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Taxation of Goods and Services in India

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The Commission on Centre State Relations has been asked to examine as part of its Terms of Reference (ToR): 'the need and relevance of separate taxes on the production and on the sales of goods and services subsequent to the introduction of value added tax regime'. This study deals with this Term of Reference. We are thankful to the Commission of Centre State Relations for entrusting this study to the Madras School of Economics. We have benefited considerably from interactions with the Hon'ble Members of the Commission on Centre State Relations and other officials during the course of this study. We would like to place on record our thanks to Shri Dhirendra Singh and Shri Vijay Shankar, Hon'ble members of the Commission with whom we had occasions to discuss the subject extensively.

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D.K.Srivastava
C.Bhujanga Rao

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TAXATION OF GOODS AND SERVICES IN INDIA: PRESENT ARRANGEMENTS

1.1 Introduction

The Commission on Centre-State Relations has been asked as part of its Terms of Reference (ToR) to examine 'the need and relevance of separate taxes on the production and on the sales of goods and services subsequent to the introduction of value added tax regime'. In a federal economy like India, there are three issues that require examination in the context of this term of reference:

1. Whether there is any need or relevance for separation of production from sales in the case of goods.
2. Whether there is need or relevance for separation of goods from services in the context of taxation in a value added tax system.
3. Whether there is need or relevance for separation of jurisdictions of the Central and the State governments in capturing the value added in the production and sale of goods as well as services.

In this Chapter, we look at the existing system of taxation of goods and services in India, and the reforms that have led to the introduction of the Value Added Tax (VAT). In Chapter 2, we examine the continuing problems and the need for further reforms to bring about a comprehensive Goods and Services Tax (GST). In Chapter 3, we examine some of the available options in regard to the form of GST that can be adopted in India. In Chapter 4, we provide the concluding observations.

1.2 Goods and Services: Value Added in the Production and Sale

The economic activities, in a modern economy, lead to the production and sale of goods as well as services. Production of a good or service requires a number of inputs, which are themselves goods and services. If the value of inputs is more than the value of the produced good or service, there is 'value added' in the process of production. Once a good or service is produced, it travels to the final user through a sales chain consisting of wholesalers and retailers. At each stage, there would be some additional value added.

The value of the final product would be the sum of the value added at the different stages in the production-sales chain. The distinction between goods and services can often be blurred. Access to goods can be even in the form of a service. Services may be needed as inputs for goods and goods may need services as inputs.

The idea in VAT is to tax the value added at each stage up to the sale to the final consumer so that eventually the total value of the product is taxed. In this sense, it amounts to a retail sales tax. However, the difference is that in following the principle of taxing at every stage and rebating at every stage, it creates a paper chain of transactions and thereby minimizes the risk that any sales may be done outside the tax net.

a. Understanding VAT: An Example

The VAT may be understood by tracking the stages of production and sale of a good or service. Various inputs are required in the production of a good or service. Together, these inputs, utilized in a production process produce an output, which is different and distinguishable from all the inputs that were used in its production. After the good/ service is produced it will travel to the consumer through a chain of wholesalers and retailers or it will be used as an input into the production of other goods and services. In a VAT system every time a sale of the good/service takes place, the value added tax is levied. But it is levied only at the value added and not at the gross value. As long as the good/service remains within the production process, it will be taxed in a manner such that the tax paid on it at any previous sale is rebated and tax falls only on the value added. Finally, the tax will be only on the sum of the value added in each step in the production/sales chain and will not at any stage be a tax on a tax previously paid. An arithmetic example is explained in Table 1.1.

Supplier A produces wheat flour from wheat which is valued at Rs. 100. This he sells to Supplier B at Rs. 110, which includes the 10 percent VAT on value addition. The supplier B in turn adds value to the extent of Rs. 50 for transforming the flour into bread, here again the value added is taxed at 10 percent which amount to Rs. 5. The supplier gives it to the marketing outlet who adds a profit to Rs. 22. At this stage the cost of bread is Rs. 172. The market outlet pays a tax of 10 percent which amounts to Rs. 2.2. The total VAT paid on bread by the consumer at 10 percent is Rs.17.2 which goes to the Government.

b. Tax Base of Goods and Services in India: Three Segmentations

Considering the value added of goods and services taken together in the overall Indian economy as providing a comprehensive tax base, there are three kinds of segmentations that take place in India under the existing arrangements: segmentation of goods from services, segmentation of Central jurisdiction vis-à-vis State jurisdictions, and segmentation of production/manufacture from sale. These artificial divisions for purposes of taxation lead to various distortions, administrative and compliance costs, and inefficiencies. These are also not consistent with prevailing tax practices in the modern economies of the world who have implemented a VAT regime including federal countries. A federal fiscal arrangement however places additional challenges because there is a need to examine the necessity and rationale of further reforms in the context of maintaining the fiscal and revenue autonomies of the two tiers of government.

Table 1.1: Value Added Tax on Bread: An Example

(Rupees)

Details	Cost	Tax Paid by Supplier/ Consumer	Value Added	Tax Received by Government	Tax Rebated by Government
Supplier A produces flour					
Cost of flour	100				
Supplier A sells flour to producer B charges VAT on flour at 10 %		10		10	
B pays to A			110		10
Cost of other inputs	50				
VAT on other inputs at 10 %		5			
B pays for other inputs			55		5
Profit margin on cost exc. VAT at 20 %	22				
Value added					
Cost of bread	172				
Value added			22 (=172-150)		
VAT on value added		2.2		2.2	
VAT paid on Bread by consumer at 10%		17.2		17.2	

The Central government levies Cenvat, which covers value added in the case of production and sale of goods up to the stage of 'manufacturing'. State governments, on the other hand, are entitled to capture the value at the stage of sale. This value covers the value added at different stages in production/sale cycle covering stages of manufacturing, wholesale, and retail stages that may be more than one. The taxation space up to the value added in the production of goods is common between the Centre and the States. Different states can have their own variations in terms of rates and classification of goods. In the State-VAT system, an attempt has been made to arrive at a broad convergence of rates, but states have gone for their own classification schemes and there are many differences in the classification schemes. In addition to the State-VAT, the levy of a central sales tax continues on inter-State sales.

While the system of taxation is thus characterized by fragmentation and overlaps in the case of goods, the taxation of services remains separated and disjointed from that of goods. The service tax is levied by the Central government. With different tiers of government involved in taxation of value added in the case of goods, there is considerable cascading that result. Cascading means taxation of tax already paid. Cascading is a feature of a tax system that causes several inefficiencies and distortions. In particular, it favours imports, which are treated as final goods and bear the burden of taxation only once, against domestic production, which may be taxed several times; it increases the cash balance requirement of the producers/dealers; it makes tracing the overall tax burden of a good or a service difficult; and, it encourages tax evasion and compliance costs.

Taxation of goods by either tier of government may cascade into taxation of services and vice versa since goods may be needed in the production and sale of services and services may be needed in the production and sale of goods. The nature of a modern economy is such that it is often difficult to draw lines between goods and services as these are embedded into each other.

In this overall context, this study examines the system of taxation of goods and services in India. It provides an overview of the evolution of the domestic system of taxation of goods and services and the reforms that have taken place since the nineties. It then describes the system that has emerged after this first generation of reforms and its shortcomings as judged from theoretical norms as well as international practices. The study then goes on to argue for further reforms. It argues that the there is no need or rationale to continue to maintain the distinction between goods and services and there is a need to further reform the system to bring about a comprehensive and integrated system of taxation of goods and services, which may augment the income and welfare of the society.

1.3 First Principles of a Good Tax System

In their well-known Public Finance Text, Musgrave and Musgrave (1973) describe the following as characteristics of a good tax system:

i. ***Adequacy of Revenue:*** The tax system should be revenue productive in a manner that the Government is able to finance the provision of public and merit goods to the desired extent.
ii. ***Equitable Distribution:*** The tax system should be such that every body pays his fair share of taxes according to their ability to pay. This issue should be considered in terms of final incidence of tax.
iii. ***Minimum Distortions:*** Taxes should be chosen so as to minimize interference with economic decisions relating to allocation of resources in markets that may otherwise be efficient. In fact, taxes impose excess burdens, and the design of the tax system should be such that these are minimized.
iv. ***Facilitation of Stabilization and Growth Objectives of Fiscal Policy:*** The tax structure should facilitate the use of fiscal policy for stabilization and growth by suitably providing for automatic stabilizers as well supporting the saving performance of the economic agents.
v. ***Fair Administration:*** The tax system should permit a fair, transparent, non-arbitrary, and easily understandable administration for the tax payers.
vi. ***Minimum Administration and Compliance Costs:*** The tax system should involve minimum costs of administration for the government and compliance costs for the tax payer.

For a federal system, there is the additional need to ensure that the principle of correspondence of resources and responsibilities is satisfied. In a federal system, the assignment of resources and responsibilities between the different tiers of government is normally such that the Centre is given relatively larger resources compared to its responsibilities and the States have relatively larger responsibilities compared to the resources assigned to them. This gives rise to vertical imbalance in the system. The vertical imbalance is brought into balance by a system of transfer of resources from the Centre to the States. It is done in a way such that horizontal imbalance, that is differences in the resource bases and needs of different states is also resolved to the extent possible. Excess vertical imbalance leads to centralization of fiscal space, which is contrary to the idea of federalism. Too little vertical imbalance reduces the centre's capacity to take care of the horizontal imbalances. Different countries seek a stable solution of establishing the right degree of vertical imbalance given its empirical characteristics. Reform in the indirect tax system has to take into account how the existing relativities of revenues between the Centre and the States would be affected by these reforms.

1.4 Assignment of Taxes in India

In this section, we look at the present constitutional scheme relating to taxation of goods and services and recent reforms that have led the system of taxation of goods towards a regime of VAT. In India, taxes have been assigned between the central and the state governments as specified in the Union List and State List in Seventh Schedule of the Constitution. From among the resources assigned to the states, they can assign resources to the local bodies as per the provisions of the 73rd and 74th Amendments to the Constitution. Any unlisted sources of taxation are taxable by the Union government, which has been vested with residuary powers of taxation. Table 1.2 summarizes the constitutional assignment of taxes between the Union and State governments. The main central taxes are personal income tax, corporation tax, Union excise duties (Cenvat), customs duties, and service tax. The main state taxes are sales tax, motor vehicle tax, stamp duty and registration fees, state excise duties, entertainment tax, tax on land and agricultural incomes.

Table 1.2: Assignment of Taxes: Union and State Governments

Union Taxes	State Taxes
1. Taxes on income other than agricultural income	1. Land revenue, including the assessment and collection of revenue, the maintenance of land records, survey for revenue purposes and records of rights, and alienation of revenues
2. Duties of customs including export duties	2. Taxes on agricultural income
3. Duties of excise on tobacco and other goods manufactured and produced in India except -	3. Duties in respect of succession to agricultural land
4. Alcoholic liquors for human consumption	4. Estate duty in respect of agricultural land
5. Opium, Indian hemp and other narcotic drugs and narcotics but including medicinal and toilet preparations containing alcohol or any substance included in sub-paragraph(b) of this entry	5. Taxes on land and buildings
6. Corporation tax	6. Taxes on mineral rights subject to any limitations imposed by Parliament by law relating to mineral development
7. Taxes on the capital value of the assets, exclusive of agricultural land	7. Duties of excise on the following goods manufactured or produced in the State and countervailing duties at the same or lower rates on similar goods manufactured or produced elsewhere in India
8. Duties in respect of succession to property other than agricultural land	8. alcoholic liquors for human consumption
9. Terminal taxes on goods and passengers, carried by railway, sea or air, taxes on railway fares and freights	9. opium, Indian hemp and other narcotic drugs and narcotics, but not including medicinal and toilet preparations containing alcohol or any substance included in sub-paragraph (b) of this entry
10. Taxes other than stamp duties on transactions in stock exchanges and futures markets	10. Taxes on entry of goods into a local area for consumption, use or sale therein
11. Rates of stamp duty in respect of bills of exchange, cheques, promissory notes, bills of lading, letters of credit, policies of insurance, transfer of shares, debentures, proxies and receipts	11. Taxes on the consumption or sale of electricity
12. Taxes on the sale and purchase of newspapers and on advertisement published therein	12.Taxes on the sale or purchase of goods other than newspapers, subject to the provisions of entry 92 A of List 1
13. Taxes on the sale and purchase of goods other than newspapers, where such sale or purchase takes place in the course of interstate trade or commerce	13.Taxes on advertisements other than advertisements published in newspapers and advertisements broadcast by radio or television
14. Taxes on the consignment of goods(whether the consignment is to the person making it or to any other person), where such consignment takes place in the course of the inter-state trade or commerce	14.Taxes on goods and passengers carried by road or inland waterways

Table 1.2: Assignment of Taxes: Union and State Governments (Contd…)

15. Service Tax	15. Taxes on vehicles, whether mechanically propelled or not, suitable for use on roads, including tramcars subject to the provisions of entry 35 of List III 16. Taxes on animals and boats 17. Tolls 18. Taxes on professions, trades, callings and employments 19. Capitation taxes 20. Taxes on luxuries, including taxes on entertainments, amusements, betting and gambling Rates of stamp duty in respect of documents other than those specified in the provisions of List I with regard to rates of stamp duty

Source: Constitution of India.

The Constitution, under Articles 268 and 269 makes provision for the assignment of some of the Union taxes to the states for collection and sharing or retaining the amount of revenues raised. The specific provisions are given at Annexure A1. Article 268 refers to taxes levied by the Union but collected and appropriated by the States. Article 269 taxes levied and collected by the Union but assigned to the States In a recent Amendment (88th Amendment), the service tax has been brought in under Article 268A. Since the sharing of central taxes with the states under Article 270 provides that taxes under Articles 268/269 are not covered by the provisions of Article 270, service tax revenues have been taken out of the purview of the recommendations of the Finance Commission. In practice, however, a share similar to other central taxes is being given to the states from out of the net proceeds of the services tax. In this context, the Twelfth Finance Commission had observed: "… it is necessary to ensure that the revenue accruing to the states, under the new arrangement should not be less than the share that would accrue to the states, had the entire service tax proceeds been part of the shareable pool". The changes in respect of Article 268 are summarized in Box 1.

Box 1: Changes with respect to the Service Tax

Insertion of New Article 268A. - After Article 268 of the Constitution, the following article shall be inserted, namely:-
(1) Service tax levied by Union and collected and appropriated by the Union and the States.
"**268A**. Service tax levied by Union and collected and appropriated by the Union and the States.-(1) Taxes on services shall be levied by the Government of India and such tax shall be collected and appropriated by the Government of India and the States in the manner provided in clause (2).

(2) The proceeds in any financial year of any such tax levied in accordance with the provisions of clause (1) shall be-
(a) collected by the Government of India and the States;
(b) appropriated by the Government of India and the States, in accordance with such principles of collection and appropriation as may be formulated by Parliament by law."

3. **Amendment of Article** 270. - In Article 270 of the Constitution, in clause (1), for the words and figures "Articles 268 and 269", the words, figures and letter "Articles 268, 268A and 269" shall be substituted.

4. **Amendment of Seventh Schedule**. - In the Seventh Schedule to the Constitution, in List I-Union List, after entry 92B, the following entry shall be inserted, namely:- "92C Taxes on services."

1.5 Changing Structure of the Indian Economy

The structure of the Indian economy has been persistently changing in favour of services. In India, the share of the agricultural sector has come down over the years, the share of manufacturing has increased to a limited extent, but the share of the services sector has been increasing steadily. Table 1.3 (Appendix Tables A1 and A3) highlights the changing structure of the Indian economy by looking at the share of GDP at factor cost (1999-00 base series) at current as well as constant (1999-00) prices. The share of agriculture has come down from more than 55 percent in 1950-51 to about 18.5 percent by 2006-07. The share of industry, which was only about 11 percent of GDP in 1950-51 now accounts for nearly 20 percent.

Table 1.3: The Changing Sectoral Composition of Indian GDP (1999-00 Base Series)

(percent)

Year	Agriculture and Allied Activities	Agriculture	Industry	Mining and Quarrying	Manufacturing	Electricity, Gas and Water Supply
At Constant (1999-00) Prices						
1950-51	55.28	48.36	10.65	1.42	8.92	0.31
1960-61	50.81	45.60	13.18	1.67	10.94	0.57
1970-71	44.31	39.42	15.46	1.69	12.64	1.13
1980-81	37.92	34.37	17.45	2.01	13.82	1.61
1990-91	31.37	28.75	19.80	2.68	14.95	2.17
2000-01	23.89	21.84	19.99	2.28	15.26	2.44
2006-07QE	18.51	16.97	19.54	2.04	15.39	2.12
At Current Prices						
1950-51	52.57	49.68	11.93	0.78	10.93	0.24
1960-61	42.85	40.59	15.76	1.07	14.14	0.55
1970-71	42.40	40.14	16.32	1.08	14.19	1.04
1980-81	35.70	32.81	20.12	1.76	16.72	1.64
1990-91	29.28	26.78	21.51	2.67	16.70	2.13
2000-01	23.35	21.24	20.37	2.37	15.60	2.39
2006-07QE	18.35	16.74	20.85	2.69	16.30	1.86

Source (Basic data): National Income Accounts, CSO.
QE: Quick Estimates

Table 1.4 (Appendix Table A2 and A4) shows the relative shares of key service sectors. The share of services in GDP has increased from nearly 34 percent in 1950-51 to more than 60 percent in 2006-07. Not only the service sector has progressively become larger but this trend is likely to continue as the service sectors are growing at relatively faster pace, particularly as compared to the agricultural sector. Within the service sector, all the sub groups have consisting of (1) construction, (2) Trade, Hotels, Transport and Communications, (3) Financing, Insurance, Real Estate and Business services, and (4) Community, Social, and Personal Services, have grown. The largest increases seem to have been in construction (nearly four-fold at current prices) and trade, hotel, transport, and communications (the increase at current prices is much more than that at constant prices, indicating the increase in the average prices of these services). The least increase in share is for the community, social and personal services sector.

Table 1.4: The Changing Composition of the Service Sector in India's GDP (1999-00 Base Series)

(percent)

Year	Service	Construction	Trade, Hotels, Transport and Communication	Financing, Insurance, Real Estate and Business Services	Community, Social, and Personal Services
At Constant (1999-00) Prices					
1950-51	34.07	4.43	11.34	7.69	10.61
1960-61	36.01	5.58	13.05	7.03	10.35
1970-71	40.23	6.64	14.74	6.82	12.03
1980-81	44.63	6.60	17.45	7.49	13.10
1990-91	48.83	6.12	18.34	10.58	13.78
2000-01	56.12	5.81	22.30	13.04	14.98
2006-07QE	61.94	7.20	26.81	14.32	13.62
At Current Prices					
1950-51	35.50	2.58	9.72	12.02	11.18
1960-61	41.39	3.84	11.64	14.26	11.65
1970-71	41.28	4.51	12.72	12.05	12.00
1980-81	44.18	4.57	16.07	10.57	12.97
1990-91	49.21	5.38	18.89	11.62	13.32
2000-01	56.28	5.82	22.28	13.23	14.94
2006-07QE	60.80	8.43	25.05	13.90	13.42

Source (Basic data): National Income Accounts, CSO.
QE: Quick Estimates

1.6 Taxation of Goods in India

a. Central Excise Duties

In this section, we look at the present constitutional scheme relating to taxation of goods and services and recent reforms that have led to the system of taxation of goods towards a regime of VAT.

Union excise duties and cesses are levied on commodities covered by the Central Excise Act, 1944 and the Central Excise Tariff Act 1985. Being an excise duty, this tax captures or uses the valued added up to the stage of manufacturing. The term 'manufacture' means bringing into existence a new article having a distinct name, character, use and marketability and includes packing, labeling etc. Most of the products used to attract excise duties at the rate of 14 percent until recently. As per an announcement in December 2008, the core Cenvat rate has been brought down to 10 percent. Some products also attract special excise duty/and an additional duty of excise at the rate of 8 percent above the Cenvat rate. In addition, there is a 2 percent education and 1 percent higher education cess applicable on the aggregate of the duties of excise. Excise duty is levied on *ad valorem* basis or based on the maximum retail price in some cases

The central excise duties have historically been an important tax on the manufacture or production of domestic goods. Since the late eighties, these excise duties have been transformed as taxes levied under the value-added principle going up to the manufacturing or production stage. It was first transformed into what was called a Modified Value Added Tax (Modvat) and later as Central Value Added Tax (Cenvat) in the latter part of the nineties.

The Modvat was introduced in the 1986-87 Budget. With effect from March 1, 1986, a proforma credit scheme was extended to products with reference to specified Chapters of the Central Excise Tariff Act, 1985. A major objective of the Modvat scheme was to initiate a system of taxation, which can reduce cascading of taxes, and thereby also reduce costs and prices. At first, the coverage was limited to 37 out of 91 Chapters. With effect from March 1, 1987, all commodities except petroleum products, textiles, tobacco, cinematographic films and matches were covered. In the Modvat system, early in the nineties, full rebate on the excise tax paid on capital goods was allowed instead of setting up a system of annual depreciation related deductions. With effect from 1995-96, the entire manufacturing chain was brought under Modvat. In the 2000-01central budget, the excise deduction on capital goods was permitted to be spread over two years.

In the late nineties, the Modvat system was renamed as Cenvat, which had fewer rates. In view of revenue and equity considerations, a few higher rates for demerit goods like tobacco products (cigarettes, cigars, chewing tobacco or mixed in pan masala) and for final, finished, luxury consumer durable goods like cars were considered justifiable.

The general highlights of Cenvat scheme may be described as follows. The Cenvat scheme is based on the system of granting credit of duty paid on inputs and input services. A manufacturer or service provider has to pay excise duty and service tax as per normal procedure on the basis of 'assessable value'. However, he gets credit of duty paid on inputs and service tax paid on input services. Credit is made available of excise duty paid on (a) raw materials (excluding few items) (b) material used in or in relation to manufacture like consumables etc. and (c) paints, packing materials, fuel etc. used for any purpose. However, duty paid on high speed diesel oil (HSD), light diesel oil (LDO) and motor spirit (petrol) is not available as Cenvat credit, even if these are used as raw materials or as fuel.

No credit is available if final product is exempt from duty or final service is exempt from service tax. If a manufacturer manufactures more than one product, it may happen that some of the products are exempt from duty. Similarly, in case of service provider, some services may be taxable while some services may not be covered. In such cases, duty paid on inputs and service tax paid on input services used for manufacture of exempted products/services cannot be used for payment of duty or tax on other final products/ services which are not exempt from the tax. In case of exempt services, he can utilise Cenvat credit only up to 20 percent of service tax payable on output service. Cenvat credit does not require a one-to-one correspondence or input-output correlation. In the case of capital goods credit of duty paid on machinery, plant, spare parts of machinery, tools, dies, etc., is available up to 50 percent in the current year and balance in subsequent financial year or years.

In 2005, the core Cenvat rate was kept at 16 percent for a majority of the items. There were two more rates: 24 percent and 8 percent. Effectively, there were several other rates of excise duty that continue to be applied on different items, subject to their enduse. With the 2008-09 budget, the core Cenvat rate was brought down to 14 percent. This has now been brought down to 10 percent but still multiple rates exist. In addition to the Cenvat, several cesses and surcharges and additional levies are used. These are listed below:

i. Special Excise Duty: Special excise duty is leviable by the Central Excise Tariff Act, 1985.
ii. National Calamity Contingent Duty: NCC Duty was levied on pan masala and certain specified tobacco products vide the Finance Act, 2001. The Finance Act, 2003 extended this levy to polyester filament yarn, motor car, two wheeler and multiutility vehicle @ 1 percent; and (b) crude petroleum oil @ Rs. 50 per metric ton. In this year's budget NCCD has been removed from Polyester Filament Yearn and imposed on Mobile Phones @1 percent.
iii. Education Cess: Education Cess is leviable @2 percent on the aggregate of duties of Excise.
iv. Secondary and Higher Education Cess: Leviable @1 percent on the aggregate of duties of Excise.

v. Cess on Motor Spirit: Cess on Motor Spirit is leviable by the Finance Act (No.2), 1998.
vi. Cess on High Speed Diesel Oil: Cess on High Speed Diesel Oil is leviable by the Finance Act, 1999.
vii. Surcharge on Motor Spirit: Surcharge on Motor Spirit is leviable by the Finance Act, 2002.
viii. Surcharge on Pan Masala and Tobacco Products: An Additional Duty of Excise has been imposed on cigarettes, pan masala and certain specified tobacco products, at specified rates in the Budget 2005-06. Bidis are not subjected to this levy.

b. Customs Duties

The customs duties are levied on imports brought into the country. These are not part of taxation of domestic value added but contain some element to bring the tax treatment of foreign producers in the matter of taxation of goods on par with domestic producers. The customs duty in India consists of 'basic' tariff, the Additional Duty of Customs (AD), and Special Excise Duty (SAD). The additional duty is the counterpart of excise duties paid by domestic manufacturers i.e. Countervailing Duty (CVD). The special excise duty has been introduced to serve as the counterpart of state sales taxes on domestically produced goods. The customs duty is thus collected under the three sub-heads (basic, AD and SAD).

In addition to the basic customs duty, several surcharges and cesses are also leviable as given below.

i. Additional Duty of Customs (CVD): Additional Duty of Customs is leviable under Section 3 of the Customs Tariff Act, 1975 equivalent to duty of Central Excise leviable on such domestically manufactured goods.
ii. Special CV Duty: Special CV Duty is leviable @ 4% on all imported goods, with few exceptions, to partially compensate the domestic levies.
iii. Cess on Motor Spirit: Cess on Motor Spirit is leviable by the Finance Act (No.2), 1998.
iv. Cess on High Speed Diesel Oil: Cess on High Speed Diesel Oil is leviable by the Finance Act, 1999.
v. Surcharge on Motor Spirit: Surcharge on Motor Spirit is leviable by the Finance Act, 2002.
vi. National Calamity Contingent Duty: This duty was imposed under Section 134 of the Finance Act, 2003 on imported petroleum crude oil. This tax was also leviable on

motor cars, imported multi-utility vehicles, polyester filament yarn and two wheelers.

vii. Education Cess: Education Cess is leviable @ 2 percent on the aggregate of duties of Customs (except safeguard duty under section 8B and 8C, CVD under section 9 and anti- dumping duty under section 9A of the Customs Tariff Act, 1985). Items attracting customs duty at bound rates under international commitments are exempted from this cess.

viii. Secondary and Higher Education Cess: Leviable @1 percent on the aggregate of duties of customs.

c. State Sales Tax

State taxes include state sales taxes, the Central Sales Tax (CST) assigned by the Central Government to the states, motor vehicle tax, state excise duties, entertainment taxes, and other taxes as indicated in Table 1.2. The Constitution empowers the states to levy 'taxes on sale or purchase of goods other than newspapers, subject to provisions of entry 92 A of List I'. This entry provides that the Central Government is empowered to levy a tax on the sale and purchase of goods other than newspapers where such sale or purchase takes place in the course of inter-State trade or commerce. The Central Government has levied a central sales tax on inter-State sales, which under Article 269, is collected and retained by the states.

The structure of sales tax, prior to reforms undertaken in late nineties was characterized by high tax rates, multiplicity of tax rate and exemptions, lack of uniformity across states, large number incentives, and cascading of taxes. During reforms of sales taxes prior to the introduction of state VAT, most states had agreed to phase out the incentive related exemptions, and implement floor rates. There are several minor taxes imposed by the States on the sale, purchase, storage and movement of different goods.

Sales taxes are normally levied at the point of sale to the consumer. In India, however, states had followed the practice of "first point sales tax," where the tax is collected at the point of sale by the producer. In such a system, the tax was not levied on all the stages of value addition or sales and distribution channel. The margins of distributors/dealers/ retailers were not subject to sales tax. As such, the single-point levy had to be at a high rate to cover the value added at all stages. The high rate structure led to the need for a highly differentiated rate structure and exempted categories, which led to various classifications disputes and tax evasion. Apart from the general sales tax, most states levied an additional sales tax or a surcharge. In addition, the states levy luxury tax as also an entry tax on the sale of imported goods.

All these practices led to heterogeneity in structure, as well as rates, causing diversion of trade as well as shifting of manufacturing activity from one State to another. Further, widespread taxation of inputs led to vertical integration of firms, encouraging production of more and more of the inputs needed rather than purchasing them from ancillary industries. This system taxation of goods became non-neutral, interfering with the producers' choice of inputs as well as with the consumers' choice of consumption, thereby leading to severe economic distortions.

With the initiative of Empowered Committee of the State Finance Ministers, states initiated indirect tax reforms in the late nineties. As a first step, they reduced the rate categories in the case of sales taxes, reduced exemptions, and introduced floor rates. There were tangible revenue benefits after these changes, which facilitated, under the guidance of the Empowered Committee, the implementation of state level VAT.

The State-VAT recommended by the Empowered Committee of State Finance Ministers was elaborated in a White Paper brought out by the Government of India. The State- VAT provides full set-off for input tax as well as tax on previous purchases. It also abolished the burden of several of the existing taxes, such as turnover tax, surcharge on sales tax, additional surcharge, special additional tax, etc. The CST however continues although its rate has been progressively brought down. The main features of the scheme suggested by the Empowered Committee were:

i. uniform schedule of rates of VAT for all states, making the system simple and uniform and prevent unhealthy tax competition among states;
ii. the provision of input tax credit meant for preventing cascading effect of tax;
iii. the provision self assessment by dealers aimed at reducing harassment; and
iv. the zero rating if exports aimed at increasing the competitiveness of Indian exports.

As per the basic principles of VAT, the State-VAT provides that for all exports made out of the country, tax paid within the state will be refunded in full. Units located in Special Economic Zone (SEZ) and Export Oriented Units (EOUs) are to be granted either exemption from payment of input tax.

In the original proposal registration of dealers with gross annual turnover above Rs. 5 lakh was made compulsory. There was a provision for voluntary registration with flexibility given to the states to fix their own threshold limits. Small dealers with annual gross turnover not exceeding Rs. 50 lakh who are otherwise liable to pay VAT, may be given the option for a composition scheme with payment of tax at a small percentage of gross turnover. The dealers opting for this composition scheme will not be entitled to input tax credit. For better inter-State coordination, the Empowered Committee has suggested that there should be a Tax Payer's Identification Number, which will consist of 11 digit numerals throughout the country.

The basic simplification of the State-VAT is that VAT liability is self-assessed by the dealers themselves in terms of submission of returns upon setting off the tax credit. In the State-VAT scheme, all the goods, including declared goods are to be covered and get the benefit of input tax credit. The few goods outside the VAT are liquor, lottery tickets, petrol, diesel, aviation turbine fuel and other motor spirit since their prices are not fully market determined. These will continue to be taxed under the Sales Tax Act or any other State Act or even by making special provisions in the VAT Act itself, and with uniform floor rates decided by the Empowered Committee.

The most important part of the VAT scheme relates to the tax rates. Under the VAT system covering about 550 goods, only two basic VAT rates of 4 and 12.5 percent are to apply plus a specific category of tax-exempted goods and a special VAT rate of 1 percent only for gold and silver ornaments.

Under the exempted category, the Empowered Committee placed 46 commodities comprising of natural and unprocessed products in the un-organized sector, items that are legally barred from taxation and items which have social implications. Under the State-VAT, there is the proposal to give flexibility to the states to select a set of maximum of 10 commodities States for exemption from a list of goods specified by the Empowered Committee, which are of local social importance for the individual States without having any inter-State implications.

The rest of the commodities in the list are common for all the States. Under 4 percent VAT rate category, the largest number of goods (about 270) were placed, common for all the States, comprising of items of basic necessities such as medicines and drugs, all agricultural and industrial inputs, capital goods and declared goods. The remaining commodities, common for all the States, will fall under the general VAT rate of 12.5 percent.

It was proposed that VAT on AED items relating to sugar, textile and tobacco, because of initial organizational difficulties, will not be imposed for one year after the introduction of VAT and till then the existing arrangement will continue.

Table 1.5 indicates the sequence in which the states joined the State-VAT scheme. Five states implemented VAT in 2006-07. Tamil Nadu and Uttar Pradesh were the last to join the VAT system. The States had already taken measures to streamline the procedures, rationalize tax rates and address other issues so as to enable a smooth transition to VAT in their respective States. State Governments in general have aimed at expanding the tax payer base, better compliance, rationalization of tax rates, improving the efficiency of tax administration, simplification of tax laws and introducing a modern and improved tax system. Excepting for a few States which have contemplated to bring in new taxes (tax on lottery tickets in Maharashtra, tax on resale of certified used cars in Goa, 'green tax' on old vehicles in Rajasthan), most State Governments have intended to reduce their tax rates on various types of taxes and even abolish certain taxes. In this context it may be mentioned that two States (Punjab and Maharashtra) have shown inclination to do away with Octroi. Kerala, on the other hand, has created a new schedule of goods to be taxed at 20 percent which is higher than the highest level under VAT i.e., 12.5 percent.

Table 1.5: Implementation of Value Added Tax by States

States	Month and Year	States	Month and Year
1. Andhra Pradesh	April 2005	16. Manipur	July 2005
2. Arunachal Pradesh	April 2005	17. Meghalaya	April 2006
3. Assam	May 2005	18. Mizoram	April 2005
4. Bihar	April 2005	19. Nagaland	April 2005
5. Chhattisgarh	April 2006	20. Orissa	April 2005
6. Goa	April 2005	21. Punjab	April 2005
7. Gujarat	April 2006	22. Rajasthan	April 2006
8. Haryana	April 2003	23. Sikkim	April 2005
9. Himachal Pradesh	April 2005	24. Tamil Nadu	January 2007
10. Jammu and Kashmir	April 2005	25. Tripura	October 2005
11. Jharkhand	April 2006	26. Uttaranchal	October 2005
12. Karnataka	April 2005	27. Uttar Pradesh	January 2008
13. Kerala	April 2005	28. West Bengal	April 2005
14. Madhya Pradesh	April 2006	29. NCT Delhi	April 2005
15. Maharashtra	April 2005		

Source: RBI, Based on Information received from the State Governments.

The Empowered Committee emphasized the phasing out of Central Sales Tax (CST) after introduction of VAT. State were collecting nearly Rs. 15 thousand crore every year from CST when the rate was 4 percent. The Central Government has reduced the rate first to 3 percent and now to 2 percent and agreed to give the states some compensation. As CST is phased out, there is also a critical need for putting in place a regulatory frame work in terms of Taxation Information Exchange System to give a comprehensive picture of inter-State trade of all commodities. This process of setting up of Taxation Information Exchange System has already been started by the Empowered Committee.

Under exempted category, the Empowered Committee suggested that about 46 commodities comprising of natural and unprocessed products in the un-organized sector, items that are legally barred from taxation and items which have social implications should be included with a flexibility to the states to select a set of maximum of 10 commodities States for exemption goods of local social importance for the individual States without having any inter-State implications.

Under 4 percent VAT rate category, items of basic necessities such as medicines and drugs, all agricultural and industrial inputs, capital goods and declared goods are to be included. The remaining commodities, common for all the States, will fall under the general VAT rate of 12.5 percent.

Notwithstanding the guidelines given by the Empowered Committee, in terms of actual implementation, considerable variation developed across states. Most states have divided the goods taxable at different rates into several schedules. We consider a set of selected states to highlight some of the differences in the way that the goods are being classified in the states. For example, in Tamil Nadu, there are six separate schedules, which contain different parts. In the first schedule, part A relates to goods which are taxable at the rate of one percent. These include bullion, gold, silver and precious stones. Part B of the first schedule lists goods that are taxable at the rate of 4 percent. This list includes 150 items. Part C of the first schedule includes the residual category of goods which are taxable at the rate of 12.5 percent. The second schedule includes goods where there is no entitlement for input tax credit. These include alcoholic liquors, gasoline, petrol and high speed and diesel oil, kerosene other than those sold through the PDS, molasses, and sugarcane. The rates vary very widely among these goods from 4 percent to 73 percent. The third schedule provides for compounded rates for hotels, restaurants and sweet stalls. The fourth schedule gives a list of goods exempted from the state VAT under two parts, part A and part B. Part A contains 10 goods and part B contains 81 goods. The fifth and sixth schedules relate to international organizations where sale is zero-rated and where a transit pass is permissible, respectively.

In the case of Andhra Pradesh, there are six schedules. However, these are quite differently organized compared to Tamil Nadu. Schedule 1 provides a list of exempted goods which are about 47 in number. Schedule 2 provides a list of zero rated goods that are eligible for input tax credit. Schedule 3 provides a list of credits that are taxable at 1 percent rate and include bullion, jewellery and precious stones. Schedule 4 provides a list of goods that are taxable at 4 percent. The list contains 90 items. Schedule 5 is the residual category of goods where the rate of 12.5 percent applies. Schedule 6 includes goods subjected to tax at special rates including liquor, petrol, aviation motor spirit, aviation turbine fuel and diesel oil. These are levied at first point sales and range from 21.33 percent to 90 percent. However, in the case of Andhra Pradesh, input tax credits for these items in schedule have been provided for.

In the case of Punjab VAT schedules have been divided into 8 categories and the schedules range from A to H. Schedule A contains the list of exempted goods. These are 65 in number. Schedule B contains goods taxable at 4 percent and these are 149 in number. Liquor is included in this list. Schedule C contains goods taxable at one percent covering bullion etc. Schedule D contains only one item, viz., aviation turbine fuel taxable at the rate of 20 percent. No input tax credit is provided in respect of purchases of petrol, diesel, aviation turbine fuel, liquefied petroleum gas, and condensed natural gas. This is also applicable for beverages and tobacco products. Schedule E provides a list of goods taxable at special rates. This includes only three items viz., diesel, molasses and petrol and the tax rates vary from 8.8 percent for diesel to 27.5 percent for petrol. Schedule F is the residual category where goods are taxable at 12.5 percent. Schedule G makes reference to the UN bodies and Schedule H provides a list of good on which VAT is levied on the taxable turnover. These include paddy, wheat, cotton, sugarcane and milk.

For Maharashtra, there are five schedules. Schedule A gives a list of exempted goods. These are 54 in number and include electricity. Schedule B refers to the tax rate of one percent applicable on gold, silver and precious metals. Schedule C gives the list of goods that are taxes at 4 percent. In this list, 109 groups of goods are mentioned. These include iron and steel, various metals, lime and lime stone and their products, paper, and plastic granules etc. Schedule D includes goods taxed at 20 percent or above. Foreign and country liquor and molasses and spirit are taxed at 20 percent. For high speed diesel oil, aviation turbine fuel, aviation gasoline and motor spirit the rates vary between 27 to 34 percent with a specific component added amounting to Re. 1 per litre in most cases. Schedule E is the residual category taxed at 12.5 percent. A distinction is made according to whether the dealer is located in Brihan Mumbai, Navi Mumbai or Thane and a dealer located elsewhere in Maharashtra.

In the case of Delhi, there are 7 schedules. Schedule 1 gives the list of exempted commodities which includes electricity and energy, rubber and plastic footwear and plastic waste. Schedule 2 is for the 1 percent rate relating to gold, and precious metals. Scheduled 3 include goods that are taxed at 4 percent. This includes 84 items that covers industrial cables and ferrous and non ferrous metals, paper and news print, pipes and plastic footwear, and plastic granules, powder and master batches. It also includes cooper and various other metals and carbon. It also includes insecticides, fungicides and pesticides of technical grade, and various industrial inputs. Schedule 4 provides a list of goods taxed at 20 percent. It includes petroleum products other than liquid petroleum oil, naphtha, aviation turbine fuel, spirit, gasoline, liquor including country liquor and molasses among others. The 5th and 6th schedules give the list of various categories of dealers and organizations that are exempted on paying tax on sale of goods. The 7th schedule provides a list of non creditable goods. This includes all automobiles including commercial vehicles, and two and three wheelers, fuels in the form of petrol, diesel, LPG, CNG and coal, beverages for human consumption, air conditioners, tobacco etc. The residual category of goods where the tax rate is 12.5 percent is not separately mentioned and is included in Chapter 2, clause 4 of the Act.

It is clear that while there is some uniformity in the tax rates which range from exempted goods, zero rated goods (for exports), goods taxed at one percent, goods taxed at 4 percent, and goods taxed at 12.5 percent, there is considerable variation among the states regarding the goods included in different categories. There are also several goods where special rates are applied and these rates vary considerably across states. There is also considerable variation in the list of goods subject to special rates where credit on taxes paid on goods is allowed or not allowed. Many goods that may be considered as polluting inputs and outputs are taxed at different rates in the states. With a view to deriving a broad idea of such differences, we consider the state-wise treatment of a selective list of these goods which may be considered prima-facie as polluting inputs and outputs.

d. Other State Taxes on Goods and Services

i. Motor Vehicle Tax

In most states a compounded system of motor vehicle tax exists, where a one time levy is paid for the life of the vehicle. This may be useful, particularly if the tax payers are to be saved from the hassle of interacting with the tax department every year. However, compounded levies are neither revenue productive nor do they permit additional taxation when vehicles become less efficient and more polluting. Stamp Duty and Registration Fees The stamp duty on the registration of property or other conveyances has the main difficulty of getting the correct method of evaluation. Until recently, the stamp duty rates were excessively high in most states and the procedures for evaluating the conveyances were also complicated. In recent years, states have undertaken reforms by reducing the duty rates and streamlining procedures for evaluation of property. There has been an attempt to move towards uniform stamp duty rates. While in Punjab it is 6 percent, in Himachal Pradesh, there is a 12 percent duty, Uttar Pradesh 10 percent and Rajasthan 11 percent.

The Union finance ministry has asked states to adopt a uniform 5 percent stamp duty. Following this, some states like Maharashtra and Bihar went for a reduction in existing stamp duties. In 2002, Delhi cut stamp duty rates from 13 percent to 8 percent for men registering property and brought it down to 6 percent for women owners. In case of joint ownership by men and women, the duty is 7 percent. In Delhi, stamp duty rates were further reduced for women at 4 percent against 6 percent for men. Recently, Haryana reduced stamp duty for women to 8 percent while that for men in the state is 10 percent.

ii. State Excise Duties

The power of states to levy excise duties is limited to alcoholic liquors for human consumption, and opium, Indian hemp and other narcotic drugs excluding those used for medicinal purposes or for toilet preparations. The revenues accrue to the states in the form of licence duties from the vendors as well as the tax, which can be specific or ad valorem. Consumption of alcohol and other beverages containing spirit are known to be hazardous and injurious to health. The Constitution has provided the State governments with a monopoly to tax the production and sale of alcoholic beverages. The State governments also control the production of these by giving licenses and often specifying the quantity to which the production should limited. Since demand for alcoholic beverages is generally assessed to be price-inelastic, this tax provides a case for keeping high tax rates for controlling the level of consumption. In fact high tax rates yield both high revenues and greater control on consumption. Some states have from time to time embarked upon the path of total prohibition. Attempts at full prohibition often lead to illegal production and export of the tax base to the neighboring states. Production of alcoholic beverages involves considerable pollution due to the effluents that are discharged.

iii. Electricity Duty

Electricity duty is charged to consumers along with the electricity tariffs or rates. The rates are meant for electricity boards or the providers of electricity, while the electricity duty is meant for the State government. The State government administers the electricity prices, and often owes to the electricity boards payments on account unpaid but committed subsidies. In actual practice, as State governments is unable to pay the requisite amounts due to electricity boards, the boards in turn collect the electricity duty but do not pass these on to the State government. In most states, electricity prices are now regulated by the Electricity Regulatory Authorities but the State governments have a large say in the determination of these prices.

iv. Entertainment Tax

The entertainment tax is a levy on admission to places of amusement or entertainment including cinema, circus, theatrical performances, exhibitions, etc. The entertainment tax is used to be an important source of revenue for the states, but has lost its importance in recent times due to proliferation of means of home-based entertainment, which has also made it difficult to revise tax rates.

e. Local Taxes

The resources of the local bodies, i.e., Panchayats and Municipalities include assignment of land tax, profession tax and surcharge/cess on state taxes in addition to property tax/house tax, octroi/entry tax, and other user charges.

i. Land taxes: In many States, land revenue has either been abolished or land holdings up to a certain size have been exempted.

ii. Property/House tax: Property tax/house tax is the single most important local tax in a majority of the States. However, it has been beset with a variety of problems that have prevented the local bodies to exploit its full potential. In most States, the tax rates have not been revised periodically and there is no standard mechanism for determination of property tax rates and their revision. One major impediment to the growth of revenue from the property/house tax has been the rent control laws.

<u>iii. Octroi/Entry tax</u>: Besides the property/house tax, octroi has been the major source of revenue for the municipalities and, in some States, even for the panchayats. Many States have, however, abolished octroi with a view to removing impediments to the physical movement of goods, though several other new barriers have been created. Some States have introduced a levy in lieu of octroi, an entry tax, the net proceeds of which are transferred to the local bodies in the form of grant.

1.7 Taxation of Services

A service tax was levied by the Central government under its residuary powers, as the subject has not been mentioned in any of the Lists of the Seventh Schedule of the Constitution. The service tax was brought into force with effect from 1st July 1994. Initially three services were notified: (1) Telephone (2) Stockbroker, and (3) General Insurance. The Finance Act (2) 1996 enlarged the scope of levy of Service Tax covering three more services, viz., (4) Advertising agencies, (5) Courier agencies, and (6) Radio pager services.

The Finance Acts of 1997 and 1998 further extended the scope of service tax to cover a larger number of services rendered by the following service providers, from the dates indicated against each of them:

(7) Consulting engineers (7th July, 1997), (8) Custom house agents (15th June, 1997) (9) Steamer agents (15th June, 1997), (10) Clearing & forwarding agents (16th July, 1997), (11) Air travel agents (1st July, 1997), (12) Tour operators (exempted up to 31.3.2000 Notification No.52/98, 8th July, 1998, reintroduced w.e.f. 1.4.2000), (13) Rent-a-cab operators (exempted up to 31.3.2000 Vide Notification No.3/99 Dt.28.2.99, reintroduced w.e.f. 1.4.2000), (14) Manpower recruitment Agency (1st July, 1997), and (15) Mandap Keepers (1st July, 1997).

The services provided by goods transport operators, outdoor caterers and pandal/ shamiana contractors were brought under the tax net in the Budget 1997-98, but abolished vide Notification No.49/98, 2nd June, 1998. Twelve new services were notified on 7th October, 1998 and were subjected to levy of Service Tax w.e.f. 16th October, 1998. These are:

(16) Architects, (17) Interior decorators, (18) Management consultants, (19) Practicing chartered accountants, (20) Practicing company secretaries, (21) Practicing cost accountants, (22) Real estates agents/consultants, (23) Credit rating agencies, (24) Private security agencies, (25) Market research agencies, and (26) Underwriters agencies.

The ambit of the services tax was steadily increased in successive budgets as summarized below.

Budget 2001-02: (27) Scientific and technical consultancy services, (28) Photography, (29) Convention, (30) Telegraph, (31) Telex, (32) Facsimile (fax), (33) Online information and database access or retrieval, (34) Video-tape production, (35) Sound recording, (36) Broadcasting, (37) Insurance auxiliary activity, (38) Banking and other financial services, (39) Port, (40) Authorised service stations, and (41) Leased circuits services.

Budget 2002-2003: (42) Auxiliary services to life insurance, (43) Cargo handling, (44) Storage and warehousing services, (45) Event management, (46) Cable operators (47) Beauty parlours, (48) Health and fitness centres, (49) Fashion designer, (50) Rail travel agents, and (51) Dry cleaning services.

Budget 2003-04: (52) Commercial vocational institute, coaching centres and private tutorials, (53) Technical testing and analysis (excluding health and diagnostic testing) and technical inspection and certification service, (54) Maintenance and repair services, (55) Commission and installation services, (56) Business auxiliary services, namely business promotion and support services (excluding on information technology services), (57) Internet café, and (58) Franchise services.

Budget 2004-05: (59) Transport of goods by road (earlier Goods Transport Operators service re-introduced), (60) Out door caterer's service (re-introduced), (61) Pandal or Shamiana service (re-introduced), (62) Airport services, (63) Transport of goods by air services, (64) Business exhibition services, and (65) Construction services in relation to commercial or industrial building construction services in relation to commercial or industrial building.

Budget 2005-06: (66) Intellectual property services, (67) Opinion poll services, (68) TV or radio programme services, (69) Survey and exploration of minerals services, (70) Travel agent’s services other than rail and air travel agents, (71) Forward contract services, (72) Transport of goods through pipe line or other conduit services, (73) Site preparation and clearance services, (74) Dredging services, (75) Survey and mapmaking services, (76) Cleaning services, (77) Membership of clubs and associations, (78) Packaging services, (79) Mailing list compilation and mailing services, and (80) Construction services in relation to residential complexes.

Budget 2006-07: (81) ATM operations, maintenance and management; (82) registrars, share transfer agents and bankers to an issue; (83) sale of space or time, other than in the print media, for advertisements; (84) sponsorship of events, other than sports events, by companies; (85) international air travel excluding economy class passengers; (86) container services on rail, excluding the railway freight charges; (87) business support services; (88) auctioneering; (89) recovery agents; (90) ship management services; (91) travel on cruise ships; and (92) public relations management services.

Budget 2007-08: (93) Services outsourced for mining of mineral, oil or gas; (94) renting of immovable property for use in commerce or business; however, residential properties, vacant land used for agriculture and similar purposes, land for sports, entertainment and parking purposes, and immovable property for educational or religious purposes will be excluded; (95) development and supply of content for use in telecom and advertising purposes; (96) asset management services provided by individuals; (97) design services, and (98) on services involved in the execution of a works contract (an optional composition scheme under which service tax will be levied at only 2 percent of the total value of the works contract).

Budget 2008-09: (99) asset management service provided under ULIP, will be on par with asset management service provided under mutual funds; (100) services provided by stock/commodity exchanges and clearing houses; (101) right to use goods, in cases where VAT is not payable; and (102) customised software, to bring it on par with packaged software and other IT services.

The service tax rate was also progressively increased. It was increased from 5 to 8 percent on all the taxable services w.e.f. 14.5.2003. It was then enhanced to 10 percent from 8 percent in September 2004. Besides this 2 percent education cess on the amount of service tax was introduced. Subsequently the secondary and higher education surcharge of 1 percent was also added. Currently the effective service tax rate is 12.36 percent including education cess.

The main services that have proved to be revenue productive in the case of service are telephones, insurance, brokerage, advertising, courier services, air travel agent services, clearing and forwarding agent services, banking and other financial services, and port services.

1.8 Conclusion

Taxation of goods and services in India has been subject to multiplicity of taxes, large number of cesses and surcharges, cascading, distinction between goods and services and excessive rate categories among the goods, overlapping of taxation space between the Central and State governments in the case of goods up to the stage manufacturing, artificial segmentation of the value added in the process of production and sale between manufacturing and beyond up to the retail space. Such a system did not meet the first principles of a good tax system and several reforms were initiated to bring about a system of value added taxation. In spite of these reforms various problems remain. The system of VAT is at present segmented between Cenvat, State-VAT, the central service tax, and a variety of other taxes at the state level. In all cases, multiple tax rates and a variety of exemptions apply and cascading continues between different taxes. The next chapter discusses the problems arising out of the present system of taxation of goods and services in India after the introduction of the value added tax system.

Chapter 2

CONTINUING CHALLENGES IN THE FRAGMENTED VAT SYSTEMS

2.1 Introduction

In spite of reforms, the system of taxation of goods and services in India falls short of international norms and practices in many developed and developing countries. The main problems relate to issues in defining manufacturing, fragmentation of space of taxation of valued added, issues relating inter-State trade, and the overarching nature of many services that cross state borders in the stages from production to final consumption. India's problems are particularly challenging because of the federal structure of government. The next logical step is to continue with reforms so as to bring about a comprehensive system of taxation of goods and services consistent with the needs of a modern and efficient economy while preserving the basic features of our federal arrangements. For this purpose, we need to identify the main deficiencies and challenges of the current system, even after nearly two decades of reforms including the introduction of Cenvat and State-VAT. In this Chapter, we examine the continuing problems and the need for further reforms to bring about a comprehensive GST.

2.2 Taxation at Manufacturing Level

The Cenvat is levied on goods manufactured or produced in India. This gives rise to definitional issues as to what constitutes manufacturing, and valuation issues for determining the value on which the tax is to be levied. Manufacturing itself is a narrow base. Limiting the tax to the point of manufacturing is a severe impediment to an efficient and neutral application of tax. The definition of manufacturing and the methodology of valuation have evolved through judicial rulings. The effective burden of tax becomes dependent on the supply chain, i.e., the taxable value at the point of manufacturing relative to the value added beyond this point. It is for this reason that most countries have abandoned this form of taxation and replaced it with multi-point taxation system covering valued added up to the retail level.

a. Concept of Manufacture

The central excise duty, now known as, Central Value Added Tax (CENVAT) is levied on the manufacture and production of 'excisable goods' in India. Excise duty may be levied and collected on goods only if (a) the goods are manufactured, and (b) the goods are marketable. The task of determining what is 'manufacture' has led to various disputes and the Courts have often clarified, from time to time, as to what should be considered as manufacture for the purpose of central excise duty.

The Supreme Court of India in the case of **Union of India vs. Delhi Cloth & General Mills Co. Limited**, held that the word 'manufacture' is generally understood to mean "as bringing into existence a new substance" and does not merely mean "to produce some change in substance".[1]Later, the Supreme Court further clarified the meaning of the term 'manufacture' in the case of **South Bihar Sugar Mills Ltd vs. Union of India**. The Court held:

> "The word "manufacture" implies a change but every change in the raw material is not manufacture. There must be such a transformation that a new and different article must emerge having a distinctive name, character or use."

In a recent judgment, the Supreme Court, in the case of **Kores India Ltd., Chennai vs. Commissioner of Central Excise**, defined the concept of manufacture as follows: "… manufacture is the end result of one or more processes through which the original commodities are made to pass… There may be several stages of processing, a different kind of processing at each stage. With each process suffered the original commodity experiences a change. Whenever a commodity undergoes a change as a result of some operation performed on it or in regard to it, such operation would amount to processing of the commodity. But it is only when the change or a series of changes takes the commodity to the point where commercially it can no longer be regarded as the original commodity but instead is recognized as a new and distinct article that a manufacture can be said to take place. … (See **Collector of Central Excise, Jaipur vs. Rajasthan State Chemical Works, Deedwana, Rajasthan (1891 (4) SCC 473**)."

Thus, for consideration as 'manufacture', the process involved must bring about a transformation and as a result of such transformation a new and different commercial

[1] The Court quoted with approval a passage appearing in Volume 26 of the Permanent Edition of the "Words and Phrases" as below:
"'Manufacture' implies a change but every change is not manufacture and yet every change of an article is the result of treatment, labour and manipulation. But something more is necessary and there must be transformation: a new and different article must emerge having a distinctive name, character or use".
"In our view, the gas generated by these concerns is kiln gas and not carbon dioxide as known to the trade, i. e., to those who deal in it or who use it. The kiln gas in question therefore is neither carbon dioxide nor compressed carbon dioxide known as such to the commercial community and therefore cannot attract Item 14-H in the First Schedule."

article must emerge having a distinctive name, character and use. A mere change of form, shape or size of the same article or substance would not ordinarily amount to manufacture.

The definition of manufacture in the Excise Act underwent various Amendments in years 1986, 1999, 2002 and 2003. As a result, 'manufacture' was defined to include any process, which is specified as amounting to manufacture in relation to any goods in the Section or Chapter Notes specified in the First Schedule to the Central Excise Tariff Act, 1985 and in respect of goods specified in the Third Schedule to the Excise Act which involve packing or re-packing of such goods in the unit container or labeling or re-labeling of containers including the declaration or alteration of retail sale price on it or adoption of any other treatment on the goods to render the product marketable to the consumer. Thus, by a 'legal fiction', certain processes have been equated with manufacture, even though as a result of such processes no new or different article emerges having a distinctive name, character or use.

b. Concept of Goods and Marketability

The second main issue is about valuation. Technically, the manufacturing process may be complete but unless the good enters a market and faces a buyer, there is no value that can be attached to the product. Excise duty, as provided under Section 3 of the Excise Act, is levied on the manufacture or production of 'excisable goods'. In several judgments, the Supreme Court has held that in order to be goods, an article must be something which can ordinarily come to the market and is brought for sale and must be known to the market as such. Therefore, the essentiality of the concept of marketability is that the goods manufactured are known in the market or are capable of being sold and purchased in the market.

Several cases judgments have clarified this concept. In the case of **Union of India vs. Delhi Cloth & General Mills Co. Limited**, the assesse was manufacturing hydrogenated vegetable oil (vanaspati). During the process of manufacture, at an intermediate stage, refined oil came into existence. It was the contention of the Revenue Authorities that excise duty was leviable on such refined oil. The assesse contended that the refined oil that came into existence was not refined oil as known to the market since refined oil as known to the market must have undergone the process of deodorization and that, in their case, the refined oil had not undergone such process. The Supreme Court held that to become "goods" an article must be something which can ordinarily come to the market to be bought and sold and that since the refined oil, in the condition in which it came into existence in the assesse's factory, was not refined oil which could ordinarily come to the market to be bought and sold, that the said refined oil was not 'goods'.[1]

c. Classification of Goods

A third problem arises because there is a need to classify the goods so as to determine the appropriate level of duty in a highly differentiated system of levy. It is often not possible to identify all the goods individually. Often the goods are identified through groups and sub-groups and then to determine the rate of duty on each group or sub-groups of goods. For the purposes of classifying goods under various heads and/or sub-heads, Parliament has passed the Central Excise Tariff Act, 1985. The Tariff Act is based on the International Convention of Harmonised System of Nomenclature (HSN).

The First Schedule of the Tariff Act is divided into 20 Sections, which broadly cover separate categories of goods. For instance, Section I deals with live animals: animal products; Section II deals with vegetable products; Section XI deals with textile and textile articles; and Section XV deals with base metals and articles of base metal. Each Section contains a number of Chapters. The First Schedule comprises 96 Chapters.

The Sections and Chapters contain elaborate sections and/or chapter notes. The Tariff Act also contains Rules for the Interpretation of the First Schedule. In spite of these provisions being quite elaborate, they are not always adequate to correctly classify a product. As a result, Courts and Tribunals had to evolve rules over the years for the classification of the products.

d. Valuation

The next problem is the issue of valuation of goods arises where the rates of duty are *ad valorem*, i.e., expressed as a percentage of the value of goods. For this purpose the

[1] In the case of South Bihar Sugar Mills Ltd vs Union of India, the assesse manufactured sugar. During the process of manufacture of sugar, a gas known as 'kiln gas' emerged as a byproduct and was released to the atmosphere. The Revenue Authorities sought to levy excise duty on the said kiln gas on the ground that it was either carbon dioxide or compressed carbon dioxide. The contention of the assesse was that kiln gas was not carbon dioxide as known to the market or to the commercial community dealing in carbon dioxide. The Supreme Court held that excise duty is levied on goods and as the Act does not define 'goods', the legislature must be taken to have used that word in its ordinary, dictionary meaning. The dictionary meaning is that to become goods it must be something which can ordinarily come to the market to be bought and sold and is known to the market. Looking at the evidence on record the Court held:
"Thus, before excise duty can be levied and collected on any goods, the twin tests of manufacture and marketability have to be satisfied. The burden of proving that goods satisfy the twin tests lies on the Revenue Authorities".

assessable value of the goods has to be determined. There are three main ways for valuation in cases where the duty is ad valorem: (i) a tariff value that is fixed by the government in respect of certain goods; (ii) transaction value, and (iii) valuation based on the retail sale price printed on a package of goods.

The Central Government has power to fix tariff values in respect of goods under Section 3 (2) of the Excise Act. In such a case, the assesse pays the ad valorem duty on the tariff value as fixed. In cases where either a tariff value has not been fixed by the Central government or the valuation is not based on the retail sale price, the valuation of goods is required to be carried out under Section 4 of the Excise Act. In such cases, valuation is based on the 'transaction value' of the goods. The concept of 'transaction value' was introduced in the Excise Act with effect from July 1, 2000, subject to the following conditions:

i. The price must be the sole consideration for the sale. In other words, the assesse must not receive any other sum either by way of money or by way of any other assistance for the manufacture of goods or any manufacturing assistance from the buyer.
ii. The buyer of the goods must not be related person. The term related person has been defined in sub-section (3) (b) of Section 4 of the Excise Act.
iii. Goods must be sold by the assesse for delivery at the time and place of removal.

The transaction value includes any amount that is paid or payable by the buyer to or on behalf of the assesse on account of the sale of goods. However, for determining the transaction value the duty of excise, sales tax and other taxes, actually paid or payable are not to be included. If any one of the above-mentioned three conditions is not satisfied then the value of the goods is determined in such manner as may be prescribed. For this purpose, the Central Government has framed the 'Central Excise Valuation (Determination of Price of Excisable Goods) Rules, 2000'. These rules provide the manner for determination of value of goods which do not satisfy the above mentioned conditions.

With effect from May 14, 1997 Section 4 A was inserted in the Excise Act. Under this provision, valuation of products may be made with reference to the retail sale price of the products. However, the conditions precedents for the application of the section are:

i. The excisable goods must be packaged goods on which there is a requirement to specify the retail sale price under the provisions of the Standards of Weights and Measures Act, 1976 or the rules framed there under or any other law for the time being in force;
ii. The excisable goods are notified by the Central Government for purposes of the section; and
iii. The goods must be chargeable to duty based on their value.

On satisfaction of these three conditions, the value for purposes of levy of excise duty shall be the retail sale price of such goods less such amount of abatement from such retail sale price as the Central government may notify. The abatement is given as a percentage of the retail sale price.

In the Cenvat system, the provision of Cenvat credit has been put in place since all manufactured goods are not used by end-users or consumers. The final products manufactured by some manufacturers may be the raw material/input for other manufacturers. Similarly capital goods purchased by a manufacturer may be utilised by him for setting up a plant, machinery or a factory. The inputs/capital goods so purchased by the manufacturer are duty paid. In order to overcome the cascading effect of tax, under the Cenvat Credit Scheme, a manufacturer or a service provider may take credit, *inter alia*, of excise duty or additional duty of customs (levied under Section 3 (1) of the Customs Tariff Act, 1975) or service tax paid on the inputs or capital goods or inputs services and adjust such credit for making payment of tax on his final products or output services.

The law relating to valuation of excisable goods chargeable to ad valorem rate of duty under Section 4 of the Central Excises and Salt Act, 1944 has been the subject matter of a large number of disputes for a long time, beginning from the famous Voltas case where the dispute was as to what constituted 'wholesale cash price' and, when wholesale cash price was available, whether the department could have recourse to retail price as the basis for assessment. The Supreme Court coined concepts like Manufacturing cost plus the manufacturing profit, post-manufacturing cost and profit, which were not understood in the true spirit and were interpreted to the disadvantage of the revenue. In later cases which came up before the Supreme Court a decision about the interpretation of old Section 4 as well as new Section 4 (which came in force in October 1975) was rendered. The law on central excise valuation has gradually emerged through ruling of the Supreme Court in different cases.

e. Exemptions and Multiple Rates

The most significant cause of complexity is, of course, the existence of exemptions and multiple rates, and the irrational structure of the levies. These deficiencies are the most glaring in the case of the Cenvat and the Service Tax. The starting base for the Cenvat is narrow, and is being further eroded by a variety of area-specific, and conditional and unconditional exemptions. A few years ago the government attempted to rationalize the Cenvat rates by reducing their multiplicity. However, the government has not adhered to this policy and reintroduced concessionary provisions for several sectors/products.

In summary, since Cenvat relates to an artificial fragmentation of the value added space, it has led to several problems regarding definition, classification, and valuation.

2.3 Levy of Service Tax: Disputes

The present disjointed levy of service tax has also been equally complicated. Ever since the service tax was levied as a distinct and separate tax, it was subjected to several disputes. The key problem with the service tax is the basic approach of levying it on specified services, each of which generates an extensive amount of argumentation as to what is included in them. Ideally, the tax base should be defined to include all services, with a limited list of exclusions, that is, specifying only a negative list. The validity of service tax levy has been challenged in various courts of India from time to time. Some important decisions in this regard are given below.

The Gujarat High Court in the case of **Addition Advertising vs. Union of India (1998 (98) ELT 14)** has held that levy of tax on advertising service is not unconstitutional. It was held that this is not a tax on any profession, trade, calling or employment, but in respect of service rendered. If there is no service, there is no tax. It was further held that 'the tax is not on advertisement' but on the services rendered with reference to the advertisement and there is a clear distinction between the advertisement service and advertisement.

In another case of **M/s. Laghu Udyog Bharati vs. UOI (1999 (89) ELT 247)** the petitioners challenged the Government's decision to shift the burden of duty liability to the service receivers in case of Goods Transport Operators and Clearing & Forwarding Agents. In this case, the Hon'ble Supreme Court upheld the contention of petitioners and held that the relevant provisions of Service Tax Rules were ultra vires the Finance Act, 1994. The Hon'ble Supreme Court while deciding the case, observed as follows:

> "The service tax is levied by reason of services which are offered. The imposition is on the person rendering the service. Of course, it may be indirect tax, it may be possible that the same is passed on to the customer but as far as the levy and assessment is concerned, it is the person rendering the service who alone can be regarded as an assesse and not the customer. This is the only way in which the provision can be read harmoniously. The charge of tax is on the value of services and it is only the person who is providing service can be regarded as an assesse. The rules, therefore, cannot be so framed which do not carry out the purpose of the Chapter (Statute) and cannot be in conflict with the same."

A number of trade bodies and individual service providers had challenged the levy of service tax by the Union Government under the Residuary Entry No.97, List I in Seventh Schedule of the Constitution. They contended that the service tax is nothing but a tax on professions, which is specifically listed, in the State list. Therefore, the Union Government is not empowered to levy service tax on professional services. Additionally, the levy has also been challenged on the grounds of hostile discrimination vis-à-vis other services and/or the service providers within the same category. The Institute of Architects and certain representative bodies of Chartered Accountants were the main bodies making these representations.

The Gujarat High Court in its judgement dated 27.12.2000 (in SCA No.469/1999 and 7220/1999) and the Mumbai High Court in the judgement dated 22.02.2001 (in the W/ P no. 142/1999 and 1174/2000) have held that the tax on profession (which is in the State list) is a tax on the privilege of carrying on such profession. Therefore, such a tax is irrespective of the fact whether professional does or does not render professional service for remuneration. Whereas the service tax is a levy, which has to be paid each time a professional renders services for remuneration. Thus, professional tax and service tax are different in pith and substance. Further, the legislature is competent to identify and reasonably discriminate between various services and service providers for the purposes of taxation. Therefore, there is no ground to challenge the levy on the grounds of discrimination. The Madras High Court has also taken the same view in a plethora of petitions pending before them.

Considering the importance of early resolution of these disputes, the Directorate actively pursued such cases pending in Ahmedabad, Mumbai and Chennai High Courts that have upheld the constitutional validity of the service tax law provisions contained in the Chapter V of the Finance Act, 1994 as amended and the Rules framed there under.

Service tax on taxable services rendered in India are exempt, if payment for such services is received in convertible foreign exchange in India and the same is not repatriated outside India. The Cenvat Credit Rules allow a service provider to avail and utilize the credit of additional duty of customs/excise duty for payment of service tax. Credit is also provided on payment of service tax on input services for the discharge of output service tax liability.

2.4 Nature of Modern Services

The distinction between goods and services is increasing getting blurred with the advancements in information technology and digitization. Under Indian jurisprudence, goods have been defined to include intangibles, e.g., copyright, and software, bringing them within the purview of state taxation. But intangibles are often supplied under as part of a service contract. Software upgrades are considered as 'goods' but these can be supplied as part of a contract for software repair and maintenance services. The modern telecommunications give scope of providing many 'value-added services' (VAS) that may include supplies of 'goods' like wallpapers, ring tones, or weather reports for mobile phones. An on-line subscription to newspapers could be viewed as a service, but online purchase and download of a magazine or a book could constitute a purchase of goods. Leasing of equipment without transfer of possession and control to the lessee may be interpreted is a service but may be deemed as sale of goods.

The traditional distinctions between goods and services (and for other items such as land and property, entertainment, and luxuries) have become dated. In modern economies, goods and services are being bundled together and offered to the consumers as a composite bundle. Under the current division of taxation powers, neither the Centre nor the States can apply the tax to such bundles in a seamless manner. Each can tax only parts of the bundle, creating possibility of gaps and/or disputes.

2.5 Problems of State VAT

The complexities under the State VAT relate primarily to classification of goods to different tax rate schedules. Traditionally, the lower tax rates are applied to basic necessities. This is not the case under the State VAT. The lowest rate of 1 percent applies to precious metals and jewellery and such other items made of them. The middle rate of 4 percent applies to selected items of basic necessities and also a range of industrial inputs and IT products. In fact, basic necessities fall into three categories – exempted from tax, taxable at 4 percent, and taxable at the standard rate of 12.5 percent.

Another source of complexity under the State VAT is determining whether a particular transaction constitutes a sale of goods. This problem often arises when dealing with software products and intangibles like a right to distribute/exhibit movies or time slots for broadcasting advertisements.

Local or other state level taxes like octroi, entry tax, lease tax, workers contract tax, entertainment tax and luxury tax are not integrated into the State-VAT regime, which goes against the basic premise of VAT which is to have uniformity in the tax structure.

There is considerable heterogeneity across states because they have gone different schemes of scheduler organization of goods.

2.6 Continuing Cascading

Tax cascading occurs under both the Centre and the State taxes. The most significant contributing factor to tax cascading is the partial nature of the taxes levied by them. Oil and gas production, and mining, agriculture, wholesale and retail trade, construction, and range of services remain outside the ambit of the Cenvat and the service tax levied by the Centre. The exempt sectors are not allowed to claim any credit for the Cenvat or the service tax paid on their inputs. Similarly, under the State-VAT, no credits are allowed for the inputs of the exempt sectors, which include the entire service sector, real property sector, agriculture, oil and gas production and mining. Another major contributing factor to tax cascading is the CST on inter-State sales, which is collected by the state of origin and for which no credit is allowed.

Poddar (2008) highlights that under the Canadian manufacturers' sales tax, which was similar to the Cenvat, the non-creditable tax on business inputs and machinery and equipment accounted for approximately one-third of total revenues from the tax. The extent of cascading under the provincial retail sales taxes in Canada, which are similar to the State-VAT, is estimated to be 35-40 percent of total revenue collections. He argues based on an earlier study by Kuo and Poddar (1998) that on a priori considerations, the expectation is that the magnitude of cascading under the Cenvat, service tax, and the State-VAT to be even higher, given the more restricted input credits and wider exemptions under these taxes.[1] It is also clear that the service tax which is predominantly on business to business (B2B) services and remains highly cascading in nature.

2.7 Continuation of Central Sales Tax

The continuation of CST is also a cause for cascading. Not allowing tax credit for interstate trade seriously undermines the basic benefit of enforcing a vat system, namely the removal of the distortions in movement of goods across the states. CST creates unnecessary tax barriers in achieving an all-India integrated market. Further, the denial of input tax credit on inter-State sales and inter-State transfers would affect free flow of goods. Elimination of CST would be a prerequisite for implementing a proper goods and services tax.

2.8 Rationale for Extending Services for State Taxation

In order to resolve these problems, two changes need to be brought about simultaneously: extension of all services within the purview of State-VAT and extension of value added up to the retail level in the case of goods to be brought under the purview of the Cenvat. This is what the Kelkar Committee had called the 'grand bargain'. These changes will have the effect of integrating for goods and services for purposes of taxation under the value added system.

We can cite at least four reasons why services should be extended for taxation along with goods for State-VAT. The first is a revenue reason. Given that services are fast growing sector (Table 2.1), this will ensure that states will share in the revenue buoyancy of the GDP via services. This is so because the share of consumption expenditure will progressively increase in favour of services. This will also make state revenue more stable since the services are the least volatile of the output sector in an economy. Table 2.1 gives a comparative picture of the relative growth performance of the different components of GDP.

[1] Kuo, C.Y., Tom McGirr, Satya Poddar (1988), "Measuring the Non-neutralities of Sales and Excise Taxes in Canada", Canadian Tax Journal, 38, 1988, provide estimates of tax cascading under the Canadian federal manufacturers' ' sales tax and the provincial retails sales taxes.

The second reason is that expanding the taxation of services as part of the VAT system will make the sales tax fairer. The sales tax is intended to be a general tax on consumption where consumption of goods and services are often substitutes and should treated on par. It violates the principle of horizontal equity, for example, to tax the person who rents a videotape but not the person who watches a pay-per-view movie on cable TV.

Thirdly, taxing services at the same rate as goods would improve the allocation of economic resources. Differential rates or lower rates for services distort resource allocation by providing an incentive to purchase services rather than goods.

Table 2.1: Growth Rates of Agricultural and Allied Activities, Industry and Services Sectors (1999-00 Base Series: Constant Prices)

(Percent)

Year	Agriculture and Allied Activities	Agriculture	Industry	Mining and Quarrying	Manufacturing	Electricity, Gas and Water Supply
1950-60	2.71	2.93	5.99	4.07	6.12	10.32
1961-70	1.51	1.27	5.15	5.03	4.74	11.59
1971-80	1.74	1.94	5.07	4.62	4.89	7.39
1981-90	2.97	3.09	6.41	7.39	5.95	8.76
1991-00	3.34	3.36	6.63	4.41	6.91	7.30
2001-07	2.79	2.85	7.12	5.63	7.63	5.21
Year	**Service**	**Construction**	**Trade, Hotels, Transport and Communication**	**Financing, Insurance, Real Estate & Business Services**	**Community, Social, and Personal Services**	**GDP at Factor Cost**
1950-60	4.34	5.87	5.29	3.05	3.51	3.66
1961-70	4.94	6.87	4.77	3.11	5.24	3.36
1971-80	4.36	3.06	5.40	4.44	3.68	3.41
1981-90	6.35	3.73	5.93	9.26	6.23	5.17
1991-00	7.32	4.84	8.29	7.95	6.50	6.05
2001-07	9.24	12.02	10.85	8.76	5.79	7.42

Source (Basic Data): National Income Accounts, CSO

Fourthly, treating servicers and goods on par will minimize if not altogether eliminate classification disputes as whether a supply is of that of a good or a services. It will reduce both the administration costs and compliance costs enormously. Since states in India are precluded from taxation of services except those specific services that may be listed in the State List, this has given rise to difficulties in taxation of goods supplied as part of a composite works contract involving a supply of both goods and services, and under leasing contracts, which involve a transfer of the right to use goods without any transfer of their ownership. Although these specific problems have been addressed by amending the Constitution to bring such transactions within the ambit of the tax on the sale or purchase of goods, services by themselves remain outside the scope of state taxation powers.

2.9 Rationale for Extending Taxation of Goods up to Retail for the Centre

Similar reason can be cited as grounds for extending the taxation of goods up to retail for the Centre. First, it will eliminate the need to define 'manufacturing'. Every supply from one registered dealer of a good or service will then become taxable up to the retail stage. This will also eliminate most of the valuation problems since in the valuation will be determined by the market and the incentive to underestimate values will also be minimal as tax credits are to be claimed at all stages. Secondly, this will permit a symmetrical treatment of goods and services. Thirdly, the centre will be compensated for sharing the taxation of services with the states. Fourthly, taxation of goods all the way up to the retail stage will create a paper record of all goods leaving state boundaries making settlement of inter-State disputes far easier in implementing a destination based principle of taxation.

2.10 Conclusions

Even after the introduction of the principle of taxation of value added in India, its application has remained piecemeal and fragmented. Several problems continue with each segment of the system of taxation of goods and services as summarized below.

i. In the case of Cenvat, the issues relating to definition of manufacturing and methodology of valuation remain causing difficulties in implementation of the tax.
ii. The problem of multiple rates remains although the tax rate structure is simpler than what it used to be. This leads to various classification disputes.
iii. In the case of services taxation, problems relate to distinguishing between a good and a service. The distinction between the two is often blurred.
iv. Exclusion of services from the tax base of the states potentially erodes their tax-buoyancy in a growing economy.
v. Cascading has not been fully eliminated as there is cross cascading between Statevat, Cenvat, and central services tax.
vi. The Central sales tax continues to cause artificial inter-State border boundaries and violating the destination based principle of taxation of goods and services.

vii. Many of these problems can be addressed by extending the scope of taxation of services for the states and the scope of taxation of goods up to the retail stage for the centre.

This is not to underplay the importance of the success already achieved in bringing about a value added taxation mechanism in highly distorted system of taxation in India that existed prior to these reforms. However, the logic of reforms would remain incomplete until the goods and services are integrated for purposes of taxation of the value added in the process of production and sale of goods and until a countrywide integrated market is not created. In the next Chapter, we consider the options available for India for a comprehensive Goods and Services tax, given its federal structure of governance.

Chapter 3

INTEGRATING GOODS AND SERVICES FOR TAXATION: OPTIONS FOR A COMPREHENSIVE GST

3.1 Introduction

A comprehensive value added tax requires encompassing both goods and services in a common tax base extending through the country, unfettered by state boundaries. This will be consistent with the provision of Article 301 of the Constitution, which provides that subject to the other provisions of this Part [of the Constitution, see Annexure 2 for details], trade, commerce and intercourse throughout the territory of India shall be free. Such a country-wide integrated market will also be 'efficient' from an economic viewpoint with a view to enabling the realization of the full potential of opportunities of economic growth. In a federal country like India, this requires careful handling of inter -State trade of goods and services.

Such a tax has already being proposed and discussed in the Indian context and is being referred to as a Goods and Services Tax (GST). For India, in making a transition to GST from the present system of Cenvat-State VAT-Service Tax and other related taxes, one has to take into account the present assignment of powers of taxation to the central and State governments, changes required in these to bring about a comprehensive GST, relative revenue-impact on the Centre and the States in the short run and over time as well as issues of co-ordination and harmonization with a view to achieving an effective and comprehensive market in the country for purposes of taxation of all goods and services.

In making this transition, the paramount objective should be to ensure that the basic federal structure in terms of the relative revenue and fiscal autonomies of the Central and State governments are not disturbed. The issue therefore is to find a suitable form of GST such that the relative positions of the two tiers of governments are not disturbed. In this Chapter, we examine some of the available options to bring about reforms to enable GST to be adopted in India.

It may be noted that although more than 135 countries levy VAT/GST including many federal countries, almost all of them quite successfully, a distinction is now being made between the 'old' type of VAT and the more 'modern' GST. New Zealand and Australia are cited as examples of the modern type of VAT. In these cases, the tax bases are wide enough to include many public services and food items, and the tax rate is single and low.

3.2 Towards Integration of Goods and Services for Taxation: Options for India

The introduction of Cenvat for capturing value added up to manufacturing in place of the central excises and the replacement of the state sales taxes by the State-VAT, adopted by all the states now, constitutes a significant first step towards a comprehensive GST in India. Both these however cover only goods. The service tax has been separate but in the case of service tax also the principle of giving rebate on tax on services already paid has been introduced. Taken together, these changes have provided useful starting points for a GST. The main issues that need to be resolved now relate to:

i. The form of GST: Whether the country should move to a national GST, or a system of state GSTs, or a concurrent dual GST or a non-concurrent dual VAT.
ii. Required Constitutional changes: Depending on the choice of the form of GST, what will be changes in the constitution required to enable the transition from the present system to the selected GST form?
iii. Treatment of special goods like food, housing, land and property, financial services, and public services.
iv. Treatment of inter-State movement of goods and services such as transportation and telecommunication. Except in the case of a National GST, there will be issues in relation to the treatment of inter-State flows of goods as well as services.
v. Depending on the selected form, a decision will have to be taken as to the taxes of the Centre and the States that should be merged in the GST.
vi. The Central government has limited administrative infrastructure while the states have larger manpower dealing with the administration of the sales and other indirect taxes. The transition to GST will require careful planning as to needed administrative infrastructure and responsibilities of the centre and the states in providing such infrastructure.
vii. In all cases, there would be a tangible revenue impact on the centre and the states and this will have implications for system of transfers from the centre to the states.

The main options for selecting a suitable form of GST may be listed as follows:

i. National GST,
ii. System of State GSTs,
iii. System of non-concurrent dual GST, and
iv. System of Concurrent Dual GST.

It is important also to recognize that the vertical imbalance, that is relative revenue raising powers of the central and the state governments prior to transfers, may be affected depending on the way the goods and services tax (GST) is implemented in India.

3.3 National GST

Under this option, the two levels of government would combine their levies in the form of a single National GST. Such a GST will by definition ensure a country-wide common market. Since the rate structure will be common for all states, there will be harmonization by definition and there will be no problems about inter-State trade. Collection of tax can be done by the centre or the states or a suitable combination. The basic problem would be that it would take away the fiscal and revenue autonomy of the states who will have to be compensated by a suitable revenue sharing mechanism possibly based on the destination principle so that there is a one-to-one link between the share of a state in the consumption of goods and services, and its share in the GST revenues. Some variant of such a tax is followed in Australia, Austria, Argentina, Germany, and Mexico. The conventional wisdom on VAT/GST seems to suggest that the only good VAT is one levied by the central government. For example, McLure (1993, 58) noted that "…it is not appropriate to assign the VAT to subnational governments."

In the case of central GST, all the State-VATs will be subsumed in this central levy in consumption of goods and services. This would be like the Australian model. But this will increase vertical imbalance tremendously. In Australia, the implementation of GST led to a substantial increase in the vertical imbalance because the states agreed to forego a number of taxes assigned to them in favor of a national GST.

A provision will have to be made for distribution of the centrally collected VAT. Although a similar arrangement has been implemented in Australia, it will have a significant impact on the nature fiscal federal relations. States will lose their autonomy to fix rates and collect their own revenues. It is doubtful that states will agree to such an arrangement. The scheme of redistribution would also be required to follow a principle different from the one normally used by the Finance Commissions so that states are adequately compensated for the revenues that they would have otherwise earned through the existing system of State-VAT or sales taxes.

3.4 System of State GSTs

Under this option, the GST would be levied by the States only. The Centre will continue to levy customs duties, and may levy some excise duties on selected goods like petroleum and petroleum products. There will be considerable revenue loss to the centre and while this may require a reduction in the volume of fiscal transfers, it would also mean a reduction in the capacity of the centre to undertake equalizing transfers to the economically weaker states. The USA with its retail sales tax that are with the states is an important example of this type of arrangement. This option raises various issues of harmonization and inter- State flows of goods and services.

The European Union VAT (EUVAT) may also be considered as an example of a system of State-VATs among participating member countries of an Economic Union/federation. The EUVAT is a value added tax encompassing all member states in the European Union Value Added Tax Area. It taxes the consumption of goods and services in the European Union Value Added Tax Area. The EUVAT is levied after determining where the supply and consumption occurs. This decides which member state will collect the VAT and what VAT rate will be charged.

Different rates of VAT apply in different EU member states. The minimum standard rate of VAT throughout the EU is 15 percent, although reduced rates of VAT, as low as 0 percent, are applied in various member states on various types of supply (for example, newspapers and certain magazines in Belgium). The maximum rate in the EU is 25 percent.

VAT that is charged by a business and paid by its customers is known as "output VAT" (that is, VAT on its output supplies). VAT that is paid by a business to other businesses on the supplies that it receives is known as "input VAT" (that is, VAT on its input supplies). A business is generally able to recover input VAT to the extent that the input VAT is attributable to its taxable outputs. Input VAT is recovered by setting it against the output VAT for which the business is required to account to the government. If there is an excess, a repayment may be claimed.

The Sixth VAT Directive of the EU requires certain goods and services to be exempt from VAT (for example, postal services, medical care, lending, insurance, betting), and certain other goods and services to be exempt from VAT but subject to the ability of an EU member state to opt to charge VAT on those supplies (such as land and certain financial services). Input VAT that is attributable to exempt supplies is not recoverable, although a business can increase its prices so the customer effectively bears the cost of VAT.

This option also changes the vertical balance equations drastically although in favor of the states. The centre will then largely lose power to undertake transfers for purposes of horizontal transfers. Even to provide centrally provided public goods, it may need to save some sumptuary excises for itself. Otherwise it may have to depend on reverse transfers. The problem of inter-State harmonization and inter-state transactions will remain. For the case of an exclusive State-VAT regime, Keen and Smith suggested the system of Viable Integrated VAT (VIVAT). In this case, for all intermediate purchases, that is, sales between dealers, a uniform tax rate regime is advocated for sales between dealers. This would be applied to transactions within a state as also across states. The system of compensating VAT (CVAT) is also known as the Versano proposal has also been suggested in this context. Mclure Jr. (2000) suggested a modified version of the CVAT. In CVAT, uniform definitions and laws for the tax base in all jurisdictions are needed. States are allowed however to have their own tax rates with the proviso that all inter-state transactions are zero-rated for state VAT. The Central government levies a compensating VAT for all inter-state transactions. The rate of compensating VAT is common across states. For inter-state imports, a system of deferred payment of State-VAT and credit for compensating VAT is then put in place. The Compensating VAT is an additional federal level tax to ensure the tax revenues that might otherwise be lost due to cross-border tax evasion are not so lost.

At the present juncture of the Indian economy, the central government is not likely to accept the option of a full-fledged State-GST as the centre needs resources for addressing the high degree of horizontal imbalance in the system. If the vertical imbalance in the system is not to be drastically altered, the concurrent and dual VAT regime seems to be most relevant in the current fiscal conditions of India.

3.5 System of Non-concurrent Dual GST

One recent suggestion (Poddar, 2008) has been about a system of non-concurrent Dual GSTs. In this case, the proposal is to let the states levy GST on all goods and the centre levy the GST on all services. No special effort would be needed for levying a unified central tax on inter-state services. The centre would withdraw from the taxation of goods. Even the revenues collected from the taxation of services could be transferred back to the States, partially or fully. This option will not however resolve the difficulties in delineating supplies of goods and services and cascading between goods and services may remain a problem unless arrangements are put in place for cross-administration rebates on input taxes paid. In this case, the centre will required to rebate input tax paid on goods and states will be required to rebate input tax on services.

3.6 Concurrent Dual GST

Under this model a concurrent or dual GST is levied by the Centre as well as the States. This seems the most practical route as it can be implemented while maintaining the current pre-and post-transfer profiles of vertical imbalance. It would require that states be enabled to tax services and the service tax rate should be the same as that for goods. Alongside, Central government should be enabled to tax value added in the case of goods up to the retail stage. These changes would lead to a comprehensive and unified system of taxation of goods and services. The major problem in this case will be handling of inter-State transactions.

In dual VAT, central and State-VAT rates are applied. States have autonomy to determine the State-VAT rates. The Central-VAT is included in the tax base of the State - VAT. States therefore have an incentive to collect the central component, if they are asked to collect it.

a. Scheme Proposed by the Empowered Committee

A Committee of State Finance Ministers under the Chairmanship of Dr. Ashim Dasgupta, Hon'ble Finance Minister of West Bengal referred to as the Empowered Committee (EC) of State Finance Ministers has been deliberating on the various aspects of a comprehensive goods and services tax in the Indian federal context. While many aspects of the GST are yet to be decided upon, the EC has favoured a concurrent GST with a central and state GST components. After a draft discussion paper, the EC has now put forward a 'First Discussion Paper' for wide ranging discussions. The views expressed by the EC may be summarised as below.

a1. Draft Discussion Paper

The main features of the proposed GST model are summarized below:

i. For Centre, the following taxes would be subsumed under the GST are: Central Excise duties (extended up to the retail level), Additional Excise duties, Additional Duty of Customs or CVD, CST and Service Tax including all cesses and surcharges. Except for essential services such as primary public health and primary public education, all services should be comprehensively covered under the GST. The Additional Duty of Customs (known as CVD) which is essentially an excise imports would be subsumed under GST and would be made up of the same two components viz. the Central GST and the State GST.

ii. The major State taxes to be subsumed under GST are: VAT or Sales Tax; Entertainment Tax, Luxury Tax, Octroi or Entry Tax and Taxes on Lotteries, Betting and Gambling, and Purchase Tax, and electricity duty, and any cesses and surcharges levied by the State governments.
iii. The Centre shall levy one component (Central GST or CGST) and the states / Union Territories shall levy the other (State GST of SGST). Both CGST and SGST should be applicable, to all transactions of goods and services.
iv. HSN classification for goods should be used both for Central GST and State GST.
v. A classification for services should be evolved by examining international practice, while keeping in view the particular characteristics of India's services sector.
vi. Separate accounts should be maintained for the central and the state GST. While input tax credit (ITC) should be permitted within each of the taxes, cross flow between Central and State GST should not be permitted.
vii. Both CGST and SGST should ideally be at single rates. However, certain categories of goods may need to be taxed at a rate lower than the standard- rate, both for CGST and SGST.
viii. Exports should be fully zero-rated i.e. exports should be relieved of the burden of all embedded taxes and levies, both Central and states.
ix. Demerit goods such as alcoholic beverages and tobacco should be brought under GST with ITC. However, Excise duties (without ITC) should be levied over and above the GST by both the centre and the states.
x. Since crude and petroleum products are non-renewable resources, a similar model, as recommended for· alcoholic beverages and tobacco, could be adopted. An alternative would be to, keep crude, motor spirit, and high speed diesel out of the purview of the GST. This would reflect current practice in India that does not allow ITC of petrol and diesel to downstream users.
xi. The annual turnover threshold should be uniform for the Centre and the states.
xii. Every taxpayer, to be assigned a common taxpayer identification number and should be required to submit one periodical return (i.e. same document) with one copy to the Central GST authority and the other to the concerned State GST authority.
xiii. Inter-State sales should be governed by the destination principle.
xiv. For operationalizing this, banks are to be used as an intermediary. It would require that the seller in the exporting State collects GST from the purchasing dealer in the importing State and deposits it in the designated bank to the credit of the importing State/Centre. The seller also provides details of all transactions, including details of

purchasing dealer to the bank. The bank uploads the information on the GST Portal, through which the information becomes available to both the central as well as State Authorities. The purchasing dealer claims ITC on the basis of a digitally signed challan sent by the seller's bank. The importing State/Centre grants ITC on the basis of the credit received by them from the bank in the exporting State.

xv. Under the GST exemptions should be minimized. The dual GST structure at the Central and the State levels should have a common list of exemptions. Specific provisions to provide limited flexibility to the states within a set of prescribed criteria may be incorporated in order to accommodate exemption of goods of local importance, and

xvi. CST would be eliminated.

The Draft Discussion paper circulated earlier by the Empowered Committee had clearly recognized the issue of negative externalities. In particular, it recognized the issues of 'demerit goods' and 'non-renewable' resources. It recommended as follows:

i. Demerit goods such as alcoholic beverages and tobacco should be brought under GST with ITC. However, Excise duties (without ITC) should be levied over and above the GST by both the centre and states.

ii. Since crude and petroleum products are non-renewable resources, a similar model, as recommended for· alcoholic beverages and tobacco, could be adopted. An alternative would be to, keep crude, motor spirit, and high speed diesel out of the purview of the GST. This would reflect current practice in India that does not allow ITC of petrol and diesel to downstream users.

Union and State taxes on petroleum and related products contribute in the range of 35- 51 percent of the revenue on average from central excise duty as also significant shares of states tax revenues. At present, neither the Union government nor the State governments allow ITC on major petroleum products. The Empowered Committee suggested two alternatives. In the first model, all petroleum products should be subjected to GST (with ITC). Over and above the GST, both the centre and the states can levy additional excise duty (without ITC) at different rates subject to a floor. Alternatively, out of the basket of petroleum products, Crude, Motor Spirit (including ATF) and HSD could be kept outside the GST. This will leave a significant source of cascading in the system.

These proposals imply that the overall efficiency in production and sales will go up and the compliance costs will go down. Much will depend on the level at which the overall GST rate is fixed and its components for the central and the state GSTs. The state component of the GST rate is likely at best to be revenue neutral with respect of all-state revenues and will have a differential revenue impact on the states, some of which may need to be compensated by the centre. It may be difficult to set up a mechanism where the gainer states would compensate the states losing out in relative terms.

a2. First Discussion Paper

The First Discussion Paper of the Empowered Committee carries forward the ideas of the Draft Discussion Paper but comes clearly in favor of an integrated GST (IGST) for dealing with inter-state trade in goods and services.

i. The GST will have two components: one levied by the Centre (CGST) and the other to be levied by the States (SGST). The basic features of law such as chargeability, definition of taxable event and taxable person, measure of levy including valuation provisions, basis of classification etc. should be uniform across these statutes as far as practicable.

ii. The CGST and SGST would be applicable to all transactions of goods and services made for a consideration except for the exempted goods and services, goods which are outside the purview of GST and the transactions which are below the prescribed threshold limits.

iii. The CGST and SGST are to be paid to the accounts of the Centre and the States separately. It would have to be ensured that account-heads for all services and goods would have indication whether it relates to Central GST or State GST (with identification of the State to whom the tax is to be credited). Taxes paid against the CGST and SGST will get input tax credit (ITC) within the CGST and SGST chains respectively but cross utilization of ITC between CGST and SGST would not be allowed.

iv. The administration of the CGST will be with the centre and that of SGST with the States.

v. A uniform State GST threshold across States is desirable. A threshold of gross annual turnover of Rs.10 lakh both for goods and services for all the States and Union Territories may be adopted with adequate compensation for the States (particularly, the States in North-Eastern Region and Special Category States) where lower threshold had prevailed in the VAT regime may be kept at Rs.1.5 crore and the threshold for Central GST for services may also be appropriately high. Even now there is a separate threshold of services (Rs. 10 lakh) and goods (Rs. 1.5 crore) in the Service Tax and CENVAT.

vi. The following Central Taxes should be, to begin with, subsumed under the GST: (i) Central Excise Duty, (ii) Additional Excise Duties, (iii) Excise Duty levied under the Medicinal and Toiletries Preparation Act, (iv) Service Tax, (v) Additional Customs Duty, commonly known as Countervailing Duty (CVD), (vi) Special Additional Duty of Customs (SAD), (vii) Surcharges, and (viii) Cesses.

The following State taxes and levies should be, to begin with, subsumed under GST: (i) VAT / sales tax, (ii) entertainment tax (unless it is levied by the local bodies, (iii) luxury tax, (iv) taxes on lottery, betting and gambling, (v) State cesses and surcharges in so far as they relate to supply of goods and services, and (vi) entry tax not in lieu of Octroi.

Alcoholic beverages would be kept out of the purview of GST as part of demerit goods. Sales Tax/VAT can be continued to be levied on alcoholic beverages as per the existing practice. In case it has been made VAT able by some States, then this may be continued. Tobacco products would be subjected to GST with ITC. Centre may be allowed to levy excise duty on tobacco products over and above GST without ITC. As far as petroleum products are concerned, i.e. crude, motor spirit (including ATF) and HSD would be kept outside GST as is the prevailing practice in India. Sales Tax could continue to be levied by the States on these products with prevailing floor rate. Similarly, Centre could also continue its levies. On Natural Gas, whether it should be kept outside the GST, a final view has not been taken yet.

In this model, the Centre would levy Integrated Goods and Services Tax (IGST) which would be CGST plus SGST on all inter-State transactions of taxable goods and services with appropriate provision for consignment or stock transfer of goods and services. The inter-State seller will pay IGST on value addition after adjusting available credit of IGST, CGST, and SGST on purchases. The exporting state will transfer to the Centre the credit of SGST used in payment of IGST. The importing dealer will claim credit of IGST while discharging his output tax liability in his own State. The Centre will transfer to the importing State the credit of IGST used in payment of SGST. The relevant information will also be submitted to the Central Agency which will act as a clearing house mechanism, verify the claims and inform the respective governments to transfer the funds.

a3. Task Force of the Thirteenth Finance Commission

The Thirteenth Finance Commission had set up a Task Force for designing a suitable form of GST. The main recommendations of the Task Force are summarised below.

i. The GST should be a dual levy imposed concurrently by the Centre and the States, but independently to promote cooperative federalism consisting of the Central Goods and Services Tax (CGST) and the State Goods and Services Tax (SGST), which should be levied on a common and identical base. The tax base should comprehensively extend over all goods and services upto the final consumer point.

ii. There should be no classification between goods and services in law so as to ensure that there is no classification dispute.

iii. 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.

iv. 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.

v. 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 GST 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. With a view to reducing administrative and compliance burden, small dealers with annual aggregate turnover of goods and services between Rs.10 lakh to Rs.40 lakh 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.

vi. 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. Dealers in such high value items may, subject to the threshold exemption but without the ceiling of Rs. 40 lakh, may be allowed to opt for the compounded levy of one percent, each towards CGST and SGST.

vii. The Centre and the States should draw up a common exemption list which should be restricted to the following:
   - All public services of Government (Central, State and municipal/panchayatiraj) 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 should not include railways, post and telegraph, other commercial departments, public sector enterprises, banks and insurance, health and education services;
   - Any service transactions between an employer and employee either as a service provider, recipient or vice versa;
   - Any unprocessed food article which is covered under the public distribution system should be exempt regardless of the outlet through which it is sold;
   - Education services provided by non-governmental schools and colleges; and
   - Health services provided by non-governmental agencies.

viii. The following central taxes should be subsumed in the CGST:
   - Central Excise Duty (including Additional Excise Duties);
   - Service Tax;
   - Additional Customs Duty (commonly referred to as 'CVD'); and
   - Surcharges and all cesses.

   The following State level taxes, should be subsumed in the SGST:
   - VAT/Sales Tax (including central sales tax and purchase tax);
   - Entertainment tax (other than levied by local bodies);
   - Entry taxes not in lieu of Octroi;
   - Other Taxes and Duties (includes luxury tax, taxes on lottery, betting and gambling, and all cesses and surcharges by States).

   These were also recommended by the EC. In addition, the Task Force recommends that the following other taxes levied by the Centre or the States, should be subsumed in the GST:
   - Stamp duty;
   - Taxes on Vehicles;

- Taxes on Goods and Passengers; and
- Taxes and duties on electricity.

ix. The power sector is to be an integral part of the comprehensive GST. 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.

x. The tax on vehicles and the tax on goods and passengers levied by the State Governments should also be subsumed in the GST. All transport equipment 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 the Task Force over which both the Central and State Governments would have concurrent jurisdiction. The tax regime for the transport equipment and transport services should be the same as in the case of any other normal goods. j. The consumption of financial services should be comprehensively taxed under the GST framework on the basis of the full taxation method.

xi. 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 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. Also, 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.

Sin Goods and Polluting Goods: The Task Force refers to the demerit goods as sin goods. The sin goods are listed as emission fuels, tobacco products and alcohol, which should be subject to a dual levy of GST and excise. No input credit should be allowed for this excise duty. However, industrial fuels should be subjected only to GST (both Central and State) with the benefit of input credit like any other intermediate good.

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. All entry and Octroi duties levied by the third tier of Government must be abolished.

Thus, the Task Force on GST set up by the 13th Finance Commission recognized the issue of negative externalities in a clearer way and collectively refers to these as sin goods and services and makes a distinction between sin goods and non-sin goods. The Task Force defines sin goods as goods whose consumption create negative externalities and for the purposes of their Report it, collectively or severally, refers to emission fuels, tobacco goods and alcohol. It observes that emission fuels generate negative externalities, whose consumption needs to be checked. It notes that generally, goods with negative externalities should be subjected to excise duties in respect of which input tax credit is not allowed.

Modified Bank Model: Inter-State Transactions of Goods and Services
Instead of IGST, the Task Force recommends adoption of a Modified Bank Model (the Bank Model was referred to in the EC Draft Discussion Paper) and suggests that **all** inter-State transactions in goods and services should be effectively zero rated by adopting the Modified Bank Model. The consignment sales and branch transfers across states should be subject to treatment in the same manner as if it was an inter-State transaction in the nature of sale between two independent dealers.

3.7 Constitutional Changes
Depending on the selected form of the GST, there will be a need to bring about constitutional changes so that both the centre and the states are ensured of their relative powers and the arrangements remain stable. If the Empowered Committee option of dual GST is adopted, centre will have to be given powers to tax the value added up to the retail stage in the case of goods instead of only up to manufacturing and the states will need to have power to tax all services. The service tax will need to be taken from Article 268 and the GST should be covered by Article 270. It would be best to place 'taxation of goods and services' in the concurrent list and delete all the individual taxes of the Union List and State List subsumed in it. Article 268 A will not be required and Article 270 should specifically make mention of the central GST.

In regard to the constitutional Amendments, there are several issues.

At present the Constitution of India demarcates taxing powers in a two-tier structure wherein levies on production and international imports are with the Union and postproduction levies rest with the States. The tax bases for both the Centre and the States are different under the principle of separation of tax powers. Schedule VII divides this subject into three categories:

- Union List (Article 246 (1) of the Constitution specified that Parliament has exclusive powers to make laws with respect of any of the matters enumerated in List I in the Seventh Schedule to Constitution)
- State List (As per Article 246 (3) State Government has exclusive powers to make laws with respect to matters enumerated in List II)
- Concurrent List (both Parliament and State Government can pass legislation with respect of items specified in the list). The Concurrent List does not contain any taxes.

The dual GST would require giving the Centre and the States identical indirect taxation powers. The incidence of tax will be restricted to consumption within the territory of the taxing jurisdiction. With concurrent powers, both the Centre and the States, one option is that the powers of the legislation of GST on supply of goods and services be assigned to the Centre and the States in the Concurrent List-III. However, this option has several problems. It changes the basic structure of the Constitution. The entry 'GST on supply of goods and services' in List-III would authorize the Centre and the States to frame Concurrent legislation on GST. This will mean that the centre will have over-arching powers. The States should have autonomy in exercise of their taxation powers.

The Constitution was designed to provide revenue autonomy to the state governments so that they can fulfill the responsibilities assigned to them as enumerated in the State List and Concurrent List of the Seventh Schedule to the Constitution. Revenue autonomy implies the power to change tax rates, define the tax base, define the exemption provisions, introduce rate categories where needed with respect to the areas assigned for taxation to the states. The Constitution has provided for separation of powers between the Union and the State governments so that within their assigned areas of jurisdictions, State legislatures and Parliament have full authority in terms of raising revenues and incurring expenditures to meet the responsibilities.

There is a clear link between revenue and expenditure autonomy both as per the constitutional design and principles of public economics. Expenditure autonomy is required so that State legislatures can recognize the preferences of the citizens under their jurisdiction regarding the nature and extent of regional or local public goods. The provision of these goods should be financed by taxation of the citizens under the same jurisdiction. Hence there is need for revenue autonomy. These powers are provided under the Constitution. The powers of the legislation of GST on supply of goods and services can be assigned to the Centre and the States in List-I and List-II respectively.

3.8 Determining the Overall Rate and Central and State Components

All important issue is to determine a suitable GST rate. At present goods are taxed at the core rate of Cenvat at 10 percent and State-VAT of 12.5 percent. This together would be very high although it would be less than 22.5 percent as the 10 percent rate applies to value added only up to the manufacturing stage and the GST will have a larger base. The service tax rate has been at 12 percent although it was reduced to 10 percent in the context of the economic slowdown. The highest GST rates are in Sweden and Denmark at 25 percent. At the lower end, Switzerland, Japan, Thailand and Singapore have GST/VAT rates at 5 percent or marginally above. Appendix Table A5 and A6 give a summary of the international VAT/GST rates.

In relation to the rates in vogue in many countries, except the Scandinavian countries where the tax is levied at the standard rate of 25 percent, a 20 percent overall rate is too high. In New Zealand, GST was introduced at the rate of 10 percent, with a base consisting of virtually all goods and services (with the exception of financial services). Singapore GST rate was 3 percent at inception, which has now been raised to 7 percent

A large tax base enables a relatively lower tax rate to be revenue-neutral. The lower the revenue-neutral tax rate, the lower will be the demand for concessional rates or exemptions or zero-rating. A single rate GST comprehensively covering all goods and services at a single rate will be most conducive to tax compliance and rule out all classification disputes and other legal issues and minimize scope of evasion or avoidance.

There will be however issues related to selected goods and services like food, public services, etc. With a low single rate, much of support for basic necessities should be handled by government expenditure. Determining a suitable overall GST rate(s) and its CGST and SGST components is a critical component in planning the transition.

A related issue relates to decomposing the overall GST rate into its central and state components making sure that the relative pre-transfer revenue levels are not disturbed. The Kelkar Committee had suggested a division of the overall rate of 20 percent into a 12:8 ratio in favor the centre. This may need to be reexamined with current levels of revenues under Cenvat and service taxes and the Statevat and other related taxes that may be subsumed in the GST.

Bagchi and Poddar (2007, Economic Times) have estimated of the size of the GST base in India and the GST rates that would be required to replace the current indirect tax revenues of the Centre and the States. They show that if the GST were to be levied on a comprehensive base, the combined Centre-State revenue neutral rate (RNR) need not be more than 12 percent. This rate would apply to all goods and services, with the exception of motor fuels which would continue to attract a supplementary levy to maintain the total revenue yield at their current levels. In the exercise by Bagchi and Poddar, for the RNR calculations, data for 2005-06 were used. The total excise/service tax/VAT/sales tax revenues of the Centre and the States in that year were Rs.1,34,000 crore and Rs.1,39,000 crore respectively. They estimate that the overall revenue neutral GST rate is 11.3 percent with the RNR for the Centre at 5 percent and that for the states at 6.3 percent. Allowing for some leakages, the combined RNR could be in the range of 12 percent.

In a recent study Kavita Rao (2008) estimates the revenue neutral GST rate using two methods, namely, a GDP based method and a consumption expenditure based method. Following the GDP –based method she estimates the revenue neutral GST rate to be about 14 with a 10 percent rate of non-rebatable excises on passenger cars and multi-utility vehicles, petroleum products, and tobacco products. Following the consumption expenditure method she observes that the rate of GST required for revenue neutrality would be 20 percent. With improved tax administration, the GST rate can be reduced further.

The Task Force of the Thirteenth Finance Commission has estimated with reference to a comprehensive tax base (as discussed in this chapter) a revenue neutral rate of 12 percent, with 5 percent for the centre, and 7 percent for the states.

Table 3.1 indicates that overtime the relative share of the GST components for the Centre and the States have been changing marginally away from the Centre due to the erosion of buoyancy of Union excise duties.

The Task Force has recommended a single 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. The Task Force favours a single rate structure GST and some international experience with VAT in support. States have said that a single rate of State GST for all goods and services will be highly regressive in India with its large low income population. 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. To deal with problem, the Task Force suggests a moderate threshold exemption level for registration of dealers. Consequently, all small dealers would remain outside the purview of the GST. The Task Force Report argues that 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.

Table 3.1: Revenue Importance of Central and States Taxes for Determining GST Rate Shares

(Rs. crore)

State Taxes	2000-01	2001-02	2002-03	2003-04
State's Own Tax Revenue	117981.0	128096.7	142143.0	162806.0
Taxes on Property and Capital Transactions	11186.9	12984.3	15424.4	17861.1
i) Land Revenue	1414.9	1717.5	1751.3	2170.0
ii) Stamps and Registration Fees	9674.7	11182.8	13595.6	15627.1
iii) Urban Immovable Property Tax	97.3	84.0	77.4	64.0
Taxes on Commodities and Services	104823.6	112054.4	124556.2	142612.9
i) Sales Tax (a to f)	73363.9	76885.2	86037.8	98377.9
a) State Sales Tax	58499.6	59797.3	69847.1	77023.5
b) Central Sales Tax	10221.3	10985.7	10721.1	12537.8
c) Sales Tax on Motor Spirit and Lubricants	4161.4	5645.0	5106.0	8689.7
d) Surcharge on Sales Tax	48.7	44.7	26.6	17.1
e) Receipts of Turnover Tax	4.7	10.3	0.5	6.1
f) Other Receipts	428.2	402.2	336.5	103.7
ii) State Excise	16035.5	17110.1	18994.0	20562.3
iii) Taxes on Vehicles	6665.6	7644.4	8441.0	9802.9
iv) Taxes on Goods and Passengers	2074.7	3671.4	3569.3	4983.6
v) Taxes and Duties on Electricity	4430.9	4691.6	5255.9	6314.4
vi) Entertainment Tax	1146.9	798.7	799.7	892.9
vii) Other Taxes and Duties	1106.0	1253.1	1458.5	1679.0
Central Taxes				
Union excise duties	68526.0	72555.0	82310.0	90774.0
Service tax	2613.0	3302.0	4122.0	7891.0
Additional duties of customs*	16582.0	14910.0	15936.0	16368.0
Special CVD*	3269.0	2925.0	3595.0	4083.0
Central Taxes (Union excise duties +service tax+ CVD+SAD)	90990.0	93692.0	105963.0	119116.0
State taxes: Group 1#	104823.6	112054.4	124556.2	142612.9
State taxes: Group 1+Group 2##	116010.4	125038.7	139980.5	160474.0
Centre +State I	**195813.6**	**205746.4**	**230519.2**	**261728.9**
Share of Centre (%)	46.5	45.5	46.0	45.5
Share of States (%)	53.5	54.5	54.0	54.5
Centre +States II	**207000.4**	**218730.7**	**245943.5**	**279590.0**
Share of Centre (%)	44.0	42.8	43.1	42.6
Share of States (%)	56.0	57.2	56.9	57.4

Table 3.1(contd.): Revenue Importance of Central and States Taxes for Determining GST Rate Shares

(Rs. crore)

State Taxes	2004-05	2005-06	2006-07	2007-08	2008-09
State's Own Tax Revenue	189133.0	212307.3	252548.5	293391.7	336809.7
Taxes on Property and Capital Transactions	22307.0	27667.1	35972.7	42690.9	49294.7
Land Revenue	19713.0	2716.3	3298.3	3987.9	4350.9
Stamps and Registration Fees	2530.0	24867.8	32452.3	38429.4	44629.1
Urban Immovable Property Tax	63.0	83.1	222.1	273.7	314.8
Taxes on Commodities and Services	164478.0	182077.0	213714.2	247494.6	284152.8
Sales Tax (a to f)	116754.0	128769.2	153572.9	178197.7	203622.8
a) State Sales Tax		104731.7	128776.0	147527.4	171817.8
b) Central Sales Tax		15611.0	17888.6	17712.5	16928.8
c) Sales Tax on Motor Spirit and Lubricants		2951.0	1331.6	12173.3	13864.2
d) Surcharge on Sales Tax		88.5	65.8	20.2	25.7
e) Receipts of Turnover Tax		25.0	35.6	218.4	393.5
f) Other Receipts		5362.1	5475.5	545.9	592.8
State Excise	21940.0	25035.6	29316.3	34200.3	39463.3
Taxes on Vehicles	10811.0	11964.1	13238.3	15413.7	17905.5
Taxes on Goods and Passengers	5206.0	6449.6	6808.3	7270.3	8910.4
Taxes and Duties on Electricity	7255.0	7717.6	8161.2	9366.3	10713.5
Entertainment Tax	862.0	648.7	704.9	779.7	831.0
Other Taxes and Duties	1650.0	1492.3	1912.4	2266.6	2706.4
Central Taxes					
Union excise duties	99125.0	111226.0	117613.0	123425.0	108359.0
Service tax	14200.0	23055.0	37598.0	51301.0	65000.0
Additional duties of customs*	22110.0	29750.0	38035.0	46935.0	46015.0
Special CVD*	35.0	0.0	10595.0	13165.0	14095.0
Central Taxes (Union excise duties + service tax + CVD+ SAD)	135470.0	164031.0	203841.0	234826.0	233469.0
State taxes: Group 1#	164478.0	182077.0	213714.2	247494.6	284152.8
State taxes: Group 1+Group 2##	186785.0	209744.2	249686.8	290185.5	333447.6
Centre +State I	**299948.0**	**346108.0**	**417555.2**	**482320.6**	**517621.8**
Share of Centre (%)	45.2	47.4	48.8	48.7	45.1
Share of States (%)	54.8	52.6	51.2	51.3	54.9
Centre +States II	**322255.0**	**373775.2**	**453527.8**	**525011.5**	**566916.6**
Share of Centre (%)	42.0	43.9	44.9	44.7	41.2
Share of States (%)	58.0	56.1	55.1	55.3	58.8

Source: Reserve Bank of India: State Finances and Central Budget Documents (Receipts Budget).

* Figures relate to revised estimates

Group 1: All sales taxes, state excise duties, motor vehicle tax, tax on goods and passengers, taxes and duties on electricity, entertainment tax, other taxes on goods and services

Group 2: land revenue, stamps and registration fees, urban immovable property tax

The Task Force has used the fiscal year 2007-08 as the base year for calculation of the RNR. For the purposes of estimation of the GST base, the Task Force used several alternative approaches and estimated the GST base under these methods. The various estimates of the GST Base for 2007-08 are summarized in Table 3.2. Since the five estimates are different, the Task Force adopts their average of Rs. 3125325 crore, 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, the Task Force uses the same tax base for calculating the RNR for both levies.

Table 3.2: Estimation of GST Base and the RNR

(Rs. crore)

Sl. No	Description	Amount
A	Subtraction- Indirect Method	3073037
B	Consumption	
	i. Task Force Estimate	3743077
	ii. Chadha Estimate	3077952
C	Shome Index Method	2782809
D	Revenue Method	2949748
E	Average of all estimated GST Base	3125325
F	Centre's RNR (%)	5.05
G	State's RNR (%)	6.02

The Task Force estimated the RNR for the CGST at 5.0 percent. Similarly, the RNR in respect of the state level taxes which are proposed to be subsumed in the SGST is estimated to be 7.0 percent. The combined RNR is estimated to be 12 percent. The Task Force also recommended the abolition of all entry and Octroi taxes by state governments and other sub-national governments.

3.9 Other Considerations

a. Administration and Harmonization

Administration and compliance will require considerable harmonization. Such harmonization will have to cover aspects like tax laws, taxpayer registration system, taxpayer identification numbers, tax forms, tax reporting periods and procedures, invoice requirements, place of supply and other rules, and consumption and cross-border trade information system. The Empowered Committee has already proposed a common tax payer identification system.

b. Treatment of Land and Property

Another issue relates to the treatment of land and real property transactions in the dual GST system. In terms of international practices as well as theory, GST will not be sufficiently comprehensive until land and property are brought into its ambit. The Service tax has already been extended to rentals of commercial property and construction services. Another item requiring attention would be land and real property transactions. If these are brought in the ambit of GST, as is done in recent international experience, it would help reduce the overall GST rate considerably. In the GST/VAT of Australia, New Zealand, Canada, Singapore, and South Africa, for example, housing and construction services are treated like any other commodity. When a real estate developer sells a home (first time sales), it is subject to GST/VAT on the selling price that includes the cost of land, building materials, and construction services. Commercial buildings and factory sales as well as rental charges for leasing of industrial and commercial buildings are also subject to GST. Only two exceptions are generally provided for, namely, resale of used homes and private dwellings, and rental of dwellings. However, short-term residential accommodation (in hotels, for example) is normally subject to VAT. The levy of GST should be considered as distinct from stamp duty and registration fees, which is a fee for registering and documenting titles to property.

The Task Force of the Thirteenth Finance Commission has recommended including of property, housing and rent also in the GST base.

c. Treatment of Food

Certain categories of goods often require special treatment. In the case of foodgrains and cereals and related items that are generally exempt in the case of CENVAT and taxed at the concessional rate of 4 percent or exempted in the case of State-VAT. In the GST, if these items are exempted or zero-rated the revenue neutral rate would increase considerably since the share of these items is nearly one-third in the aggregate consumption expenditure. It may be better to handle the issue of food security through the expenditure side of the government budgets. The Task Force of the Thirteenth Finance Commission has also recommended this.

d. Non-profit Sector and Public Bodies

Supplies made or services provided by governmental bodies and non-profit organizations have been exempted from VAT on the grounds that such bodies are not engaged in a business and their activities are not commercial in nature. This requires reconsideration. For one thing, the dividing line between public administration and industrial/commercial activities often is not clear enough. Services like postal and telecommunication services, radio and television, etc. may be provided by the private sector and/or the government.

In the EUVAT, activities of the public sector are categorized as non-taxable, taxable, or non-taxable, or exempt. There is a need to carefully determine the non-taxable and exempt categories and keep these lists quite narrow. In the case of New Zealand and Australia, the GST treats all activities of public sector and non-profit bodies as fully taxable with the exception of revenues from taxes, interest and dividends, and gifts and charitable donations. In these GST systems, any distinction between public administration and commercial/industrial activities of the state or non-profit organizations is not considered relevant. In fact, being part of the VAT chain, these bodies are eligible to claim a full credit for their input VAT.

e. Financial Services

Financial services are exempted from VAT in most countries mainly because the charge for the financial services provided by banks and insurance companies is generally implicit in the interest, dividends, or annuity payments. Explicit fees can however be charged. In some case, like China, financial services are taxable under their business tax, without the provision of input tax credits. In India, financial services where an explicit charge is made are generally subject to the service tax. These should be part of GST.

f. Inter-State and International Transactions

One of the main issues that need to be resolved is in regards to inter-state supply/ Integrating Goods and Services for Taxation: Options for a Comprehensive GST consumption of services. Many inter-State services have no unique place of supply. Take for example the supply of group health insurance to a corporation with employees throughout India, or auditing or business consulting services provided to a corporation or conglomerate with business establishments in several States. The determination of place of supply of such services is going to be somewhat arbitrary. However, such services are almost entirely B2B supplies, the tax on which is fully creditable to the recipient. The arbitrariness in the rules would thus have no impact on the final tax collections of the Centre or the States. Fortunately, many inter-State services are provided mainly by the organized sector (e.g., telecom, and transportation services). It would be possible to formulate basic rules and guidelines for this purpose taking into account international practices in this regard.

Ideally, VAT should be levied on the basis of the destination principle. In practice, in order to distinguish between the tax treatment of supply and consumption, certain rules need to be defined. A sale of goods is taxable if the goods are made available in or delivered/shipped to that jurisdiction. Based on international experience, particularly in the European Union, some rules can adopted for implementing a dual GST. 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). B2B supplies are generally defined to be made where the recipient is located or established, regardless of where the services are performed or used. This is particularly useful for advisory or consulting services for which the place of performance is not important. These services become zero-rated, thereby avoiding tax cascading. In the case of B2C services, generally the rule is these are taxable in the jurisdiction where the supplier is located.

Special rules should be applied to the mobile services. For transportation services, the place of supply is defined by reference to the point of origin or destination. For telecommunication services, the supply is made in the jurisdiction if the points of origin and termination are in that jurisdiction, or if one of the points is in the jurisdiction and the supply is billed to an account in the jurisdiction. The European Union provides some useful guidelines for mobile services. In the case of passenger transport, services are taxed according to the distances covered in different jurisdictions. In the case of intra-EU transport of goods, taxation is at the place of departure. If the customer is identified for VAT purposes in another Member State and provides the supplier with this VAT identification number, the service will be taxed in the Member State where the customer is identified. In the case of ancillary services to an intra-EU transport of goods, such as the loading and unloading services, these are taxable in the Member State where these services are physically carried out. If rendered to a customer who is identified for VAT purposes in another Member State and he provides the supplier with this VAT identification number of that other Member State, the service is instead taxed in the Member State where the customer is identified.

For short-term car rentals, the place of supply is where the car is first made available to the customer, regardless of the place of its subsequent use. For long-term leases, place of supply could depend on the place of use of the vehicle. Often, similar rules are adopted for leases and rentals of other goods also.

3.10 Integrating Environmental Considerations

Treatment of polluting inputs and output in the context of environmental management is of critical importance in the context of GST as these inputs and output create negative externalities. Environmental considerations were also specifically refereed to the Thirteenth Finance Commission in their ToR relating to the ecology and environment. This has special relevance in the context of the proposed GST whatever may be the form in which it is implemented. Proponents of eco-taxes have argued for a 'green shift' in taxation of goods and services, which implies that the overall tax burden does not increase on the system so that inefficiency costs of excess taxation such as deadweight losses, compliance costs, and administrative costs do not increase.

Pollution has serious implications for economic growth and welfare because of its impact on health, resource depletion, and natural calamities linked to climate change. There are two major groups of policy instruments for achieving pollution reduction: regulatory and market based economic instruments. Regulatory instruments prescribe emission standards or effluent limits. These require considerable information and involve significant administrative costs for implementation and monitoring. Market based instruments include taxes, subsidies, and trading instruments. In comparison with the regulatory policies, market based instruments may be able to reduce the costs of achieving a given level of environmental protection through incentives.

The main forms of pollution are atmospheric pollution, land degradation and soil pollution, water pollution, and noise pollution. Many forms of pollution have adverse effect on the local and state population.

All environmental legislations in India come under Criminal Laws. In implementation of the laws as well as in judicial decisions, the issue is on compliance or no compliance, and not on the extent of compliance. The penalties for non-compliance are unrelated to the compliance costs. On the other hand the economic compliance cost increases with the level of pollution prevention or abatement. This type of pollution control regime creates an opportunity for corruption and rent-seeking. The present standards and control regime – particularly the ones based on technology standards and input usage norms – provides no incentive for polluters to search for and adopt environmentally sound cost minimizing technologies/practices.

Environmental Tax Reforms (ETR) constitutes indirect, self-monitoring, incentive-based changes in the tax structure to achieve environmental objectives. These have the potential to induce appropriate environmental decisions through instituting an incentive structure by raising the relative costs of polluting inputs and outputs.

In undertaking reforms of the taxation of goods and services one needs to ensure that the ecological tax reforms are an integral part of the overall tax reforms. It should be recognized that in a value added tax regime, input taxes are to be fully rebated. As such, taxation of polluting inputs will be ineffective as the tax paid on the inputs will be fully rebated, unless a non-rebatable cess is levied on the inputs. The more appropriate method would be to tax outputs and introduce ecological considerations by taxing at a higher rate, outputs that are either polluting or use highly polluting inputs. Eco-taxes should be designed in an integrated way for taxation at the central, state and local levels. These should complement each other and should not be at cross purposes. Global sources of pollution or pollution where state boundaries are generally crossed should be taxed at the national level, regional sources at the state level, and pollution with strong local characteristics should be taxed at the local level. There should be inter-State coordination so that as result of taxation of polluting inputs and outputs, industries do not attempt to relocate in other states where eco-taxes are less stringent.

The issue of environmental consideration also opens up the possibility of giving some revenue and fiscal flexibility to both tiers of governments. As is done in European Union and other countries, the environmental considerations within the framework of a comprehensive GST requires that on certain outputs non-rebatable special duties be levied. This may be the only ground for levy of such special duties. Some of the items that may be covered under this provision are petroleum and related products, products involving extensive use of coal, plastics, lead, metals, alcoholic beverages the production of which involves pollution. Most of these items are the ones that have relatively inelastic demand. As such, these can also serve as an instrument providing flexibility to the states to take into account local conditions in determining the relevant rates of special duties. These can also help the states in at least partially absorbing the revenue impact of moving to GST.

Special provisions have to be made in the case of the Special Economic Zones and Export Oriented Units who are given inputs including polluting inputs on a zero-rated basis. While their products may be exported or treated as imports if sold in the domestic economy, much of the pollution that they generate is affecting the geographical area in which they are located. Polluting inputs in their case should not be zero-rated. They should also be subject to all other applicable regulatory measures for pollution control.

Both the Empowered Committee and the Task Force have considered the issue under 'demerit goods' or 'sin goods'. The Empowered Committee has made reference to 'demerit goods' and the Task Force setup by the Thirteenth Finance Commission has referred to these as 'sin goods'. These concepts also allow for integrating environmental considerations into the GST regime as both of these relate to 'negative externalities' and good and services whose use need to be discouraged.

In its Draft Discussion paper, the Empowered Committee has discussed about the demerit goods including petroleum products (which, as already discussed, above are one of the main polluting goods in India). The Empowered Committee has argued in favour of keeping the demerit goods including petroleum products, tobacco, and alcohol out of the GST purview. These goods in turn will be subjected to separate non-debatable excise duties. In the Draft Discussion paper circulated by the Empowered Committee the following was recommended.

" ….Demerit goods such as alcoholic beverages and tobacco should be brought under GST with ITC. However, Excise duties (without ITC) should be levied over and above the GST by both the centre and states.

Since crude and petroleum products are non-renewable resources, a similar model, as recommended for· alcoholic beverages and tobacco, could be adopted. An alternative would be to, keep crude, motor spirit, and high speed diesel out of the purview of the GST. This would reflect current practice in India that does not allow ITC of petrol and diesel to downstream users."

The Task Force set-up for the 13th Finance Commission clubbed the petroleum products, tobacco and alcohol under the category 'sin goods'. The Task Force recognized the issue of negative externalities in a clearer way and collectively referred to these as sin goods and services and makes a distinction between sin goods and non- sin goods. The Task Force defines sin goods as goods whose consumption create negative externalities and for the purposes of their Report these, collectively or severally, refer to emission fuels, tobacco goods and alcohol. The Task Force notes that generally, goods with negative externalities should be subjected to excise duties in respect of which input tax credit is not to be allowed.

It is suggested here that in the case of polluting goods and other natural resources, taxation should be considered as a potent instrument which should be used to curb both production and consumption. Accordingly, the Centre and the State governments should be allowed to levy non-rebatable excise and/or cesses on all polluting goods and natural resources (coal, petroleum, fertilizers, pesticides, textiles, plastics, leather, electricity) being mined out from their regions (coal, metals) and all potential health hazards for their citizens (alcohol, tobacco) at rates considered appropriate by them and Constitutional Amendments for introducing GST should leave adequate fiscal space for the levy of such excises/cesses.

3.11 Conclusions

In this Chapter, we have discussed various options available for India in selecting a suitable form of GST with the overall objective of achieving a comprehensive and integrated domestic market while maintaining the basic feature of our federal structure including the present level of vertical imbalance before and after transfers at least in broad terms. The following are some of the specific suggestions:

i. India should opt for a dual and concurrent system of GST.
ii. The aggregate GST base should be large enough to permit a low single GST rate.
iii. The rates for the central and state components should be determined taking into account not only the present relativities but likely growth of revenues of the taxes to be subsumed in the GST rate.
iv. Petroleum and petroleum products, alcoholic beverages, and polluting inputs or outputs intensively using polluting inputs may be subjected to special non-rebatable levies (in the form of excise and cesses) both by the Central and State governments. This should apply to all polluting goods and services also.
v. Exports should be zero-rated and inter-State flow of goods and services should be handled on the destination principle with limited exception of localized environmental damage where a special levy can be imposed by the producing state.
vi. Exemptions should be minimized if not altogether avoided including foods and related items. All income or consumption support policies should be implemented through direct subsidy or explicit government expenditure rather than through tax expenditure implicit in tax exemptions.
vii. The efficiency gains of a simple single rate system would be such that the extra revenue earned by both the tiers of government that India will be ushered into a modern productive economy with high growth rate.

Chapter 4

CONCLUDING OBSERVATIONS

4.1 Introduction

The Commission on Centre-State Relations has been asked as part of its Terms of Reference (ToR) to examine 'the need and relevance of separate taxes on the production and on the sales of goods and services subsequent to the introduction of VAT regime'. In a federal economy like India, there are three issues that require examination in the context of this term of reference:

i. Whether there is any need or relevance for separation of production from sales in the case of goods.
ii. Whether there is need or relevance for separation of goods from services in the context of taxation in a VAT system.
iii. Whether there is need or relevance for separation of jurisdictions of the Central and the State governments in capturing the value added in the production and sale of goods as well as services.

This study has looked at the shortcomings of the existing system of taxation of goods and services in India, the rationale for further reforms leading to an integrated treatment of goods and services in a comprehensive all-India market, and a suitable form of a GST that can maintain the relative share of revenues of the Central and State governments before and after transfers from the centre to the states so that the existing profile of vertical balance is not disturbed.

4.2 Taxation of Goods and Services in India: Existing Arrangements

The existing system of taxation of goods and services in India, even after considerable reforms, has many deficiencies although a sound beginning has been made in bringing about the principle of VAT of goods and services. At present, the system of taxation of goods and services consists of three disjointed parts: Cenvat (taxation of goods up to manufacturing by the central government), State-VAT (taxation of goods up to the retail level by the state governments), and taxation of services by the central government.

The taxation space up to the value added in the production of goods (up to manufacturing) is common between the Centre and the States. Different states can have their own variations in terms of rates and classification of goods. In the State-VAT system, an attempt has been made to arrive at a broad convergence of rates, but states have gone for their own classification schemes and there are many differences in the classification schemes. In addition to the State-VAT, the levy of a CST continues on inter-State sales. While the system of taxation is thus characterized by fragmentation and overlaps in the case of goods, the taxation of services remains separated and disjointed from that of goods. With different tiers of government involved in taxation of value added in the case of goods, there is considerable cascading that result, which causes several inefficiencies and distortions. In particular, it favours imports, which are treated as final goods and bear the burden of taxation only once, against domestic production, which may be taxed several times; it increases the cash balance requirement of the producers/dealers; it makes tracing the overall tax burden of a good or a service difficult; and, it encourages tax evasion and compliance costs. In addition, in every type of tax, there are a large number of cesses and surcharges. Such a system does not meet the first principles of a good tax system and more reforms are needed.

The main problems of the existing system of taxation of goods and services are summarized below.

i. In the case of Cenvat, the issues relating to definition of manufacturing and methodology of valuation remain causing difficulties in implementation of the tax.
ii. The problem of multiple rates remains although the tax rate structure is simpler than what it used to be. This leads to various classification disputes.
iii. In the case of services taxation, problems relate to distinguishing between a good and a service. The distinction between the two is often blurred.
iv. Exclusion of services from the tax base of the states potentially erodes their tax buoyancy in a growing economy.
v. Cascading has not been fully eliminated as there is cross cascading between Statevat, Cenvat, and central services tax.
vi. The CST continues to cause artificial inter-State border boundaries and violating the destination based principle of taxation of goods and services.

Many of these problems can be addressed by extending the scope of taxation of services for the states and the scope of taxation of goods up to the retail stage for the centre.

4.3 Changing Structure of the Indian Economy

It has been noted in this study that the structure of the Indian economy has been persistently changing in favour of services. The share of the agricultural sector has come down over the years, the share of manufacturing has increased to a limited extent, but the share of the services sector has been increasing steadily. The share of agriculture has come down from more than 55 percent in 1950-51 to about 18.5 percent by 2006-07.

The share of industry, which was only about 11 percent of GDP in 1950-51 now accounts for nearly 20 percent. The share of services has increased to more than 60 percent of GDP at factor cost by 2006-07. The service sectors show not only the relatively higher growth rates but also much less volatility in the growth rates.

4.4 Rationale for Similar Treatment of Goods and Services

The traditional distinction between goods and services (and for other items such as land and property, entertainment, and luxuries) has become dated. In modern economies, goods and services are being bundled together and offered to the consumers as a composite bundle. Under the current division of taxation powers, neither the Centre nor the States can apply the tax to such bundles in a seamless manner. Each can tax only parts of the bundle, creating possibility of gaps and/or disputes.

The distinction between goods and services is increasing getting blurred with the advancements in information technology and digitization. For example, under Indian jurisprudence, goods have been defined to include intangibles, e.g., copyright, and software bringing them within the purview of state taxation. But intangibles are often supplied as part of a service contract. Software upgrades are considered as 'goods' but these can be supplied as part of a contract for software repair and maintenance services. The modern telecommunications give scope of providing many VAS that may include supplies of 'goods' An on-line subscription to newspapers could be viewed as a service, but online purchase and download of a magazine or a book could constitute a purchase of goods. Leasing of equipment without transfer of possession and control to the lessee is a service but may be deemed as sale of goods.

In order to resolve these problems, two changes need to be brought about simultaneously: extension of all services within the purview of State-VAT and extension of value added up to the retail level in the case of goods to be brought under the purview of the Cenvat. This is what the Kelkar Committee had called the 'grand bargain'. These changes will have the effect of integrating goods and services for purposes of taxation under the value added system.

4.5 Rationale for Extending Services to States for Taxation

There are good reasons why services should be extended for taxation along with goods for State-VAT. The first is a revenue reason. Given that services are growing relatively faster than other sectors, extension of services for taxation by the states will ensure that the state's share in the revenue buoyancy with respect to the GDP. This will also make state revenue more stable since the services are the least volatile of the output sector in an economy. The second reason is that expanding the taxation of services as part of the VAT system will make the sales tax fairer. The sales tax is intended to be a general tax on consumption where consumption of goods and services are often substitutes and should treated on par. Thirdly, taxing services at the same rate as goods would improve the allocation of economic resources. Lower rates for services distort resource allocation by providing an incentive to purchase services rather than goods.

Fourthly, treating servicers and goods on par will minimize if not altogether eliminate classification disputes as to whether a supply is of that of a good or a services. It will reduce both the administration costs and compliance costs enormously. Since states in India are precluded from taxation of services except those specific services that may be listed in the State List, this has given rise to difficulties in the taxation of goods supplied as part of a composite works contract involving a supply of both goods and services, and under leasing contracts, which involve a transfer of the right to use goods without any transfer of their ownership.

4.6 Rationale for Extending Taxation of Goods up to Retail for the Centre

Similar reasons can be cited as grounds for extending the taxation of goods up to retail for the centre. First, it will eliminate the need to define 'manufacturing'. Every supply from one registered dealer of a good or service will then become taxable up to the retail stage. This will also eliminate most of the valuation problems since valuation will be determined by the market and the incentive to underestimate values will also be minimal as tax credits are to be claimed at all stages. Secondly, this will permit a symmetrical treatment of goods and services. Thirdly, the centre will be compensated for sharing the taxation of services with the states. Fourthly, taxation of goods all the way up to the retail stage will create a paper record of all goods leaving state boundaries making settlement of inter- State disputes far easier in implementing a destination based principle of taxation.

4.7 Towards a Comprehensive GST

Although various options may be considered in selecting a suitable form of GST for India, the option of a dual concurrent GST seems most practicable at the present juncture. Under this model a concurrent or dual GST is levied by the Centre as well as the States. This can be implemented while maintaining the current pre-and post-transfer profiles of vertical imbalance. It would require that states be enabled to tax services and the service tax rate should be the same as that for goods. Alongside, Central government should be enabled to tax value added in the case of goods up to the retail stage. These changes would lead to a comprehensive and unified system of taxation of goods and services.

The Empowered Committee of the State Finance Ministers has also recommended the concurrent dual GST. The main features of the proposed GST model are summarized below:

i. For Centre, the following taxes would be subsumed under the GST: Central Excise duties (extended up to the retail level), Additional Excise duties, Additional Duty of Customs or CVD, CST and Service Tax including all cesses and surcharges. Except for essential services such as primary public health and primary public education, all services should be comprehensively covered under the GST. The Additional Duty of Customs (known as CVD) which is essentially an excise on imports would be subsumed under GST and would be made up of the same two components viz. the Central GST and the State GST.

ii. The major State taxes to be subsumed under GST are: VAT or Sales Tax; Entertainment Tax; Luxury Tax; Octroi or Entry Tax and Taxes on Lotteries, Betting and Gambling, and Purchase Tax, and electricity duty, and any cesses and surcharges levied by the State governments.

iii. The Centre shall levy one component (Central GST or CGST) and the states /Union Territories shall levy the other (State GST of SGST). Both CGST and SGST should be applicable to all transactions of goods and services.

iv. Separate accounts should be maintained for the central and the state GST. While input tax credit (ITC) should be permitted within each of the taxes, cross flow between Central and State GST should not be permitted.

v. Both CGST and SGST should ideally be at single rates. However, certain categories of goods may need to be taxed at a rate lower than the standard- rate, both for CGST and SGST.

vi. Exports should be zero-rated i.e. exports should be relieved of the burden of all embedded taxes and levies, both Central and states.

vii. Demerit goods such as alcoholic beverages and tobacco should be brought under GST with ITC. However, Excise duties (without ITC) should be levied over and above the GST by both the centre and states.
viii. Since crude and petroleum products are non-renewable resources, a similar model, as recommended for alcoholic beverages and tobacco could be adopted.
ix. Inter-State sales should be governed by the destination principle.
x. Under the GST exemptions should be minimized. The dual GST structure at the Central and the State levels should have a common list of exemptions. Specific provisions to provide limited flexibility to the states within a set of prescribed criteria may be incorporated in order to accommodate exemption of goods of local importance; and
xi. CST would be eliminated.

Union and State taxes on petroleum and related products contribute more than 40 percent of the revenue from central excise duty as also significant shares of states tax revenues. At present, neither the Union government nor the State governments allow ITC on major petroleum products. The Empowered Committee has suggested two alternatives. In the first model, all petroleum products should be subjected to GST (with ITC). Over and above the GST, both the centre and the states can levy additional excise duty (without ITC) at different rates subject to a floor. The Empowered Committee has since come out with the First Discussion Paper on GST. It has suggested that petroleum products and alcoholic beverages should be left out of GST and central excise and state sales tax on these should continue. For tobacco, it has recommended levy of central excise alongwith CGST and SGST. The Task Force set up by the Thirteenth Finance Commission has recommended a more comprehensive tax base for GST, which enables a reduction of the revenue neutral rate.

4.8 Need for Ensuring Revenue Neutrality in Transition

In order to main the relative profile of vertical balance in the share of revenues for the centre and states, a suitable GST rate needs to be determined and divided between a central GST rate and a state GST rate. The larger is the tax base, the lower can be the overall GST rate. Apart from some Scandinavian countries where the GST rate may be as high as 25 percent, most other countries have settled for a comprehensive base and low rate with minimum exemptions. A single rate GST comprehensively covering all goods and services will be most conducive to tax compliance and rule out all classification disputes and other legal issues and minimize scope of evasion or avoidance.

The Kelkar Committee had suggested an overall rate of 20 percent divided into a 12:8 ratio in favor the centre. This may need to be reexamined with current levels of revenues under Cenvat and service taxes and the Statevat and other related taxes that may be subsumed in the GST. Bagchi and Poddar (2007) an overall revenue neutral GST rate of 11.3 percent with the central GST rate at 5 percent and that for the states at 6.3 percent. Allowing for some leakages, they suggest that the overall rate can be 12 percent.

In a recent study Kavita Rao (2008) has estimated the revenue neutral GST rate using two methods, namely, a GDP based method and a consumption expenditure based method. Following the GDP-based method, she estimates the revenue neutral GST rate to be about 14 with a 10 percent rate of non-rebatable excises on passenger cars and multi-utility vehicles, petroleum products, and tobacco products. Following the consumption expenditure method, she observes that the rate of GST required for revenue neutrality would be 20 percent. With improved tax administration, the GST rate can be reduced further.

The Task Force of the Thirteenth Finance Commission has estimated the RNR at 12 percent, 5 percent for centre and 7 percent for the states.

4.9 Need for Integrating Environmental Considerations

Another contextual issue, also specifically refereed to the Thirteenth finance Commission relates to ecology and environment. This has special relevance in the context of the proposed GST whatever may be the form in which it is implemented. It should be recognized that in a value added tax regime, input taxes are to be fully rebated. As such, taxation of polluting inputs will be ineffective as the tax paid on the inputs will be fully rebated, unless a non-rebatable cess is levied on the inputs.

As is done in European Union and other countries, the environmental considerations within the framework of a comprehensive GST requires that on certain outputs non-rebatable special duties be levied. Some of the items that may be covered under this provision are petroleum and related products, motor vehicles, products involving extensive use of coal, plastics, lead, metals, alcoholic beverages the production of which involves pollution. Most of these items are the ones that have relatively inelastic demand. As such, these can also serve as an instrument providing flexibility the states to take into account local conditions in determining the relevant rates of special duties.

These can also help the states in at least partially absorbing the revenue impact of moving to GST.

Both the Empowered Committee and the Task Force bring into consideration the issue of negative externalities through the concept of 'demerit goods' and 'sin goods'.

The Task Force recommended that environment polluting taxes should all be clubbed into a central excise and state excise, which should be non-rebatable.

Environmental taxes or eco-taxes constitute and indirect, self-monitoring, incentive-based instrument for pollution control. These have the potential to induce appropriate environmental decisions through instituting an incentive structure by raising the relative costs of polluting inputs and outputs. Also called 'green taxes', these are not necessarily meant as a revenue-augmenting device. Instead, the idea is to change the structure of taxation rather than putting additional burden on the tax payers. Environmental taxes may yield benefits over and above a cleaner environment. In particular, governments can use the revenues from pollution taxes to decrease other distortionary taxes, thereby providing a 'double dividend'.

4.10 Conclusions

Thus, for the overall objective of achieving a comprehensive and integrated domestic market encompassing all goods and services while maintaining the basic feature of our federal structure including the present level of vertical imbalance before and after transfers at least in broad terms, the following are some of the specific suggestions:

i. India should opt for a dual and concurrent system of GST.
ii. The aggregate GST base should be large enough to permit a low single GST rate.
iii. The rates for the central and state components should be determined taking into account not only the present relativities but likely growth of revenues of the taxes to be subsumed in the GST rate.
iv. Petroleum and petroleum products, alcoholic beverages, and polluting inputs or outputs intensively using polluting inputs may be subjected to special non-rebatable levies (excise and cesses) both by the central and State governments.
v. Exports should be zero-rated and inter-State flow of goods and services should be handled on the destination principle with limited exception of localized environmental damage where a special levy can be imposed by the producing state.
vi. Exemptions should be minimized if not altogether avoided including foods and related items. All income or consumption support policies should be implemented

through direct subsidy or explicit government expenditure rather than through tax expenditure implicit in tax exemptions.

vii. The Constitutional Amendment to bring about GST, should ensure that revenue autonomy of the states is not adversely affected.

viii. The efficiency gains of a simple single rate system would be such that, with the extra revenue earned by both the tiers of government, India will be ushered into a modern productive economy with a sustained high growth rate for many years to come.

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ANNEXURE A1: TAXES LEVIED AND ASSIGNED

Article 268. Taxes levied by the Union but collected and appropriated by the States

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

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

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

(2) The proceeds in any financial year of any such duty leviable within any State shall not form part of the Consolidated Fund of India, but shall be assigned to that State.

Article 269. Taxes levied and collected by the Union but assigned to the States

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

Explanation—For the purposes of this clause

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

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

(2) The net proceeds in any financial year of any such tax, except in so far as those proceeds represent proceeds attributable to Union territories, shall not form part of the Consolidated Fund of India, but shall be assigned to the States within which that tax is leviable in that year, and shall be distributed among those States in accordance with such principles of distribution as may be formulated by Parliament by law.

(3) Parliament may by law formulate principles for determining when a sale or purchase of, or consignment of, goods takes place in the course of inter-State or commerce.

ANNEXURE 2: ARTICLE 301-307 OF THE CONSTITUTION

Article 301 Freedom of trade, commerce and intercourse: Subject to the other provisions of this Part, trade, commerce and intercourse throughout the territory of India shall be free.

Article 302 Power of Parliament to impose restrictions on trade, commerce and intercourse: Parliament may by law impose such restrictions on the freedom of trade, commerce or intercourse between one State and another or within any part of the territory
of India as may be required in the public interest.

Article 303 Restrictions on the legislative powers of the Union and of the States with regard to trade and commerce: (1) Notwithstanding anything in Article 302, neither Parliament nor the Legislature of a State shall have power to make any law giving, or authorising the giving of, any preference to one State over another, or making, or authorising the making of, any discrimination between one State and another, by virtue of any entry relating to trade and commerce in any of the Lists in the Seventh Schedule. (2) Nothing in clause (1) shall prevent Parliament from making any law giving, or authorising the giving of, any preference or making, or authorising the making of, any discrimination if it is declared by such law that it is necessary to do so for the purpose of dealing with a situation arising from scarcity of goods in any part of the territory of India.

Article 304 Restriction on trade, commerce and intercourse among States: Notwithstanding anything in Article 301, the Legislature of a State may by law -

a. impose on goods imported from other States or the Union territories any tax to which similar goods manufactured or produced in that State are subject, so, however, as not to discriminate between goods so imported and goods so manufactured or produced; and
b. impose such reasonable restrictions on the freedom of trade, commerce or intercourse with or within that State as may be required in the public interest:

Provided that no Bill or amendment for the purposes of clause (b) shall be introduced or moved in the Legislature of a State without the previous sanction of the President.

Article 305 Saving of existing laws and laws providing for State monopolies: Nothing in Articles 301 and 303 shall affect the provisions of any existing law except in so far as the President may by order otherwise direct; and nothing in article 301 shall affect the operation of any law made before the commencement of the Constitution (Fourth

Amendment) Act, 1955, in so far as it relates to, or prevent Parliament or the Legislature of a State from making any law relating to, any such matter as is referred to in sub-clause (ii) of clause (6) of article 19.

Article 306 Power of certain States in Part B of the First Schedule to impose restrictions on trade and commerce: Article 307 Appointment of authority for carrying out the purposes of articles 301 to 304: Parliament may by law appoint such authority as it considers appropriate for carrying out the purposes of Articles 301, 302, 303 and 304, and confer on the authority so appointed such powers and such duties as it thinks necessary.

Appendix Table A1: The Changing Composition of Agricultural and Allied Activities and Industry Sectors (Constant Prices)

(Percent)

Year	Agriculture and Allied Activities	Agriculture	Industry	Mining Quarrying	Manufacturing	Electricity, Gas and Water Supply
1950-51	55.28	48.36	10.65	1.42	8.92	0.31
1951-52	54.78	47.99	10.88	1.56	8.99	0.34
1952-53	55.04	48.69	10.95	1.55	9.06	0.34
1953-54	55.93	50.07	11.04	1.48	9.21	0.35
1954-55	55.23	49.37	11.30	1.48	9.45	0.36
1955-56	53.36	47.41	11.80	1.47	9.93	0.39
1956-57	53.21	47.52	11.97	1.46	10.10	0.41
1957-58	51.52	45.73	12.69	1.58	10.63	0.47
1958-59	52.66	47.24	12.37	1.51	10.36	0.50
1959-60	51.03	45.56	12.95	1.55	10.83	0.56
1960-61	50.81	45.60	13.18	1.67	10.94	0.57
1961-62	49.38	44.14	13.87	1.71	11.53	0.63
1962-63	47.38	42.28	14.68	1.88	12.11	0.69
1963-64	46.15	41.00	15.24	1.84	12.62	0.78
1964-65	46.85	42.04	15.06	1.73	12.54	0.79
1965-66	43.16	37.67	16.01	2.00	13.11	0.90
1966-67	42.02	36.36	16.04	2.03	13.05	0.97
1967-68	44.56	39.29	15.01	1.93	12.09	0.99
1968-69	43.38	38.18	15.47	1.93	12.44	1.09
1969-70	43.43	38.52	15.99	1.91	12.96	1.12
1970-71	44.31	39.42	15.46	1.69	12.64	1.13
1971-72	43.06	37.99	15.86	1.72	12.92	1.21
1972-73	41.01	35.96	16.57	1.83	13.47	1.27
1973-74	42.14	37.37	16.51	1.77	13.48	1.25
1974-75	40.99	35.90	16.84	1.84	13.71	1.29
1975-76	42.37	37.53	16.05	1.89	12.82	1.35
1976-77	39.47	34.85	17.20	1.93	13.78	1.49
1977-78	40.45	36.52	16.94	1.86	13.63	1.45
1978-79	39.39	35.46	17.94	1.82	14.58	1.54
1979-80	36.13	32.30	18.41	1.93	14.84	1.64
1980-81	37.92	34.37	17.45	2.01	13.82	1.61
1981-82	37.55	34.12	17.99	2.17	14.16	1.67
1982-83	36.38	33.10	18.29	2.35	14.21	1.73
1983-84	37.15	33.99	18.48	2.25	14.52	1.71

Appendix Table A1 (contd.) : The Changing Composition of Agricultural and Allied Activities and Industry Sectors (Constant Prices)

(Percent)

Year	Agriculture and Allied Activities	Agriculture	Industry	Mining Quarrying	Manufacturing	Electricity, Gas and Water Supply
1984-85	36.30	33.18	18.57	2.19	14.55	1.83
1986-87	33.38	30.48	18.97	2.38	14.58	2.00
1987-88	31.72	28.93	19.34	2.39	14.87	2.08
1988-89	33.30	30.68	19.24	2.52	14.65	2.08
1989-90	31.75	29.03	19.72	2.55	15.02	2.15
1990-91	31.37	28.75	19.80	2.68	14.95	2.17
1991-92	30.32	27.69	19.46	2.73	14.38	2.35
1992-93	30.69	28.13	19.07	2.61	14.07	2.39
1993-94	30.01	27.47	19.40	2.51	14.46	2.43
1994-95	29.53	27.04	20.13	2.58	15.06	2.50
1995-96	27.34	24.96	21.24	2.54	16.21	2.48
1996-97	27.83	25.52	21.23	2.37	16.44	2.43
1997-98	26.00	23.74	20.77	2.49	15.77	2.51
1998-99	25.91	23.83	20.16	2.40	15.24	2.51
1999-00	24.99	22.93	19.60	2.33	14.78	2.49
2000-01	23.89	21.84	19.99	2.28	15.26	2.44
2001-02	23.99	21.97	19.33	2.20	14.79	2.34
2002-03	21.43	19.44	19.88	2.30	15.22	2.36
2003-04	21.72	19.86	19.42	2.19	14.95	2.28
2004-05	20.20	18.47	19.61	2.20	15.12	2.29
2005-06 P	19.56	17.91	19.37	2.11	15.06	2.19
2006-07 QE	18.51	16.97	19.54	2.04	15.39	2.12
2007-08 RE	17.75		19.38	1.96	15.35	2.07

Source (Basic Data): Central Statistical Organization; New Series (Base: 1999-2000); GDP at factor cost.

Appendix Table A2: The Changing Composition of Service Sector (Constant Prices)

(Percent)

Years	Service	Construction	Trade, Hotels, Transport and Communication	Financing, Insurance, Estate and Business services	Community, Social, and Personal Services
1950-51	34.07	4.43	11.34	7.69	10.61
1951-52	34.34	4.62	11.37	7.68	10.67
1952-53	34.01	4.18	11.43	7.80	10.60
1953-54	33.03	4.06	11.19	7.46	10.32
1954-55	33.47	4.38	11.42	7.42	10.25
1955-56	34.84	5.08	11.94	7.52	10.30
1956-57	34.82	5.35	12.13	7.23	10.11
1957-58	35.79	4.76	12.70	7.61	10.72
1958-59	34.97	4.94	12.40	7.26	10.36
1959-60	36.02	5.17	12.90	7.38	10.58
1960-61	36.01	5.58	13.05	7.03	10.35
1961-62	36.75	5.61	13.50	7.12	10.52
1962-63	37.94	5.69	14.01	7.20	11.03
1963-64	38.61	6.08	14.27	7.07	11.19
1964-65	38.09	6.10	14.15	6.75	11.09
1965-66	40.83	6.74	14.94	7.20	11.94
1966-67	41.93	7.21	15.15	7.24	12.33
1967-68	40.43	7.13	14.60	6.86	11.83
1968-69	41.15	7.20	14.89	7.02	12.05
1969-70	40.58	6.98	14.76	6.88	11.96
1970-71	40.23	6.64	14.74	6.82	12.03
1971-72	41.09	6.60	14.94	7.11	12.44
1972-73	42.42	6.77	15.36	7.40	12.88
1973-74	41.35	6.07	15.34	7.27	12.68
1974-75	42.17	5.81	16.09	7.16	13.11
1975-76	41.57	6.07	16.06	7.01	12.43
1976-77	43.32	6.59	16.62	7.48	12.63
1977-78	42.61	6.76	16.46	7.30	12.08
1978-79	42.67	6.29	16.94	7.44	12.00
1979-80	45.46	6.27	17.75	7.90	13.54

Appendix Table A2 (contd.) : The Changing Composition of Service Sector (Constant Prices)

(Percent)

Years	Service	Construction	Trade, Hotels, Transport and Communication	Financing, Insurance, Estate and Business services	Community, Social, and Personal Services
1980-81	44.63	6.60	17.45	7.49	13.10
1981-82	44.45	6.59	17.53	7.67	12.67
1982-83	45.33	5.95	17.96	8.16	13.26
1983-84	44.37	5.81	17.50	8.31	12.75
1984-85	45.13	5.79	17.64	8.59	13.12
1985-86	46.52	5.87	18.29	9.05	13.31
1986-87	47.66	5.76	18.59	9.59	13.72
1987-88	48.93	5.88	18.90	9.94	14.21
1988-89	47.46	5.72	18.16	9.90	13.68
1989-90	48.53	5.77	18.37	10.49	13.91
1990-91	48.83	6.12	18.34	10.58	13.78
1991-92	50.21	6.16	18.55	11.56	13.94
1992-93	50.23	6.05	18.59	11.57	14.02
1993-94	50.60	5.76	18.81	12.17	13.86
1994-95	50.33	5.70	19.42	11.88	13.32
1995-96	51.43	5.63	20.49	11.97	13.33
1996-97	50.94	5.31	20.51	11.78	13.34
1997-98	53.23	5.63	21.14	12.61	13.85
1998-99	53.93	5.61	21.33	12.74	14.25
1999-00	55.40	5.71	21.69	13.07	14.93
2000-01	56.12	5.81	22.30	13.04	14.98
2001-02	56.68	5.71	23.01	13.22	14.74
2002-03	58.69	5.94	24.25	13.75	14.75
2003-04	58.86	6.13	25.03	13.37	14.33
2004-05	60.19	6.62	25.79	13.53	14.25
2005-06 P	61.08	7.05	26.28	13.78	13.96
2006-07 QE	61.94	7.20	26.81	14.32	13.62
2007-08 RE	62.87	7.26	27.55	14.68	13.40

Source (Basic Data): Central Statistical Organization; New Series (Base : 1999-2000); GDP at factor cost.

Appendix Table A3: The Changing Composition of Agricultural and Allied Activities and Industry Sectors (Current Prices)

(Percent)

Year	Agriculture and Allied Activities	Agriculture	Industry	Mining Quarrying	Manufacturing	Electricity, Gas and Water Supply
1951-52	51.39	48.66	12.57	0.82	11.47	0.27
1952-53	50.59	48.36	12.06	0.85	10.92	0.29
1953-54	51.28	49.33	12.40	0.79	11.32	0.28
1954-55	46.11	43.75	13.63	0.88	12.41	0.34
1955-56	43.88	41.49	13.78	0.88	12.52	0.38
1956-57	47.00	44.76	13.84	0.90	12.57	0.37
1957-58	44.90	42.64	14.52	1.02	13.06	0.45
1958-59	46.71	44.62	13.94	0.98	12.50	0.47
1959-60	44.58	42.39	14.82	0.99	13.30	0.53
1960-61	42.85	40.59	15.76	1.07	14.14	0.55
1961-62	42.06	39.63	16.44	1.07	14.78	0.59
1962-63	40.04	37.72	17.14	1.20	15.30	0.65
1963-64	41.34	39.12	17.11	1.14	15.31	0.67
1964-65	43.38	41.32	16.17	1.03	14.46	0.68
1965-66	41.19	38.98	16.54	1.13	14.67	0.74
1966-67	42.20	39.98	16.03	1.08	14.13	0.81
1967-68	45.09	43.00	14.77	1.08	12.89	0.80
1968-69	44.03	41.66	15.21	1.09	13.22	0.91
1969-70	43.83	41.60	15.94	1.10	13.86	0.98
1970-71	42.40	40.14	16.32	1.08	14.19	1.04
1971-72	40.62	38.28	16.90	1.06	14.76	1.07
1972-73	40.63	38.20	17.01	1.04	14.92	1.05
1973-74	43.91	41.45	16.71	0.98	14.80	0.93
1974-75	40.79	38.29	18.33	1.18	16.13	1.01
1975-76	37.92	35.37	18.31	1.41	15.74	1.16
1976-77	35.98	33.41	19.10	1.50	16.17	1.43
1977-78	37.43	34.92	18.81	1.46	15.92	1.44
1978-79	35.75	33.03	20.11	1.47	17.04	1.60
1979-80	33.84	30.93	21.22	1.68	17.85	1.69
1980-81	35.70	32.81	20.12	1.76	16.72	1.64
1981-82	34.37	31.46	21.10	2.67	16.80	1.62

Appendix Table A3: The Changing Composition of Agricultural and Allied Activities and Industry Sectors (Current Prices)

(Percent)

Year	Agriculture and Allied Activities	Agriculture	Industry	Mining Quarrying	Manufacturing	Electricity, Gas and Water Supply
1982-83	33.17	30.18	21.09	2.95	16.42	1.72
1983-84	33.84	31.05	21.21	2.83	16.64	1.74
1984-85	32.49	29.72	21.35	2.83	16.64	1.87
1985-86	31.17	28.47	21.25	2.71	16.51	2.02
1986-87	30.00	27.29	21.27	2.84	16.37	2.06
1987-88	29.44	26.76	21.07	2.62	16.41	2.04
1988-89	30.47	27.92	21.06	2.87	16.20	1.99
1989-90	29.23	26.64	21.78	2.75	16.96	2.07
1990-91	29.28	26.78	21.51	2.67	16.70	2.13
1991-92	29.65	27.33	20.52	2.54	15.72	2.26
1992-93	28.99	26.68	20.92	2.55	15.87	2.49
1993-94	28.93	26.58	20.91	2.56	15.83	2.53
1994-95	28.52	26.15	21.93	2.47	16.75	2.71
1995-96	26.49	24.32	22.93	2.35	17.88	2.70
1996-97	27.37	25.26	22.23	2.21	17.51	2.50
1997-98	26.12	23.88	21.43	2.40	16.38	2.65
1998-99	26.02	23.94	20.57	2.22	15.51	2.84
1999-00	24.99	22.93	19.60	2.33	14.78	2.49
2000-01	23.35	21.24	20.37	2.37	15.60	2.39
2001-02	23.20	21.09	19.58	2.28	15.03	2.26
2002-03	20.87	18.82	20.49	2.77	15.30	2.41
2003-04	20.97	19.03	20.06	2.52	15.31	2.23
2004-05	19.20	17.42	20.79	2.95	15.76	2.08
2005-06 P	18.80	17.01	20.70	2.87	15.86	1.97
2006-07 QE	18.35	16.74	20.85	2.69	16.30	1.86
2007-08 RE	17.75		20.89	2.76	16.38	1.75

Source (Basic Data): Central Statistical Organization; New Series (Base: 1999-2000); GDP at factor cost.

Appendix Table A4: The Changing Composition of Service Sector (Current Prices)

(Percent)

Years	Service	Construction	Trade, Hotels, Transport and Communication	Financing, Insurance, Estate and Business services	Community, Social, and Personal Services
1950-51	35.50	2.58	9.72	12.02	11.18
1951-52	36.04	2.79	9.96	12.25	11.03
1952-53	37.35	2.62	10.14	13.07	11.51
1953-54	36.33	2.42	9.90	12.97	11.04
1954-55	40.26	2.84	10.76	14.69	11.98
1955-56	42.35	3.48	10.93	15.48	12.46
1956-57	39.16	3.31	10.65	14.15	11.04
1957-58	40.57	2.97	11.50	14.79	11.32
1958-59	39.35	3.07	11.27	14.22	10.79
1959-60	40.61	3.25	11.56	14.50	11.29
1960-61	41.39	3.84	11.64	14.26	11.65
1961-62	41.50	3.81	11.93	13.81	11.95
1962-63	42.83	3.75	12.17	14.78	12.12
1963-64	41.54	3.76	11.95	14.03	11.80
1964-65	40.45	3.83	12.04	13.09	11.48
1965-66	42.27	4.20	12.43	13.48	12.16
1966-67	41.77	4.36	12.73	12.70	11.99
1967-68	40.13	4.35	12.42	11.90	11.46
1968-69	40.76	4.47	12.53	12.07	11.69
1969-70	40.23	4.54	12.31	11.78	11.60
1970-71	41.28	4.51	12.72	12.05	12.00
1971-72	42.48	4.65	12.94	12.39	12.50
1972-73	42.36	4.61	12.98	12.33	12.44
1973-74	39.38	3.90	12.74	11.28	11.47
1974-75	40.88	3.62	14.26	10.75	12.25
1975-76	43.76	4.24	15.17	11.43	12.93
1976-77	44.92	4.66	15.26	11.80	13.20
1977-78	43.76	4.76	15.08	11.31	12.60
1978-79	44.14	4.54	15.37	11.34	12.89
1979-80	44.94	4.19	16.23	11.32	13.21
1980-81	44.18	4.57	16.07	10.57	12.97
1981-82	44.53	4.46	16.84	10.65	12.58
1982-83	45.74	4.53	17.20	10.93	13.08

Appendix Table A4(Contd..): The Changing Composition of Service Sector (Current Prices)

(Percent)

Years	Service	Construction	Trade, Hotels, Transport and Communication	Financing, Insurance, Estate and Business services	Community, Social, and Personal Services
1983-84	44.95	4.45	17.08	10.69	12.73
1984-85	46.16	4.65	17.51	10.95	13.04
1985-86	47.59	4.86	18.30	11.22	13.20
1986-87	48.73	5.01	18.55	11.54	13.62
1987-88	49.49	5.24	18.69	11.64	13.92
1988-89	48.47	5.12	18.49	11.33	13.53
1989-90	48.99	5.16	18.79	11.59	13.46
1990-91	49.21	5.38	18.89	11.62	13.32
1991-92	49.83	5.24	18.87	12.30	13.42
1992-93	50.09	5.21	19.40	11.90	13.59
1993-94	50.16	4.95	19.72	12.36	13.12
1994-95	49.55	4.87	20.15	11.96	12.57
1995-96	50.58	4.90	20.70	12.30	12.68
1996-97	50.40	4.79	21.02	11.66	12.94
1997-98	52.46	5.35	21.67	11.94	13.50
1998-99	53.41	5.49	21.53	12.07	14.32
1999-00	55.40	5.71	21.69	13.07	14.93
2000-01	56.28	5.82	22.28	13.23	14.94
2001-02	57.23	5.76	22.70	13.96	14.80
2002-03	58.64	5.98	23.26	14.62	14.78
2003-04	58.97	6.18	23.82	14.63	14.33
2004-05	60.01	7.40	24.54	14.08	14.01
2005-06 P	60.50	8.08	24.90	13.82	13.71
2006-07 QE	60.80	8.43	25.05	13.90	13.42
2007-08 RE	61.35	8.53	25.22	14.27	13.34

Appendix Table A5: VAT Rates in EU Countries

Country	Standard Rate	Reduced Rate	Abbreviation	Name
Austria	20%	12% or 10%	USt.	Umsatzsteuer
Belgium	21%	12% or 6%	BTW	Belasting over de toegevoegde waarde
			TVA	Taxe sur la Valeur Ajoutée
			MWSt	Mehrwertsteuer
Bulgaria	20%	0% or 7%		
Cyprus	15%	5%		
Czech Republic	19%	9%	DPH	Daň z přidané hodnoty
Denmark	25%	none	moms	Merværdiafgift
Estonia	18%	5%	km	käibemaks
Finland	22%	17% or 8%	ALV	Arvonlisävero
			Moms	Mervärdesskatt
France	19.60%	5.5% or 2.1%	TVA	Taxe sur la valeur ajoutée
Germany	19%	7%	MwSt./USt.	Mehrwertsteuer/Umsatzsteuer
Greece	19%	9% or 4.5% (reduced by 30% to 13%, 6% and 3% on islands)		
Hungary	20%	5%	ÁFA	általános forgalmi adó
Ireland	21.5% (as of December 1 2008)	13.5%, 4.8% or 0%	CBL	Cáin Bhreisluacha (Irish)
			VAT	Value Added Tax (English)
Italy	20%	10%, 6%, or 4%	IVA	Imposta sul Valore Aggiunto
Latvia	18%	5%	PVN	Pievienotās vērtības nodoklis
Lithuania	18%	9% or 5%	PVM	Pridėtinės vertės mokestis
Luxembourg	15%	12%, 9%, 6%, or 3%	TVA	Taxe sur la Valeur Ajoutée
Malta	18%	5%	VAT	Taxxa tal-Valur Miżjud
Netherlands	19%	6% or 0%	BTW	Belasting toegevoegde waarde
Poland	22%	7%, 3% or 0%	PTU/VAT	Podatek od towarów i usług
Portugal	20% (as of July 1, 2008)	12% or 5%	IVA	Imposto sobre o Valor Acrescentado
Madeira and Azores	15%	8% or 4%	IVA	Imposto sobre o Valor Acrescentado
Romania	19%	9%	TVA	Taxa pe valoarea adăugată
Slovakia	19%	10%	DPH	Daň z pridanej hodnoty
Slovenia	20%	8.50%	DDV	Davek na dodano vrednost
Spain	16%	7% or 4%	IVA	Impuesto sobre el valor añadido
Canary Islands	5%	0% or 2%	IGIC	Impuesto General Indirecto Canario
Sweden	25%	12% or 6%	Moms	Mervärdesskatt
United Kingdom	17.50%	5% or 0%	VAT	Value Added Tax

Source:http://ec.europa.eu/taxation_customs/taxation/vat/how_vat_works/rates/index_en.htm

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