied Petroleum Gas (LPG). While industrial fuels are intermediate inputs, transportation fuels and kerosene (collectively referred to as “emission fuels”) are used both as intermediate inputs and in final consumption. The emission fuels generate negative externalities, whose consumption needs to be checked. Therefore, generally, such emission fuels are subject to an excise against which no input tax credit is allowed in respect of inputs (including capital goods) used in the manufacture of such fuels. However, in large number of cases, such emission fuels are also used as intermediates. As a result, the cascading effect of embedded input taxes is significant.

2.29 In view of the above, the Task Force recommends a dual levy of GST and excise on the entire range of emission fuels. As a general rule, no input credit will be allowed to any person in respect of GST on the emission fuels since emission fuels are predominantly used in final consumption and has the potential for creating a flourishing market in trading of invoice and input tax credit. However, this general rule should be relaxed in the case of consumption of transportation fuels by the Ministry of Railways, the State Road Transport Corporations, the Airlines, truckers, taxi operators and a dealer¹⁶ trading in these goods on the consideration that the consumption is essentially intermediate in nature and the unlikelihood of these entities indulging in purchase of bogus invoices. However, in the case of truckers and taxi operators, the benefit of input tax credit has the potential of misuse and therefore credit may be allowed through the abatement mechanism only. Further, no input tax credit in respect of excise would be allowed to any other person. (

2.30 We also recommend that the industrial fuels should be subjected only to GST (both Central and State) with the benefit of input credit like any other intermediate good.

¹⁶ For example, a dealer operating a petrol station will be allowed input credit in respect of GST on petrol purchased by him from an oil marketing company.

2.31 Both the Central and the State Governments may determine the appropriate revenue neutral rate of excise in the case of emission fuels.

h. Treatment of tobacco goods and alcohol

2.32 Like emission fuels, all tobacco goods and alcohol are also **SIN-goods**¹⁷. Therefore, on the same analogy, we recommend a dual levy of GST and excise on the entire range of these goods. As a general rule, no input credit will be allowed to any person in respect of GST on these goods since they are predominantly used in final consumption. However, this general rule should be relaxed in the case of a dealer trading in these goods on the consideration that the consumption is essentially intermediate in nature. Further, no input tax credit in respect of excise would be allowed to any person. Both the Central and the State Governments may determine the appropriate revenue neutral rate of excise in the case of these products. However, we would like to point out that excessively high rates of tax on tobacco and alcohol may encourage evasion and become a source for financing of undesirable activities.

i. Treatment of natural gas

2.33 Natural gas, like petroleum products, is derived from the same source. However, unlike petroleum products, natural gas does not generate negative externalities. Therefore, the tax regime for natural gas should be distinctively different from the regime applicable to petroleum products. Accordingly, natural gas should be subjected only to GST (both Central and State) with all the benefits of input credit as in the case of other normal goods. We recommend accordingly.

¹⁷ **SIN-goods** are goods whose consumption create negative externalities and for the purposes of this Report, collectively or severally, refers to emission fuels, tobacco goods and alcohol.

j. Treatment of the power sector

2.34 Power is one of the most important inputs in the process of production of goods and services. Hence, it is necessary to rationalise the tax treatment of the power sector so as to ensure that there is seamless flow of input tax credit across all the processes/activities in the power sector. At present, the power sector is subject to multiple taxation. At the Central Government level, power equipments are either exempt from CENVAT or subject to concessional rates. As a result, either no or partial input tax credit is available and the input taxes remain embedded in the cost of the power equipments. This problem is further compounded by the absence of a levy on power generation, distribution or consumption thereby denying input tax credit even for equipments and stores which are subject to CENVAT. Similarly, at the State level, there is no benefit of input tax credit in respect of the State VAT on inputs used in the process of power generation and distribution. The cumulative impact of the taxation regime at both the Central and State level is significant cascading effect¹⁸ of taxes when power is used as an intermediate input. This phenomenon partly explains the cause for high cost of power generation and distribution. As a result, the international competitiveness of Indian industry is significantly undermined.

2.35 In view of the above, we recommend the following:

- (i) The electricity duty levied by the States should be subsumed in the SGST.
- (ii) The power sector must form an integral part of the comprehensive GST base recommended by us over which both the Central and State Governments would have concurrent jurisdiction.
- (iii) The tax regime for the power sector should be the same as in the case of any other normal good.

¹⁸ The Task Force has not made any independent assessment of the impact of the embedded taxes in power generation and distribution. However, discussions with experts in the field suggest that the embedded taxes could account for as high as 30 per cent of the cost of power production and distribution.

- (iv) Article 278 and Article 288 of the Constitution should be amended to enable levy of GST on supply of electricity to Government at all levels like any other normal goods.

2.36 The inclusion of the power sector in the GST model would significantly reduce the cost of power projects and consequently the cost of generation and distribution of electricity. As a result, it will improve profitability of power projects thereby attracting new investments into the sector. To the extent the cost of power will witness reduction, downstream industries will also benefit from cost savings and thus become internationally more competitive.

k. Treatment of transport services

2.37 Transport services, like most other services, is used both as intermediate input and in final consumption. Further, the transport equipments are also subject to multiple taxation at both Central and State level. The present regime leads to cascading effect of embedded taxes on the downstream industry which do not get rebated thereby leading to enhanced cost for such industries. Hence, it is imperative to rationalise the taxation regime for transport services.

2.38 Accordingly, we recommend the following:

- (i) The tax on vehicles and the tax on goods and passengers levied by the State Governments should be subsumed in the GST.
- (ii) All transport equipments and all forms of services for transportation of goods and services by railways, air, road and sea must form an integral part of the comprehensive GST base recommended by us over which both the Central and State Governments would have concurrent jurisdiction.
- (iii) The tax regime for the transport equipments and transport services should be the same as in the case of any other normal good.

- (iv) It is not necessary to levy higher rates of taxes on vehicles as is the existing practice since it is proposed to subject the use of these vehicles to tax at higher rates through excise on emission fuels. Accordingly, the present practice of levying higher rates of taxes on vehicles should be done away.

I. Treatment of financial services

2.39 The financial sector constitutes a significant component of the gross domestic product and also private final consumption. Further, in developing countries, taxation of consumption of financial services is viewed as progressive because such services as banking, brokerage, property and casualty insurance and foreign exchange transactions are connected closely with those having higher income and wealth. The progressive revenue objective thus dictates as wide an application of VAT to financial services as possible. It also encourage countries to consider compensatory taxes where an exemption must be provided and even additional ad hoc taxes for revenue purposes. Therefore, given the progressive nature of taxation of financial services and the distortionary impact of compensatory and ad hoc taxes, we recommend that the consumption of financial services should be comprehensively taxed under the GST framework.

2.40 We recognise that there are predominantly three alternative methods for levying GST on financial services: the exemption method, the zero rating method and the full taxation method. While the exemption method and the zero rating method reduces the potential GST base and also distorts consumption across financial services and other business services, the full taxation method significantly enhances the tax base and also results in equal treatment of all services. Therefore, we recommend that the consumption of financial services should be taxed on the basis of the full taxation method.

2.41 There are alternative approaches to full taxation of financial services. These are the addition method, the subtraction method and the cash flow method. We recommend that the choice of the method may be based on administrative and compliance consideration.

m. Treatment of immovable properties

2.42 The **case for** including the real estate sector in the tax base for the GST rests on a number of competing reasons. **Firstly**, the construction and exploitation of real estate comprises one of the larger sources of gross domestic product. Therefore, any exclusion of the real estate sector would lead to significant reduction in the tax base. This would lead to an increase in the GST rate for other sectors thereby distorting economic efficiency and incentive for compliance.

2.43 **Secondly**, expenditure on housing also constitutes a significantly large proportion of total personal consumption expenditure. Therefore, the exemption of the housing sector from the GST base would distort the consumption pattern. Further, it would also undermine vertical equity in as much as consumption of housing services is relatively high in the case of the rich.

2.44 **Thirdly**, real estate is subject to multiple taxation at both levels of Government. At the Central Government level, there has been an attempt to introduce service tax on housing services and allow credit for inputs used for the supply of such services. However, at the State level input tax credit is not available for all taxes, thereby leading to significant cascading effect. Further, there is no incentive to the purchaser to obtain an invoice. Consequently, the audit trail of such transactions is lost and producers of inputs are also encouraged to suppress such transactions. The cumulative effect is to incentivise transactions in black money.

2.45 At the State level, the taxes on the real estate sector include 'sales tax' on works contract, state level VAT on various inputs used in the construction of real estate, stamp duty and registration fee. Registration and stamp duties exhibit the same distortionary cumulative and cascading effects as excises. The problem is further compounded by the fact that in most states, the statutory rates of stamp duty on immovable property transaction

are high. Therefore, the effective rate on value addition is exorbitant, thereby encouraging under-reporting of transactional value and evasion of stamp duty. Since stamp duties are directly or indirectly related to other taxes, any stamp duty evasion triggers a similar adverse response to compliance with other taxes. As with other transaction taxes, it generates a bias in favour of not selling, and inhibits the development of a liquid secondary market. In the context of a distortionary tax regime governing the real estate industry in India, there is a strong tendency for this industry to remain outside the organised sector and consequently the regulatory framework. Therefore, it serves as a breeding ground for tax evasion and criminal activities.

2.46 **Fourthly**, rationalisation of the tax regime governing the real estate industry could yield numerous benefits: improve tax compliance in the property tax which is critical for the revenue base of local government, a reduced role for black money, and a reduced role for the criminal element in the real estate sector and significantly lowering of costs by mass housing.

2.47 Keeping in view the implications of the different methods for taxing real estate and housing services discussed in Annexe-I, we recommend the following strategy for integrating the real estate sector into the GST framework:

- i. The stamp duty on immovable properties levied by the States should be subsumed in the GST to facilitate input credit and eliminate cascading effect.
- ii. The new GST regime for immovable property transactions and real estate services should be designed on the lines of the comprehensive taxation method. Therefore, the new regime would comprise of the following elements: -
 - (a) The GST should apply for all newly constructed property (both residential and commercial). If it is self-used by the person who

constructed it, the GST should be applied on the cost of construction. If it is sold or transferred, the GST should be applied on the consideration received at first transfer or sale. In both cases, credit should be allowed in respect of input tax paid on raw materials used in construction.

- (b) Rental charges received (excluding imputed rental values) in respect of leasing of immovable property used for both residential and commercial purposes should be charged to GST. Input tax credit would be allowed only in respect of input tax paid on goods and services used for maintenance. No input tax credit should be allowed in respect of tax paid on construction or acquisition of the property or tax paid on improvements thereto.
- (c) All secondary market transactions in immovable properties (whether constructed before or after the introduction of GST) should be liable to GST. However, if the property has been constructed after the introduction of GST, the GST should be levied on the resale value and input tax credit should be allowed in respect of the GST paid upon construction or purchase of the property after making adjustment for inflation. If the property has been acquired by the seller before the introduction of GST, the GST should be levied on the difference between the sale price and the cost of acquisition and improvements thereto. In such cases, no input tax credit would be allowed.
- (d) The adjustment for inflation may be made on the basis of the same inflation index as provided for the purposes of determination of capital gains under the Income-tax Act, 1961.

- (e) The new regime will also be subject to the threshold exemption of Rs.10,00,000/- for small businesses thereby eliminating the problem of excessively large number of landlords seeking GST registration.
 - (f) Immovable property will also include land¹⁹ and, therefore, the new regime will also be applicable to land transactions. However, where land is used for construction of a property, it will be treated as an input. In such cases, the GST paid in respect of land will be allowed as input tax credit in the same manner as other inputs used in construction.
- iii. The State Governments would continue to perform essential asset registry functions, and enforces property rights associated with them. These functions are comparable to those of a depository on the markets. The registration fees can be interpreted as user charges for these records keeping functions – which justify small charges. The imposition of large scale indirect taxes through registration and stamp duties constitutes a case of erroneous tax policy. Therefore, States may continue to levy a registration fee at a specific rate not exceeding Rs 1000 per transaction in immovable property, which is merely a user charge for the IT systems used in property registration.

2.48 The proposed new regime will lead to more efficient allocation of resources in as much as it will be comprehensive in its scope for taxation of immovable property transactions and real estate services. It will be neutral between old and new properties, and

¹⁹ The increase in the value of land is attributable to the direct or indirect improvements in the form of development of townships, landscaping, and construction of infrastructure that make it usable for agricultural, industrial, or residential purposes. Raw land is similar to the minerals underneath, which are of little or no value unless they can be extracted for commercial/industrial use or consumption. VAT is applied to the full selling price of minerals. In the same manner, VAT should apply to the full value of land.

between rented and self occupied properties. It will be administratively less burdensome since no distinction would be required to be made between residential and commercial properties. Similarly, the treatment of input tax credit will be relatively simple with the tax paid on construction/acquisition of the property being allowed as a set off, after inflation indexing, against the GST on resale of the property **and** any tax paid on minor repairs and maintenance being allowed as set off against the rental charges, if any, in the same year. Further, under the model, the real estate developer will also be entitled to set off input tax on all inputs (including land) used for the purposes of construction and development of the real estate. As a result, the distortionary cascading effect of the existing tax regime for immovable property transaction and real estate services will be fully eliminated. This would have significant downward effect on pricing of real estate. The new regime has the potential for creating an efficient secondary market in immovable property and real estate services which will facilitate better price discovery. The role of the underworld elements associated with this sector will be eliminated. Since the new regime will impart greater transparency through market mechanism, it will also strike a major blow to the underground economy. Therefore, it is imperative that the reform of the present system of taxation of immovable property transaction and real estate services forms an integral part of the proposed GST design.

n. Place of supply rules

2.49 The value added tax system is based on tax collection in a staged process, with successive taxpayers entitled to deduct input tax on purchases and account for output tax on sales. Each business in the supply chain takes part in the process of controlling and collecting the tax, remitting the proportion of tax corresponding to the margin realised on transactions, or the difference between the VAT paid out to suppliers and the VAT charged to customers.

2.50 In practice, most countries with value added taxes impose the tax at all stages and normally allow immediate deduction of taxes on purchases by all but the final consumer. These features give value added taxes their main economic advantage, that of neutrality.

The full right to deduction of input tax through the supply chain, with the exception of the final consumer, ensures the neutrality of the tax, whatever the nature of the product, the structure of the distribution chain and the technical means used for its delivery (stores, physical delivery, Internet).

2.51 Internationally, VAT is designed on the destination principle which allows the tax to keep its neutrality in cross-border trade. According to this principle, exports are exempt with refund of input taxes (“zero-rated”) and imports are taxed on the same basis and with the same rates as local production. This VAT on imports is generally collected at the same time as customs duties, although in some countries collection is postponed until declared on the importer’s next VAT return. Deduction of the VAT incurred at importation, in the same way as input tax deduction on domestic supply, ensures neutrality and no distortion of international trade. This implies that the total tax paid in relation to a commodity is determined by the rules applicable in the jurisdiction of its consumption and therefore all revenue accrues to the jurisdiction where the sale to the final customer occurs.

2.52 In the international trade in tangible goods, the place of taxation (or the place of supply) is the place of delivery, or shipment, of the goods to the recipient (buyer). In other words, a sale of goods is taxable in a jurisdiction if the goods are made available in, or delivered/shipped, that jurisdiction.

2.53 However, the nature of service and intangible products does not allow for the application of the same rules. In principle, the provider should account for the tax in the jurisdiction where the service or the intangible property is consumed or used, irrespective of the contract, payment, beneficial interest or the location of the supplier and customer at the time of the supply. Whether intangible property is used or a service is actually performed in a jurisdiction is essentially a matter of fact. However, it is not always easy to determine where services and intangibles are likely to be consumed. The increasing global nature of businesses and communication technologies makes it more difficult to apply a pure consumption test. The solution developed in most countries consists of identifying the place of consumption by reference to proxies rather than directly trying to identify the

actual or intended place of consumption. The nature of those proxies and the way they are used vary widely across jurisdictions since they result from local history and legal frameworks.

2.54 While the rules and approaches vary across countries, the basic criteria for determining the place of taxation (or place of supply) in the case of services is as follows:-

- a) In the case of a sale of real property, the place of supply is the jurisdiction in which the property is located. Similarly, services directly connected with real property (i.e services provided by real estate agents or architects) are also taxed in the place in which the property is located.
- b) In the case of mobile services (that is, passenger travel services, freight transportation services, telecommunication services, motor vehicles lease/rentals and E-commerce supplies), there is no fixed place of performance or use/enjoyment of the service. Therefore special rules need to be framed keeping in mind the basic destination principle.
- c) In the case of other services and intangible property, the place of supply is determined on the basis of one or more of the following proxies:
 - i. Place of performance of service;
 - ii. Place of use or enjoyment of the service or intangible property;
 - iii. Place of location/residence of the recipient; and
 - iv. Place of location/residence of the supplier.

2.55 In defining the place of supply of services and intangible property, a distinction is often made between supplies made to businesses (B2B) and final consumers (B2C). In general, the place of supply in the case of B2B transaction is the place where the recipient is located or established regardless of where the services are performed or used. This is particularly in the case of intangible services like advisory or consulting services for which the place of performance is not important. Therefore, all such services rendered to a non-resident are zero-rated. By contrast, many B2C services tend to be tangible or physical in nature, e.g. haircuts, hotel accommodation, local transportation and entertainment services

which are consumed in the place of their performance. Therefore, the place of supply in the case of B2C transaction is the place where the supplier is located. In some countries even such services to non-residents is zero-rated.

2.56 In addition to the above, there are a variety of other complex cross-border transactions for which supplementary rules are required to ensure uniformity and consistency across jurisdictions. 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.

2.57 The place of supply rules indicated above relate to international transactions of goods and services. Ordinarily, these rules should also apply to inter-state supplies. However, in practice there are substantial deviations in these rules. The recipient of the services may be located in more than one state and there is no practice to determine the residency of the recipient unlike in the case of international transactions. Therefore, it is extremely difficult to identify the place in which the recipient is established/ located. In general, it would be desirable to tax B2B supplies of services and intangibles in the State of destination, and not of origin.

2.58 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 should be defined as the place of predominant use of the service. However, if there is no unique place of predominant use, the place of destination could be the mailing address of the recipient as stated on the invoice, which would normally be the business address of the contracting party. The risk of misuse of this rule would be minimal if it is limited to B2B supplies where the tax is fully creditable.

2.59 For B2C services, the place of supply should be the State in which the supplier is located, which, in turn, could be defined as the place where the services are performed. If there is no unique place of performance of the service, the place of supply could be defined

as the State where the supplier's establishment most directly in negotiation with the recipient is located.

2.60 The rules relating to the place of supply of goods and services, discussed above, are in conformity with best international practice and expert advice. Therefore, we recommend that the Centre and the States may consider framing the rules on the basis of the guidelines indicated above.

o. Threshold Limit for registration of GST dealers

2.61 Typically a small number of firms account for a large proportion of revenues from taxes on goods and services. Simultaneously, resources used in the collection of taxes are scarce and must therefore be deployed effectively; these need to be concentrated on the largest taxpayers as part of the risk management strategy. Further, the compliance burden under the invoice credit method is relatively high and it is uneconomical to collect revenues from a large number of small taxpayers. Hence, keeping in view the compliance cost and administrative feasibility, small dealers (including service providers) and manufacturers should be exempted from the purview of both CGST and SGST if their annual aggregate turnover (excluding both CGST and SGST) of all goods and services does not exceed Rs.10 lakh. However, like in most other countries, those below the threshold limit may be allowed to register voluntarily to facilitate sales to other registered manufacturers/dealers, limit competitive distortions and avoid inequities.

2.62 A case is made out that the states should be allowed to adopt different threshold limits keeping in view the size of the revenue base. Consequently, states with low revenue potential like the North-eastern states in particular must be allowed to adopt a lower threshold limit to protect their revenues. The objective of providing a threshold exemption is two-fold; firstly to mitigate the incidence of tax on the poor who generally make purchases of their goods and services from small dealers and secondly to reduce administrative burden of dealing with a multitude of small dealers who account for a dis-

proportionately low share in the revenues. Hence, allowing some states to adopt a lower threshold implies that the poor in these states will bear the incidence of tax on their consumption unlike those similarly placed in other states and therefore, would be inequitable. This will also have the potential to trigger tax-induced migration from these states. Accordingly, we recommend that the threshold exemption limit should be uniform for both CGST and SGST and across States.

2.63 Further, with a view to reduce administrative and compliance burden, we also recommend small dealers with annual aggregate turnover of goods and services between Rs.10 lakh to Rs.40 lakh²⁰ may be allowed to opt for a compounded levy of **one percent**, each towards CGST and SGST. However, no input credit should be allowed against the compounded levy or purchases made from exempt dealers.

2.64 The Group recognizes that certain high value goods comprising of (i) gold, silver and platinum ornaments; (ii) precious stones; and (iii) bullions (hereafter referred to as “high value goods”) are prone to smuggling due to high tax incidence thereby generating negative externalities in terms of social and economic disorder. Therefore, we recommend that dealers in such high value items may, subject to the threshold exemption but without the ceiling of Rs. 40 lakh, also be allowed to opt for the compounded levy of **one percent**, each towards CGST and SGST.

p. Treatment of Small Scale Industries

2.65 At present small scale industries are entitled to exemption from payment of CENVAT in respect of their turnover upto Rs.1.5 crores. However, there is no such threshold exemption in respect of state level VAT. The main reason for exemption from payment of CENVAT is to liberate them from the onerous compliance burden under the CENVAT regime particularly in the context that, in general, the small scale industries are managed by one or two entrepreneurs with the support of a handful of semi-skilled office staff.

²⁰ The limit of Rs 40 lakh is based on the consideration that dealers with turnover of Rs 40 lakh or more are subject to tax audit under the Income Tax Act, 1961 and therefore they would suffer from any additional burden in terms of documentation under the GST.

2.66 In the context of the GST, we have recommended the reporting of payment and transaction information of both CGST and SGST through the combined Form No. GST-I. Therefore, in any case the small scale industry has to comply with the reporting of payment and transaction information of SGST. No additional burden is cast upon the small scale industry for compliance with the CGST. Hence, the case for continuing with the existing exemption upto Rs.1.5 crores of turnover is extremely weak. Accordingly, we recommend that this exemption should not be continued under the GST framework.

2.67 Further, the small scale industries are generally wary of dealing with multiple tax administrations. Therefore, in order to inspire confidence of the small scale industry in the new GST framework, we also recommend that the scrutiny/audit of the small scale industry should be conducted only by the state tax administration. However, the State tax administration may seek the assistance of the central tax administration or any other state tax administration if the operations of the small scale industry transcend the state boundaries. Since the CGST and the SGST are proposed to be levied on an identical GST tax base, the outcome of any investigation impacting SGST will also have a corresponding impact on CGST. Therefore, enforcement by the State tax administration would be adequate to even deal with CGST evasion.

q. Area based exemptions

2.68 Under the CENVAT, industries set up in the North East, Jammu & Kashmir, Sikkim, Uttaranchal and Himachal Pradesh (hereinafter referred to as 'specified areas') enjoy exemption from payment of CENVAT. This area based exemption creates economic distortions and affect economic viability of units located in non-exempt areas. They are difficult to administer and prone to misuse. Moreover, durability of investment attracted by such measures beyond the exemption period is also doubtful.

2.69 The Prime Minister's Economic Advisory Council, which had recently examined the issue of area based exemption in the context of its impact on pharmaceutical industry, has observed that:-

“The policy of granting area based exemptions was ill advised. It created a host of distortions. We have to design and introduce subterfuges to neutralize those distortions. But such subterfuges make the tax administration needlessly clumsy and complex and run counter to our declared policy of simplifying the tax system. There is clearly a case for revisiting the whole issue of area based tax exemptions. If their premature withdrawal is not possible for political and business reasons, at the minimum such incentives should not be extended to fresh areas and the ones already in force should be extinguished when their applicability ends.”

2.70 Further, the existing exemption for Uttranchal and Himachal has been objected to by many States. In particular, Chief Ministers of Haryana, Uttar Pradesh and Punjab have often expressed their opposition to such exemptions as these had the effect of diverting industries to Himachal Pradesh and Uttranchal.

2.71 Para 3.3.2.(viii) of the draft of “An Approach to the 11th Five Year Plan” has also commented on the undesirability of the area based exemptions. To quote :-

“The existing incentive programmes such as those available for the North East, J&K, Himachal Pradesh and Uttranchal need to be reviewed with a view to assessing their impact on industrialization in these regions. The extension of excise duty exemption to Himachal and Uttranchal has had an adverse impact on industrial investments in both the North Eastern region and the adjacent States. Consideration would need to be given to restricting these incentives to only hilly areas or to replacing these incentives by a special programme for roadways and railway development in these States.”

2.72 The area based exemptions erode the tax base. The revenue foregone on account of area-based exemptions is estimated to be Rs. 8,073 crores in 2007-08.

2.73 Further, the case for providing area based exemption is extremely weakened in the face of our recommendation for a sharp reduction in the combined rates of CGST and SGST and the ease of compliance through a combined transaction reporting and payment Form No. GST-I.

2.74 In view of the above, we recommend that the area based exemption in respect of CENVAT should not be continued under the GST framework. In case it is considered necessary to provide support to industry for balanced regional development, it would be appropriate to provide direct investment linked cash subsidy.

r. Treatment of Special Economic Zones

2.75 Since the GST is designed to ensure that all producers and distributors are treated as complete pass-through and exports are zero-rated, there is no case for allowing any form of incentive to the developers of, or units in, the Special Economic Zones. We recommend accordingly.

CHAPTER – III

Treatment of Inter-State transactions

3.1 The Indian Constitution as it originally stood envisaged taxation of interstate sales only in the state where it was consumed. Unfortunately, this led some states to issue notices to dealers not resident within their jurisdictions to file returns. To bring some order in the matter, a law was enacted by the Parliament in 1956 authorising the central government to levy a tax on interstate sales called the central sales tax (CST). But the power to administer the tax was delegated by the Centre to the states of origin of the sales who were also allowed to retain the revenue. Initially, the tax was levied at the rate of only 1 per cent but it was raised successively to 4 per cent. In 2006-07, the Central Government and the State Governments came to an understanding to reduce CST in a phased manner and completely eliminate it by 1st April, 2010. Accordingly, the CST was reduced to 3 per cent. in 2007-08 and subsequently to 2 per cent. in 2008-09. However, on account of revenue implications, it has now been decided to continue with the CST at the present level of 2 per cent until GST is introduced.

3.2 The rate of CST is 2 per cent if the sale is between two registered dealers across states and the transaction is documented through the use of “C Forms”. The latter is issued by the importing state to the importing registered dealers within the state, and is submitted to the exporting dealer in order that the latter can avail himself of the concessional rate of tax. If the good is sold to unregistered dealers outside the state and is not a declared good, the transaction, by law attracts the rate applicable in the exporting state. If the rate applicable in the exporting state is less than the CST rate, the transaction is not required to be documented through the “C Form”. Since sales tax applies only when there is a sale, no tax is attracted when goods move from one state to another as transfer between branches of the same enterprise or on a ‘consignment’ basis.

3.3 The CST constitutes a distorting factor in the location of industries and the flow of internal trade, impeding the growth of a truly common market in the country. It also causes

inter-jurisdictional inequity and reduces the international competitiveness of exports. Further, the administration of and compliance with the CST is also beset with problems. The Department is constantly under pressure to monitor the exports to registered dealers. Similarly, the importers have to incur considerable transaction cost to procure “C Forms” from the department. The exporters are also burdened with the responsibility of obtaining the “C Forms” from the importers on time. Further, the treatment of branch transfers and consignment sale under the CST provides an easy avenue for evasion. In spite of the adverse economic implications of the CST, the States have come to acquire a vested interest in maintaining the status-quo since it account for about 15 per cent of their tax revenues.

3.4 In the context of the GST, it is necessary to resolve the problem relating to the treatment of inter-state sales/transfers in a manner that the incidence of the tax falls on the consumption of commodities without any distortionary cascading effect and the revenue accrues to the State where the final consumer is located.

3.5 The Empowered Committee of State Finance Ministers had set up a Working Group for designing the model. The following models for treatment of inter-state trade have been analysed by the Group:-

- i. Bank model
- ii. TDS model
- iii. SGST authority model
- iv. CGST authority model
- v. TINXSYS (De-matted C-form) model
- vi. TINXSYS with reverse charge model
- vii. Full De-mat model
- viii. Inter-State De-mat model
- ix. IGST model.

3.6 After a detailed analysis of the merits and demerits of all the models, the Group recognised that the success of every model depended on the following pre-requisites:-

- a. E-filing of return every month with dealer wise transaction details
- b. E-payment of taxes
- c. National Portal for access to information by member States and dealers
- d. National agency for overseeing the flow of information and taxes
- e. Strong IT infrastructure for the above issues
- f. The intra and inter state rates of tax should be equal to avoid evasion and camouflaging the intra state transactions as inter state transactions.

3.7 Based on its analysis, the Group has recommended the adoption of the IGST Model for implementation with the caveat that a *'strong IT infrastructure and complete information of the interstate transactions is a precondition and essential prerequisite for considering the IGST model. Without addressing these fundamental concerns of IT infrastructure and information support systems, the adoption of IGST model which is still at a conceptual stage is far from realistic at this stage in adoption of GST in the course of interstate transaction in goods and GST for the nation.'*

3.8 The 'Road Map to GST' released by the Empowered Group of Ministers proposed the Bank Model as a mechanism to deal with inter-state transaction of goods and services. The functional components of the Model are :-

- a. Collection of SGST by the seller of the selling State.
- b. Remittance of SGST collected by the seller to the respective buying State's Account in the designated bank, along with the details of buyers and invoices.
- c. Transfer of remitted tax amount by the designated bank to the respective buying State.
- d. Refund of input SGST by the selling state to the seller in the event of inter-state transactions
- e. Allowance of Input tax credit to the buyer in the buying State to the extent of the SGST received by remittance and transfer of tax amount.

3.9 The Bank Model was found to be more suitable Model, to monitor the interstate transactions of goods including stock transfer, on the following assumptions:

- i. This model would ensure evasion free tax environment and easy administration of credit flow to the buyers in the buying States.
- ii. This model envisages a level of automation that would ensure capturing all the information relating to interstate transactions in the exporting state and transferring the same to the importing state.
- iii. This model requires the bank to evolve an IT infrastructure to communicate electronically with all concerned in respect of interstate transaction of goods through a national level portal and to provide the related information to all concerned.

3.10 The Working Group recognised that the Bank Model is a ‘better system ensuring evasion free inter-state business environment’. However, the Group was of the view that it would entail higher cost of both compliance and administration. Further, it was also alarmed by the fact that ‘few members’ created an uproar by stating *“Why should the importing States permit their buyers to pay tax to the sellers of the exporting States and wait for the tax money so paid till remittance by the sellers and transfer by the bank to their exchequer?; and why can’t the Importing States levy SGST on the interstate purchases treating them as import from outside for commencement and flow of SGST credit in the importing States?”* Therefore, the Group abandoned the Bank Model.

3.11 We have also analysed the various Models presented in the Report of the Working Group. The IGST Model recommended by the Group, while requiring a IT and complex accounting infrastructure, would also require a separate legislation for levy of IGST on inter-state transactions. This will have to be similar to the present CST legislation. Further, the IGST Model envisages that the IGST may be paid either by using the CGST or the SGST. Similarly, credit for the IGST by the buyer can be claimed to make payment of either CGST or SGST. Rules would also be required to be framed for prioritising the set off against CGST, IGST and SGST. This implies a complex accounting of input tax credit and apportionment

between CGST and SGST which would considerably enhance both compliance and administrative burden. Further, the Centre and the States may also have to compensate each other at different points in time. It also envisages the establishment of a centralized agency for settlement of accounts between the Centre and the States. Therefore, we do not support the adoption of the IGST Model. We would recommend a modified version of the Bank Model (hereafter referred to as 'Modified Bank Model') for inter-state trade in goods and services.

3.12 The functional components of the **Modified Bank Model** would be as under :-

- (i) In the course of inter-state B2B supply, the seller in the origin State shall collect the SGST leviable on the transaction from the buyer in the destination State as if the sale was within the origin State.
- (ii) The seller would issue an invoice to the buyer indicating the details of the transaction (including the date of the transaction) and his business identification number (BIN).
- (iii) The seller shall use the input SGST for payment of the output SGST on both intra-state and inter-state transactions. To the extent total output SGST is in excess of the input SGST, the same shall be paid into any of the authorised bank in the prescribed manner. This will ensure a self-adjustment mechanism for input credit thereby minimizing the need for issue of refunds.
- (iv) The buyer in the destination State shall make use of the SGST so paid in the State of origin for making payment of output SGST in the destination State.
- (v) All registered dealers across the country shall pay the sum due as CGST and SGST to the credit of the Central Government and all other States within one week from the end of the month to which the sale transactions relate.
- (vi) The Central Government and State Governments shall jointly identify a nodal bank to receive the collection of CGST and SGST by collecting banks. The

nodal bank will also receive all information relating to purchase and sale by registered dealers.

- (vii) The nodal bank shall host the IT infrastructure, provide payment gateway to all banks in India and provide screen-based upload or file upload facility for receiving payment and transaction information.
- (viii) It would be mandatory for all registered dealers to make the payment by electronically furnishing Form No. GST-I, which would be a combined monthly payment and return form for all intra-state and inter-state transactions..
- (ix) As far as the registered dealer is concerned, he would be required to make a **single payment** of the aggregate of all sums due to the Centre and all other States. Even though he would have collected tax in the Origin State for inter-state transactions with buyers in a number of destination States, he can fulfil his obligation of directly remitting the tax so collected to all the destination states through a single payment made along with the electronic furnishing of Form No. GST-I. This mechanism will have the benefit of extremely low compliance cost.
- (x) It would be mandatory for all registered dealers to make electronic payment of CGST and the SGST by electronically remitting it in to the RBI, SBI or any authorized bank.
- (xi) The procedure for making payment of CGST and SGST **and** furnishing information relating to transactions of both purchases from and sales to registered dealers in Form No. GST-I shall be as under:-
 - (a) Seller will open Nodal Bank website or approach GST facilitation centre (which will provide Bank website access and also guide Seller) to submit Form No. GST-I. The Nodal Bank would only serve as the payment gateway to facilitate payment in any bank in which the dealer has an internet banking account.

- (b) Seller will enter his basic details such as his BIN, Name, Phone and email (Financial year will be current year by default and can be changed, date of deposit will be the current date) on Form No.GST-I.
- (c) In case the number of Invoices for sale to registered dealers and purchases from registered dealers is less than 10, the Seller shall enter the details of such individual invoices online (Invoice number, date of the invoice, BIN of the registered purchaser or seller and amount of GST collected or paid for the Invoice). If the number of invoices for sale or purchase to registered dealers is more than 10 , the seller can enter these details offline and upload the file.
- (d) The total of GST will be computed automatically and Seller can enter additional details for Interest, penalty or other amounts as applicable. The complete total will be calculated automatically and mentioned in figures and words.
- (e) Seller will have to submit this information for payment by direct debit to his bank account (as per his selection on the Nodal Bank website) as is the procedure for any e-payment.
- (f) Nodal Bank will transmit ONLY the total GST amount information, along with details of the Seller as per the challan information, to the bank for debit to the Seller's bank account. Nodal Bank will NOT transmit any information about the Invoices to the bank.
- (g) The Internet banking website of the bank will be opened automatically and the Seller will have to enter his login and password relevant for internet banking to access his bank account. Then the total GST amount

as per the challan will be debited to his account and credited to Government account by the bank.

- (h) The bank will confirm to Nodal Bank details of successful deposit of GST amount to Government account.
- (i) Nodal Bank, upon receipt of confirmation from bank of the GST payment by Seller, would generate the Form No. GST-I, which can be printed out by the Seller for his own record purposes.
- (j) The Seller would issue an Invoice to the Buyer with details of the Invoice Number and the GST amount for that Invoice. The Buyer can verify if the GST amount has been credited to the Government by using the Seller BIN, Invoice number, date of invoice and Invoice Amount to verify the corresponding entry from the nodal bank website.
- (xii) Input credit for GST would be available to the Buyer against that Invoice by using the combination of Seller BIN, Invoice Number, date of invoice and Amount of GST for that Invoice
- (xiii) All banks receiving payments from the registered dealers would be required to transfer the funds to the Nodal Bank on T+1 basis. The Nodal Bank in turn would credit the funds to the respective States.
- (xiv) The software can be designed in a manner which would have the capacity to allocate the amount paid by any registered dealer between the States on the basis of the business identification number of the buyer. The amounts so allocated can be automatically credited to the account of the destination States without any manual intervention. As a result, it would not be necessary to set up any clearing house mechanism whereby at any given point in time sums would be due to, or from, any other States. Therefore,

the destination State would not be dependent on any other State for collection of revenue.

- (xv) There will be no requirement for the buyer to make pre-payment of taxes separately for each transaction in the destination State. It will also eliminate the problem of extensive documentation like the 'C' Form in the case of CST.
- (xvi) Since every registered dealer would be required to furnish information relating to both the purchases and sales to registered dealers, this would enable automatic matching of input credit claims and identify all mismatches for follow up action. This will eliminate any possibility of fraudulent claim of input credit and evasion.
- (xvii) The Nodal Bank should be paid on per transaction record basis and the entire cost should be borne by the Central Government.
- (xviii) Further, in case of any default, the administrative responsibility and control over the collection and recovery of SGST should vest in the origin State.

3.13 As described above, the Modified Bank Model will continue to be evasion proof as the Bank Model. Since the Model envisages a single payment mechanism through a combined monthly payment-cum-return Form No. GST-I, the registered dealer can develop the data relating to the transactions on a real time basis over the entire month and eventually upload the file anytime in the first week of the following month. As a result the compliance cost would be minimal.

3.14 The IT infrastructure would be hosted by the Nodal Bank and the State tax administration would be required to establish a central computer server to download the data from the Nodal Bank. The data so downloaded can be allowed to be used by its officers through IT Network or through any other communication system. This will also reduce immediate pressure to set up the IT infrastructure in all States on or before 1st April,

2010. Further, the Model does not envisage the establishment of a clearing house mechanism. Therefore, the Model is also administratively efficient.

3.15 As stated above, the Bank Model was abandoned by the Working Group in view of an alarm set off by few States. In this context, it must be recognised that trade flow is, in general, a two way process between States. Buyers in the destination State have to pay tax to the sellers in the origin State in all cases. Therefore, if buyers in State 'A' have made payment to sellers in State 'B' and, therefore, certain amounts have become due to State 'A', there would be similar situations where sellers in State 'A' would be required to make good certain amounts to either State 'B' or any other State. Hence, it would result in almost no gain or loss to any State as they would mostly cancel each other over a period of time and over a number of transactions.²¹ The problem lies in the fact that the seller is allowed a float for a certain period before remitting the amounts to the destination States. The alternate remedy of collecting taxes like on imports at the State border check posts is fraught with severe economic inefficiency. It has been well documented that border check posts are extremely inefficient mechanisms for tax collection since they slow down the movement of goods across borders which in turn translates into high cost of inventory management. The deadweight loss on account of such economic inefficiencies far outweighs the loss on account of float allowed to the sellers in the origin State. Therefore, we are of the view that the apprehensions expressed by few States on the Bank Model are exaggerated in the absence of sufficient information and analysis.

3.16 The Modified Bank Model would not require large resources to be committed since the nodal bank would be paid on per transaction record basis. Further, since the cost would be entirely borne by the Central Government, it would not impose any additional burden on the States. In fact, the states will be able to save resources since input credit mismatches will be automatically detected thereby significantly improving its effectivity. This Model

²¹ This may not apply to States which are net exporters. However, in the Modified Bank Model proposed by us, the input tax which would be required to be refunded by these States to the registered dealers within their jurisdiction on account of inter-state transactions would be required to be paid directly to the importing State and not to the dealer.

does not require any separate clearing house mechanism as under the Bank Model. Under this Model, there is no possibility of default or failure on the part of the Sellers of the selling State to remit the SGST collected to the destination State since a single consolidated payment is required to be made in respect of all CGST and SGST liability.

3.17 In some quarters, doubts have been expressed about the efficacy of the Bank process in transfer and reconciliation of SGST remittances and its ability to handle and transfer the vast information of inter-state transactions of goods between millions of business entities across the State borders. In this context, it may be pointed out that, even today, all taxes of the Central and State Governments are collected by the banks, reconciled and transferred to the Government at different levels. Further, the large volume of data can be smoothly handled by creating appropriate IT structure. Such capacity has been developed by TCS for NSDL to handle the Income tax Department's database. We believe other large IT firms like Infosys and WIPRO also have similar software design and IT project executing capacity. The Nodal Bank can hire any such firm for developing the IT structure for GST payment and transaction information management. Therefore, such doubts are entirely misplaced.

3.18 Another apprehension expressed relates to the refund of accumulated Input tax credit on the basis of interstate transaction of goods which would continue to be a challenge and require high level of audit trails. The accumulated input tax credit on the basis of interstate transaction can be utilised to make payment of output SGST in respect of local transactions. In most cases the accumulated credit would be fully exhausted. In cases where accumulated credit remains unutilised, the same would have to be refunded. The number of such cases may not be very large. Nevertheless, the Government can establish a centralised processing centre (CPC) for processing of returns (Form No GST-I), along the same lines as the CPC established by the Income tax Department at Bangalore. This will fully meet the challenge of issuing refunds.

3.19 Another argument advanced against the Bank Model is that there is no international precedence (even in EU) in favour of adopting this model to the complexities of Indian situation. **Unlike in the EU, we have a common thread in the form of CGST which binds inter-state transactions.** This, coupled with the system of consolidated payment of CGST and SGST and transaction related information, ensures a fool proof compliance mechanism.

3.20 In view of the above, we recommend that-

- i. all inter-state transactions in goods and services should be effectively zero rated by adopting the Modified Bank Model along the lines discussed in the aforesaid paragraphs.
- ii. the consignment sales and branch transfers across states should be subject to treatment in the same manner as if it was a inter-state transaction in the nature of sale between two independent dealers.
- iii. the function of all state border check posts should be reduced to checking contrabands by setting up large scanners for trucks to pass through without any need for physical verification.
- iv. The cost of the scanners should be entirely borne by the Central Government.
- v. All check-posts should be jointly manned by both States so as to reduce the number of check-posts and enhance efficiency in the road movement of goods.

CHAPTER - IV

Administrative Structure

4.1 It is now well-recognised that tax administration is tax policy. An inefficient tax administration will not be able to provide the requisite level of deterrence thereby leading to non-compliance and under performance of the tax regime. Therefore, the full potential of the pure tax regime will remain unrealised. Hence, the structure, design and the business process of the tax administration is an important factor in the determination of the revenue performance.

4.2 In the context of the GST we are not embarking on an exercise of comprehensively designing all the elements of the tax administration. We intend to restrict our recommendations only to a few important issues.

a. Registration of taxpayers

4.3 The creation of an efficient taxpayer information system for the purposes of administering a VAT necessarily entails the creation of a taxpayer's master file through a mechanism of registration of all dealers liable to GST. Registration brings a person within the control of the tax authorities. Steps towards its compilation must be taken well in advance of the start of the GST.

4.4 Fortunately, there exists a unique taxpayers identification number at the central level in the Income Tax Department in the form of the Permanent Account Number (PAN). All persons who are liable to income tax or whose sales exceed Rs.5,00,000 are required to obtain a PAN. The Customs and the Central Excise Department has already adopted the PAN for registration of importers and exporters and manufacturers. Since the operation of a successful VAT entails coordination between the tax administrations at both the national and the state level through computerised information sharing we recommend the following:

- i. All persons with annual aggregate turnover of goods and services exceeding Rs.10 lakh (excluding CGST and SGST) should be required to register and obtain a GST registration number. Persons with lower turnover may be allowed an option to register.
- ii. The GST registration number should be a twelve digit alpha numeric number. The first ten digits should be the alpha-numeric Permanent Account Number (PAN) followed by a space and two more digits indicating the state code. This number scheme should be publicised widely and should be self-generated after obtaining a PAN²².
- iii. There will be a single GST registration number for all branches in a State. Therefore, a dealer having branches across States will have as many GST registration numbers as the number of States in which he operates.
- iv. The registrant dealer should be required to furnish a form, only by way of information, indicating the registration number for every State in which he operates. He should not be allowed to use the registration number, though self-generated, unless he has furnished the form.
- v. Since the number is PAN based, it is not necessary to have any pre-registration verification. However, the states may, if necessary, undertake post-registration verification to eliminate any potential abuse.
- vi. To begin with, on the eve of the introduction of GST, the dealer must furnish a consolidated form for all States in which he operates. If, at a later stage, the dealer extends his operation to a new State, he should be required to furnish a form for extension of activities and register the self-generated number for the new State.
- vii. Overtime, the string corresponding to PAN will be replaced by the Unique Identification Number (UIN) proposed to be issued to all residents.
- viii. It should be mandatory for all registrant dealers to obtain an e-mail ID and

²² At present, PAN has been allotted to more than 80 million people, including companies, firms and other business entities. Therefore, it is highly unlikely that there would be any existing business entity which would not have obtained a PAN.

also open an internet banking account with any bank. The form must capture the e-mail ID and the internet bank account number.

- ix. All persons with annual aggregate turnover of goods and services exceeding Rs.10 lakh (excluding CGST and SGST) would be required to compulsorily acquire the 18 digit identification number. Persons with lower turnover will have the option of obtaining the identification number.

4.5 These recommendations will enable the GST administration to save on considerable time for registration and also enable computerisation of transactions by distinguishing one record from another. Given the simplicity of the proposed registration system, the GST administration can begin registration of dealers from 1st January, 2010.

b. GST invoice

4.6 Another important element of the taxpayer information base is the VAT invoice, which forms the primary source of information and therefore a crucial control document of VAT. In an invoice based VAT system, the issue of invoices in the proper form is an essential part of the procedure for imposing and enforcing the VAT. Typically, under the VAT laws the allowance of a credit for input tax is conditional on the existence of a VAT invoice issued during the period for which the credit is claimed. An invoice is also required by the tax authorities to audit the collection of VAT. Further as indicated above, the VAT invoices form the primary source from which the return of VAT invoices will have to be prepared and furnished to tax authorities for third party information matching. Accordingly, we make the following recommendations relating to VAT invoices:

- i. The law should require a supplier making a taxable supply to another taxable person to provide a VAT invoice with that supply or the payment for it. The requirement should be enforceable by some penalty.
- ii. The VAT invoice should be standardised across all states so as to contain a minimum of information about the supply being invoiced.

c. Periodicity of GST Payment

4.7 Since the amount of VAT collected by a dealer is related to his turnover, the dealer is likely to accumulate a huge VAT liability within a very short period. Hence, it is necessary to minimise the risk of payment defaults by dealers, in particular fly-by-night operators. Given that the collection under VAT will serve as the dominant source of revenue for state governments it is imperative to provide for a collection mechanism which would ensure a periodic flow of revenue to the exchequer subject to a minimum compliance burden on taxpayers and risk of revenue loss. Therefore, we recommend that the VAT period should be a calendar month.

d. Administrative structure

4.8 The proposed GST will be a dual levy. Therefore, concern has been expressed at different fora on the administrative structure for implementing the CGST and the SGST consistent with the autonomy of the different levels of Government. Therefore, we recommend that the tax administration and procedures for the dual GST should be designed in the following manner:-

- (a) The Central Board of Excise & Customs (CBEC) shall be responsible for implementing the CGST and the State Tax administrations will be separately responsible for implementing the SGST²³. The various tax administrative functions such as assessment, enforcement, scrutiny and audit should be undertaken by the CBEC in respect of the CGST and by the State tax administration in respect of the SGST subject to our recommendation on small-scale industries.
- (b) All procedures under CGST and SGST should be uniform.

²³ The jurisdiction between the CBEC and the State Administration may be divided between the two in such manner that the interface of the taxpayer is confined to one tax administration only. The basis for division could be turnover or any other criteria which is considered reasonable so that the compliance and administrative burden is minimized.

- (c) Each taxpayer should be allotted a PAN based taxpayer identification number, as recommended above.
- (d) The unit of taxation for the purposes of GST should be persons as defined under the Income Tax Act. Consequently, for the purposes of CGST, all production units/branches of a person located anywhere in the country will be treated as a single taxable entity eligible for CGST input credit across units/branches. Similarly, for the purposes of SGST, all production units/branches of a person located anywhere within the State will be treated as a single taxable entity eligible for SGST input credit across units/branches in that State.
- (e) The Central Government shall establish a common IT infrastructure which will serve the needs of both CGST and SGST.
- (f) The Central Government will be responsible for establishing a taxpayers information network (TIN) keeping in view the information requirement of CBEC and the State tax administration. The TIN will be shared between the Centre and the States.
- (g) The payment of tax and the transaction reporting should be made through a combined payment and transaction reporting statement in Form No. GST-I. This statement should detail all business to business transactions relating to sales. This statement should be common for both CGST and SGST compliance and it should be mandatory to file this statement electronically on a monthly basis while making payment of taxes.
- (h) Taxpayers opting for the compounded levy may be required to pay their taxes and file their returns on a quarterly basis.
- (i) Electronic filing of all other returns, if any, should also be mandatory. Therefore, the return forms should be common for CGST and SGST compliance.

- (j) The information furnished shall be stored in a common database to which both the CBEC and the State tax administration will have access.
- (k) For the purposes of audit, both CBEC and the State tax administration can design an independent risk management strategy. However, both must coordinate to ensure that the same taxpayer is not subject to simultaneous audit under CGST and SGST.
- (l) The administration of this levy should be based on audited accounts and not on the basis of any form of physical controls.
- (m) Since the tax base will be common, there should be a common appellate authority. Similarly, the Authority for Advance Ruling will also be common.
- (n) Best international practices should be embedded in the Central-GST, particularly in respect of laws relating to levy of penalties, and circumstances and method of prosecution.
- (o) No authority should have any power to make preventive detention for the purposes of CGST and SGST.
- (p) Procedures for collection of both the CGST and SGST should be uniform.

4.9 The uniformity in the procedures recommended by us will considerably reduce compliance and administrative cost. This should undoubtedly result in improved voluntary compliance.

CHAPTER - V

Rates of Tax

I. Single or Multiple Rates

5.1 The choice of a single or a multiple VAT rates is highly controversial. There is a belief that the public will accept a VAT type GST more easily if products consumed by low-income households are taxed at lower rates than products consumed by those that are better off. Administrators who actually implement the tax know that every additional rate will significantly increase cost and complexity. The cost of auditing the classification of exempt and taxable items and the applicable rates thereon at every stage of production, distribution and sale is also extremely high. Therefore, they support the elegance of a single rate (other than the zero rates). Economists espouse the optimality of tax rates based on elasticity. In general, business and industry also espouse a single rate since it is simple to comply and eliminates the problem of classification which arises under the multiple rates regime leading to protracted legal disputes and taxpayers' grievances. Further, multiple rates also implies that the standard rate is relatively high. Since taxes result in economic distortion which increases exponentially with the increase in the applied tax rate, a relatively high standard rate creates much larger economic distortion. It also provides an incentive for evasion and frequent lobbying by trade and industry for favourable modifications in the tax schedule.

5.2 Early VAT systems were characterised by a progressive tax structure whereby basic necessities were taxed at lower rates, luxuries at higher rates and all other goods and services at a standard rate. The problem was further compounded by numerous exemptions. However, since the 1990s there is a growing trend towards a single positive rate, a zero rate and some, or no, exemptions.

5.3 The Task Force on Implementation of the Fiscal Responsibilities and Budget Management Act, 2003 sketched the elements of a reform strategy which would achieve the core economic policy goals of promoting efficiency, equity and high quality growth.

These elements, inter-alia, included low and few rates. The Task Force expressed the view that *“High tax rates distort economic decisions and fuel and deployment of resources into tax avoidance and tax evasion. A large number of rates of taxes exacerbates the problem of bracket creep and classification disputes. These arguments suggest that a rational tax system is one with very few rates and low rates. For example, debates on customs duties have universally argued that if customs tariffs have to exist, there should be a single uniform rate on all goods. Similarly, it is well accepted that there should be a single VAT rate covering all kind of production”*. In view of the fact that both the Centre and the States had multiple rates, the service tax base was extremely narrow, and the States had not moved to VAT, the Task Force, even while recognising the efficacy of a single VAT rate, recommended multiple rates as a transitory step towards a single VAT rate²⁴. The recommendation does not, in any way, undermine the efficacy of a single VAT rate²⁵.

5.4 Bogetic and Hassan (1993)²⁶ analysed a diverse group of 34 countries on a wide spectrum of VAT structures bases and revenues. In terms of VAT structure, two groups of countries were identified: single rate and multiple rate countries. Given the revenue performance data and the consensus preference of tax experts for single rates, they examined whether existing data on VAT support the contention that countries with single rate mobilise more revenue than those that have multiple rates. The empirical results confirm that the dispersion of rates if found to negatively affect VAT revenues. The results also confirm in other conventional view that VAT generates, other things being constant, higher revenue in single VAT rate countries than in multiple rates countries. The difference in the estimated models for the two country groups statistically significant indicating a structural change²⁷. Accordingly, they recommend that to generate superior revenues, a VAT should be levied in a single rate on as broad base as possible; it also must be accompanied by a strong tax administration to ensure enforcement and compliance.

²⁴ This has been ascertained from Dr. Vijay L. Kelkar, who headed the Task Force.

²⁵ The recommendation for multiple VAT rates was adversely commented upon by experts.

²⁶ Bogetic, Zeljko and Fareed Hassan (1993). Determinants of Value-Added Tax Revenue: A Cross-Section Analysis, The World Bank Working Paper No.1203.

²⁷ They also point out that the change in the pattern of VAT revenues cannot be exclusively explained in terms of difference in rate structures.

5.5 Mello (2008)²⁸ empirically analyses 38 OECD and non-OECD countries and concludes that VAT efficiency is inversely related to the statutory rate and the share of tax administration costs in tax revenue (proxying for tax administration efficiency)²⁹. The VAT efficiency is affected adversely by the level of the statutory rate. The co-efficient in the tax is small in magnitude, although it is highly significant, so that the loss in efficiency due to an increase in the VAT rate is relatively modest. The elasticity of VAT revenues to VAT rate is (-) 0.3 approximately. Silvani and Wakefield (2002) analyse a sample of 22 countries in the 1990s and show that, if the VAT tax rate is raised by one percentage point, productivity falls by 3.6 per cent.

5.6 The Group took note of the fact that, in 2007-08, the combined statutory incidence of CENVAT, CST and State level VAT on goods was in the range of 27 per cent and 30 per cent³⁰. This combined rate is one of the highest in the world and is not conducive to voluntary compliance. Further, it also underscores the need for multiple rates.

5.7 The Group also took note of the need to minimize the tax burden on consumption by low income households. However it does not recommend a low rate of tax, or exemption, for products consumed by low income households since the same products also form part of the consumption basket of the middle and high income households. As stated earlier, the introduction of a low rate or exemption for products commonly consumed by low income households also results in increase in the standard rate. Since low income households also consume goods liable to tax at the standard rate, the cumulative burden on the aggregate consumption by the low income households remains unaffected in spite of the exemption or

²⁸ Mello, Luiz de (2008). Avoiding the Value Added Tax: Theory and Cross-Country Evidence, OECD, Economics Department Working Paper No. 604.

²⁹ VAT efficiency also tends to be higher in countries where the regulatory framework in product markets is pro-business and governance (regulatory quality, rule of law and government effectiveness) is strong. Moreover, VAT productivity does not seem to differ in a statistically significant manner between OECD members and non-members. Finally, the ratio of administrative costs to tax revenue is the best-performing indicator of tax administration quality used in the empirical analysis, with other metrics, such as the ratio of audit and other non-audit verification assessments to net revenue having a much lower predictive power.

³⁰ This does not include the incidence of embedded taxes which are not vatiable. This combined statutory incidence has since reduced to a lower range of 18 per cent to 20 per cent in 2008-09 as a consequence of the sharp temporary cut in the CENVAT rate.

low rate for the common goods consumed by them. The Group also recognized that, in general, the low income households purchase their requirement of daily necessities from the small neighbourhood retail outlets whose turnover is generally low/moderate. Therefore, the burden of GST on consumption by low income households should be minimized, more appropriately, by providing a moderate threshold exemption for registration of dealers. Accordingly, the Group has, in para 2.61 above, recommended a threshold exemption limit of Rs.10 lakh.

5.8 Further, in terms of best international practice, recent experience shows that the preference of the policymakers is for adoption of a single rate as it is more efficient.³¹

5.9 In the light of the above, the Group recommends **one positive rate**, each for CGST and SGST on all goods and services. In addition, there should be a **zero rate** applicable to all goods and services exported out of the country.

5.10 A view has been expressed that a single rate of State GST for all goods and services will, in our country with its large low income population, be highly regressive. It is mainly the articles of common consumption which are in the lower rate bands of VAT. The single revenue-neutral rate will definitely be much higher than the rate now prevailing at the lower bands. In short, the incidence of taxation on the articles consumed by the common man will rise, while the rate of tax on luxuries will fall. The implementation of a regressive tax during an economic slowdown is even worse than doing so in a boom. In other countries where such a shift to a single rate has occurred, an increased propensity to evade has also been noticed. Those who argue for a single rate GST on grounds of economic efficiency and growth are ignoring the adverse distributional consequences. The implementation of a single rate will thus be highly unpopular with the common man.

5.11 Under the present Indirect Tax regime at the State level, the lower rate is generally 4 per cent. However, in the absence of a seamless flow of the input credit mechanism resulting in cascading of taxes **and** the CENVAT-inclusive tax base, the incidence on products

³¹ Michael Keen (2009): "What makes a successful VAT?", Presentation at the Workshop on September 30, 2009 at the National Institute of Public Finance and Policy (NIPFP), New Delhi.

liable to the lower rate of 4 per cent is substantially higher. Since we recommend in para 5.79 a single rate, which is extremely low in comparison to the existing standard rate of 12.5 per cent, there is little scope for providing a further lower rate. In addition, the proposed GST design structure envisages a comprehensive base with a seamless flow of the input credit mechanism. Consequently, the cascading effect would be negligible. Further, the tax base will be exclusive of CENVAT. The cumulative effect would be that the real tax incidence under the proposed GST model would approximate the statutory rate and would not be significantly different from the present levels of incidence on such products. The proposed single rate GST regime will be transparent in comparison to the present opaque system. A move to a single rate of GST is regressive if the initial point is a destination based VAT type regime across a comprehensive base and allowing for seamless flow of input credit where the cascading effect is either non-existent or negligible. Since the existing indirect tax structure is characterised by significant cascading effect, the move to a single rate of GST which approximates the real incidence, does not result in any adverse distributional consequences.

5.12 A tax on consumption can be regressive. The structure should be designed to alleviate the tax incidence on consumption by the relatively poorer section of the society. One of the methods could be to identify such items of consumption by the poor and either exempt them from GST or subject them to a lower rate. Under this method, consumption by the rich would also suffer the same level of tax since no distinction can be made between the rich and the poorer consumers at the point of sale. Therefore, this method is highly regressive. The second method is to provide for a moderate threshold exemption level for registration of dealers. Consequently, all small dealers would remain outside the purview of the GST and, therefore, the tax incidence on products sold through such dealers would be relatively lower. Since the poorer section of the society tend to make their purchases from such small and unregistered dealers, the consumption of any commodity by the poor would bear a relatively lower incidence of tax than the consumption of the same commodity by the relatively richer section of the society. In the aforesaid paragraphs, we have

recommended a modest threshold exemption level of Rs.10 lakh. This recommendation is aimed to address the issue.

5.13 The distributional consequences of the proposed GST should be analysed keeping in view its impact on economic growth and employment. To the extent it enhances economic efficiency, it will also create new opportunities for employment which would obviously benefit the relatively poorer section of the society and improve equity³². There is yet another instrument to improve the distributional outcome of this by direct cash transfer to the target groups. With the proposed UIN system such a policy is feasible and a more efficient option.

5.14 In view of the above, the apprehension that the move to a single rate would be regressive is misplaced.

5.15 It has been argued that the proposal to have a uniform rate of State GST reduces the autonomy of the States and, therefore, undermines the federal structure of our Constitution. Further, the States would lose the flexibility to swiftly respond to any crisis³³. In the present context, the design of the structure of the GST will be determined through the collective process of a 'grand bargain' between the Centre and all the States for the collective welfare of its people. The decision to have a uniform rate should, therefore, be viewed as a collective decision of all States and Centre to harmonize the tax rates, arrived on the basis of consensus in the Empowered Committee of State Finance Ministers. Further, the proposed GST structure would confer upon the States the power to tax services which accounts for about 54 per cent of the GDP. This would significantly improve the vertical imbalance in the federal fiscal relations in favour of the States³⁴. The States would also have the flexibility to impose surcharges to meet any financial need in an emergency-like situation.

³² Unemployment results in an implicit taxation of the poor at the rate of 100 per cent.

³³ Some States have argued that but for the flexibility, the Central Government would not have been able to reduce the CENVAT rate as a response to the economic slowdown witnessed in the second half of the fiscal year 2008-09.

³⁴ This would be so even after making appropriate adjustment for allowing the Centre to levy tax upto the retail stage.

5.16 It is now well recognised that the performance of GST is dependant, amongst others, on the ratio $\left[\frac{\textit{Weighted average of statutory rates}}{\textit{Standard rate}}\right]$ ³⁵. Therefore, the ratio is less than one if there are multiple rates. Hence, it is necessary to adopt a single rate so as to optimize the performance of the GST.

II. Determination of the rate of GST

5.17 One of the crucial issues relates to the determination of the rate of CGST and SGST. Since the GST is primarily intended as an exercise in reforming the consumption tax in India and not an exercise for additional resource mobilisation through discretionary changes, the CGST and SGST rates should be such rates which would yield the same revenue as collected from the various taxes which will be subsumed in the CGST and SGST (hereafter such rates shall be referred to as ‘**revenue neutral rates**’ or ‘**RNR**’).

5.18 The Thirteenth Finance Commission has been mandated to make its recommendations having regard to the basis of levels of taxation likely to be reached at the end of 2008-09. However, the fiscal year 2008-09 has been characterised by unprecedented economic meltdown necessitating immediate and temporary midyear corrections in the rates of CENVAT and Service Tax. Further, due to intra-year extreme volatility in the prices of various commodities, the levels of taxation achieved in 2008-09 are substantially lower than what would have been achieved if the trend of the preceding five years had continued. Further, detail firm level data is required for the purposes of calculation of RNR. This is available only upto the fiscal year 2007-08. **Therefore, the Group has used the fiscal year 2007-08 as the base year for calculation of the RNR.**

³⁵ A **standard rate** is defined to mean the rate on supply of all general goods and services for which no other specific rate is provided. In effect, this is the rate applicable to the residuary category of goods and services. Further, detail analysis of this is presented in Chapter – VI.

5.19 The RNR for the CGST and the SGST is determined in accordance with the formula-

$$\text{RNR} = \frac{\text{R}}{\text{B}} \times 100$$

Where,

RNR : Revenue Neutral Rate for the Centre or the States as the case may be;

R : Collection from the Central or State taxes, as the case may be, which are proposed to be subsumed in the CGST and SGST;

B : Estimated Tax base of the GST

a. Taxes to be subsumed in the GST

5.20 The **Central taxes** which are proposed to be subsumed by the Empowered Committee in the CGST are indicated in Para 2.11 of Chapter-II of this Report. We concur in this proposal of the EC. Further, the SIN goods will be subject to a dual levy comprising of the CGST and Excises. The total collection from these central taxes in 2007-08 was **Rs 233435 crores** (including collection from petroleum and tobacco products) of which collection from non-SIN goods and services was **Rs 157733 crores only**. The breakup of the collections is presented in Table-1. Since the SIN-goods will continue to be subject to excises as at present, the RNR for the CGST is sought to be calculated only in respect of **Rs 157733 crores**, being the collections from non-SIN goods and services.

Table-1: Revenues from Central taxes to be subsumed in CGST					
Sl No	Nature of Tax	Non-SIN Goods	POL	Tobacco	Total
1	CVD	53510	5199	0	58709
2	Union Excise Duties	52922	60231	10272	123425
3	Service Tax	51301	0	0	51301
4	Total	157733	65430	10272	233435
<p>Note: Union Excise Duties includes Additional Excise Duties and the various cesses listed out for subsumation in the CGST</p>					

5.21 Similarly, the total collection from “EC-taxes” in 2007-08 was **Rs.118356 crores** (excluding collection from petroleum, alcohol and tobacco products). However, the total collection from “TF-taxes” (excluding collection from petroleum, alcohol and tobacco products) was **Rs 188285 crores** in 2007-08 as per details presented in Table-2. Since we are of the view that all the “TF-taxes” should be subsumed in the SGST, our RNR for the SGST is sought to be calculated in respect of an amount of **Rs 188285 crores**.

Table-2: Revenues from State taxes to be subsumed in SGST

Sl. No	Nature of Taxes	Non-SIN Goods	POL	Tobacco	Alcohol	Total
1	Stamp Duty	38473				38473
2	Taxes on Vehicles	15549				15549
3	Taxes on Goods & passengers	6719				6719
4	Taxes and Duties on Electricity	9188				9188
5	Sales Tax/VAT (incl. CST and Purchase Tax)	110826	56442	3000	11450	181718
6	Entertainment tax	1062				1062
7	Entry taxes not in lieu of Octroi	3914				3914
8	Other taxes and Duties*	2554				2554
9	Total (sum of 1 to 8)	188285	56442	3000	11450	259177
10	TF- Taxes (sum of 1 to 8)	188285				
11	EC- Taxes (sum of 5 to 8)	118356				

* This includes (i) taxes on lottery, betting and gambling; (ii)luxury tax; and (iii) cesses and surcharges by States

b. Estimation of the GST base

5.22 For the purposes of estimating the RNR, we need to first **estimate the GST base** in the light of the GST Model designed by us. There are essentially two methods of estimating the GST base. **One method** is to estimate the final consumption in the country and make appropriate allowance for leakage. However, the pre-GST indirect tax system is generally characterised by high leakage while the shift to a consumption-type GST is compliance

enhancing. Therefore, estimating the degree of leakage under the proposed GST is vexatious. The **second method** is to estimate the gross value addition by the producers of goods and services and make appropriate adjustments relating to imports and exports. The gross value addition by the producers can be estimated by either using the input-output table or the profit and loss account of the producers.

5.23 For the purposes of estimation of the GST base, we use the following methods/approaches:-

1. Subtractive – indirect method (SI method);
2. Consumption method
 - i. Task Force Estimate; and
 - ii. NCAER Estimate.
3. Shome Index method
4. Revenue method

5.24 We use the average of the estimates under these methods as the estimate of the GST Base for the purposes of calculating RNR.

1. Subtractive – indirect method (SI method)

5.25 At the producer level, the GST base is equivalent to the value added which is the value that a producer adds to his raw materials or purchases before selling the new or improved product or service. That is, the inputs (the raw materials, transport, rent, advertising, and so on) are bought, people are paid wages to work on these inputs and, when the final good or service is sold, some profit is left. So value added can be looked at from the additive side (wages plus profits) or from the subtractive side (output minus inputs).

5.26 Value added = wages + profits = output – input. If the tax rate on this value added is 't', there are four basic forms that can produce an identical result:

- (1) t (wages + profits) : the additive – direct (accounts) method;

- (2) t (wages) + t (profits): the additive – indirect method³⁶,
- (3) t (output – input) : the subtractive – direct (accounts) method; and
- (4) t (output) – t (input) : the subtractive – indirect (the invoice or credit) method.

5.27 While there are four possible ways of levying a VAT, in practice, the method used (number 4) never actually calculates the value added; instead, the tax rate is applied to a component of value added (output and inputs) and the resultant tax liabilities are subtracted to get the final net tax payable. This is sometimes called the “indirect” way to assess the tax on value added.

5.28 The Subtractive – indirect method (SI method) is based on the profit and loss account of producers. Since extensive producer level data was available with the Income Tax Department, the Group analysed the profit and loss accounts of **28, 51, 248 business entities** for the financial year ending on the 31st March, 2008 (financial year 2007-08) which have electronically filed their profit and loss account along with their return of income with the Income Tax Department for assessment year 2008-09. The activities of these entities are classified into 9 sectors and further sub classified into 74 sub-sectors (refer Annex - II). Further, the sample includes **3,50,894** companies and **3,84,425** partnership firms. Since it is mandatory for firms with an annual turnover of more than Rs.40 lakhs and all companies to electronically file their return of income, the dataset includes all companies and such firms, who have filed their return upto 15th August, 2009 for the financial year 2007-08 (assessment year 2008-09). In addition, it also includes other business entities which have voluntarily opted to electronically file their return. For the purposes of this exercise, we assume that these **28, 51,248** entities constitute the universe of the GST taxpayers. This sample does not include the multitude of taxpayers who have filed their tax returns in paper form. Charitable organizations are required to file their return only in paper form. Therefore, the sample does not include the tax returns of any charitable organization. Since

³⁶ This method is so called because value added itself is not calculated but only the tax liability on the components of value added is calculated.

most entities engaged in providing education and health services operate as charities, the sample does not include education and health services providers. Further, since agricultural income is exempt from income tax, the sample does not capture the data relating to the agricultural sector.

Table-3: Turnover based Distribution of sample entities			
Turnover* range	Number of cases	Amount of Output base (Rs in crores)	Share in the total turnover (in percent.)
Less than zero	2014	-719	-0.01
Between 0 to Rs 10 lakh	1616862	25761	0.28
Between 10 lakh to Rs 25 lakh	237333	38933	0.42
Between 25 lakh to Rs 40 lakh	146984	48061	0.51
Between 40 lakh to Rs 100 lakh	333047	219065	2.34
Between 1 crore to Rs 2 crore	199099	280778	3.00
Between 2 crore to Rs 5 crore	165385	519055	5.55
Between 5 crore to Rs 10 crore	71341	498382	5.33
Between 10 crore to Rs 100 crore	71332	1840605	19.68
Above 100 crore	8160	5884524	62.91
Gross Total	2851557	9354445	100
Less: Indirect Taxes		281168	
Turnover net of indirect taxes		9073277	
* Turnover is defined as total credits in the Profit and Loss Account as reduced by the value of closing stock. This is the same definition used for computing the GDP			

5.29 The distribution of taxpayers across turnover is shown in Table-3. For this purpose, “turnover” is defined to mean the aggregate of all income receipts credited to the Profit and Loss account so as to align it with the definition of “gross value of output” for the purposes of National Accounts by the CSO. The aggregate gross value of output of the sample entities

is Rs.90,73,277 crores³⁷ in 2007-08 as against the gross value of output of Rs.75,78,410 crores estimated by CSO for the non-agricultural sector³⁸. Therefore, it is obvious that the CSO estimation of gross value of output seems to be an under estimation.³⁹ Consequently, the estimation of GDP, private final consumption etc., by the CSO also appears to be understated. Therefore, the sample size is extremely large and any estimation of the GST base on the basis of this sample will be fairly representative of the actual GST base.

5.30 The computation of the GST base under the SI method involves the following steps:

- a. The receipt items on the credit side of the Profit and Loss Account, which would be liable to output tax, are identified and appropriately adjusted for indirect taxes to arrive at the **'value of supply of domestically produced goods and services (net of indirect taxes)'** (hereinafter referred to as **'net value of supply of domestically produced goods and services'**);
- b. Since imports are liable to GST at the point of importation, the **'value of imports'** is aggregated with the **'net value of supply of domestically produced goods and services'** to arrive at the **'net value of domestically available goods and services'**.
- c. Since exports are zero rated in a GST regime, the value of exports is reduced from the **'net value of domestically available goods and services'** to arrive at the **'net value of goods and services available for domestic consumption'** or the **'aggregate output tax base'**.
- d. Similarly, the expense items on the debit side of the Profit and Loss Account, in respect of which input tax credit would be potentially

³⁷ Since agricultural income is exempt from income tax and persons whose income is predominantly from agriculture are not required to file their tax returns, this does not include the gross value of output produced in the agricultural sector.

³⁸ This is derived by reducing the aggregate of the value of output of Rs.9,18,846 crores in agriculture, Rs 3,33,098 crores in Public Administration and Defense and Rs 2, 84, 953 crores being 50 percent of the value of the output under 'Other services' from the value of total output of Rs 91,89,784 crores in 2007-08 as reported by CSO.

³⁹ The turnover of the sample entities relate to the organised sector. The under reporting of the value of output by the CSO is further accentuated if we adjust for the unorganised sector.

available, are identified and appropriately adjusted for indirect taxes to arrive at the **'value of purchase of intermediate goods and services'**.

- e. Under the GST Model, full and immediate input credit is proposed to be allowed for GST paid on purchase of capital goods in the year of purchase. Therefore, the **'value of purchase of capital goods'** is aggregated with the **'value of purchase of intermediate goods and services'** to arrive at **'gross value of purchase of intermediate goods and services'**.
- f. Since no input tax credit would be available in respect of purchases made from unregistered dealers, the **'value of purchases from the unregistered dealers'** is reduced from the **'gross value of purchase of intermediate goods and services'** to arrive at the **'aggregate input tax base'**.
- g. The **'aggregate output tax base'** is reduced by the **'aggregate input tax base'** to arrive at the **'GST Base'**.

5.31 On the basis of the profit and loss accounts of the 28,51,248 business entities, the **"net value of supply of domestically produced goods and services"** is the aggregate of the value (net of indirect taxes) of (i) Sales/gross receipts from business; (ii) Commission; (iii) Profit on sale of fixed assets; and (iv) 'Any other income' since output tax would be charged only in respect of these four items credited to the profit and loss account.⁴⁰ This is estimated to be **Rs. 87,21,874 crores in the financial year 2007-08 for all sectors**. This constitutes 105.02 percent of the gross value of the output in the non-agriculture sector in 2007-08, as reported by CSO. However, the corresponding figure for the **taxable sectors (excluding financial, rail and real estate sectors) is Rs. 77,62,224 crores**.

5.32 The item 'any other income' as reported in the accounts does not include rent, dividend, interest, profit on sale of investments liable to STT, profit on other investment,

⁴⁰ In the case of rent, the expenditure on rent is reduced by the rental income reported. Therefore, we do not separately include this item in the 'net value of supply of domestically produced goods and services'.

profit on currency fluctuation and agricultural income. In practice, a large number of professional entities report their gross receipts under this item since they do not view themselves as carrying on business or engaged in sales. Since the Group has recommended a comprehensive GST base to include all goods and services, the value of supply of goods and services must therefore, include the item 'any other income'. As regards, rent, dividend, interest, profit on sale of investment liable to STT, profit on other investment, profit on currency fluctuation and agricultural income, these have been excluded from the value of the supply of goods and services since the source of these items of income is, in general, a business-to-business transaction and therefore, a wash transaction in the context of GST.

5.33 The various receipts which have been excluded from the item 'any other income' basically arise from transaction in financial services and immovable property. While the base for GST is proposed to include financial services and immovable property (real estate), the size of the base relating to these services is determined separately and not on the basis of the subtractive-indirect (invoice or credit) method.

5.34 Input tax base comprises of all goods and services used as intermediate inputs in the production of goods and services and on which output tax has been paid. The **'value of purchases of intermediate goods and services'** is the aggregate of the expenditure on items listed in Table-4. The aggregate of such expenditure by all the sample entities during the financial year 2007-08 is Rs.73,29,483 crores of which Rs 4,32,910 crores relates to purchase of agricultural commodities and the balance Rs 68,96,573 crores relates to purchases from the non-agricultural sector. However, the **'value of purchases of intermediate goods and services'** by the **taxable sectors (excluding financial, rail and real estate sectors)** is **Rs. 67,12,418 crores.**

Table-4: Intermediate goods and services forming part of Input Tax Base

A	Purchases of trading goods and raw material	
B	Special services	
	1	Freight
	2	Consumable Stores
	3	Power & Fuel
	4	Building repair
	5	Machinery repair
	6	Total expenditure on insurance
	7	Workmen and staff welfare expenses
	8	Entertainment
	9	Hospitality
	10	Conference
	11	Sales promotion including publicity (other than advertisement)
	12	Advertisement
	13	Commission
	14	Hotel boarding and lodging
	15	Travelling expenses including foreign travelling
	16	Conveyance expenses
	17	Telephone expenses
	18	Guest house expenses
	19	Club expenses
	20	Festival celebration expenses
	21	Gift
	22	Audit fee
C	Miscellaneous Services	
		Other expenses

5.35 The aggregate of the purchases of trading goods and raw material by all the sample entities during the financial year 2007-08 is Rs.56,70,610 crores. However, the corresponding figure for the **taxable sectors (excluding financial, rail and real estate sectors)** is Rs. 51,80,108 crores. These purchases include purchase of trading goods and raw materials from registered and unregistered dealers in both the primary and secondary sector. To the extent these include purchases of trading goods and raw materials from the unregistered dealers, no input tax credit would be available since no output tax would have been paid by the unregistered dealers. In the case of primary articles like cereals and plantation crops, these would generally be purchased from agriculturists who would be

outside the scope of GST either by virtue of exemption or by virtue of their turnover being below the threshold limit. If for some reason, the agriculturist falls within the scope of the GST, he would be liable to collect GST for which the purchaser in our sample would be eligible to claim input credit. Since agriculturists do not ordinarily file an income tax return, his sales do not form part of the output base estimated above. Therefore, purchases of primary articles would not be entitled to any input credit. Such purchases are estimated to be Rs.4,32,910 crores. Further, we also estimate 10 percent of the purchases of trading goods and raw materials from the secondary sector to have been purchased from the unregistered dealers on which no input credit would be available. Such purchases amount to Rs.5,23,770 crores. Therefore, the aggregate purchases of trading goods and raw material from unregistered dealers is Rs 9,56,680 crores in 2007-08 for all sectors.

5.36 The value of **Special services** availed by all sample entities is Rs.7,25,657 crores. Given the nature of the services, we estimate 25 percent of the services to have been acquired from **unregistered dealers** and therefore, no input credit would be available. **The value of such services is estimated to be Rs.1,92,756 crores.**

5.37 Similarly, the value of **Miscellaneous Services** availed is Rs.8,67,077 crores which is charged to the profit and loss account under the head 'other expenses'. These are generally petty expenses in nature most of which are acquired from unregistered dealers. It is estimated that 60 percent of this amount would be from unregistered dealers. Accordingly, a sum of Rs. 5,32,709 crores will not be eligible for input credit.

5.38 Accordingly, the '**value of purchases from the unregistered dealers**' in 2007-08 for all sectors is computed at Rs.16,82,145 crores of which Rs 4,32,910 crores relate to purchases of agricultural commodities and the balance Rs .12,49,235 crores to non-agricultural goods and services. In the course of discussion in different fora on the estimated purchase from unregistered dealers, a view was expressed that this estimate may be upwardly biased. Therefore, it is important to undertake a validation check of the estimate.

5.39 In general, the unorganized sector in terms of the National Accounts Statistics is a good proxy for the unregistered dealers under the GST. The share of the unorganised sector in the non-agriculture Net Domestic Product in 2007-08 is 48.69 percent and 90.27 percent in the agricultural sector.⁴¹ Applying these ratios to the firm level profit and loss account, the purchases from the unorganised sector/unregistered dealers is estimated at Rs37,48,729 crores of which Rs 3,90,788 crores relates to agricultural commodities and the balance Rs 33, 57, 941 crores relate to purchase of non-agricultural goods and services from the unorganised sector. Our own estimate of Rs 16,82,145 crores is only 45 percent of the purchases from the unorganised sector estimated on the basis of the National Accounts Statistics. Therefore, there is no reason to doubt the veracity of our estimates.⁴²

5.40 On the basis of the above, the GST bases for the '**Taxable sectors**' and '**Exempt sectors**' (which comprises of the Food sector and health and education services) are computed separately.

- Exempt sectors

5.41 We have earlier recommended exemption from GST of unprocessed food articles. Producers of food grains do not file income tax returns. Similarly, most of the trading in food grains is undertaken by small traders with low turnover. Such traders, in general, file their income tax returns in paper form. However, the sample represents electronically filed returns only. The impact of the exemption for unprocessed food articles (rice and wheat) on our estimation of the GST base is not significant.

5.42 Similarly, we have also recommended exemption from GST in respect of health and education services. The health and the education sector is mostly organised as charitable trusts. The charitable trusts are required to file their returns in paper form and therefore do

⁴¹ See Statement 76.1 of National Accounts Statistics 2009

⁴² In reality, it is likely that the purchases from unregistered dealers would be substantially larger than our estimate. To the extent it is so, the GST base is likely to increase, and the RNR would be lower, than our estimate.

not form part of the sample. However, 3928 trusts with a total turnover of Rs 8133 crores have electronically filed their returns. Assuming that these trusts operate in the health and education sector, the volume of the total turnover is insignificant to make any material difference to the estimation of the GST base. Therefore, no separate adjustment is made to provide for the exemption for the health and education sector under the proposed GST.

5.43 Separate data relating to life-saving drugs is not available. Therefore, we estimate the GST base relating to this sector at Rs 5000 crores on the basis of anecdotal information.

5.44 Therefore, the GST base relating to the 'Exempt sectors' is estimated at **Rs 86, 575** crores.

- Taxable sectors

5.45 The '**Taxable sectors**' is sub-divided into two, namely, the '**General sectors**' and the '**Special sectors**'. The latter comprises of the Financial Sector, Rail Transport Sector and Real Estate Sector. The GST base relating to the '**General sectors**' is computed by using the **SI method**.

5.46 In terms of the proposed GST Model, the tax base will include real estate (land and buildings) and housing services. In the case of real estate transactions, the incremental value between two transactions will be subject to GST thereby, subsuming the stamp duty within the GST base. Further, rent, whether from residential or commercial property, will also form part of the GST base. However, rent in a business-to-business transaction will be a wash transaction. Since expenditure on rent is greater than the rental income in the case of sample entities, the net expenditure on rent is included in the '**value of purchase of intermediate goods and services**'. To the extent GST on rent will also be collected on business-to-consumer transactions, it is not feasible to make any estimate of the volume of such rental transactions. Therefore, the estimate of the tax base relating to real estate and housing services is limited to the estimated base in respect of real estate (land and

buildings) transactions. In 2007-08, the Gross Fixed Capital Formation by way of construction in the household sector is Rs 429260 crores. This does not include the value of land. Assuming that the land value accounts for 50 percent of the total value of the real estate, the GST base relating to land is estimated at Rs 429260 crores.

5.47 The comprehensive GST is intended to bring within its fold rail transport services also. However, this is intended to be confined to rail services provided for transportation of goods only. The rail transportation sector is entirely under the Ministry of Railways which is not required to file a tax return. Therefore, the sample does not include rail services. Accordingly, based on the information contained in the National Accounts (2009), the GST Base in respect of rail services is estimated at Rs 44,746 crores.

5.48 The GST Base in respect of the **'General sectors'** is computed on the basis of the Profit and Loss Account of the entities who filed their income tax returns electronically by following the steps indicated in Para 5.30. The GST Base for 2007-08 is estimated at Rs 24,29,924 crores.

5.49 The **'GST Base' for all the sectors is summarized in Table-5. As would be noted, the 'GST Base' for the 'Taxable sectors' is estimated at Rs 30,50,228 crores.**

Table-5 : Estimation of the GST Base under the SI Method

Sl.No	Description	Unit	All Sectors	Exempt Sector	Taxable Sector				
					Special Sectors			General Sectors	Total
					Financial Services	Rail Services	Land Sector		
					1	2	3	4	5
	Sample Size	Nos.	2851248	77851	100055			2673342	2773397
A.	Output Tax Base								
	1 Net value of supply of domestically produced goods and services	Rs. In crs	8721874	112713				7762224	
	2 Value of Imports	Rs. In crs	1200678					1200678	
	3 Net value of domestically available goods and services (1+2)	Rs. In crs	9922552	112713				8962902	
	4 Value of Exports	Rs. In crs	989505					989505	
	5 Aggregate Output Tax Base (3-4)	Rs. In crs	8933047	112713				7973397	
B.	Input Tax Base								
	1 Value of purchase of Capital Goods	Rs. In crs	457504	9743				431504	
	2 Value of purchase of Intermediate Goods and Services	Rs. In crs	7329483	98091				6712418	
	3 Gross value of purchase of intermediate goods and services (1+2)	Rs. In crs	7786987	107835				7143921	
	4 Value of purchases from Unregistered dealers	Rs. In crs	1682145	81696				1600449	
	5 Aggregate Input Tax Base (3-4)	Rs. In crs	6104842	26138				5543473	
C.	GST Base (A5-B5)	Rs. In crs	2828205	86575	193103	20750	429260	2429924	3073037

2. Consumption Method

i. Task Force Estimate

5.50 In addition to the SI method, we also estimate the GST Base by estimating the total final consumption.

5.51 For this purpose, we use the Input Flow Matrix 2006-07 at factor cost⁴³ published by the National Accounts Division of the CSO. The Input Flow Matrix or contains details of 130 commodities consumed as input in 130 industries, covering the entire range of economic activities. Commodities are recorded in columns and industries are recorded in rows in a square matrix form. The value of each commodity consumed by each industry is at factor cost. It also provides commodity-wise detail of Total final use, that is, private final consumption expenditure (PFCE), government final consumption expenditure (GFCE), gross fixed capital formation (GFCF), change in stock (CIS), export and import.

5.52 To estimate the GST base, we need to estimate the contribution of all commodities in the primary, secondary and tertiary sectors of economy to the value addition chain. Since GST will be applicable only on the output of registered dealers with a turnover of more than Rs 10 lakh, consumption of goods and services from unregistered dealers will not be subject to GST. Therefore, it is necessary to estimate the value of such purchases forming part of the Private Final Consumption Expenditure (PFCE). For this purposes, we assume that the share of purchases from the unregistered dealers is in the same ratio as the share of the unorganized sector in the total National Domestic Product (NDP). The contribution of the organized and unorganized sectors in the NDP for 2006-07 is calculated on the basis of information available in statement 76.1 of National Accounts Statistics, 2009. The PFCE on goods and services from registered dealers (organized sector) for inclusion in the GST base is estimated at **Rs 10,12, 609 crores** (Table-6).

⁴³ This matrix is also referred to as 'The Absorption Matrix'

5.53 Government Final Consumption Expenditure (GFCE) comprises of two elements, namely, compensation to employees and Net purchase of Goods and Services. Since compensation to employees will be outside the scope of the GST base, we exclude public administration in the Input Flow Matrix from the GFCE to arrive at the Net purchases of goods and services by Government.

5.54 Gross Fixed Capital Formation (GFCF) comprises of two broad components i.e., construction and machinery equipments. The machinery equipments component is in the nature of capital goods which, under the GST, are proposed to be treated as intermediate inputs. Therefore, this element is not included as part of the GST base. Similarly, expenditure on construction by the Public Sector and the Private Corporate Sector is also proposed as intermediate input by allowing full and immediate input credit on capital goods. Therefore, for the purposes of this exercise what is relevant is the estimate of the Gross fixed Capital Formation in the household sector.

5.55 The expenditure on construction as reported in Statement 19 of National Accounts Statistics, 2009 is Rs. 5,00,036 crores comprising of Rs. 3,66,855 crores towards construction and Rs. 1,33,181 crores towards plant and machinery. The household sector in general would be in the un-organised sector (unregistered dealers or final consumers) and therefore, the expenditure on plant and machinery and construction by the household sector would be in the nature of final consumption. The expenditure on construction in the household sector would comprise of two components, namely, material and labour. In general, tax would be payable on the material component only since the labour component being from the un-organized or own labour will not be captured under the GST. Accordingly, we estimate the labour component as one-third of Rs. 3,66,855 crores i.e. Rs. 1,22,285 crores. Hence, the final consumption component in the Gross Fixed Capital Formation in the household sector in 2006-07 is estimated at Rs. 3,77,751 crores.

5.56 Some element of the food sector, and education and health services are proposed to be exempt from the GST. Similarly, services categorised under the labels 'Other Commercial,

Social, Personal Services', 'Others Services' and 'Public Administration' are also proposed to be excluded since these would essentially be rendered by entities with turnover below the threshold limit or by government or by the non-profit sector.

5.57 The estimate of the non-land GST Base for 2006-07 is obtained by aggregating the PFCE on goods and services from registered dealers (organized sector), the net purchases of goods and services by the Government and the component relating to final consumption in the Gross Fixed Capital Formation in the household sector.

5.58 In Table-6, the size of the non-land **GST Base for 2006-07** is estimated at **Rs 28,98,520 crores**, which accounts for 76.69 percent of the GDP at factor cost at current prices (Rs. 3779385 crores). Applying the same ratio, the size of the non-land **GST Base in 2007-08** is estimated to be **Rs 33,13,817 crores**. The GST Base relating to land for 2007-08 is estimated to be **Rs. 4,29,260 crores** as computed under the SI method. **Therefore, the aggregate GST Base in 2007-08 is estimated at Rs. 37,43,077 crores**. This estimate is significantly higher than the size of the GST base estimated under the SI method.

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Table-6: Task Force Estimate of the GST Base using the Consumption Method			
Sl. No.	Description	Units	Amount
1	Aggregate Private Final Consumption Expenditure	Rs. in crs	2260042
2	Private Final Consumption Expenditure relating to purchases from unregistered dealers (unorganised sector)	Rs. in crs	1247433
3	Private Final Consumption Expenditure (Organized sector) (Row 1 - Row 2)	Rs. in crs	1012609
4	Government Final Consumption Expenditure on goods and services	Rs. in crs	421059
5	Gross Fixed Capital Formation in household sector (excluding labour)	Rs. in crs	377751
6	Intermediate inputs from unregistered dealers	Rs. in crs	1713887
7	Gross Total (Row 3 + Row 4 + Row 5 + Row 6)	Rs. in crs	3525306
8	Exemption for food, health , education and some services	Rs. in crs	626786
9	Estimated non-land GST Base in 2006-07 (Row 7 - Row 8)	Rs. in crs	2898520
10	GDP at factor cost in 2006-07	Rs. in crs	3779385
11	Non-land GST base as a proportion of GDP (Row 9 divided by Row 10)	in percent	76.69
12	GDP at factor cost in 2007-08	Rs. in crs	4320892
13	Estimated non-land GST Base in 2007-08 (Row 11 * Row 12)	Rs. in crs	3313817
14	GST base relating to land for 2007-08 /1	Rs. in crs	429260
15	Estimated GST Base in 2007-08 (Row 13 + Row 14)	Rs. in crs	3743077
/1 The GST base relating to land in 2006-07 is estimated at Rs.366855 crores.			

ii. NCAER Estimate

5.59 The Thirteenth Finance Commission had assigned a study to Dr. Rajesh Chadha of the NCAER to carry out a study on the implication of GST for international study. Using CGE Model, NCAER has, inter alia, also estimated the RNR for a comprehensive GST factoring the impact of

exemption for the food sector, education and health services. However, it **does not** factor the impact of-

- a. exemption for small businesses (i.e. the threshold exemption of Rs 10 lakh for GST registration by dealers); and
- b. inclusion of land transactions within the scope of the GST.

5.60 The RNR for non-petroleum taxes of Rs 1,76,893 crores for the base year 2003-04 has been estimated to be 7.22 percent⁴⁴. Implicit in this estimate is the estimate of the GST Base at Rs 2450042 crores for 2003-04.

5.61 We use the purchases from the unorganized sector as a proxy for the purchases from the unregistered dealers. The private final consumption expenditure (PFCE) at market prices in 2003-04 was Rs 1699485 crores. We first adjust for the embedded net indirect taxes by applying the ratio of GDP at factor cost at current prices to the GDP at market prices at current prices for the financial year 2003-04 to the PFCE to arrive at the PFCE at factor cost at current prices. Thereafter, we estimate the purchases from the unorganised sector at Rs 894152 crores by applying the share of the unorganised sector in the net domestic product in the year 2007-08.

5.62 In 2007-08, the Gross Fixed Capital Formation by way of construction in the household sector is Rs 429260 crores. This does not include the value of land. Assuming that the land value accounts for 50 percent of the total value of the real estate, the GST base relating to land is estimated at Rs 429260 crores.

⁴⁴ NCAER has estimated the RNR for non-petroleum taxes at 6.20 percent under the **first scenario** that there will be no threshold exemption for registration and no specific goods and services based exemption. This scenario is not relevant for us since we intend to provide a threshold exemption and exemption for some specific goods and services. Under the **second scenario** of no threshold exemption but exemption of the same goods and services which we have recommended, the RNR is estimated to be 7.22 percent for non-petroleum taxes. Similarly, **the third and fourth scenarios** envisage that the GST will subsume all taxes including petroleum taxes and the scope of commodity specific exemptions will expand to larger baskets. The estimates of RNR under the third and fourth scenarios are 9.01 and 9.4 percent, respectively. However, the two latter scenarios are irrelevant for our purposes since we do not intend to subsume petroleum taxes within the scope of GST.

Table-7: NCAER Estimate of the GST Base			
Sl. No.	Description	Units	Amount
1	Estimated GST Base(excluding land and the threshold exemption) in 2003-04	Rs. in crs	2450042
2	Impact of the threshold exemption (purchases from the unorganised sector)	Rs. in crs	894152
3	Non-land GST Base in 2003-04 adjusted for threshold exemption (Row 1 - Row 2)	Rs. in crs	1555890
4	GDP at factor cost in 2003-04	Rs. in crs	2538170
5	Estimated non-land GST Base in 2003-04 (Row 3 divided by Row 4)	in percent	61.30
6	GDP at factor cost in 2007-08	Rs. in crs	4320892
7	Estimated non-land GST Base in 2007-08 (Row 5 * Row 6)	Rs. in crs	2648692
8	GST base relating to land for 2007-08 /1	Rs.in crs	429260
9	Estimated GST Base in 2007-08 (Row 7 + Row 8)	Rs. in crs	3077952

/1 The GST base relating to land in 2003-04 is estimated at Rs.197305 crores.

5.63 After adjusting the NCAER estimates to reflect the design and structure of the GST recommended by us, the GST Base in 2007-08 is estimated at Rs 30,77,952 crores as per calculations indicated in Table-7. This estimate of the GST Base also approximates the estimate under the SI method.

3. Shome Index Method

5.64 Parthasarathi Shome, one of our leading fiscal economists, has written extensively on tax policy and revenue trends. Among his observations is one that pertains to the revenue productivity of the VAT. The relationship between VAT rate and its revenue implication in terms of GDP could be referred to as the Shome Index as has sometimes been reflected in the context of Latin America. Thus, if the general rate of the VAT is, say 10 percent, the revenue collection from the VAT can be expected to be 5 percent of GDP⁴⁵. This revenue achievement is possible if-

⁴⁵ This is calculated by the formula $(1/2) * 10$ percent = 5percent of GDP

- i. the VAT base is broad with few exemptions;
- ii. the general VAT rate is not impeded by other lower rates;
- iii. tax administration is transparent; and
- iv. social norms do not erode tax compliance.

5.65 This has been observed in Chile whose VAT bases were proverbially wide. With an 18% VAT rate, Chile’s VAT revenue was almost 9% of GDP. Chile taxed even unprocessed food and fresh vegetables.

5.66 If the VAT base is narrow as is the case in the U.K., then the Shome Index would reveal a small percent collection in terms of GDP. Thus, in the U.K., with a VAT rate of 17.5%, the revenue intake has hovered around 6%. In terms of the Shome Index, at a VAT rate of ‘X’ percent, the VAT revenue in terms of GDP is nearly as low as $(1/3^{\text{rd}} * 'X')$ percent. In other countries, say with some other characteristic such as low compliance, a similar outcome would be experienced.

5.67 In most countries, as a thumb rule, VAT revenue hovers between $(1/3^{\text{rd}} * 'X')$ percent and $(1/2 * 'X')$ percent of GDP. The strategy for countries that have an x% VAT rate should invariably be to design the VAT structure and enhance its administration in a way that the achievement of $(1/2 * 'X')$ percent of GDP in revenue is feasible.

5.68 However, this Index is valid generally for countries which do not include real estate and housing services and financial services within the scope of VAT.

5.69 Based on the Shome Index, the GST Base is estimated in Table-8 at **Rs 27,82,809 crores**.

Table-8: Estimating the GST Base on the basis of the Shome Index

SI No.	Description	Amount [Rs in crs]
1	GDP at factor Cost at current prices	43,20,892
2	Estimated base on the basis of Shome Index [50 percent of row 1]	21,60,446

3	Estimated base relating to Financial Services	1,93,103
4	Estimated base relating to Real Estate	4,29,260
5	GST Base [Row 2+Row 3+ Row 4]	27,82,809

5.70 This estimation of the base is lower than the base estimated under the SI method primarily due to the fact that the estimates of GDP per se appears to be under reported since the value of output reported in the sample is substantially higher than the value of output as estimated from the National Accounts Statistics prepared by CSO for comparable sectors.

4. Revenue Method

5.71 A common method used by the revenue authorities both at the centre and state levels is to estimate the implicit GST base in the revenues actually collected and make such adjustments as are necessary to reflect the increase or decrease in the base on the basis of the recommended design and structure of the GST.

5.72 As would be seen, the output tax base is computed by estimating the implicit base underlying the aggregate of (i) the amount of collection by way of countervailing duty and Union excise duties for non-POL goods; and (ii) the estimated revenue foregone as reported in the Receipts Budget of the Union Government). This implicit base is calculated at the aggregate Union Excise Duty rate of 16.48 percent (inclusive of 3 percent of education cess). Similarly, the input tax base is computed by estimating the implicit base underlying the CENVAT credit allowed to producers at the same duty rate. The difference between the output tax base and the input tax base so calculated is the GST base relating to goods which is estimated at **Rs 11,77,706 crores** in 2007-08 (Table-9). Similarly the service tax base is estimated at **Rs 4,13,697 crores** for 2007-08 as shown in the said Table.

5.73 Since the proposed GST is comprehensive in its base, it will extend to a much larger base particularly in the financial services, rail transport, land, petroleum, tobacco and alcohol, trade and construction sectors. The estimated increase in the tax base in respect of each of these sectors is indicated separately in Table. The aggregate of the increase is estimated at Rs. 13,58,344 crores for 2007-08 as shown in the said Table.

Table- 9 :Estimation of GST Base: Revenue Method			
A	Non-POL (Existing Base)	Units	Amount
	Countervailing Duty	(Rs. In crs)	53510
	Public Ledger Account (paid to Govt)	(Rs. In crs)	53108
	Revenue foregone	(Rs. In crs)	87468
	Cenvat	(Rs. In crs)	147447
	Output Tax	(Rs. In crs)	341533
	Output tax Base	(Rs. In crs)	2072409
	Input Tax Base	(Rs. In crs)	894703
	Existing GST Base (Goods)	(Rs. In crs)	1177706
B	Services (Existing Base)	(Rs. In crs)	413697
C	Additional Base		
	Financial Services	(Rs. In crs)	66835
	Rail	(Rs. In crs)	20750
	Land	(Rs. In crs)	429260
	Trade	(Rs. In crs)	518102
	Petroleum, Power and Tobacco	(Rs. In crs)	191513
	Construction	(Rs. In crs)	131884
	Sub-total	(Rs. In crs)	1358344
D	GST Base	(Rs. In crs)	2949748

5.74 Based on the above, the aggregate GST Base for 2007-08 is estimated at **Rs 29,49,748 crores** as shown in Table-9. As would be noted this estimate is larger than the estimate under the Shome Index Method but lower than the estimate under the SI method.

5.75 The various estimates of the GST Base for 2007-08 are summarized in Table-10. As may be noted, the Task Force estimate of the GST Base using the Consumption method is the highest (Rs.37,43,077 crores) whereas the Shome Index method provides the lowest estimate. All other estimates fall within this range. Since the five estimates are different, we adopt their average of Rs 31,25,325 crores⁴⁶(row E of Table-10), as the size of the comprehensive GST base for 2007-08 for the purposes of estimating the RNR. Since the tax base for both the CGST and the SGST are proposed to be identical, we use the same tax base for calculating the RNR for both levies.

Table-10: Estimation of GST Base and the RNR			
SI No	Description	Units	Amount
A	Subtraction-Indirect Method	(Rs in crs)	3073037
B	Consumption Method		
	i. Task Force Estimate	(Rs in crs)	3743077
	ii Chadha Estimate	(Rs in crs)	3077952
C	Shome Index Method	(Rs in crs)	2782809
D	Revenue Method	(Rs in crs)	2949748
E	Average of all estimated GST Base	(Rs in crs)	3125325
F	Centre's RNR	(in percent)	5.05
G	State's RNR	(in percent)	6.02

⁴⁶ The standard deviation of these estimates is calculated to be Rs 640977 crores.

c. The Revenue Neutral Rate(RNR)

5.76 Given the estimate of the GST Base and the level of central taxes which are intended to be subsumed in the GST, we estimate the RNR for the CGST at 5.0 percent. Similarly, the RNR in respect of the state level TF-taxes which are proposed to be subsumed in the SGST is estimated to be 6.0 percent. **Therefore, the combined RNR is estimated to be 11 percent.** Incidentally, this estimate is the same as estimated by Bagchi and Poddar in their pioneering study published in November, 2007⁴⁷.

5.77 These estimates do not factor in the revenue gains from increased compliance and GDP. To the extent, the flawless GST will reduce cascading effect, there will be significant increase in the corporate profits and hence corporate tax collections. Therefore, in actual practice, the RNR of 11 percent will be revenue positive.

5.78 As would be noted, we have, in para 2.11, recommended the abolition of all entry and Octroi taxes by state governments and other sub-national Governments. Therefore, it is imperative to provide for an alternate buoyant source of revenue to the third-tier of Government.

5.79 In view of the aforesaid, we recommend the following:-

- i. The rate of CGST and SGST on all non-SIN goods should be fixed at the **single rate of 5 percent and 7 percent, respectively**;
- ii. A formula-based devolution of an amount equivalent to collection of SGST at 2 percentage points should be made to the third-tier of Government after an appropriate Constitutional Amendment;
- iii. The formula should be based on the recommendations of the State Finance Commission.

⁴⁷ Poddar, Satya and Amaresh Bagchi (Nov 2007), "Revenue-neutral rate for GST", The Economic Times, 15th November, 2007, Delhi

- iv. Pending Constitutional Amendment, the collection from 7 percent SGST shall accrue to the State Government and devolution to the third-tier Government should continue to be made on the basis of the recommendations of the State Finance Commission.
- v. Both the Central and the State Governments may continue to levy taxes, in addition to the CGST and SGST, on the various non-SIN goods as at present.

Chapter - VI

Revenue Performance of GST

6.1 As is well-known, VAT is, potentially, a broad-based tax levied on all commodity sales with a view to, ultimately, taxing the whole of final consumption. VAT is not a progressive but a proportional tax. It was never designed to meet social or redistributive objectives. In theory, the tax is, therefore, most “efficient” when imposed on all goods and services at a single standard rate. The efficiency of the VAT system can be optimized depending on the ability of tax administration to collect the tax due effectively. In this respect, a single rate and a simpler tax system is easier for tax administrations to administer and for businesses to comply. In this perspective, a VAT system is, in absolute terms, “efficient” when it covers the whole of the potential tax base (consumption by end users) at a single rate and where all the tax due is collected by the tax administration. Therefore, the ratio of the revenues actually collected and the revenues that would arise from a theoretically “pure” VAT system with a single rate applied to all final consumption and 100 per cent compliance would be a good measure to evaluate the performance of VAT. In literature, this ratio is referred to as the VAT Revenue Ratio (VRR). This ratio gives an indication of the efficiency of the VAT regime in a country compared to a standard norm.

6.2 In theory, the closer the VAT system of a country is to the “pure” VAT regime, the more its VRR is close to 1. Any other value – higher or lower – indicates deviation from a single tax rate applied on all final consumption or a failure to collect all tax due. A VRR close to 1 is taken as an indicator of a VAT bearing uniformly on a broad base with effective tax collection. On the other hand, a low VRR may indicate an erosion of the tax base at the standard rate. This can result from exemptions, reduced rates, registration thresholds for small traders, poor compliance or poor tax administration or a combination of these.

6.3 The VRR is characterised by a number of deficiencies. The estimation of the potential VAT tax base (i.e. consumption by end users or national consumption) is difficult to assess with precision. In general, the figures of national consumption used to calculate the VRR are taken from the national accounts⁴⁸, but “consumption” within the meaning of national accounts does not exactly match the potential VAT tax base. For example, several investment goods (such as new buildings) are not considered as consumption in national accounts (where they are treated as “investments” or “gross fixed capital formation”) but they are subject to VAT in many countries. A combination of this factor together with the cascading effects of exemption in the value chain may lead to a VRR above one. Therefore, for the purposes of calculation of VRR in respect of the proposed ‘flawless’ GST, we compute the potential tax base by expanding the scope of final consumption within the meaning of National Accounts to include also the Gross fixed capital formation (including transaction (“consumption”) in land) in the household sector. Accordingly, the ‘**potential tax base**’ of a GST is estimated at Rs 39,49,907 crores as indicated in Table-11. However, the ‘**actual tax base**’ under the ‘flawless’ GST is estimated at a reduced amount of Rs 31, 25,325 crores. **Accordingly, VRR of the ‘flawless’ GST is calculated to be 0.79.**

6.4 The VRR is affected by both policy decisions – over the base and the number of rates – and compliance levels. The VRR is actually the product of a “**Policy efficiency ratio**” (comparing the theoretical revenue from actual VAT law and revenue from a pure VAT system) and a “**Compliance efficiency ratio**” (comparing actual VAT revenues with theoretical revenue from actual tax law). Therefore, mathematically expressed,-

$$\text{VRR} = \frac{\text{Weighted average of statutory rates}}{\text{Standard rate}} * (1 - \text{Exemptions}) * (\text{Compliance level})$$

The product of the two terms [$\frac{\text{Weighted average of statutory rates}}{\text{Standard rate}} * (1 - \text{Exemptions})$] denotes the “**Policy efficiency ratio**” and the term *(Compliance level)* denotes the “**Compliance efficiency ratio**”.

⁴⁸ There is currently no internationally agreed method to assess a VAT theoretical base.

6.5 Our recommendation is for a single rate for both CGST and SGST and zero rate is applicable only for international exports. Therefore, the weighted average of statutory rates is equal to the single rate (standard rate) and accordingly, the ratio $\frac{\text{Weighted average of statutory rates}}{\text{Standard rate}}$ is equal to 1 (one).

Sl. No	Description	Unit	Amount
A	Private Final Consumption Expenditure	Rs in crs	2605859
B	Government Final Consumption Expenditure	Rs in crs	479099
C	Gross Fixed Capital Formation(Household Sector)	Rs in crs	435689
D	Gross Fixed Capital Formation(Land)	Rs in crs	429260
E	Potential GST Base (A+B+C+D)	Rs in crs	3949907
F	Actual Tax Base	Rs in crs	3125325
G	VAT Revenue Ratio (F divided by E)	Nos	0.79
H	Standard Rate	in percent	12.00
I	Weighted Average of Statutory rates	in percent	12.00
J	Weighted average of Statutory rates as a ratio of Standard rate	Nos	1.00
K	Amount of Exemption**	Rs in crs	206830
L	Impact of exemption [K divided by (F+K)]	Nos	0.062
M	Policy Efficiency Ratio	Nos	0.938
N	Compliance Efficiency Ratio	Nos	0.84

* The estimates should be taken as approximates.
 **The exemptions relate only to exemptions for unprocessed food articles, health services and education services. This does not include the impact of threshold exemption

6.6 Similarly, the 'flawless' GST recommended by us envisages very limited number of exemptions. These are essentially restricted to food, education and health services, the threshold exemption for registration of small dealers and public administration. As regards the

threshold exemption for registration of small dealers, it has both a positive and a negative impact on revenues. To the extent sales by unregistered dealers is exempt, there is a revenue loss. However, part of the revenue loss is recouped since purchases from unregistered dealers are not eligible for input tax credit. Similarly, a large part of the food items is distributed by small dealers and therefore there is significant overlap in the revenue effect of the threshold exemption and the food sector. The same also holds well in the health and education sector. The net impact of the exemptions under the 'flawless' GST on the tax base is estimated to be Rs 206830 crores only. This accounts for **6.2 percent** erosion in the potential tax base. Hence, the ratio ($1 - Exemptions$) is calculated to be 0.938. Consequently, the '**Policy Efficiency Ratio**' is estimated to be **0.938**.

6.7 We do not have any method of making a direct estimate of compliance. However, compliance level is the ratio of the VRR to the 'Policy Efficiency Ratio'. Therefore, the implicit **compliance level is estimated to be 0.84**.

6.8 It has been pointed out by some that given the cross-country estimates of the VRR, our estimate of VRR is extremely high. It is argued that if the VRR is aligned to the international norm, the revenue neutral rate (RNR) would be substantially higher than the 11 percent estimated by us. In this context it would be useful to point out that given the deficiencies in the VRR as a measure of the revenue performance of VAT, it is difficult to draw typical profiles for "efficient" and "inefficient" countries in the collection of VAT revenues on the basis of this VRR. Since the VRR depends upon a number of factors, there is considerable variation in the VAT Revenue Ratio across countries. Therefore, it is best to use VRR as a tool to measure a single country's performance over a number of years rather than as a tool for comparison across countries. Nevertheless, 5 countries (i.e. Korea, Japan, Switzerland, Luxemburg and New Zealand) from amongst 29 OECD countries indeed have a VRR exceeding 0.7; another 17 countries have a VRR ranging between 0.5 and 0.7 and the balance 7 countries have a VRR of less than 0.5. Therefore, our estimate of VRR (and also the RNR) cannot be considered as an

outlier. The reason underlying such high VRR is the minimization of the exemptions and the elimination of the multiple rates.

6.9 The existing VRR in the case of Central Government levy on goods and services is extremely low. The current base is estimated to be as low as 0.36⁴⁹. Further, the factor $\frac{\text{Weighted average of statutory rates}}{\text{Standard rate}}$ is also estimated to be 0.75⁵⁰. Therefore, the 'Policy efficiency ratio' is estimated to be a low of 0.27⁵¹. We have no estimate of the compliance level but we have anecdotal information that there is substantial evasion. If we assume that the compliance is 0.84, the VRR for central taxes on goods and services is estimated to be 0.23⁵².

6.10 Given this estimate of an extremely low VRR, it is not surprising that the estimate of the GST Base by both Central Government and State Governments on the basis of the existing revenues is extremely low. As is well known, the existing tax structure is riddled with a plethora of incentives and multiple rates. Therefore, the 'Policy efficiency ratio' is extremely low. Once these policy deficiencies are removed the VRR would automatically increase to a substantially higher level of 0.76. The purpose of introducing the flawless GST is precisely to achieve this policy objective. Our calculation of the VRR of the 'flawless' GST is based on the existing level of compliance and not on the basis of any increase in the compliance level. Hence, any apprehension that given the existing compliance level, the high level of VRR cannot be achieved is totally misplaced. The VRR under the 'flawless' GST can be achieved by eliminating the policy deficiencies under the existing regime for taxation of goods and services. **What is required is a strong political consensus to do so.**

⁴⁹ The value of exemptions (excluding threshold exemption) from Table-9 is estimated to be Rs 18,89,096 crores (Rs 1358344 crores plus Rs 530752 crores) and the estimated potential base is Rs 29,49,748 crores. Therefore, the share of exemptions in the potential base is estimated to be 0.64. Hence, the share of the actual base is 0.36.

⁵⁰ The standard rate is 16.48 percent and the weighted average of statutory rates is estimated to be 12.28 percent. Therefore, the ratio of weighted average of statutory rates to standard rate is 0.75.

⁵¹ This is the product of 0.36 and 0.75.

⁵² This is the product of the 'Policy Efficiency Ratio' (0.27) and the 'Compliance Efficiency Ratio' (0.84).

CHAPTER - VII

Implications of the Goods and Services Tax

7.1 The economic case for a ‘flawless’ GST is straightforward: Income is taxed irrespective of source and use; therefore, consumption should also be taxed on the same principle. This is the feasible second-best solution, compared to the unattainable first best distortion-free world of lump sum taxation. The ‘flawless’ GST is rooted in this breathtakingly simple analytical proposition. In the Indian economic policy context, poverty reduction and inclusive growth are key policy objectives and will, undoubtedly, continue for some time. What, then, are the implications of the **switchover** from the cascading and distortionary taxation of goods and services to the the ‘flawless’ GST for, amongst others, economic growth, equity and poverty?

a. GST and economic growth

7.2 High import tariffs, excises and turnover tax on domestic goods and services have enormous cascading effects, leading to a distorted structure of production, consumption and exports. The existing tax system introduces myriad distortions which favour some goods and services at the expense of others. These distortions yield inefficient resource allocation and consequently, inferior GDP growth. In India, the motivation underlying the hugely differentiated scheme of indirect taxation of production and sales that has evolved over the country’s history was progressive and noble; the actual impact of such a structure is now widely acknowledged to be regressive, capricious, and sub optimal in terms of the efficiency of tax effort, leaving the door open for lobbyists and special pleading. The problem of the present distortionary indirect tax system can be effectively addressed by shifting the tax burden from production and trade to final consumption. The ‘flawless’ GST, which subsumes all indirect taxes on goods and services, is the most elegant method of taxing consumption. Under this structure, all different stages of production and distribution can be interpreted as a mere tax pass-through, and the tax essentially ‘sticks’ on final consumption within the taxing jurisdiction.

7.3 The introduction of the GST will also bring about a macroeconomic dividend by reducing what have been called the “negative grey area dynamic effects” of cascading taxation. As a result it reduces the overall incidence of indirect taxation by removing the many distortionary features of the present indirect tax system. There are seven important macroeconomic channels through which the ‘flawless’ GST minimises the distortions. **First**, the failure to tax all goods and services distorts consumption decisions; it weakens the signalling power of relative prices. GST will reduce these distortions and enable all economic agents to respond more effectively to price signals. This will improve the allocative efficiency of the tax system. **Second**, the failure to exempt all sales to business distorts decisions regarding choice of production methods, particularly decisions on vertical and horizontal integration and what inputs to produce or sell. Since the GST will be a tax on consumption, all stages of production and distribution will be mere pass-through. Therefore, there will be no tax incentive for vertical and horizontal integration. **Third**, the taxation of capital goods discourages savings and investment and retards productivity growth. The ‘flawless’ GST envisages full and immediate credit for GST on capital goods (both buildings and plant and machinery), thereby fully eliminating the incidence of any indirect tax on the capital goods. This enhances the productivity of capital and hence reduces the incremental capital-output ratio (ICOR). This is perhaps the most important gain through the introduction of the GST in India. **Fourth**, for a given constellation of exchange rates and price levels, violation of the destination principle places local producers at a competitive disadvantage, relative to producers in other jurisdictions. The GST envisages comprehensive taxation of imports on consideration of consumption in India and irrespective of whether the imported goods and services are produced in India or not, thereby, providing a level playing field to domestic producers particularly in the import-substitution industry. **Fifth**, differences in the tax structure of different States and the Central Government greatly increase the cost of doing business⁵³. The proposed GST, though dual in nature, envisages a uniform structure, design and compliance system at all levels of Government and across States.

⁵³ This is a league table in which we have long languished at the bottom.

Therefore, the cost of doing business in India will significantly reduce. The GST based tax reform provides a real policy opportunity to deal with this problem without waiting for prior and sweeping political economy changes. **Sixth**, GST, once introduced, will create a common market across the length and breadth of the country- something which has eluded us since long. The size of the market will cease to be limited by tax considerations. Further, it will restore the comparative advantage of resource rich states and enable them to emerge as production hubs. **Seventh**, at present, the combined statutory rate of VAT is close to 22 per cent⁵⁴. Further, this marginal rate is applied to a very narrow base on account of a plethora of exemptions. Since economic decisions and compliance behaviour are based on the marginal rate, the higher the rate the greater the distortion and evasion. This is further compounded by distortion in resource allocation on account of a plethora of exemptions. Since we have recommended a substantially lower, uniform, and combined single rate of 12 percent⁵⁵ on all goods and services, the economic distortion and the incentive to evade will be considerably reduced. We can also expect an upsurge in compliance and hence, revenue collections. This in turn will improve fiscal management and reduce the 'crowding-out' effect.

7.4 The overall macroeconomic effect of reduction in economic distortions due to GST would be to provide an impetus to economic growth. Using CGE Model, the NCAER study commissioned by the Thirteenth Finance Commission estimates the impact of the introduction of a GST which would eliminate all taxes on production and distribution and rest on final consumption only. The study is based on two important assumptions of full employment and that 50 percent of indirect taxes remain embedded and 'stick' on production and distribution. The study concludes that 'implementation of a comprehensive GST in India will lead to efficient allocation of factors of production thus leading to gain in GDP and exports. This would translate into enhanced economic welfare and returns to the factors of production, i.e. land, labour and capital. The gains in real returns to land range between 0.42 and 0.82 per cent. Wage rate gains

⁵⁴ Prior to the tax cut in December 2008 as part of the economic stimulus, the combined rate was 28 per cent approximately.

⁵⁵ However, there will be a special rate of 1 percent on high value items like gold and platinum and zero rate on exports.

vary between 0.68 and 1.33 per cent. The real returns to capital would gain in the range of 0.37 and 0.74 percent.’.

7.5 Further, the study also shows that ‘implementation of GST across goods and services is expected, *ceteris paribus*, to provide gains to India’s GDP somewhere within a range of 0.9 to 1.7 per cent. The corresponding change in absolute values of GDP over 2008-09 is expected to be between Rs. 42,789 crore and Rs. 83,899 crore, respectively.

7.6 These additional gains in GDP, originating from the GST reform, would be earned during all years in future over and above the growth in GDP which would have been achieved otherwise. The present value of the GST-reform induced gains in GDP may be computed as the present value of additional income stream based on some discount rate. We assume a discount rate as the long-term real rate of interest at about 3 per cent. The present value of total gain in GDP has been computed as between Rs. 1,469 thousand crores and 2,881 thousand crores. The corresponding dollar values are \$325 billion and \$637 billion or as much as one-third to one-half of the country’s GDP for the year 2009-10.

7.7 The manufacturing sectors would benefit from economies of scale. Output of sectors including textiles and readymade garments; minerals other than coal, petroleum, gas and iron ore; organic heavy chemicals; industrial machinery for food and textiles; beverages; and miscellaneous manufacturing is expected to increase. The sectors in which output is expected to decline include natural gas and crude petroleum; iron ore; coal tar products; and nonferrous metal industries.”. The results of the NCAER Study are also suggested of the GSTs positive environmental impact on the economy.

7.8 Further, the changeover to GST will be neutral to vertical and horizontal integration. This will therefore, encourage industries to be located in states which enjoy a comparative advantage. This has far reaching implication for resource rich backward states; it will serve as an attraction to natural resources based industries to locate in these states regardless of the

fact that the consumer is located elsewhere. Another dynamic implication of the GST would be to generate greater employment as GST helps to increase labour intensive sectors.

b. GST and International Trade

7.9 There are also benefits to foreign trade that can be reasonably expected. At present export of taxes to other countries is sought to be eliminated through the mechanism of duty draw back on the basis of estimated incidence of embedded taxes. This scheme is far from satisfactory.

7.10 Destination based taxation is a fundamental principle of a sound GST. It requires that exports from the taxing jurisdiction would be tax free by zero rating and imports into the jurisdiction would be taxed at the same rate as products produced and consumed within the jurisdiction. The 'flawless' GST embodies this principle. Consequently, both export-oriented industries and import-substituting industries would become internationally more competitive. As a result, while exports can be expected to register an increase, imports are likely to decrease. These outcomes are supported by the NCAER study.

7.11 Gains in exports are expected to vary between 3.2 and 6.3 per cent with corresponding absolute value range as Rs. 24,669 crore and Rs. 48,661 crore. Imports are expected to gain somewhere between 2.4 and 4.7 per cent with corresponding absolute values ranging between Rs. 31,173 crore and Rs. 61,501 crore.

7.12 The sectors with relatively high proportional increase in exports include textiles and readymade garments; beverages; industrial machinery for food and textiles; transport equipment other than railway equipment; electrical and electronic machinery; and chemical products: organic and inorganic. The moderate gainers are agricultural machinery; metal products; other machinery; and railway transport equipment. Exports are expected to decline in agricultural sectors; iron and steel; wood and wood products except furniture; and cement. There are minor gains and losses in exports of other sectors.

7.13 The major import gaining sectors include leather and leather products; furniture and fixtures; agricultural sectors; coal and lignite; agricultural machinery; industrial machinery; other machinery; iron and steel; railway transport equipment; printing and publishing; and tobacco products. The moderate gainers include metal products; non-ferrous metals; and transport equipment other than railways. Imports are expected to decline in textiles and readymade garments; minerals other than coal, crude petroleum, gas and iron ore; and beverages.

7.14 In general, our imports are sourced from countries which effectively zero rate their exports. Further, India has also entered into a large number of free trade agreements under which it will, in general, not be possible for India to use customs duty as a means to providing protection/level playing field. Therefore, it is necessary to ensure that the imports into the country are subject to the same level of taxation as domestically produced goods. The 'flawless' GST will ensure this by subjecting the imports to both CGST and SGST. This will provide a level playing field to the domestic industry and, in particular, the manufacturing sector vis-a-vis imports.

c. GST: Equity and Poverty reduction

7.15 Poverty reduction will continue to remain the central objective of economic policy making in India. Any policy for poverty reduction must enable the provision of, at least, food, clothing, shelter, education and health.

7.16 At present, primary food articles like rice and wheat are liable to tax by many states either by way of purchase tax or sales tax at a lower rate. As a result, the incidence of tax on primary food articles comprises of two elements: tax on inputs and tax on the output (primary food articles). However, under the 'flawless' GST, all food items covered under the public distribution system are proposed to be exempt from GST. As a result primary food articles like rice and wheat would be exempt from GST (i.e. there will be no output tax). Hence, the tax incidence on such items of mass consumption will be limited to tax on inputs. Since expenditure

on food constitutes a large proportion of the total consumption expenditure of the poor, the GST is designed as a pro-poor policy initiative. In any case, the poor will continue to have accessibility to these items at subsidised prices through the public distribution system. Therefore, the poor will not suffer any additional burden on their consumption of food items due to the implementation of GST.

7.17 Like food, basic health and education services are also intended to be fully exempt. As a result consumption of these services will bear a relatively lower burden. Since these services are necessary to meet the basic human needs, the tax exemption for these services will enable the poor to have cheaper accessibility. In any case, as at present, these services will continue to be exempt from tax and therefore no additional burden will arise on account of the switchover to GST.

7.18 Housing is yet another important item of basic needs of the poor. The GST provides for including within its scope the transactions in real estate. Therefore, for a registered real estate builder, all taxes on inputs (including on land) will be off-set against the tax payable on the constructed property.⁵⁶ This will effectively reduce cost of housing to the extent of embedded taxes and hence, benefit the poor.

7.19 Another necessary item of consumption by the poor is clothing. The NCAER study shows that the implementation of the GST will result in a sharp decline in the prices of cotton textiles (by 6.44 percent), wool, silk & synthetic fibre textiles (by 11.4 percent), and textile products including wearing apparel (by 17.45 percent). To the extent, the share of expenditure on clothing in the total expenditure on consumption is relatively higher than in the case of the rich, the poor will gain relatively more from large drop in prices.

7.20 The rural poor comprise essentially of small and marginal farmers and landless labourers. Similarly, the urban poor comprises of the unemployed. The implementation of GST

⁵⁶ At present, the value of a constructed property includes stamp duty on land and other indirect taxes on inputs. Hence, these taxes form part of the cost of the property. On registration of the constructed property, stamp duty is payable on the entire cost including the embedded taxes. There is no mechanism for complete off-set of these taxes. This results in an increase in the overall cost of the property

will witness an increase in the real returns to land, labour and capital (as shown in the NCAER study). Therefore, the rural poor will also enjoy an increase in their income. Similarly, on account of increase in economic activity resulting in higher growth, there will be new opportunities for employment which will directly benefit the urban poor.

7.21 Further, in terms of the theory of optimal taxation, tax rates should *not* be uniform. They should, rather vary inversely with the elasticity of demand for particular goods and services, and tax rates should be higher on products that are complementary with leisure that cannot be taxed directly. (as opposed to work which generates income that can be taxed). This holds well in a world where it is possible to implement optimal tax reforms without any residual distortions caused by successful attempts at incidence shifting. However, in practice, shifting of tax incidence is well documented. Further, the representative consumer assumption that operates an optimal tax model is not just invalid, but actively dangerous in a policy context where poverty reduction and inclusive growth are key policy objectives. For instance, if, as intuition would lead us to expect, the demand for the basket of goods consumed by the poor is less elastic than that consumed by the rich, then the regressive policy implications of implementing optimal tax reform would be horrific i.e impose a higher tax on goods of consumption by the poor. Hence, the principle remains valid that all consumption should be taxed uniformly without regard to source and use. Even in this context, the GST reform is potentially far pro poor than theoretically elegant competing alternatives.

7.22 The benefit to the poor from the implementation of GST will therefore, flow from two sources: first through increase in the income levels and second through reduction in prices of goods consumed by them. The proposed switchover to the 'flawless' GST should, therefore, be viewed as pro-poor and not regressive. Hence, the switchover will improve the vertical equity of the indirect tax system.

7.23 The switchover to GST also entails the taxation of all goods and services in the formal sector. To the extent purchases are made from the informal sector by producers in the formal sector, no input tax credit would be available. Consequently, the value addition in the informal

sector on such inputs would be recaptured when used in the formal sector. Similarly, to the extent purchases are made from the formal sector by the informal sector, they will be GST borne and since no output tax will be payable in the informal sector, the tax will stick on the producer. Therefore, comprehensive consumption type destination based GST will also result in a higher tax burden on the informal economy than the present level. Hence, the switch over to the 'flawless' GST will also improve horizontal equity.

d. GST and Prices

7.24 Prices of agricultural commodities and services are expected to rise. Most of the manufactured goods would be available at relatively low prices especially textiles and readymade garments.

7.25 There are two opposing forces which determine the changes in price levels. First, increased payments to the primary factors of production, viz. land, labour and capital, increase the cost of production and hence tend to have upward pull on prices. Second, sectors under imperfect competition (manufacturing sectors) get benefits of cost reduction through increasing returns to scale which are not reaped by sectors assumed to be in perfect competition. The relative impact of the force determines the overall price change. It may also be noted that the share of primary inputs (land, labour and capital) in total output is relatively high in agricultural and services sectors.

7.26 Another factor that impacts the price levels refers to the quantum of intermediate input purchases from sectors under perfect competition versus imperfect competition. Relatively low proportions of intermediate inputs purchased by agriculture and service sectors (i.e. sectors under perfect competition) are sourced from manufacturing sectors and hence these sectors do not reap the benefit of relatively low cost inputs from manufacturing sectors.

7.27 Further, the terms of trade can also be expected to improve in favour of agriculture vis-a-vis manufactured goods. The prices of agricultural goods would increase between 0.61 and 1.18 percent whereas the overall prices of all manufacturing sector would decline between 1.22

and 2.53 percent. Consequently, the terms of trade will move in favour of agriculture between 1.9 to 3.8 percent.

7.28 The increase in agricultural prices would benefit millions of farmers in India. Similarly, the urban poor will also benefit from new employment opportunities. With regard to the food crops the poor would continue to remain secured through the public distribution system. The prices of many other consumer goods are expected to decline. These include sugar; beverages; cotton textiles; wool, silk and synthetic fibre textiles; and textile products and wearing apparel.

e. GST and informal sector

7.29 Another challenge to the consensus on GST based indirect tax reform in developing countries like India has been the argument that given the existence of an informal sector, a comprehensive GST can be welfare reducing, when revenue neutral. The argument rests on the premise that when the choice of a commodity set for VAT increase is restricted by the existence of a large informal sector, then there are negative welfare effects in transition to a revenue neutral VAT. If this holds true then there are serious policy implications if such negative welfare incidence impacts the consumption basket of the poor. However this argument rests on the foundation that the relative size of the formal and informal economies is exogenous to the tax structure in place. In India, the implementation of VAT is in fact expected to reduce the size of the informal economy relative to the formal economy by moving producers who choose to remain in the informal sector for *tax avoidance* reasons, incentivized by the size biased nature of indirect tax exemptions in the historic regime of taxation of domestic goods and services. When this is taken into account the welfare effects of GST can, in fact, be expected to be positive.

7.30 This highlights the fact that a GST based reform of the present indirect tax system can be expected to have significant positive welfare effects even while maintaining revenue neutrality.

f. GST and Fiscal management

7.31 The changeover to GST is designed to be revenue neutral at existing levels of compliance. Given the design of the 'flawless' GST, the producers and distributors will only pass through for the GST. Further, given the single and low rate of tax the benefit from evasion will significantly reduce. Therefore, there will be little incentive for the producers and distributors to evade their turnover. Accordingly, this policy initiative should witness a higher compliance and an upsurge in revenue collections. This will also have an indirect positive impact on direct tax collections. Further, given the fact that GST will trigger an increase in the GDP, this in turn would yield higher revenues even at existing levels of compliance. Another important source of gain for the Government would be the savings on account of reduction in the price levels of a large number of goods and services consumed by the Government.

7.32 However, to the extent, the Central Government will be required to incentivise the states to adopt the GST, there will be an increase in the budgetary outgo. Given the smallness of the size of the compensation, it is expected that there would be a net gain in the tax revenues. This should enable the Central Government to better manage its finances.

7.33 As regards the State Governments, the design and the road map of the GST recommended by us would lead to substantial gain in revenues. While the revenue neutral rate for the States is estimated to be 6 percent, we have recommended that the states should be allowed to impose GST at the rate of 7 percent. An increase in the RNR of the States by 1 percent implies a revenue gain of Rs. 31381 crores per annum in the base year 2007-08 (i.e. 16.67 percent increase in the revenues from the 'TF- taxes'). If the States decide to phase out the stamp duty over a period of three years, the revenues from stamp duty will be additionality for the States. Therefore, in the first year of implementation of GST and phasing out of the Stamp duty, the States should expect additional revenues to the extent of Rs 70,000 crores (excluding the incentive amount). However, in the subsequent years this gain would diminish on account of the phasing out of stamp duty but will be more than adequately compensated as compliance starts improving.

7.34 Therefore, overall the implementation of GST should enable the Government at both levels to better meet the challenges of fiscal correction.

g. GST and vertical balance of power

7.35 The GST envisages a mechanism whereby both the Centre and the States will cease to have any independent power to make changes in the design and structure once agreed upon. Since both levels of Government would be similarly placed, this has no impact on the balance of power.

7.36 Under the proposed GST, both the Centre and the States will have concurrent power to tax all goods and services. Therefore, the taxing powers of the states would now also extend to services which comprises 54 percent of the GDP and also constitutes the fastest growing sector in the economy. Similarly, the taxing powers of the Centre will also extend to the retail stage and to this extent there will be an expansion in its taxing powers. This increase will be limited to about 12 percent of the GDP (assuming a retail margin of 25 percent on manufacturing value). In addition, the Centre will also acquire the power to tax land /real estate transaction which would account for an estimated 10 percent of GDP. Since the expansion in the power of the States is significantly larger than the Centre, the proposed GST will alter the balance of power in favour of the states thereby reducing the vertical imbalance.

7.37 To conclude, the implications of a switch over to the 'flawless' GST recommended by us are indeed far-reaching. Every stakeholder stands to gain. This has the potential to transform not only the tax system in the country but also the way we organise and do business.

CHAPTER - VIII

“Flawless” Goods and Services Tax and the autonomy of States

8.1 The design of the GST based on a common base and a uniform rate across states without the power to make any unilateral changes, is viewed by some states as undermining the fiscal autonomy of the States. Therefore, it is argued that the states should agree to a floor rate of tax and should have the flexibility to increase their rates to meet any revenue crisis.

8.2 Full autonomy in the exercise of taxation powers would mean that the Centre or the States, as the case may be,-

- a. Retain the power to enact the tax;
- b. Enjoy the risks and rewards of ‘ownership’ of the tax (i.e. not be insulated from fluctuations in revenue collections),
- c. Be accountable to their constituents; and
- d. Be able to use the tax as an instrument of social or economic policy.⁵⁷

8.3 Tax autonomy to any level of Government is necessary to enable it to design the base and set the tax rates according to its revenue needs. However, it is equally important to ensure that the exercise of these powers do not result in inter-jurisdictional differences in policies and procedures so as to generate additional economic distortions, create negative externalities, or impose higher compliance and enforcement burden.

8.4 In general, the States would like to have some degree of control to design the base and set the rates as an instrument to promote various social and economic policy objectives. However, cross-country experience shows that there is complete disillusionment with the use of the tax system as a tool to promote various social and economic objectives by allowing exemptions and incentives. Therefore, tax reforms undertaken across countries since the mid-1980 have focussed on re-designing the tax system so as to restrict its role to revenue collection. There is almost unanimity amongst fiscal experts on assigning a limited role of revenue collection to the tax system and using the direct transfer mechanism for achieving the

⁵⁷ See Poddar, Satya and Ehtisham Ahmad (2009)

various social and economic objectives. Given this new strand of economic thinking, the ability to use the tax system as a tool for achieving various social and economic objectives should cease to be a measure of tax autonomy.

8.5 In the past under the sales tax regime in the states, the flexibility to use the tax system as a tool for achieving various social and economic objectives has generated economic distortions and also triggered a race to the bottom. Further, if the States are allowed the autonomy to increase the rates by setting the SGST rates as the floor rates, they would have a tendency to opt for this lazy option rather than improve their enforcement mechanism. Such increase in rates would mean a greater incentive to evade which, in turn, would make industries in competing states uncompetitive. It would also trigger tax-induced migration. Consequently, the decision to increase the rate would generate negative externalities which must necessarily be curbed.

8.6 Hence, it is only appropriate that in a federal structure with overlapping powers to tax goods and services, Governments across levels cease to enjoy the autonomy to design the base, set the rates and the flexibility to use the tax system as a tool for achieving various social and economic objectives. In the context of the federal structure of India, what is relevant is overall fiscal autonomy rather than tax autonomy per se. Since States would continue to have the full freedom to promote various social and economic objectives through direct transfers, effectively, there would be no loss of fiscal autonomy of the States.

8.7 The design of the 'flawless' GST, as recommended by us in the preceding Chapters, is essentially an attempt at **absolute harmonization** of the tax base, tax rates and tax infrastructure(i.e. the administration and compliance system) across Centre and all States. As discussed above, harmonization of the tax base and the tax rates will eliminate the distortionary impact on economic efficiency and equity arising from inter-jurisdictional differences. Further, such harmonization will enable consequent harmonization of the tax laws and the administration and compliance systems.

8.8 Harmonization of tax laws is critical. Variation in the wording and structure of tax provisions can be an unnecessary source of confusion and complexity, which can be avoided if the Centre and all the States adopt a common GST law as in the case of the Central Sales Tax or agree to separately legislate an identical GST law. In either situation, there would be harmonization in respect of critical elements like common time and place of supply rules, common rules for recovery of input tax, valuation of supplies, invoicing requirements, tax interpretations and rulings regarding classification of goods and services, determination of what constitutes taxable consideration and definition of export and import.

8.9 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 exchange of information between different levels of Government so as to enable effective monitoring of cross-border transactions. A common tax identifier number across states and the Central government is a key element in the efficient exchange of information.

8.10 Harmonization of the GST tax base, tax rate and administrative and compliance systems should be viewed as an imperative for optimizing the efficiency and productivity of GST across jurisdictions in a federal structure. All jurisdictions will be worse off without harmonization. Therefore, it should not be perceived as eroding the fiscal autonomy of the Centre or the States.

8.11 If harmonization across Centre and all states is envisaged, what should be the institutional mechanism to usher and maintain such harmonization? At present, the responsibility for designing the initial structure of the GST has essentially been left to the

Empowered Committee of State Finance Ministers and official level representatives of the Central Government. This body is now internationally recognised as an important institutional arrangement which has rendered yeoman service in substantially furthering the cause of indirect tax reform in the country. However, there is also a need to maintain stability and integrity in the structure of the GST to ensure that no distortions creep into the indirect tax system. Therefore, the existing mechanism for arriving at a collective decision on the structure of the GST should be permanently institutionalised so that changes in the initial design of the GST are collectively agreed and implemented by both the Centre and the States.

8.12 In view of the above, we recommend that the Empowered Committee of State Finance Ministers may, upon the introduction of the GST, be transformed into a permanent constitutional body known as the **Council of Finance Ministers**. This Council shall comprise of the Union Finance Minister and all State Finance Ministers. The Union Finance Minister would be the Chairman of this Council.

8.13 The Council should be responsible for any modification in the initial design of the dual GST and regulating the indirect tax system in the country. The initial design of the dual GST should be approved by the Chairman and three-fourth of the State Finance Ministers. Thereafter, any change in the structure of the GST (both base and the rates) should be allowed to be carried out only if the Chairman **and** two-thirds of the State Finance Ministers agree to do so. Consequently, neither the Centre nor any State will have the authority to unilaterally make any change in the agreed design of the GST. However, in the event of a crisis, the Member State or the Centre may take immediate steps to impose a surcharge subject to ex-post facto approval by the Council within one month. Further, such surcharge should not be allowed to remain in force beyond a period of one year.

8.14 This Council should, in due course, have a permanent secretariat of its own in New Delhi.

8.15 The proposed mechanism will also ensure that all changes are thoroughly analysed and debated before being implemented. More importantly, since both the Centre and the States

would surrender their individual autonomy to change the structure of the GST to the proposed constitutional body, the existing balance of federal fiscal powers will continue to be maintained.

8.16 Further, with a view to compensating for the **perceived** erosion in the tax autonomy of the States, we also recommend that there should be an increase in the formula-based devolution to the states.

CHAPTER - IX

Incentivising States to adopt GST

9.1 The movement from sales tax to VAT at the state level entailed the adoption of uniform RNR rate by all states. The RNR rate is the weighted average of rates across states. Since there was no significant expansion in the base, it implied that states with average weighted rate higher than the RNR would lose revenue while those below it would gain revenue. Hence, the States demanded compensation for adopting VAT. The States have now also demanded compensation for any loss which might be incurred as a result of the shift from the existing indirect tax system at the state level to the GST level.

9.2 States have expressed concern that the RNR for State GST may be revenue neutral at the aggregate level but not necessarily for all individual States. It has, therefore, been suggested that if the States were to be denied the flexibility of upward adjustment to the tax rates, they should be compensated for the revenue loss estimated on a transparent basis.

9.3 The RNR calculated by us in the preceding paragraph is estimated to be 6 percent if all the taxes listed in paragraph are subsumed. Our calculations of revenue estimates, based on estimated C-efficiencies of the existing state level indirect tax structure and of the proposed State GST, for each state indicates that there would be no revenue loss for any state on account of the switch over to GST at the estimated RNR rate of 6 percent and existing level of compliance. This is primarily due to the fact that the change entails significant increase in the tax base for the States. In fact, we estimate that there would be significant revenue gain at 7 percent RNR as recommended by us.⁵⁸

9.4 The Group recognises that the adoption of the GST would create significant positive externalities to impact GDP and various other macroeconomic variables. This would result in reduced cost of economic management to the Central Government. Hence it is logical that the Central Government shares with the States such positive externalities.

⁵⁸ Our detail calculations can be made available on request.

9.5 Some States have expressed their lack of confidence in the existing compensation arrangement for revenue loss to the States. It has been suggested that the compensation mechanism, to be credible, must be administered by a body independent of the Finance Ministry in which the State Governments have a say in governance. The suggestion merits consideration.

9.6 Therefore, we recommend the following:-

- i) A GST Compensation Fund should be created under the administrative control of the **Council of Finance Ministers**.
- ii) The Central Government shall transfer to the GST Compensation Fund a minimum sum of Rs 6000 crores per annum over the next five years (i.e. a total amount of Rs 30,000 crores) if, and only if, the States-
 - a. introduce the 'flawless' GST as recommended by us; and
 - b. follow the road map, as suggested by us, for its introduction;
- iii) The amounts in the Fund should be used only for the following purposes:-
 - a. To compensate the states for any revenue loss on account of the adoption of the 'flawless' GST;
 - b. The balance, if any in the Fund, to be carried forward to the subsequent year;
 - c. The balance, if any remaining at the end of the fifth year, to be distributed amongst the states on the basis of the same formula used for distributing resources in the divisible pool.
- iv) The amount will be transferred in quarterly instalments.
- v) The amounts shall be disbursed by the Council on the basis of the recommendations by a three member Compensation Committee comprising of the Secretary, Department of Revenue, Government of India, Secretary to the Council and any fiscal expert appointed by the Central Government for this purpose.
- vi) No contribution to the Fund shall be made by the Central Government in any year in which the States fail to adhere to the roadmap for implementation of the GST.

vii) The methodology to be used for estimating the revenue loss and the compensation shall be decided by the Council.

9.7 These recommendations will serve as an incentive for the states to adopt the flawless GST and also ensure that the payment for compensation, if any, is legitimate and transparent.

9.8 One of the lessons drawn from the implementation of VAT at the State-level is the frequent tendency by the States to deviate from the collectively agreed position relating to the base and the rates. This creates significant tax induced distortions in economic behaviour across states. Further, as stated earlier, it also creates negative externalities. Therefore, it is imperative to establish a mechanism whereby the defaulting state is made liable to pay for the negative externalities. Accordingly, we recommend the following:

- i. Any state which deviates from the GST base or rates, collectively agreed upon, without the authority of the Council, should be liable to such penalty for the year, as may be recommended by the Thirteenth Finance Commission.
- ii. If the deviation is for a period less than a year, the state will be liable for a proportionate amount of penalty attributable to the period of deviation. Similarly, if the deviation is for a period more than a year, the state will be liable for the completed years and the proportionate amount relating to the remainder period.
- iii. The amounts collected in penalty shall be deposited in the GST Compensation Fund for formula based devolution to the States.

9.9 This mechanism will provide symmetric treatment of positive and negative externalities whereby creation of positive externalities will be rewarded and negative externalities will be penalised.

CHAPTER - X

Goods and Services Tax - The way forward

10.1 The introduction of the Value Added Tax at the state level was discussed over a prolonged period of more than a decade before implementation. Given the fact that the reform of the indirect tax system is critical to any effort to increase efficiency and economic growth, such prolonged period of discussion on issues in respect of which there is adequate well documented international experience is costly and should, therefore, be avoided. In spite of such prolonged period of discussion, the state VAT regime in the last four years has witnessed many States deviating from the classification and the rates agreed upon in the White Paper of the Empowered Committee, released in January, 2005.

10.2 Similarly, the discussions on the introduction of a comprehensive dual GST, both at the Centre and State level, have been in progress since early 2006. It is unfortunate that no agreement on the GST has yet been reached even though the target date for its introduction i.e., 1st April, 2010, is less than six months.

10.3 The Central Government has entered into a number of free trade agreements. As these agreements are operationalized, it is necessary to optimise the efficiency and competitiveness of Indian industry. There is no headroom for pursuing distortionary policies. To the extent, the distortions are induced by the indirect tax system, there is an urgent need to reform the same by adopting a flawless Goods and Services Tax along the lines recommended in this Report. The adoption of a flawless Goods and Services Tax is critical to the survival of the Indian industry in the face of increasing international competition consequent to a number of free trade agreements entered into by India.

10.4 Hitherto, the approach of the Central Government has been to act as a catalyst in the process of the design of the GST. This responsibility has essentially been left to the Empowered Committee of State Finance Ministers and official level representatives of the Central

Government. Since the design of the GST will also impact the indirect tax system of the Central Government, it is necessary for the Central Government to play a more proactive role in this effort. Towards this, the leadership of the Union Finance Minister would be vital. This will provide the necessary impetus to the process of 'grand bargaining' for the GST.

10.5 While the Council is engaged in the process of designing the GST, the Council should approve the draft of the amendment to the Constitution to the effect that the Centre and the States shall exercise concurrent jurisdiction to subject all goods and services (other than SIN-goods) to a consumption type value added tax based on destination principle where exports will be zero rated and all imports will be subject to the levy like any other goods and services domestically produced and consumed. Further, it should also provide that the base for the levy should be common for both the Centre and the States and there would be a legislated agreement amongst the States and the Centre to (a) adopt uniform classification, (b) adopt uniform rates, (c) not modify the classification or the rates except with the agreement of all the States and the Centre and (d) provide for other essential common features like zero-rating of (or credit by importing State for) inter-State sale of goods. This could be on the lines of the GST legislation in Australia, under which all the States and the Commonwealth (the Centre) have to agree before any change in the rate or the base of GST can be implemented.

10.6 The implementation of the GST is scheduled for 1st April, 2010. However, given the fact that the discussion paper on GST has not yet been released for public debate, it is unlikely that the Centre and the States would be able to complete all legislative and administrative processes before the 1st April, 2010. Therefore, it would be appropriate for the Council to postpone the implementation by six months to 1st October, 2010. However, the Council should release a timeline of various activities for introduction of GST simultaneously with the announcement for postponement. This will enable all stakeholders to monitor the progress and ensure that the new implementation date is not missed out. The new timeline starting 1st January, 2010 is contained in Annexures.

10.7 The SGST is being designed by the Empowered Committee to subsume the ‘EC-taxes’⁵⁹ only. One of the main elements of the ‘flawless’ GST recommended by us is that all taxes on goods and services, levied by the Centre or the States, should be subsumed in the GST. Therefore, we have recommended that the following other taxes levied by the States on goods and services should also be subsumed:

- a. Stamp duty;
- b. Taxes on Vehicles;
- c. Taxes on Goods and Passengers; and
- d. Taxes and duties on electricity.

10.8 There is also a view amongst States that while they agree that these taxes should eventually be subsumed, they would like to gradually move in that direction rather than adopt a ‘big bang’ approach.

10.9 The introduction of the GST should be viewed as the last mile in the reform of the indirect tax system of this country initiated in 1986 with the introduction of the MODVAT. The present system of taxes on goods and services is an outcome of a gradual approach to tax reform over the last 23 years. Consequent to this approach, the country has undoubtedly lost out on potentially higher economic growth, higher real wage rates, fiscal consolidation and consumer welfare. All stakeholders other than the oligarchs, both within and outside the system, stand to gain from a swift comprehensive changeover to the GST. The multitude of the poor will gain from this reform measure more than any other stakeholder. To the extent the switchover is staggered, the potential gains from the comprehensive GST would remain unrealised thereby adversely impacting the poor. We therefore, recommend that all taxes on goods and services, whether levied by the Centre or the States, should be subsumed in the GST in the very first year of its introduction.

10.10 However, if for some political economy reasons it is considered expedient to introduce the GST in a phased way, we recommend the phasing in the following manner:-

⁵⁹ See para 2.11

- a) In the year 2010-11, all elements of the Flawless GST recommended by us whereby
- i. the single CGST rate should be 5 percent and the corresponding SGST rate should be 7 percent; and
 - ii. Transactions in immovable property (i.e real estate and housing services) should be brought within the fold of GST; and
 - iii. Stamp duty **may** not be subsumed but the rate of stamp duty in all states should be calibrated so as not to exceed 4 percent. As a result, transactions in real estate will be subject to a dual levy like in the case of SIN-goods;
- b) In the year 2011-12, same as (a) above, with the modification that the rate of stamp duty should be reduced to 2 percent; and
- c) In the year 2012-13, same as (a) above, with the modification that-
- i. Stamp duty should be eliminated and replaced by a Registration Fee at a specific rate;
 - ii. the revenues attributable to 2 percentage point out of the 7 percentage point of SGST should be set apart for devolution to the third-tier of Government and the revenues from the balance 5 percentage points will remain with the State Government so that the third-tier of Government have a interest in the efficient functioning of the GST and do not have to impose any cascading taxes like cess, entry tax or Octroi.⁶⁰

10.11 Further, we also recommend that the phased program for introduction of the GST as outlined above should be incorporated in the GST legislation so that there is no uncertainty on the evolution of the GST which will enable trade and industry to appropriately structure their business.

⁶⁰ We are aware that this aspect will also require to be included in the proposed amendment to the Constitution for introduction of GST.

10.12 We do not envisage any loss of revenue at the rates of CGST and SGST recommended by us. However, the rates being sufficiently low, we expect more than normal growth in revenues through better compliance and ease of administration. These low rates will also provide sufficient fiscal space to the Government to meet any contingency which may arise in the future by raising the rates as was done in Japan, Singapore and New Zealand⁶¹.

10.13 The Central Government and State Governments must come together in national interest to build a consensus on the GST and adhere to the new deadline of 1st October, 2010 for rolling out GST. Given the strategic importance of this game-changing reforms, the country can little afford any delay.

⁶¹ Japan increased the VAT rate from 3percent to 5 percent, Singapore from 3 percent to 7 percent and New Zealand from 10 percent to 12.5 percent.

Chapter-XI

Conclusion

11.1 The taxation of goods and services in India has, hitherto, been characterised as a cascading and distortionary tax on production resulting in mis-allocation of resources and lower productivity and economic growth. It also inhibits voluntary compliance. It is well recognised that this problem can be effectively addressed by shifting the tax burden from production and trade to final consumption. A well designed destination-based value added tax on all goods and services is the most elegant method of eliminating distortions and taxing consumption. Under this structure, all different stages of production and distribution can be interpreted as a mere tax pass-through, and the tax essentially ‘sticks’ on final consumption within the taxing jurisdiction.

11.2 The efficiency of the VAT enhances with increase in the purity of the GST Model. The most important **ten** elements of a pure GST are the following:-

- a. The base should extend to **all goods and services** including immovable property;
- b. There should be a **single low rate**;
- c. The tax should be **destination based**;
- d. The tax should be designed on **invoice-credit method**;
- e. **Full and immediate input tax credit** in respect of **capital goods**;
- f. The GST must **replace all transaction based taxes** on goods and services and factors of production.
- g. There should be **seamless flow of the tax** through all stages of production and distribution so as to stick on “final” consumption;
- h. The **exports** should be **zero rated** and **imports** should be **fully taxed**;
- i. There should be a **threshold exemption** for small dealers;
- j. **Full computerisation** of the compliance and administrative systems.

11.3 In the light of the above, we have recommended a ‘flawless’ GST in the context of the federal structure which would optimise efficiency, equity and effectiveness. The ‘flawless’ GST is designed as a consumption type destination VAT based on invoice-credit method. It provides for a comprehensive base including financial services and immovable property. To the extent there are exemptions, albeit limited to items covered for distribution through the public distribution system, and health and education services, the purity of the GST is diluted. A threshold exemption of Rs. 10 lakh has also been provided for small businesses. Imports into the country are proposed to be taxed in the same manner as domestically produced goods. Like intermediate inputs, full and immediate credit for tax paid on capital goods will also be provided. Further, it also provides for a single rate of tax of 12 percent for all general goods and services across all states, comprising of 5 percent by the Centre and 7 percent by the States⁶². However, products of high value like gold and platinum will be subject to tax at the rate of 1 percent each by the Centre and the States and exports will be zero rated.

11.4 There is empirical evidence to suggest that the switchover from the present distortionary taxation of goods and services to a ‘flawless’ GST will, amongst others, increase productivity of all factors of production and hence enhance GDP. The switchover has also been analysed to be pro-poor and therefore, further the cause of poverty reduction. Further in the Indian context, a dual VAT type tax concurrently levied by both the Centre and the States would enable the creation of a common market.

11.5 Given the benefits of the changeover to the flawless GST, it would be economically rational for all levels of Government to introduce and successfully implement the flawless GST and for the Central Government to invest in incentivising the State Government to adopt the flawless GST. We have, therefore, recommended that the Central Government should provide a sum of Rs 30,000 crores over the next five years which will be used to compensate the States

⁶² However, products of high value like gold and platinum will be subject to tax at the rate of 1 percent each by the Centre and the States and exports will be zero rated.

for revenue loss, if any, and the balance for distribution between the States on the basis of the same formula applicable for tax devolution to the States.

11.6 The implications for fiscal management are far-reaching. It will significantly improve fiscal management through higher tax buoyancy. While the RNR for State level ‘TF- taxes’ (including Stamp duty) is only 6 percent, we have allowed them a higher rate of 7 percent along with the flexibility to phase out the stamp duty over a period of next three years. This has the potential to increase the combined tax revenues of States by an estimated amount of Rs 70,000 crores. In addition, we have also recommended that the States should be provided with an additional Rs 30,000 crores as incentive to adopt a ‘flawless’ GST. Therefore, the switch over to the flawless GST will augment the combined resource base of the States by an aggregate sum of Rs 100,000 crores⁶³.

11.7 We recognise that the levy will be imposed and enforced by a large number of Governments. Therefore, there would be constant pressure on States to deviate from the pure VAT model and trigger harmful tax competition. This would jeopardise the sustainability of the benefits from the implementation of the ‘flawless’ GST. Therefore, it is also necessary to establish an institutional mechanism which would be responsible for making any change in the design and structure of the VAT. Our recommendation to establish a Council of Finance Ministers is intended to subsume the independent powers of the both the Central and State Governments to levy tax on goods and services in favour of collective exercise of the powers. Therefore, there is no exacerbation in the vertical imbalance in the fiscal powers.

11.8 The First Discussion Paper released by the Empowered Committee of Finance Ministers on 10th November, 2009 envisages an extremely diluted form of GST under which, inter alia, (i) a number of cascading taxes including purchase tax will continue to be levied by the States; and (ii) the base is considerably eroded on account of the proposed continuation of the exemptions. We are also given to understand that the Empowered Committee is considering a two rate structure for general goods and services (other than high value goods). The design of the GST as

⁶³ This is equivalent to 2 percent of GDP.

envisaged by the Empowered Committee is, therefore, a significant dilution of the ‘flawless’ GST. Consequently, the potential economic benefits from a switch over to the flawless GST, which we have discussed in the foregoing chapter, would not be realised.

11.9 We have recommended that the implementation of the GST should be postponed to 1st October, 2010. We believe that it should be possible to adhere to this timeline. The benefits from the switch over to the GST are contingent upon the purity of the GST design. In the context of VAT, international experience shows that any design-related ‘VAT mistakes are very hard to rectify’. Therefore, it must be ensured that there are no design related mistakes at birth. However, if there is a trade-off between the timeline and the design of the GST, the dilemma must be resolved in favour of design.

11.10 Further, in order to implement the ‘flawless’ GST it would be necessary to undertake constitutional amendments to enable both the Centre and the States to exercise concurrent jurisdiction over the taxation of all goods and services, creation of the proposed Council of Finance Ministers and assignment of part of the GST proceeds to the third-tier of government. These amendments must, inter alia, provide that the taxation of goods and services by both the Centre and the States should be a consumption-type, destination based GST.

11.11 The introduction of the ‘flawless’ GST is one of the most important reform agenda which can provide a new impetus to Indian industry and inclusive growth. It is an economic game changer. All stakeholders must unite and develop the necessary will to cooperate in introducing the flawless GST. It would be worthwhile to make greater political investment in this endeavour.

Annexures

Treatment of immovable properties under Goods and Services Tax

The **case for** including the real estate sector in the tax base for the GST rests on a number of competing reasons. **Firstly**, the construction and exploitation of real estate comprises one of the larger sources of gross domestic product. Therefore, any exclusion of the real estate sector would lead to significant reduction in the tax base. This would lead to an increase in the GST rate for other sectors thereby distorting economic efficiency and incentive for compliance.

Secondly, expenditure on housing also constitutes a significantly large proportion of total personal consumption expenditure. Therefore, the exemption of the housing sector from the GST base would distort the consumption pattern. Further, it would also undermine vertical equity in as much as consumption of housing services is relatively high in the case of the rich.

Thirdly, real estate is subject to multiple taxation at both levels of Government. At the Central Government level, there has been an attempt to introduce service tax on housing services and allow credit for inputs used for the supply of such services. However, at the State level input tax credit is not available for all taxes, thereby leading to significant cascading effect. Further, there is no incentive to the purchaser to obtain an invoice. Consequently, the audit trail of such transactions is lost and producers of inputs are also encouraged to suppress such transactions. The cumulative effect is to incentivise transactions in black money.

At the State level, the taxes on the real estate sector include 'sales tax' on works contract, state level VAT on various inputs used in the construction of real estate, stamp duty and registration fee. Registration and stamp duties exhibit the same distortionary cumulative and cascading effects as excises. The problem is further compounded by the fact that in most states, the statutory rates of stamp duty on immovable property transaction are high. Therefore, the effective rate on value addition is exorbitant, thereby encouraging under-

reporting of transactional value and evasion of stamp duty. Since stamp duties are directly or indirectly related to other taxes, any stamp duty evasion triggers a similar adverse response to compliance with other taxes. As with other transaction taxes, it generates a bias in favour of not selling, and inhibits the development of a liquid secondary market. In the context of a distortionary tax regime governing the real estate industry in India, there is a strong tendency for this industry to remain outside the organised sector and consequently the regulatory framework. Therefore, it serves as a breeding ground for tax evasion and criminal activities.

Fourthly, rationalisation of the tax regime governing the real estate industry could yield numerous benefits : improve tax compliance in the property tax which is critical for the revenue base of local government, a reduced role for black money, and a reduced role for the criminal element in the real estate sector and significantly lowering of costs by mass housing.

At a conceptual level, under a VAT, sales, rentals, and rental values of immovable property would be taxable and credit would be available for the VAT embedded in purchases. Immovable property that generates housing services should be treated in the same manner. The theoretically most attractive solution would be to register all legal persons, who own or buy residential real estate, for VAT purposes. By purchasing a dwelling, these persons would become producers of housing services. In their role as producers, they would subsequently sell the housing services to consumers. These consumers could be lessees who buy the services for consideration, i.e., a rental charge. It is also possible that producers would put the dwelling at their own disposal. In other words, as owner-producer they would "sell" the housing services to themselves in their role as occupier consumers. Therefore, the purchaser of an immovable property could use the housing services produced from ownership either for self-consumption or for 'sale' by renting out the property.

The VAT consequences of these events are as follows. On purchase of a bundle of housing services in the form of dwelling, the registered taxpayer pays tax on the purchase price,

but at the same time, he is entitled to a tax credit (and refund, if due) for the same amount. If he sells the housing services to lessee, he would have to charge VAT on the amount of the rental. The lessee, being an unregistered consumer, would not be able to pass the tax on; he would be stuck with it just like consumers of other services. Similarly, in his role as owner-occupier, the producer of housing services would "charge" VAT on these services, whose value equals the rental value of the dwelling rendered to himself as consumer. And like the lessor, he would have to remit that tax (net of any tax on inputs, such as repair and maintenance services) to the government.

In practice, the registration of all owner occupiers and the computation of all imputed rental values present formidable administrative problems and are, therefore, not feasible. If imputed rental values cannot be taxed, the taxation of rental charges would appear to favour owner-occupiers over lessees. Further, the practical difficulties of taxing small landlords might be severe. Therefore, as a second-best approach, it would be appropriate to provide a threshold exemption for GST which would ensure that the large majority of small landlords are outside the scope of GST. Since the imputed rental values in the case of self owners would predominantly be below the threshold exemption limit, it would be desirable from an administrative aspect to exclude imputed rental values in the case of self owners from the scope of GST.

The treatment of housing under a VAT like GST regime can be designed following either the comprehensive taxation method or one of the two variants of the exemption method. The treatment of transactions in immovable property and real estate/housing services under the three methods is summarised in the Table below.

Table
VAT treatment of immovable property under two approaches

Nature of transaction	Comprehensive taxation	Exemption method	
		(variant-A)	(variant-B)
A. Existing residential property stock			
i. Sale	T	T	E
ii. Rental charges	T	E	E
iii. Imputed rental values	E	E	E
iv. Alteration and maintenance	T	T	T
B. New residential property			
i. Construction/ First Sale	T	T	T
ii. Resale	T	T	E
iii. Rental charges	T	E	E
iv. Imputed rental values	E	E	E
v. Alteration and maintenance	T	T	T
C. Existing commercial property stock			
i. Sale	T	T	T
ii. Rental charges	T	E	T
iii. Imputed rental values	E	E	E
iv. Alteration and maintenance	T	T	T
D. New commercial property			
i. Construction/First Sale	T	T	T
ii Resale	T	T	T
iii. Rental charges	T	E	T
iv. Imputed rental values	E	E	E
v. Alteration and maintenance	T	T	T
E. Inputs (both goods and services) used for construction	T	T	T

Under the **comprehensive taxation method**, all new properties (both residential and commercial) constructed after the introduction of the VAT are liable to tax on construction/first sale of the building on the reasoning that the cost of construction or the price of first sale represent the present discounted value of the flow of imputed rental services over the life of the property. Thereafter, the rental charges for leasing of such properties is also liable to VAT

with the landlord being entitled to input credit on the tax paid on construction/purchase of the building. However, if the property is owner occupied, no VAT is applicable on imputed rental value of the house. Correspondingly, the owner is also not entitled to input tax credit. Upon resale of the property, VAT is realised on the full resale value and input credit to the extent not utilised against rental income is allowed as a deduction. If the input credit is greater than the VAT on resale value, the excess is ignored and no refund for such excess is allowed. As a result, VAT is payable on the margin earned on sale of the property i.e., the difference between the sale price and the cost of procurement and improvements thereto. It applies only to enhancement in the value of the property. The treatment in respect of resale of properties built prior to the introduction of VAT would be the same with the modification that no input tax credit is allowed in respect of VAT which is paid at the time of its purchase. Further, VAT is also levied on the value of the supply of all goods and services for construction, alteration and maintenance of an immovable property.

The comprehensive method, as its name suggests, is extremely wide in its scope. **Firstly**, it extends to the consumption of existing stock of properties, as well as to any unanticipated future increases in the rental value of the new properties. **Secondly**, this method also effectively entails full taxation of imputed rental value of owner-occupied properties. New properties attract tax on their full capital value (i.e., the purchase price) at the time of purchase, for which no deduction is allowed to the owner during the period of self-occupation of the property. **Thirdly**, the existing properties also attract tax on their full capital value at the time of resale. Further, this method simplifies legislation in as much as no distinction is required to be made between residential or commercial properties.

The case against the comprehensive method is essentially built on the following considerations. **Firstly**, under the method landlords would tend to register themselves to avail of credit in respect of input tax paid on construction/purchase of the property thereby increasing the administrative burden of dealing with a large number of small registrants. However, this problem is highly exaggerated in the context of a reasonably moderate threshold

exemption for small businesses whereby most small landlords would remain exempt. **Secondly**, application of tax on resale of dwellings would require the owners to keep track of input taxes paid on the acquisition of the dwellings, on improvements undertaken over the period of their ownership and input credit availed against VAT payable on rental value. Further, in many cases, there are frequent changes in the use of the dwelling as owner-occupied residence or rental dwelling. Since input tax credits are allowed only for houses used for rental purposes, these changes in the usage of the dwelling would require special rules for appointment of the input tax credits resulting in increased administration burden for the tax office. However, these problems are surmountable by not allowing any credit for input tax paid on construction/purchase of the property or improvement thereto against VAT payable on rental value. The credit for such input tax can be allowed only at the time of resale, after adjusting the same for inflation. **Thirdly**, in the case of existing stock of properties, the tax applies on the full resale value. This may be appropriate only where the existing properties did not previously bear the taxes that were being replaced by the VAT. If indeed substitute taxes (though of the cascading variety) are applied to some or all components of the existing properties, subjecting them to full taxation again under VAT would amount to double taxation. This can be resolved by allowing credit for the taxes already paid or levying the VAT only to enhancement in the value of the property.

Under the Variant – A of the exemption method, like in the comprehensive taxation method, all new properties (both residential and commercial) constructed after the introduction of the VAT are liable to tax on construction/first sale of the building. However, both the rental charges for leasing of such properties and the imputed rental value are exempt with no benefit for input tax credit whatsoever. Upon resale of the property VAT is realised on the full resale value and input credit for tax paid on construction/purchase of the property is allowed as a set off. If the input credit is greater than the VAT on resale value, the excess is ignored and no refund for such excess is allowed. As a result, like in the comprehensive taxation method, the VAT on resale is payable only on the margin earned on sale of the property. The treatment in respect of resale of properties built prior to introduction of VAT is

the same with the modification that no input tax credit is allowed in respect of VAT which is paid at the time of its purchase. Further, VAT is also levied on the value of the supply of all goods and services for construction, alteration and maintenance of an immovable property.

The Variant-A is economical neutral between rented properties and owner occupied properties in as much as both the actual rent and imputed rent is exempt. Similarly, this method is also neutral across properties constructed before and properties constructed after the introduction of VAT since resale of the property is liable to VAT. The administrative and compliance difficulties are similar to those faced under the comprehensive taxation method with the modification that the number of landlords seeking registration would be relatively small since actual rent is exempt. However, administrative complexity would increase in case of mixed use of properties i.e. where the building is partly used for residential and partly for commercial rentals or where the use of the unit changes between commercial and residential use since this would required special rules of apportionment of the input tax credits. Further, in many cases, along with the renting of the unit, various related services such as utilities, furnishings, meals and maid services are also provided. Special rules would need to be framed to segregate residential rentals from the related supplies.

Under Variant –B of the exemption method, a distinction is made between residential and commercial properties. The commercial properties are treated in the same manner as under the comprehensive taxation method. In the case of residential properties, VAT is levied at the time of construction/first sale of such properties which are constructed after the introduction of VAT. All resale of properties, whether constructed before or after the introduction of the VAT is exempt. As a result, the scope of VAT does not extend to existing properties. Further, VAT is also levied on the value of the supply of all goods and services for construction, alteration and maintenance of an immovable property.

Variant-B is extremely narrow in its scope since sale and resale of both existing and new residential properties, rental value and imputed rent are exempt. This can be highly

distortionary since the benefit from such exemption would depend on the mix of taxable and non-taxable inputs used in construction. Further, a distinction would also need to be made between residential and non-residential properties to allow for the exemption and input tax credit. This would add to the complexity in the tax administration.

The real estate sector should be integrated into the GST framework keeping in view the implications of the different methods.

**Report of the Task Force on Goods and Services Tax
Thirteenth Finance Commission**

Details of Transactions of sale or purchase undertaken during the month (if the number of records exceeds 10 for registered dealers, upload transaction file)					Upload transaction file	
Unique Transaction Number	BIN of the person with whom the transaction of sale or purchase is undertaken		Name of seller/purchaser	Value	Amount of CGST	Amount of SGST
a. Purchase transactions						
b. Sale transactions						

VERIFICATION

I..... son/daughter ofholding Permanent Account Number solemnly declare that to the best of my knowledge and belief, the information given in the return and the schedules thereto is correct and complete and that the particulars shown therein are truly stated and are in accordance with the provisions of the Central Goods and Services Tax Act, 2010 and the provisions of the State Goods and Services Tax Act, 2010 in respect of the Central Goods and Services Tax and State Goods and Services Tax chargeable for the month of..... I further declare that I am making this return in my capacity asand I am also competent to make this return and verify it.

Place :

Date :

Sign here

Note: Please do not furnish transaction wise details of unregistered purchases and sales.

**Report of the Task Force on Goods and Services Tax
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Table-13: States' Own Tax Revenues on goods and services -2007-08

(All figures in Rs in crores)

S. No.	States	State Excise	Sales Tax, VAT and Purchase Tax	Central Sales Tax	Other Receipts	Total Sales Tax	Sales tax and CST on POL	Sales Tax on alcohol	Total Non-POL Non-Alch'l Sales Tax	Ent't Tax	Entry tax in lieu of Octroi	Taxes on Vehicles	Taxes on Goods and Passengers	Taxes and Duties on Electricity	Stamps and Regn Fees	Other Taxes and Duties	Total EC-taxes*	Total TF-taxes*
		Col. 1	Col. 2	Col. 3	Col. 4	Col.5 (2+3+4)	Col.6	Col.7	Col.8 (5.6.7)	Col.9	Col.10	Col.11	Col.12	Col.13	Col.14	Col.15	col.16	Col. 17
	General Category State																	
1	Andhra Pradesh	4041	17538	1433	56	19026	5301	3248	10478	0	78	1604	80	195	3086	171	10727	15692
2	Bihar	525	2491	44	-1	2535	1133	147	1255	14	979	273	938	64	654	0	2249	4178
3	Chhattisgarh	843	2448	521	54	3024	939	0	2085	5	0	277	511	395	463	2	2092	3737
4	Goa	76	3	60	817	879	370	0	509	11	127	82	113	0		191	838	1032
5	Gujarat	47	189	1905	13010	15105	5332	12	9760	0	240	1310	152	2047	2018	263	10263	15790
6	Haryana	1379	6364	1357	0	7721	2040	11	5670	17	0	234	379	107	1763	7	5695	8179
7	Jharkhand	157	2215	636	-6	2846	730	45	2070	5	151	136	71	76	156	0	2227	2666
8	Karnataka	4767	3507	1262	9125	13894	3896	0	9998	353	0	1650	837	449	3409	37	10388	16734
9	Kerala	1169	3335	1016	5021	9372	2336	1998	5038	1	0	853	0	39	2028	78	5117	8037
10	Madhya Pradesh	1854	5488	557	0	6045	2512	0	3533	12	0	703	916	626	1532	16	3562	7338
11	Maharashtra	3963	24362	2385	6	26753	10076	1080	15596	410	0	2143	388	2688	8550	634	16640	30409
12	Orissa	525	3567	551	0	4118	1077	132	2910	2	0	459	627	327	405	29	2941	4760
13	Punjab	1862	4920	328	94	5342	1482	29	3832	5	587	499	0	604	1568	2	4427	7098
14	Rajasthan	1805	7126	405	219	7751	2819	1	4931	16	0	1164	161	584	1544	43	4990	8443
15	Tamil Nadu	4764	16434	1722	0	18156	5081	3889	9186	9	1097	1483	1097	37	3805	173	10465	16888
16	Uttar Pradesh	3948	12464	1385	1174	15023	4653	28	10342	94	553	1146	110	207	3977	63	11052	16491
17	West Bengal	935	7249	798	14	8060	2465	342	5253	30	0	532	1	507	1417	311	5595	8052
	Total	32660	119701	16365	29585	165651	52242	10961	102448	986	3812	14549	6381	8953	36374	2020	109266	175524
	Special Category States																	
1	Arunachal Pradesh	12	0	0	77	77	16	0	61	0	0	6	0	0	1	0	61	68
2	Assam	189	1310	0	1382	2691	1154	0	1537	3	0	139	12	5	110	4	1544	1809
3	Himachal Pradesh	390	979	113	0	1092	239	32	821	0	0	114	55	82	87	137	958	1295
4	Jammu & Kashmir	244	1802	0	3	1805	341	80	1384	0	97	73	265	93	66	3	1484	1981
5	Manipur	4	0	0	115	115	27	1	87	0	0	4	1	0	3	0	88	96
6	Meghalaya	42	52	21	8	81	68	26	0	1	0	5	2	0	3	1	2	12
7	Mizoram	2	51	0	11	62	21	0	41	0	0	5	1	0	0	0	41	48
8	Nagaland	3	10	9	75	95	28	0	66	0	0	12	2	0	1	0	66	82
9	Sikkim	29	25	4	27	56	21	0	35	1	0	4	0	0	2	4	40	46
10	Tripura	38	263	2	0	265	59	14	192	0	0	23	0	0	15	2	194	232
11	Uttaranchal	442	1627	0	0	1627	404	38	1185	6	5	155	0	55	424	5	1201	1836
	Total	1393	6119	150	1698	7967	2378	192	5997	11	102	541	338	235	713	156	9666	7492
	Union Territories																	
1	Chandigarh	128	429	124	0	553	114	0	439	5	0					0	444	444
2	Delhi	1295	5285	1723	0	7009	1695	293	5021	60	0	425	0	0	1350	378	5459	7234
3	Daman and Diu	0	120	50	0	170	8	0	162	0	0					0	162	162
4	Pondicherry	224	189	181	0	369	5	4	360	0	0	35	0	0	37	0	360	432
5	Port Blair	0	0	0	0	0	0	0	0	0	0					0	0	0
	Total	1647	6023	2078	0	8100	1822	297	5981	65	0	460	0	0	1387	378	6424	8271
	Grand Total	35701	131843	18593	31282	181718	56442	11450	113826	1062	3914	15549	6719	9188	38473	2554	121356	191287

* This includes an estimated amount of Rs 3000 crores as Sales Tax on Tobacco products for which we do not have State-wise breakup. Therefore, the amount of EC-taxes and TF-taxes for the purposes will be lower by Rs 3000 crores each.

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Nature of business for income tax purposes

Sector	Sub-Sector	Code	Sector	Sub-Sector	Code
1. Manufacturing Industry	Agro-based industries	0101	5. Contractors	Civil Contractors	0501
	Automobile and Auto parts	0102		Excise Contractors	0502
	Cement	0103		Forest Contractors	0503
	Diamond Cutting	0104		Mining Contractors	0504
	Drugs and Pharmaceuticals	0105		Others	0505
	Electronics including Computer Hardware	0106	6. Professionals	Chartered Accountants, Company Secretaries.	0601
	engineering goods	0107		Fashion designers	0602
	Fertilizers, Chemicals, Paints	0108		Legal professionals	0603
	Flour & Rice Mills	0109		Medical professionals	0604
	Food Processing units	0110		Nursing Homes	0605
	Marble & Granite	0111		Speciality hospitals	0606
	Paper	0112	Others	0607	
	Petroleum and Petrochemicals	0113	7. Service sector	Advertisement agencies	0701
	Power and energy	0114		Beauty Parlours	0702
	Printing & Publishing	0115		Consultancy services	0703
	Rubber	0116		Courier Agencies	0704
	Steel	0117		Computer/training/educational and coaching i	0705
	Sugar	0118		Forex Dealers	0706
	Tea, Coffee	0119		Hospitality services	0707
	Textiles, handloom, Power looms	0120		Hotels	0708
Tobacco	0121	I.T. Enabled services, BPO service providers		0709	
Tyre	0122	Security agencies		0710	
Vanaspati & Edible Oils	0123	Software development agencies		0711	
Others	0124	Transporters		0712	
2. Trading	Chain Stores	0201		Travel agents, tour operators	0713
	Retailers	0202		Others	0714
	Wholesalers	0203	8. Financial Service	Banking Companies	0801
	Others	0204		Chit Funds	0802
3. Commission Agents	General Commission Agents	0301		Financial Institution	0803
				Financial service providers	0804
4. Builders	Builders	0401		Leasing Companies	0805
	Estate Agents	0402		Money Lenders	0806
	Property Developers	0403		Non-Banking Finance Companies	0807
	Others	0404		Share Brokers, Sub-brokers etc.	0808
				Others	0809
			9. Entertainment	Cable T.V. productions	0901
				Film distribution	0902
				Film laboratories	0903
				Motion Picture Producers	0904
				Television Channels	0905
			Others	0906	

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VALUE OF OUTPUT

TABLE-12 : CROSS CLASSIFICATION OF OUTPUT/VALUE ADDED BY KIND OF ECONOMIC ACTIVITY

Sl.No	Industry	Gross Output	Intermediate Consumption	Gross Domestic Product
		2007-08	2007-08	2007-08
1	Agriculture, forestry & fishing			
	a Agriculture	918846	192105	726742
	b Forestry & Logging	32299	3039	29260
	c Fishing	42178	6499	35679
	d Total	993323	201643	791681
2	Mining & Quarrying	155075	36777	118298
3	Manufacturing			
	a Registered			504253
	b Unregistered			225875
	c Total	3404517	2674389	730128
4	Electricity, Gas & Water supply	189288	107868	81420
5	Construction	1070400	692732	377668
6	Trade, Hotels & Restaurants			
	a Trade	NA	NA	650663
	b Hotes & Restrurants	NA	NA	71350
	c Total	993621	271608	722013
7	Transport, Storage & Communication			
	a Railways	72838	27294	45545
	b Transport by other means	584385	348728	235657
	c Storage	6587	3907	2681
	d Communication	118937	22843	96094
	e Total	782747	402772	379977
8	Financing, Insurance, Real Estate & Business services			
	a Banking & Insurance	274316	31912	242404
	b Real estate, Ownership of dwellings & business services	423493	57105	366388
	c Total	697809	89017	608792
9	Community, Social & Personal services			
	a Public administration & defence	333098	91131	241967
	b Other services	569906	222397	347509
	c Total	903004	313528	589476
10	Total (Allsectors)	9189784	4790333	4399451
11	GST Comparable Sectors [10-1d-(0.5*9b)]	7578410	4386362	3192050.5

Source: CSO

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TIMELINE FOR IMPLEMENTATION

Timeline for Implementation of GST													
Sl. No	Activities	Jan	Feb	Mar	Apr	May	Jun	July	Aug	Sept	Oct	Nov	Dec
1	Adoption of the GST Model by Centre and States	█	█										
2	Amendments to the Constitution												
a	To be carried out by the Centre		█	█									
b	To be approved by the States				█	█	█						
3	Other Legislation & Rules												
a	Finalise draft tax law		█	█	█								
b	Auxiliary law												
c	Draft rules												
d	Ministry of Law review												
e	Obtain approval of the Union/State Cabinet												
f	Obtain Legislative Approval/ Issue Ordinance												
g	Obtain President's/Governor's Assent												
4	Publicity & Outreach												
a	Private sector discussion on Model and draft Law/Rules												
b	Private sector consultation on operation												
c	Copies for trade/professions												
d	Seminar for trade/professions												
e	Finalise GST guide for trade and Industry												
f	Finalise dealers' registration leaflet												
5	Advertising												
a	Registration advertising												
b	Implementation advertising												
c	Payment advertising												
6	Organisational												
a	Finalize Organizational Structure												
b	Finalize estimation of no. of taxpayers												
c	Finalize on no. of Officers and Staff for the Organization												
d	Appoint Officers and staff to administer												
e	Appoint Managerial and Supervisory Staff and Officers												
f	Appoint Auditors & Processors												
g	Appoint Date entry staff												
h	Appoint Recovery Officers and Staff												
7	Operational												
a	Design audit system												
b	Design registration system												
c	Design returns/payment/processing system												
8	Forms												
a	Finalise registration application form												
b	Finalise registration certificate												
c	Finalise payment and return form												
9	IT Infrastructure												
a	Appoint official-level Team for buiding IT infrastructure												
b	Appoint Professional Consultant												
c	Finalise IT Architecture and RFP documents												
d	Appoint Vendor												
e	Complete user specifications of all business processes												
f	Develop registration system												
g	Test and load registration system												
h	Develop Payments and Tax Accounting system												
i	Test and load payments and Tax Accounting Systems												
j	Develop, test and load other business process modules												
10	Manuals												
a	Prepare Staff manual												
b	Prepare supplimentary manual												
c	Prepare audit and compliance manual												
11	Training Delivery												
a	Preliminary training												
b	General training												
c	Audit traning delivery												
12	Registration and implementation												
a	Issue registration application forms												
b	Issue registration certificates												
c	Conduct advisory visits												
d	Issue first return forms												
e	Receive first payments												
f	Identify defaulters												
g	Pursue defaulters												
13	Monitoring cell												
a	Follow price movements												
b	Inform traders												
c	Action taken												

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Responsibility and Accountability for various Activities relating to Implementation of GST				
Sl. No	Activities	Centre	States	Empowered Committee
1	Adoption of the GST Model by Centre and States			
2	Amendments to the Constitution			
	a To be carried out by the Centre			
	b To be approved by the States			
3	Other Legislation & Rules			
	a Finalise draft tax law			
	b Auxiliary law			
	c Draft rules			
	d Ministry of Law review			
	e Obtain approval of the Union/State Cabinet			
	f Obtain Legislative Approval/ Issue Ordinance			
	g Obtain President's/Governor's Assent			
4	Publicity & Outreach			
	a Private sector discussion on Model and draft Law/Rules			
	b Private sector consultation on operation			
	c Copies for trade/professions			
	d Seminar for trade/professions			
	e Finalise GST guide for trade and Industry			
	f Finalise dealers' registration leaflet			
5	Advertising			
	a Registration advertising			
	b Implementation advertising			
	c Payment advertising			
6	Organisational			
	a Finalize Organizational Structure			
	b Finalize estimation of no. of taxpayers			
	c Finalize on no. of Officers and Staff for the Organization			
	d Appoint Officers and staff to administer			
	e Appoint Managerial and Supervisory Staff and Officers			
	f Appoint Auditors & Processors			
	g Appoint Date entry staff			
	h Appoint Recovery Officers and Staff			
7	Operational			
	a Design audit system			
	b Design registration system			
	c Design returns/payment/processing system			
8	Forms			
	a Finalise registration application form			
	b Finalise registration certificate			
	c Finalise payment and return form			
9	IT Infrastructure			
	a Appoint official-level Team for buiding IT infrastructure			
	b Appoint Professional Consultant			
	c Finalise IT Architecture and RFP documents			
	d Appoint Vendor			
	b Complete user specifications of all business processes			
	c Develop registration system			
	d Test and load registration system			
	f Develop Payments and Tax Accounting system			
	g Test and load payments and Tax Accounting Systems			
	h Develop, test and load other business process modules			
10	Manuals			
	a Prepare Staff manual			
	b Prepare supplimentary manual			
	c Prepare audit and compliance manual			
11	Training Delivery			
	a Preliminary training			
	b General training			
	c Audit tranning delivery			
12	Registration and implementation			
	a Issue registration application forms			
	b Issue registration certificates			
	c Conduct advisory visits			
	d Issue first return forms			
	e Receive first payments			
	f Identify defaulters			
	g Pursue defaulters			
13	Monitoring cell			
	a Follow price movements			
	b Inform traders			
	c Action taken			

Terms of Reference of the Task Force

The Task Force shall examine the impact of the proposed implementation of the Goods and Services Tax (GST) with effect from 01.04.2010. For this purpose, it shall examine, inter alia, -

- (a) the GST model best suited for the country;
- (b) the modalities of the implementation of GST including threshold limits, composition limits, treatment of inter-state transactions, place of supply rules;
- (c) the potential tax base of the GST as exhaustively as possible and determine an appropriate revenue neutral rate for the Centre and the states;
- (d) suggest ways to incentivize states to adopt a model GST; and
- (e) recommend a framework for administering the GST including payment of compensation, monitoring of compliance and institutional mechanism for making any change in the initial design of the GST.

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