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Decades of Indirect Tax Reforms in India

A Journey towards Goods and Services Tax (GST)

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Introduction

The quest for a suitable indirect tax framework in India encompassing goods as well as services started a long time back. The constitutional assignment of powers for taxation in India included a number of stand-alone taxes on goods and services in addition to a few relatively more broad-based taxes, none of which were comprehensive in covering both goods and services. Further, this assignment divided the powers between the union and the state governments, thereby requiring a considerable degree of cooperation and coordination between the union and the state governments in order to initiate and establish a new indirect tax regime which addressed some of the concerns emanating from the old regime. Given the constitutional assignment of taxation power to different governments, fiscal autonomy enjoyed by the subnational governments, and complexities involved in bringing consensus among the subnational governments, the evolution of the Indian goods and services tax (GST) provides an interesting example of reforms in indirect taxes for scholars interested in public finance, especially in the case of federal countries.

Reforms in indirect taxes initiated since 1986–87 helped in sequencing big tax reform such as GST in India. It helped to accommodate the political-economy dimensions as well as the acceptability aspects of the tax reform. What is significant about the Indian GST is that each and every aspect of design, structure and administration of the GST has evolved on the basis of political consensus between the union and provincial governments. For a federal country like India where

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subnational governments enjoy more or less a power structure similar to that of the union government and where there is considerable diversity among provincial (subnational) governments, building consensus for a destination-based dual GST system is a great achievement in the history of fiscal federalism. The role played by different institutions/committees in achieving the Indian GST requires special mention here. The present chapter is an attempt to provide readers an overview into the evolution of the concept of GST in India.

India introduced GST from 1 July 2017. It is a comprehensive multistage value-added tax (VAT) on goods as well as services and it provides concurrent taxation powers to the centre (federal) and state (provincial) governments to collect tax on every stage of value addition.

The objective of this chapter is to study the evolution of the concept of GST in India by reviewing reports of successive tax reforms committees. Removal of cascading of taxes and designing destination-based VAT system are the major criteria adopted in this chapter to evaluate the recommendations of the tax reform committees. Following the recommendations of various tax reforms committees, introduction of reforms at different points in time helped in sequencing tax reforms and also paved the way for a 'big bang' tax reform such as the GST in India. For a federal country like India, having a fairly decentralised system of fiscal arrangement, sequencing of tax reforms plays an important role in minimising the disruption from major tax reforms like the GST.

In the next section, titled 'Indirect Tax Reforms in Central Taxes', we provide a comprehensive overview of reforms carried out in indirect taxes for the central government since Independence. In the following section ('State Taxes'), we evaluate state VAT system (mostly introduced in April 2005 by states) and drivers for GST. Removing central sales tax (CST) was the major challenge to enshrine destination principle in GST design. In a subsection of the section, we provide discussion on challenges associated with cutting CST rate and eliminating CST. In the last section ('Casting of the Structure of GST'), we discuss the evolution of the design and structural aspects of the Indian GST. The challenges related to revenue neutrality and administration of GST are also discussed in the last section.

Indirect Tax Reforms in Central Taxes

The central excise duty, customs duty and service tax were the major indirect taxes of the central government. Central excise duty (along with additional excise duties, special additional excise duty (AED), cesses and surcharges) is a tax on the manufacturing of goods and the Indian Constitution assigns power to tax manufacturing (except alcoholic beverages for human consumption and opium, Indian hemp and other narcotic drugs and narcotics) to the central government. Following recommendation of the Indirect Taxation Enquiry Committee (1977–78) (also known as the L. K. Jha Committee), the central excise duty was converted to a manufacturing stage

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VAT for a limited number of goods in 1986–87 and renamed Modified VAT or MODVAT. Over the years more goods are brought under the MODVAT system to achieve comprehensive coverage of the manufacturing sector. This was followed by a phase of rationalisation of the rates of the tax which culminated in the introduction of a single-standard rate and a few special rates. This regime was referred to as the Central VAT (CENVAT) system. Even with all this rationalisation, however, some commodities remained outside coverage, for example, some petroleum products (gasoline, diesel and aviation turbine fuel [ATF]) and tobacco and tobacco products.

Service tax was the second important source of indirect tax revenue of the central government. The union government invoked residual power of taxation, as bestowed under article 97 in the union list (Rao 2004) and introduced a tax on the value of services supplied. In 1994–95, service tax was introduced selectively for three services – tax on telephone billing, tax on general insurance premium and tax on stock brokerage commission. Over the years, the domain of the service tax expanded by including more services under the service tax net. In 2012, the base for taxation of services was changed from a well-defined and identified set of services to one demarcated through a list of exclusions. In other words, from 2012, there was a list of services which were not subject to tax, while all other services were to be taxed. Following the recommendation of the Expert Group on Taxation of Services (2001) (chaired by M. Govinda Rao) backed by the Kelkar Task Force (KTF) Report on Indirect Taxation, input tax credit (ITC) against service tax liability was introduced for a limited number of services in 2002–03. The scheme was extended further in 2003–04 by covering all services. Cross-utilisation of credit between CENVAT and service tax was introduced in 2004–05. With this step, while the base for taxation under central tax remained patchy – though manufacturing and supply of services were taxable, sale of goods was not taxable under this regime – the ITC mechanism was reasonably comprehensive. The introduction of ITC adjustment system between CENVAT and service tax helped in reducing the cascading of taxes and paved the way for the introduction of GST in India.

Customs duty (including additional duty of customs and special countervailing duty [CVD]) is a tax on import of commodities. In addition to basic customs duty (also known as Customs or trade tariff), imports also used to attract an additional duty of customs (also known as CVD) in lieu of CENVAT and Special CVD or (special additional duty or SAD) in lieu of state taxes.[1] Customs duty was the third-largest source of indirect taxes for the central government. In 2004–05, harmonisation in CVD rates at the level equivalent to excise duty was achieved. Further, importers were allowed to claim ITC of CVD against subsequent central taxes payable. However, given that central taxes did not extend to sale of goods, at least a part of

[1] In 2005–06, CVD was introduced at the rate of 4 per cent to compensate state-level taxes on Information Technology Agreement (ITA)-bound (except IT software) items and their imports. Full credit of this duty is allowed to manufacturers of excisable goods.

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the ITC might not have been claimed. The tax rate of SAD was 4 per cent whereas standard state sales tax rate was higher at 12.5 per cent since the introduction of state VAT. The changes in customs duty were once again a change in the direction of rationalisation of the indirect tax regime towards a level playing field.

In the following discussion, we will study the recommendations of various tax reforms committees in removing cascading of taxes and achieving destination-based VAT system in India. Indian indirect tax environment has gone through major reforms and these reforms helped in achieving comprehensive GST.

Taxation Enquiry Commission (1953–54)

The indirect tax regime at the time of adoption of the Constitution of India was a destination-based regime. However, the regime lacked the necessary structure to appropriately deal with interstate transactions while at the same time maintaining the destination principle. This caused some problems of compliance for the sellers and problems of administering the tax for the tax departments. In light of this and other issues that arose from the Constitutional assignment of tax powers, the Taxation Enquiry Commission (1953–54) was set up, headed by John Matthai (Government of India 1955). Two major recommendations of the commission were implemented and had considerable implications for the indirect tax regime in India.

First, on the recommendation of the commission, CST was introduced on interstate sales of goods in 1957 (under the Central Sales Tax Act, 1956). Though the CST Act is a central legislation, the power to collect and retain the taxes on interstate trade was vested in the states. The tax was applicable only on sales but not on consignment transfers or branch transfers across state borders.

The main objective behind the introduction of CST was to reduce compliance burden of taxpayers dealing in interstate trade. The obligation to file returns in both origin and destination states resulted in considerable compliance burden for dealers dealing in interstate trade.

The commission recommended:

> *Considerations of future policy regarding sales tax.* – In essence, the sales tax must continue to be a state tax. However, power and responsibility of the State must end and that of the Union begin when the sales tax of one State impinges administratively on the dealers and fiscally on the consumers of another State. Inter-State sales should be the concern of the Union. The Union should also have power to control the taxation of sales of raw materials which figure significantly in inter-state commerce. Except in these cases, Parliament should not exercise current power in regard to the levy of sales tax. (Government of India 1955, vol. III, ch. 4, para 14)
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> *Main features of Central legislation* – Parliamentary legislation will provide for the level of sales tax on inter-State transactions. It will provide for delegating

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> to the States the powers of the Central Government in respect of assessment, collection, etc. It will also provide that receives will be distributed to the States on the basis of collection. (Ibid., para 16)

Initially, CST was introduced with a tax rate of 1 per cent on interstate sales of goods between registered dealers. The suggested CST rate for transactions between registered dealers in origin state and unregistered dealers or consumers in destination state was the prevailing tax rate in the origin state. The commission also recommended the transfer of tax proceeds to the destination state for any tax collection 'in excess of the receipts from the rate normally leviable on inter-State trade between registered dealers'. Though in principle the recommendation supports the destination principle of the VAT system, in practice states retained the entire CST proceeds.

> Rate of tax on interstate transaction (other than those relating to 'goods of special importance in the inter-State trade'). The rate of the Central tax should be low. It may be one per cent when the inter-State transaction takes place between a registered dealer in one state and a registered dealer in another. As for transactions between registered dealers in one state and unregistered dealers or consumers in another the rate of tax should be the same as the exporting state imposes on similar transaction in its own territory. The proceeds in excess of the receipts from the rate normally leviable on inter-State trade between registered dealers should be made available to the state where goods are delivered. The Central legislation should make no distinction between ordinary goods and luxury goods for the purposes of the rate of tax on inter-State transactions. (Ibid., paras 17–19)

At the time of introduction of CST, the rate was 1 per cent, which was increased first to 2 per cent, then to 3 per cent and effective from 1 July 1975 it was 4 per cent. Though ITC against CST sales was allowed, withholding of ITC for various reasons was common in many states (for example, in case of consignment/branch transfers). The introduction of CST increased the cost of doing business for manufacturers who were sourcing their inputs from multiple states and/or selling their outputs to other states. The system provided incentive to manufacturers to either locate their branch offices and/or set up their own distribution networks across all the states they operated in so that they could send the goods as branch/consignment transfers and avoid paying CST. Transaction costs associated with the setting up of branch offices or own distribution networks and compliance costs of dealing with multiple tax jurisdictions (with varying rules and regulations) were important factors determining expansion plans of businesses. The introduction of CST resulted in division of the single Indian market into several state markets. The system was not conducive for encouraging market efficiency, which in turn constrained the ability to improve efficiency and productivity of Indian business.

After the introduction of VAT, the CST rate was reduced from 4 per cent to 3 per cent with effect from 1 April 2007 and it was reduced further to 2 per cent with

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effect from 1 June 2008. Gradual reduction of the CST rate paved the way for the introduction of a destination-based VAT system in India.

Second, the commission suggested special tax treatment of certain 'goods of special importance in inter-State trade'. The recommendation is as follows:

> Central regulation of the states' sales taxes on goods of special importance in inter-State trade. The main condition will be that no state shall have a system of levy other than a single point tax on such goods. The tax maybe either on sales or purchases but will be recoverable only at the last stage of sale or purchase. We recommend that the rate of such tax should be three pies per rupee. No purchase tax will be levied by a state on these goods if a Central tax on inter-State trade has already been levied at the rate three pies in the rupee. The goods to be specified as goods of special importance in inter-State trade are coal, iron and steel, cotton, hides and skins, oilseeds and jute. (Ibid., paras 21–22)

Following the recommendation of the commission, the central government backed by Article 286(3)(a) of the Constitution of India – which authorises Parliament to declare some goods to be of 'special importance' and to impose restrictions and conditions in regard to the power of the states to levy, decide rates and other incidence of tax on such goods – declared some goods to be of special importance under under section 14 of the CST Act 1956 and placed restrictions under section 15 of the CST Act. The list of declared goods was not restricted to only those goods suggested by the commission but rather included a large number of goods (listed under section 14 of the CST Act 1956).[2]

Under section 15 of the CST Act, the centre placed the following restrictions and conditions on the powers of state governments to tax declared goods inside the state.[3]

1. Tax on declared goods not to exceed 4 per cent.
2. Reimbursement of local tax if declared goods sold interstate.
3. Goods must be sold in same form to obtain reimbursement – declared goods purchased must be sold in same form, that is, identical goods must be sold. Thus, if goods sold after processing are a different commodity, reimbursement of local sales tax is not available.
4. Special provisions about paddy and pulses
   i. If paddy is taxed within state and rice (which is produced from paddy) is also taxed, tax paid on paddy should be given setoff while levying tax on rice.
   ii. Each of the pulses, whether whole or separated and whether with or without husk, shall be treated as a single commodity for the purpose of levying tax

[2] See http://www.charteredonline.in/2012/01/declared-goods-under-cst-act-writeup.html (last accessed on 17 June 2018).

[3] Read more at https://www.caclubindia.com/articles/declared-goods-as-per-cst-act-279.asp (last accessed on 17 June 2018).

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under state tax law, that is, if tax is paid on raw pulses, no further tax is payable after it is processed.

iii. If paddy is purchased on payment of sales tax and rice procured out of such paddy is exported, the paddy and rice will be treated as 'same goods' for the purpose of section 5(3) of the CST Act.

5. Sales tax rates applicable for sale of declared goods – state governments cannot charge sales tax for sale within the state at a rate that is more than 4 per cent.

The commission did not accept the view of levying AED in lieu of sales tax. However, this question was again examined by the National Development Council (NDC) in January 1956. The proposal to levy AED in lieu of sales tax on sugar, tobacco and textiles came into force after a decision was taken by the NDC. It was decided that the net proceeds of AED would be distributed among the states in accordance with the principles laid down by successive Finance Commissions. Through the Additional Duties of Excise (Goods of Special Importance) Act, 1957, the centre started collection of AED on these three items. The objective behind the AED was to 'achieve uniformity in the sales tax systems of the different States and sought to reduce collection costs, tax-evasion and hardship to the business community which was obliged to maintain elaborate accounts for sales tax purposes' (Singh 1964). However, the system resulted in revenue loss to states (Rao 2003; Singh 1964). The KTF report on indirect taxation recommended dispensing with the AED on sugar, textiles and tobacco imposed in lieu of sales tax. As part of the centre's compensation package to states for revenue loss on account of reduction of the CST rate to 2 per cent and implementation of state VAT, the power to levy tax on tobacco, textiles and sugar was transferred to the states from 1 April 2003. The abolition of AED on these three items happened subsequently.

The commission also recommended setting up an Inter-State Taxation Council to harmonise the sales tax system across states. The Empowered Committee of State Finance Ministers, which played an important role in rolling out VAT and GST, could be seen as an institution that performed this function though it came into existence much later in time.

Indirect Taxation Enquiry Committee (1977–78)

The report of the Indirect Taxation Enquiry Committee (1977–78), chaired by L. K. Jha, is the first report that articulated the need for a comprehensive VAT system for every stage of value addition – 'from the stage of production to the retail stage'.

> Essentially, VAT in its comprehensive form is a tax on all goods and services (except exports and Government services), its special characteristics being that it falls on the value added at each stage – from the stage of production to the retail stage …. producers are in effect freed from the taxation of inputs at every stage. Thus, a distinctive merit of the VAT is that it enables a country to have an

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> extended system of commodity taxation and yet avoid the problems of cascading and escalation of costs that are concomitants of general sales and excise taxes. It is relatively easy under the VAT system to completely free exports of internal commodity taxation. (Government of India 1977, para 104)

To reduce the cascading of taxes, the committee recommended a manufacturing-level VAT (named MANVAT):

> We consider that it would be premature now to think in terms of comprehensive system of VAT extending down to the retail level. But in order to put Central taxation on a rational basis we would urge that serious consideration be given for moving over to a VAT system at the manufacturing level – the so-called MANVAT. It is our view that in the ultimate analysis a satisfactory solution to the various distortions and problems that arise from an extended system of excise taxation lies in the adoption of MANVAT. The main advantage of MANVAT would be that it would altogether eliminate cascading on account of taxation of raw materials and other inputs. The tax levied on a final product would be the total tax on it and tax on inputs at earliest stages will not affect its cost or price…. MANVAT may also minimize the requirement of physical checks to ensure that there is not much evasion. Besides, the competitiveness of our products in the export markets will get a major thrust. (Ibid., para 10.9)

However, the committee was well aware of the political and administrative constraints to the introduction of a comprehensive VAT in India and they stated that

> [t]here could be two major arguments against the introduction of comprehensive VAT in India – one is political and the other is administrative. The political argument is the obvious one that the loss of power to levy sales taxes would seriously erode the fiscal autonomy of the State Governments and weaken the federal principle that each subordinate level of Government should have the discretion to raise more or less revenue as the people of the State concerned desire. The administrative argument is that the enforcement of VAT in relation to wholesalers and retailers is likely to create serious problems due to the need for dealing with a larger number of tax-payers and the difficulties likely to be faced by a majority of the traders to cope up with the accounting requirements. (Ibid., para 18.11)
>
> Given our federal system and the administrative problems of enforcing VAT at the post-manufacturing stages, the right course of action is not to pursue the theoretical best solution, namely, one integrated system based on the VAT principle but to adopt the second best solution of VAT applied to the manufacturing stage (to begin with) combined with a reformed system of sales taxation. (Ibid., para 18.13)

At the same time, the committee was also quite aware of the challenges associated with tax administration and the interjurisdictional nature of taxes, and therefore

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perceived that extending the VAT system up to the retail stage might be difficult during that time. Therefore, as an interim measure, they suggested that

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However, it is to be noted that the suggested MANVAT system was not the first system to allow ITC in India. Prior to MODVAT, the then excise duty had provision under Rule 56-A (Proforma Credit) for setting off tax paid on inputs against the tax payable on the output. The system used to be based on physical verification instead of an invoice- or account-based method of tax credit. Moreover, the proforma credit scheme used to operate on a case-by-case basis where the decision on allowance of credit was subject to the satisfaction of the deciding authority. Possibilities of discretionary practices under the system cannot be ruled out. The MODVAT scheme was a rule-based system and the problem of classification disputes was expected to be minimum (Singh 1991). In the proforma credit system, availing credit was contingent upon the input and output of the manufacturer falling under the same or particular tariff items or sub-items. Under MODVAT, on the other hand, input fell only under tariff items or sub-items. Under the MODVAT system, the concept of input had a much wider connotation than under Rule 56-A. However, the regulations corresponding to the availing of benefits of Rule 56-A were cumbersome and Rule 56-A has been omitted since 20 May 1994.

The introduction of MODVAT in 1986–87 could be seen as the achievement of the committee. Though MODVAT was not free from shortcomings in structure, it could be seen as the first step towards the introduction of a modern VAT system in India which eventually helped to achieve GST.

The Tax Reforms Committee (1991–93) headed by Raja J. Chelliah provided a concise criticism of the MODVAT scheme:

> Under the Modvat scheme, as noted earlier, only taxes levied on inputs that go into production or get used up in the process are eligible for set-off. This means that excise taxes that fall on machinery, accessories, fittings, tools, office equipment and vehicles continue to cause cascading. There is no economic, technical or administrative justification for keeping these goods used in production out of the Modvat credit scheme except the argument that in a developing country, capital goods should be subject to tax in order to discourage the use of capital. On the other hand, in many countries, capital goods have been treated like other inputs precisely to concentrate the tax on consumption and to encourage saving. Also it is wrong to classify all non-incorporated 'inputs' along with machinery proper as capital goods. (Government of India 1991)

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It is worthwhile to present the view of the Indirect Taxation Enquiry Committee on taxation of services. This was the first structured articulation of a tax on services. The committee suggested that the central government levy and administer the service tax, and the reason for such recommendation was the interstate character of services. The committee suggested the exemption of input services from the service tax.

> In the absence of adequate data we are unable to make an estimate of potential revenue from a service tax. We suggest that if the Government consider it desirable to tax services, the revenue potential as well as practical problems of such taxation should be thoroughly examined. We are inclined to the view that if such a tax were to be introduced it should be under Central legislation and administration, even if the proceeds from the tax go to States. One reason for this is that the sales of services often have an inter-state character. Further any such taxation will have to take into account its effect on the national economy as a whole. In particular, it should be important to ensure that services sold to producers are not made subject to taxation because they are in the nature of inputs otherwise the same problem of cascading and distortions that have arisen now in respect of taxation of sales of goods will arise in respect of taxation of services. (Government of India 1978, para 14.41, p. 246)

Tax Reform Committee (1991–93)

The Tax Reforms Committee (1991–93), headed by Raja J. Chelliah (Government of India 1991, 1992, 1993), was constituted in the context of the crisis faced by the Indian economy in 1991. The committee recommended major changes in the regimes of direct and indirect taxes. Within indirect taxes, the recommendations included rationalisation of the tax rate structure, minimisation of tax exemptions and simplification of procedures of the central indirect tax system.

The specific recommendations of the committee are summarised as follows:

- The indirect tax at the central level should be broadly neutral in relation to production and consumption and should, in course of time, cover commodities and services. This means that we should move towards VAT covering services and commodities. To make the VAT scheme simple and easily administrable, it should be levied at two or three rates, say, at 10 per cent, 15 per cent or 20 per cent. The selected excise duty on non-essential consumption could be levied at 30 per cent, 40 per cent or 50 per cent (this means that the maximum rate on a commodity will not exceed 50 per cent with a few exceptions like cigarettes) (Government of India, para 9.2).
- There is a need to widen the tax base and extend the coverage of excise duties (ibid., paras 9.6 and 9.29).
- All end-used-based exemptions for inputs should be withdrawn and the minimum duty rate of 10 per cent ad valorem should be levied on such inputs. If it is not possible to withdraw all such exemptions immediately, this should be done gradually over a period of time when inputs and finished products will bear duty with the benefit of MODVAT credit for inputs (ibid., para 9.7).

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- The subsidy in the form of notional higher credit available to industries using inputs covered under the general scheme should be withdrawn (ibid., para 9.19).
- All exemption notifications should be subjected to a close scrutiny with a view to ascertaining whether these can be withdrawn (ibid., para 9.21).
- The power of granting exemptions from excise duty should be withdrawn. However, government may retain the power of adjusting rates of duty under very exceptional circumstances (ibid., para 9.22).
- In a system of commodity taxation, ad valorem duties are preferable to specific duties, particularly under the MODVAT regime. Switching over to ad valorem rates in respect of a number of commodities is, therefore, recommended. Simultaneously, rationalisation of the existing rates has also been suggested with a view to reducing multiplicity of rates. The ad valorem rates suggested for various items broadly conform to the duty slots in which the tariff is required to be structured in the long run. For administrative considerations, however, some commodities like petroleum products, tobacco products and textiles, coffee, tea, marble, and so on, may continue to have specific rates (ibid., para 9.29).
- Where specific rates are retained, there should be a system of revising the rates every year to take into account price increases as represented by the relevant sectoral wholesale price index. While fixing ad valorem rates, goods falling within the same class should as far as possible be made to be at the same rate (ibid., para 9.31).
- As the MODVAT or the VAT system gets extended and becomes the main plank for raising revenue from domestically produced goods and services, it would be necessary to move over to a system of assessment on the basis of invoice value. However, for this to be possible and easily administrable, it would be desirable to fulfil two conditions. First, there should be an extension of VAT from the manufacturing to the wholesale stage; this would considerably reduce attempts at undervaluation of products. Second, it would be necessary to give up the traditional method of administering excises on the basis of clearance of goods from the factory and move over to a system of assessment on the basis of periodic returns to be submitted by manufacturers. These are important changes and their feasibility would have to be studied in greater detail (ibid., para 9.40).
- The committee envisages that as the union exercise on commodities gets gradually transformed into a VAT at the manufacturing level, the services tax will get woven into the system and, therefore, tax could be levied also on services that enter into the productive processes (ibid., para 9.49).
- The harmful effects of the interstate sales tax-cum-consignment tax can be avoided or minimised in two different ways. The first and the more satisfactory arrangement would be as follows: (*a*) the interstate sales tax or CST or the consignment tax imposed by the exporting state will be given credit by the importing state against the sales tax payable to it by the 'importer', (*b*) the exporting state will credit the interstate sales tax and consignment tax collections to a central pool, (*c*) thus, all collections of these two taxes will be deposited in the central pool and will then be shared among the states on the basis of an agreed formula, and the formula should be so devised as to give even treatment to the producing and consuming

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states and (*d*) the rate of interstate sales and consignment taxes would be 2 per cent. The second-best arrangement could be that the consignment tax would be imposed at 1 per cent after the ceiling rate of the CST has been reduced to 1 per cent (ibid., paras 9.58 and 9.59).

Introduction of Service Tax

Although there is no explicit mention of services either in the central list or state list in the seventh schedule, entry 97 under the central list empowers the central government to levy taxes on all items not mentioned in either the central or the state list, and the central government has been levying taxes on services under this entry.

On 1 July 1994, service tax was introduced for three services and at a tax rate of 5 per cent. Over the years, more and more services were included under the service tax net. The total number of services reached 119 in 2012 and from 1 July 2012 negative-list-based taxation of services was introduced.[4] Following the recommendation of the Expert Group on Taxation of Services (2001) (Government of India 2001), ITC against service tax was introduced for select services in 2002–03 and the scheme was extended to cover all services from 2003–04. With the introduction of the ITC system, the service tax rate was increased from 5 per cent to 8 per cent from 14 May 2003 and the rate was further increased to 10.20 per cent from 10 September 2004. Backed by high economic growth, the tax rate on services was further increased to 12.24 per cent from 14 April 2006 and 12.36 per cent from 11 May 2007. However, in the face of global recession and to provide stimulus to the Indian economy, the service tax rate was reduced from 12.36 per cent to 10.30 per cent from 24 February 2009. With the recovery of the Indian economy from recession, the service tax rate was again reverted to 12.36 per cent from 1 April 2012 and it was further increased to 14 per cent from 1 June 2015. The basic rationale for increasing the tax rate on services was to harmonise the tax rate of services with the CENVAT rate. This was followed by a further increase of 0.50 per cent on account of the Swachh Bharat cess. From 1 June 2016 to 1 July 2017, the service tax rate was 15 per cent. Integration of ITC between service tax and CENVAT was introduced from 2004–05, which paved the way for the introduction of GST.

On 15 January 2004, the Constitution (Eighty-Eighth Amendment) Act, 2003, inserted a new article, 268A, after article 268 and amended the Seventh Schedule

[4] In June 2000, an Expert Group headed by Dr M. Govinda Rao observed that 'selective approach to taxation of services is undesirable for this violates neutrality in taxation, leads to inadequate coverage in addition to raising several avoidable procedural and legal complications'. The group recommended that the centre should move towards a 'general and comprehensive extension of the tax to cover all services with a small and clearly-defined exemption list'. The group identified six categories of services that may be put in the negative list, and that included all public services of governments, all public utility services of essential nature and all school education.

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to the Constitution by inserting an entry, '92C. Taxes on services', after the entry 92B of the List I – Union List.

> 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.

The amendment assigns the power to levy a service tax to the central government, with the proceeds being collected and appropriated by the central and state governments in accordance with principles formulated by the Parliament.

States also collect service tax on a few stand-alone services, for example, taxes on goods and passengers carried by road or on inland waterways (entry 56 of the state list) and taxes on luxuries, including taxes on entertainment, amusement, betting and gambling (entry 62).

KTF Report on Indirect Taxation (2002)

The Ministry of Finance and Company Affairs constituted a task force for indirect taxes, headed by Vijay L. Kelkar, with the objective to bring indirect tax systems and procedures at par with the best international practices, encourage compliance and ensure transparency in administration. The terms of reference of the task force was 'simplification of laws and procedures, reducing cost of compliance, facilitating voluntary compliance, increased use of automation for a user-friendly and transparent tax administration, review of the statutorily prescribed records and returns (including their periodicity) and suggestions on their utility and simplification, time-bound disposal of cases, etc.' (Godbole 2002).

'The Consultation Paper of Task Force' (popularly known as KTF) (Government of India 2002) recommended various measures to reform the indirect tax environment. Some of the recommendations of the task force are summarised in the following subsection.

Select Recommendations of the KTF on Service Tax (excerpted from the KTF Consultation Paper)

- To the extent possible, service tax should be levied in a comprehensive manner leaving out only a few services by including them in a negative list.

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- There should be complete integration of the CENVAT credit and service tax credit schemes with effect from 1 April 2003.
- Credit of central duties (on goods and services) should be utilised for payment of service tax collected and appropriated by the central government.
- Along with integration of the goods and services credit schemes from 1 April 2003, the rate of service tax should be suitably enhanced so as to achieve parity with the CENVAT rate by 2006–07. However, there should be two rates, one for service providers who avail credit and another, a lower rate, for those who do not.
- The service providers who provide services up to a value of INR 10 lakh (INR 1 million) in a financial year should be subjected to a total tax of 1 per cent on the value of the services annually on the basis of simple declaration. Such service providers would be exempt from the normal procedures of returns and documentation. This scheme does not envisage availing the credit of the duty paid on the input goods and services.
- There should be a separate legislation for levying service tax, which should eventually be integrated with the central excise law.
- The services should be classified on the basis of World Trade Organization (WTO) classification, which should be made a part of the service tax legislation.

The recommendations of the KTF played an important role to (*a*) shift taxation of services from selective-list-based to negative-list-based approach (implemented from 1 July 2012), (*b*) integrate CENVAT and service tax credits (2004–05), (*c*) reduce the difference between the service tax rate and CENVAT rate, (*d*) adopt the 88th amendment to the Constitution (see earlier) and (*e*) adopt a classification system for services (in 2003, section 65A was inserted in Chapter V of the Finance Act, 1994).

Select Recommendations of the KTF on Central Excise

- As a policy, we should review all levies and have only one levy, that is, the CENVAT. Some exceptions, however, have been suggested for the textile and petroleum sectors.
- Till such time as there are multiple levies, there should be a working schedule indicating the total tax payable on a particular product and the system should internally segregate the same into the respective levies.
- The following recommendations are made for the central excise duty structure:
    i. 0 per cent – for life-saving drugs and equipment, security items, food items, necessities and the like, and agricultural products.
    ii. 6 per cent – for processed food products and matches.
    iii. 14 per cent – standard rate for all items not mentioned against other rates.
    iv. 20 per cent – for motor vehicles, air conditioners and aerated water.
    v. Separate rates for tobacco products and their substitutes (like *pan masala*).

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vi. The specific rate of excise duty of INR 1 per kilogram on bulk tea today translates to about 1 per cent in ad valorem terms. Raising it to 6 per cent may not be desirable, more so when coffee is already exempt from excise duty. Thus, bulk tea may also be exempted from duty. This is anyway a plantation product.

vii. Specific duty on cement may continue as most of the clearances are to the depots where the prices vary from day to day and ad valorem levy would necessitate provisional assessments, and may result in uncertainty.

In 2000–01, MODVAT was renamed as CENVAT with a single CENVAT rate (standard rate) of 16 per cent. In addition, there was a non-rebatable special duty at the rates of 8 per cent, 16 per cent or 24 per cent. At the same time, MODVAT credit was extended to all inputs except high-speed diesel (HSD) oil and motor spirit (petrol). The extension of MODVAT credit to all finished goods (except matches) and all capital goods (subject to availing of capital goods credit being spread over two years) helped to clean up the central excise duty system in India.

The KTF recommended the restructuring of the central excise rates into three rates (6 per cent, 14 per cent and 20 per cent) (except for the zero rating of life-saving drugs and equipment, and so on). However, the government aimed to converge multiple rates into a single CENVAT rate of 16 per cent over successive union budgets since 2000–01.

Select Recommendations of the KTF on Customs Duty

- As a policy, the multiplicity of levies must be reduced. Accordingly, it is recommended that there should be only three types of duties, namely basic customs duty, additional duty of customs (or CVD) and antidumping/safeguard duties. All other duties should be removed. However, the removal of SAD should be linked to the implementation of state-level VAT, where SAD would get replaced by the state VAT to be levied on imports.

Select Recommendations of the KTF on State VAT

- Attempt should be made towards uniformity of all state legislations, procedures and documentation relating to VAT.
- Issue of compensation, if it arises, must be primarily tackled through a mutually acceptable mechanism of additional resource mobilisation through service tax and not through budgetary support.
- With the introduction of VAT, all other local taxes (for example, entry tax, luxury tax, *mandi* cess and octroi) be discontinued, and the same should be taken into account in determining the revenue neutral rate (RNR).
- Whereas AED may continue for textiles up to 2005, it may continue even thereafter for cigarettes, which should not be subjected to VAT.
- The VAT scheme should provide for grant of credit of duty by the importing state for the duty paid in the exporting state, in the course of interstate movement of goods.

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- For the stability and continuity of VAT, a VAT Council or a permanent suitable alternative vested with adequate powers to take steps against discriminatory taxes and practices and eliminate barriers to free flow of trade and commerce across the country should be explored.

State Taxes

Prior to the introduction of VAT at the state level, there was tax competition between states (Rao and Vaillancourt 1994) and disharmony in tax rates, number of tax schedules and exempted items, and so on. Table 1.1 provides a comprehensive overview of the sales tax system prevalent across states during 1989–90, much before the process of harmonisation was initiated. There was wide variation in the number of rate categories, with some states having 7 rate categories (Odisha and West Bengal) and others as high as 25 rate categories (for example, Gujarat). The general rate of sales tax varied from 4 per cent to 12 per cent. In addition, a wide variation in sales tax rate around the general rate was also reported across the states (Aggarwal 1995). Under the sales tax system, variations in the point of taxation (single point, double points and multiple points) across states resulted in major roadblocks for the introduction of state VAT. Inability to raise tax beyond first-point sales led states to impose additional levies such as turnover tax, additional sales tax, surcharges, and so on. This led to a non-transparent tax system and a high incidence of arbitrary and unpredictable taxes.

Following up on the *Chelliah Committee Report* in 1991–93, the *Reform of Domestic Trade Taxes in India*, authored by Bagchi et al. (1994), played an important role in reforming the state sales tax system to the state VAT. The main recommendations of the study are presented as follows:

1. Convert sales taxes into VAT by moving over to a multistage system of sales taxation with rebate for tax on all purchases with only minimal exceptions.
2. Extend the tax base to include all goods sold or leased with minimal exceptions. Eventually the states should be given the power to tax services in general. A beginning can be made by bringing under the state VATs services that are ancillary or incidental to the production or supply of goods and also those that form a significant part of final consumption such as photo processing. VAT on such items of consumption need not be rebatable. The Parliament can pass a legislation empowering the states to levy the tax on services so selected. Pending a general extension of the tax base to services, the taxes on entertainment, electricity duty and passengers and goods carried on road may continue to be levied by the states. In other words, since this was proposed as a replacement for the state VAT, it was not yet proposed as a comprehensive VAT covering all goods and all services.
3. Allow ITCs for all raw materials and parts, consumables, goods for resale, and production machinery and equipment. No rebate will be allowed in respect of overhead expenses such as repairs, office equipment, construction materials and

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Table 1.1 A Brief Description of the Rate Structure of Sales Tax: 1989–90

States	Mode of Levy	Treatment of Goods When Used as Raw Materials	Additional Tax	Tax Rates		
				No.	Range (%)	General Rate
Andhra Pradesh	SP	CR (≤4%)	TT, SC (10%)	8	1–25	6
Assam	SP	E (SED)	–	12	2–50	7
Bihar	SP	CR (≤3%)	TT, SC (10%)	17	2–25	8
Delhi	SP	E	–	9	1–12	7
Goa	SP	E (SRM)[1]	SC (10%)	10	1–15	7
Gujarat	SP, DP	SO (SRM)	TT, SC (20%)	25	0.5–54	4/8
Haryana	SP	SO	SC (10%)	10	0.5–20	10
Himachal Pradesh	SP	SO	SC (10%)	12	0.5–25	8
Karnataka	SP,DP,MP	CR (≤4%)	TT	14	1–150	7
Kerala	SP	CR (≤2%)[2]	TT, SC (25%)	16	2–75	5
Madhya Pradesh	SP	CR (≤4%)	–	18	0.5–50	8
Maharashtra	SP	SO (CR ≤4 OR 6%)[3]	TT, SC (12%)	12	1–50	–
Orissa	SP	CR (≤4%)	SC (10%)	7	2–16	12
Punjab	SP	E[4]	SC (10%)	12	1–12	7
Rajasthan	SP	CR (≤3%)	–	15	2–30	10
Tamil Nadu	SP,MP[5]	CR (≤3%)	TT, SC (15%)[6]	17	1–50	8
Uttar Pradesh	SP	E (SRM), CR (SRM)	SC (25%)	14	2–32.5	8
West Bengal	SP,MP	CR (≤2%)	TT, SC (15%)	7	1–20	8

Source: Aggarwal (1995: 17, Table 2.2).

Notes: SP: single point, DP: double points, MP: multi-points, TT: turnover tax, SC: surcharge, CR: concessional rate, E: exempt, SO: set off, SED: selected eligible dealers, SRM: selected raw materials.

[1]Raw materials and packing materials, that is, commodities subjected to last-point tax, to be used as inputs, can be purchased without payment of tax.

[2]The benefit of concessional rate is not available if the finished goods are exported or sent on consignment basis.

[3]6 per cent is applicable when the manufactured goods are sent on branch transfer outside Maharashtra. Set-off is given in respect of the rate, to the extent it exceeds the concessional rate.

[4]All transactions among the registered dealers are exempt.

[5]In Tamil Nadu, SP and MP up to 3 March 1990 and only SP with effect from 01 April 1990.

[6]An addition surcharge of 5 per cent is payable in the Madras area.

fixtures, and purchases in use for transportation and distribution of goods. Here, once again, there was a notion of direct relation to the taxable business being the basis of tax credit.

4. Replace the existing structure of tax rates with two or three rates within specified bands, applicable in all states and union territories. Once an agreement is reached on the rates and the bands, the taxation of textiles, tobacco and sugar

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should revert to the state governments within the state VAT regime. It was suggested that the notion of declared goods be retained to ensure that the states adhered to the harmonised rate structure.

a. The rate bands proposed are 4–5 per cent for essential goods and 12–14 per cent for all other goods. Basic, unprocessed food items may be exempted while tobacco, alcohol, petroleum, aviation fuel and narcotics may be subjected to a non-rebatable VAT at a floor rate of 20 per cent. The tax on the high-rated items will not be rebatable although the tax paid on their inputs will be credited against the VAT payable on them. Resellers would, however, be entitled to deduct the tax paid on their purchases from the VAT payable on their sales.

5. Remove the exemptions except for a basic threshold limit and items such as unprocessed food and also withdraw other concessions such as tax holiday, and so on.
6. Zero-rate exports out of the country and also interstate sales and consignment transfers to registered traders with suitable safeguards against misuse.
7. Tax interstate sales to non-registered persons as local sales. There is a fairly long discussion on the alternative models to deal with interstate transactions between two registered entities. In talking about an overhaul of the system of indirect taxes in India, the study provides a design of destination-based VAT system by suggesting a tax system for interstate trade where rebatable CENVAT would be the only tax on interstate sales and all taxes levied by the origin state will be zero-rated. The importing state will levy taxes on imports and importers will pay the taxes in destination state and get credit against CENVAT paid in origin state. A similar system was also proposed by the Indirect Taxation Enquiry Committee. The continuation of the ITC chain was the major challenge and such designs are useful to remove such challenges.
8. Modernise tax administration, computerise operations and the information system, and simplify forms and procedures.

The other recommendations of the study were as follows:

1. The most convenient method of operating a destination-based system of state VATs is to zero-rate interstate sales between registered dealers. As a safeguard against misuse, a system of advance payment of tax by the importing dealer can be devised. Under this system, interstate movement of goods through consignment transfers should be treated on the same footing as interstate sale between registered dealers. As an interim system, exporting states may levy a tax on interstate sales at a low rate for which importing states would grant rebate and the revenue will be shared through a pooling arrangement.

Under the initiative of the NDC, harmonisation in sales tax rate was achieved in January 2000 and the Empowered Committee of State Finance Ministers was formed to hammer out a consensus on the design of a VAT at the state level to replace

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the existing state sales taxes. Difficulties in arriving at decisions through consensus resulted in a considerable delay in introducing state VAT regimes. The introduction of this regime was not simultaneous in all the states – Haryana was the first state to introduce the tax in 2003. The rest of the states introduced the regime either in 2004 or 2005 (Nepram 2011).

To an extent, the introduction of the state VAT system resulted in a harmonisation of rules and regulations, number of tax schedules, tax rates and methods of tax administration. The variations in standard rates across states was limited to 3 per cent, and the number of tax schedules or rate categories too was limited and uniform across the country. However, this state VAT was not a destination-based consumption tax, especially with CST on interstate sales (Das-Gupta 2005).

State VAT was the first coordinated tax reform in India at the subnational (state) level. Introduction of the state VAT resulted in a harmonisation of the sales tax structure (VAT design), rules, regulations and processes (more or less). It also helped to achieve uniform floor rates for different categories of commodities. Deviation from the agreed VAT rates has been contained to less than 3 per cent in the standard rate. It resulted in a minimisation of the cascading effect (allowance of ITC against VAT purchases). The introduction of VAT resulted in differential revenue impact across states (Das-Gupta 2012). The gain from VAT was not uniform across states. In working towards the introduction of VAT, we also got an institution – the Empowered Committee of State Finance Ministers – which helped to build consensus among states to overcome challenges in the introduction of VAT.

However, VAT was not free from shortcomings. It was characterised by a narrow base, a plethora of exemptions, a multiple-rate structure (at least four), and a cascading effect on account of the breakdown of the ITC chain due to interstate sales. Non-inclusion of certain indirect taxes on goods (for example, petroleum products) and services (such as luxury tax and entertainment tax) under VAT meant that some cascading of taxes remained. Further, state VAT was applied on a base inclusive of CENVAT, implying an additional element of cascading. The system of CST and entry tax also resulted in cascading of taxes and divided the Indian market into several tax jurisdictions.

The discussion on state taxes will be incomplete without discussing entry tax. There are two forms of entry tax – (*a*) entry tax in lieu of octroi and (*b*) tax on entry of goods into the local area. The first type of entry tax was introduced after phasing out octroi. Octroi used to be a tax on entry of goods into the administrative jurisdiction of urban local bodies/municipalities and it used to be collected after valuation of goods based on physical verification at the entry points. Since revenue from octroi was dependent on physical verification and it required intensive monitoring of inflow of goods, possibilities of leakage of revenue could not be ruled out. In view of the revenue leakage and requirement of intensive monitoring,

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account-based 'entry tax' was introduced as a replacement for octroi.[5] The second type of entry tax was more or less an equalisation levy imposed on entry of goods by a state. The difference in the tax rate, where the tax rate in the destination state is lower than the origin state for a specific good, was the genesis for the imposition of entry tax. In some states, entry tax was commodity-specific whereas in some other states it was a broad-based levy for all interstate imports. Some states used to provide ITC against entry tax whereas in some other states there was no provision for ITC. Tax competition among states prior to the agreement on harmonisation of rates of tax across states created opportunities for trade diversion as a result of the difference in tax rates. The second type of entry tax was introduced to address this concern. The system of levying central sales tax along with entry tax divided the Indian market into several islands of tax jurisdictions. Manufacturers located in a state, irrespective of their productivity and efficiency, might enjoy absolute advantage over manufacturers located in other states. For a long time, there were a number of lawsuits before the Supreme Court of India challenging the legal validity of imposing entry tax by states. The Supreme Court upheld the constitutional validity of the entry tax imposed by states on goods coming in from other states on 11 November 2016.[6]

Casting of the Structure of GST

In the budget speech of the 2006–07 union budget, the then finance minister announced that a national-level GST would be introduced from 1 April 2010.[7]

> 155. It is my sense that there is a large consensus that the country should move towards a national level Goods and Services Tax (GST) that should be shared between the Centre and the States. I propose that we set April 1, 2010 as the date for introducing GST. World over, goods and services attract the same rate of tax. That is the foundation of a GST. People must get used to the idea of a GST. Hence, we must progressively converge the service tax rate and the CENVAT rate. I propose to take one step this year and increase the service tax rate from 10 per cent to 12 per cent. Let me hasten to add that since service tax paid can be credited against service tax payable or excise duty payable, the net impact will be very small. (Government of India 2006)

[5] 'Unlike Octroi, entry tax is not collected at the time of entry of a commodity into the state. It is an account-based levy assessed and collected on the pattern of sales tax, generally from the same set of registered dealers. It is collected along with the sales tax liability of the dealers' (Purohit 2015).

[6] In the Supreme Court of India, Civil Appellate Jurisdiction, Civil Appeal No. 3453/2002 dated 11 November 2016.

[7] At that time, it was not what the finance minister actually meant by 'national level' GST (Bagchi et al. 2006).

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On the request of the finance minister, the Empowered Committee of State Finance Ministers prepared a road map for the introduction of GST in India.[8] The committee came out with the 'First Discussion Paper on Goods and Services Tax in India' on 10 November 2009 (The Empowered Committee of State Finance Ministers 2009). The discussion paper provided a broad contour of the expected design of the GST and played an important role in initiating debates and discussion among stakeholders on the expected benefits and costs of moving towards a GST regime.

The proposals of the discussion paper were as follows:

1. Constitutional amendment for concurrent taxation power to the centre and the states for all goods and services and for all stages of value addition.
2. Phasing out of CST from the date of introduction of GST.
3. Compensation of losses to the states for permanent phasing out of CST.
4. A dual GST structure with defined functions and responsibilities of the centre and the states: central GST (CGST) and state GST (SGST). The former was to be the responsibility of the union government and the latter of the states, both in forming the laws and rules and administering the acts.
5. A harmonised rate structure of GST.
6. Harmonisation of basic features of law such as chargeability, definition of taxable event and taxable person, measure of levy including valuation provisions, basis of classification, tax credit rules, and so on, across these statutes as far as practicable between union and state taxes as well as across states. However, since the two levies would be two separate levies, cross-adjustment/utilisation of ITC between CGST and SGST was not proposed, except for interstate transactions that will attract integrated GST (IGST).
7. Interstate transactions (including branch/consignment transfers) will attract IGST. The interstate seller will pay IGST on value addition after adjusting available credit of IGST, CGST and SGST on his purchases. The exporting state will transfer to the centre the credit of SGST used in payment of IGST. The importing dealer will claim credit of IGST while discharging his output tax liability in his own state. The centre will transfer to the importing state the credit of IGST used in the payment of SGST.
8. In case of exports, refund of input taxes proposed. It also recognised that there could be instances of refunds in case of an inverted duty structure.
9. A uniform SGST exemption threshold across states was proposed as being desirable – it was proposed at INR 10 lakh both for goods and services for

[8] First, before the introduction of state-level VAT, the unhealthy sales tax 'rate war' among the states would have to end, and sales tax rates would need to be harmonised by implementing uniform floor rates of sales tax for different categories of commodities with effect from 1 January 2000. Second, on the basis of achievement of the first objective, steps would be taken by the states for the introduction of state-level VAT after adequate preparation. For implementing these decisions, a Standing Committee of State Finance Ministers was formed which was then made an Empowered Committee of State Finance Ministers.

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all the states and union territories. For CGST, however, it was proposed that the threshold be kept higher following from the existing regime where the CENVAT threshold was INR 1.5 crore (INR 15 million). It was proposed that for states which might be left with a higher exemption threshold than they had prior to the introduction of GST, adequate compensation should be provided.

10. Composition/compounding scheme for the purpose of GST should have an upper ceiling on gross annual turnover (of INR 50 lakh) and a floor tax rate (of 0.5 per cent) with respect to gross annual turnover.
11. Submission of periodic returns, in common format as far as possible, to both the central GST authority and the concerned state GST authorities.
12. PAN-linked taxpayer identification number (or GST registration number) with a total of 13/15 digits.
13. Functions such as assessment, enforcement, scrutiny and audit would be undertaken by the authority that is collecting the tax, with information sharing between the centre and the states.
14. Two-rate structure – a lower rate for necessary items and goods of basic importance and a standard rate for goods in general. There will also be a special rate for precious metals and a list of exempted items. For taxation of services, there may be a single rate for both CGST and SGST.
15. After the introduction of GST, the tax exemptions, remissions, and so on, related to industrial incentives should be converted, if at all needed, into cash refund schemes after the collection of tax, so that the GST scheme on the basis of a continuous chain of set-offs is not disturbed.
16. Need for compensation during the implementation of GST.
17. Specific provisions would also be made to the issues of dispute resolution and advance ruling.
18. Tobacco products would be brought under GST with provision for ITC. The centre may consider levying excise duty on tobacco products over and above GST without ITC.
19. A basket of petroleum products, that is, crude, motor spirit (including ATF) and HSD would be kept outside GST.
20. Alcoholic beverages would be kept out of the purview of GST.
21. In case purchase tax has to be subsumed under GST, then adequate and continuing compensation has to be provided to the states where the tax is prevalent.
22. Under the GST system, CGST will subsume central excise duty, AED, the excise duty levied under the Medicinal and Toiletries Preparation Act, service tax, additional customs duty, commonly known as CVD, SAD of customs (4 per cent), surcharges and cesses.
23. SGST will subsume VAT/sales tax, entertainment tax (unless it is levied by the local bodies), luxury tax, taxes on lottery, betting and gambling, state cesses and surcharges insofar as they relate to the supply of goods and services, and entry tax not in lieu of octroi.

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The terms of reference of the Thirteenth Finance Commission (TFC) also demanded an assessment of 'the impact of the proposed implementation of Goods and Services Tax with effect from 1st April, 2010, including its impact on the country's foreign trade'. With this objective, the TFC constituted a task force to examine (*a*) the GST model best suited for the country, (*b*) the modalities of the implementation of GST including threshold limits, composition limits, treatment of interstate transactions and place of supply rules, (*c*) the potential tax base of the GST as exhaustively as possible and determine an appropriate RNR for the centre and the states, (*d*) suggest ways to incentivise states to adopt a model GST and (*e*) recommend a framework for administering the GST, including payment of compensation, monitoring of compliance and the institutional mechanism for making any change in the initial design of the GST.

The task force submitted the report (*Report of the Task Force on Goods & Services Tax*) on 15 December 2009 (Thirteenth Finance Commission 2009a) and, based on the recommendations, the TFC provided recommendations on GST in Chapter 5 of the commission's report. Among the recommendations, the most contentious was the compensation mechanism and the conditionalities in the disbursement of GST compensation (for losses on account of rolling out of GST), which was subject to fulfilling the conditions listed under 'Grand Bargain'.

Rao (2010) carried out an in-depth assessment of the recommendations of the TFC on GST (Thirteenth Finance Commission 2009b, Chapter 5: 'Goods and Service Tax'). Because of space constraints, we are avoiding a discussion on the TFC recommendations here. However, it is to be mentioned that the TFC recommendation on the 'Grand Bargain' and the conditionalities for transferring GST compensation to states made the states reluctant, which undermined the trust required to push through a major reform such as GST (Rao 2011). For a federal country such as India, introduction of GST required understanding between the centre and the states, as mutual fiscal autonomy would be put at stake in the GST regime. The recommendations were against the grain of cooperative federalism and detrimental for taking further the discussion on GST.

Rao (2011) observed:

> Not surprisingly, the entire reform process that was progressing so well got stalled. The recommendation that the states should not be compensated for loss of revenue if they did not implement the 'model GST' did not go down well and the very low estimate of the revenue-neutral rates led the states into increasing the VAT rate from 12.5% to 13.5% to ensure adequate compensation in case of a shortfall.

The Department of Revenue (DoR) under the Ministry of Finance, Government of India, gave detailed 'Comments of the Department of Revenue (DoR) on the

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First Discussion Paper on GST' (2010).[9] The DoR suggested a uniform threshold of INR 10 lakh for goods and services and for both CGST and SGST. It also recommended single registration by a single agency for both SGST and CGST, no physical verification of premises and no pre-deposit of security, a simplified return format, longer frequency for return filing, electronic return filing through certified service centres, chartered accountants (CAs), and so on, audit in 1–2 per cent cases based on risk parameters, and lenient penal provisions. The DoR also suggested a composition scheme for businesses that had a turnover of up to INR 50 lakh and a floor rate of 0.5 per cent for the composition scheme. It further suggested leaving the administration of the composition scheme to the state tax administration for both CGST and SGST.

The Constitution (One Hundred and Twenty-Second Amendment) Bill, 2014, was introduced in the Lok Sabha on 19 December 2014, and passed by the House on 6 May 2015. In the Rajya Sabha, the bill was referred to a Select Committee on 14 May 2015. The Select Committee of the Rajya Sabha submitted its report on the bill on 22 July 2015. The committee accepted the majority of the provisions of the bill and recommended a few changes (Government of India 2015). Certain official amendments were circulated to the 2014 bill on 1 August 2016.[10] The bill was passed by the Rajya Sabha on 3 August 2016, and the amended bill was passed by the Lok Sabha on 8 August 2016. The bill, after ratification by the states, received assent from the President on 8 September 2016, and was notified in the *Gazette of India* on the same date.

In the 2014 bill, there was a provision for an additional tax of up to 1 per cent on the supply of goods in the course of interstate trade or commerce. The tax was to be levied by the centre and directly assigned to the states from where the supply originated. This would be for two years or more, as recommended by the GST Council. On the recommendation of the Select Committee, the provision was deleted in the revised 2016 bill. The Select Committee also recommended that GST compensation should be provided for a period of five years. This recommendation was not addressed by the 2016 amendments. However, in the Constitution (One Hundred and First Amendment) Act, 2016 (8 September 2016), the recommendation was accepted.

In the 2014 bill, it was mentioned that '[t]he GST Council may decide upon the modalities to resolve disputes arising out of its recommendations'. The 2016 amended bill made it explicit and mentioned that '[t]he GST Council shall establish a mechanism to adjudicate any dispute arising out of its recommendations. Disputes

[9] Available at http://www.gstcouncil.gov.in/sites/default/files/Comments-DoR-1st-discn-paper-01012010.pdf (last accessed on 25 June 2018).

[10] Notice of Amendments, Rajya Sabha, The Constitution (122nd Amendment) Bill, 2014, 1 August 2016, http://www.prsindia.org/uploads/media/Constitution%20122nd/GST%20amendments-%201%20aug%202016.pdf (last accessed on 30 January 2019).

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can be between: (a) the centre vs. one or more states; (b) the centre and states vs. one or more states; (c) state vs. state. This implies there will be a standing mechanism to resolve disputes'. In the final Act, it is mentioned that

> '[t]he Goods and Services Tax Council shall establish a mechanism to adjudicate any dispute – (a) between the Government of India and one or more States; or (b) between the Government of India and any State or States on one side and one or more other States on the other side; or (c) between two or more States, arising out of the recommendations of the Council or implementation thereof. (Government of India 2016)

Under the 2014 bill, the GST Council would make recommendations on the apportionment of the IGST. However, the term 'IGST' was not defined. The 2016 amendments replaced this term with 'goods and services tax levied on supplies in the course of inter-state trade or commerce'. This was a technical change in relation to the apportionment of the IGST. It clarified that the states' share of the IGST should not form a part of the consolidated fund of India.

In the 2014 bill it was mentioned that the GST collected and levied by the centre, other than the states' share of IGST, would also be distributed between the centre and states. In the 2016 amendments, it was stated that the CGST and the centre's share of IGST would be distributed between the centre and the states. This was just a restatement of the provisions in the 2014 bill in clearer terms.

On the inclusion of petroleum products under GST, the earlier draft bill kept these products out of the ambit of the Constitution amendment. The revised bill included these products but the decision on inclusion under GST was left to the GST Council. In the final Act, it is mentioned that '[t]he Goods and Services Tax Council shall recommend the date on which the goods and services tax be levied on petroleum crude, high speed diesel, motor spirit (commonly known as petrol), natural gas and aviation turbine fuel'.

The report of the Rajya Sabha Select Committee suggested that GST rates would be levied with floor rates and with bands, where a band was defined as a

> [r]ange of GST rates over the floor rate within which Central Goods and Service Tax (CGST) or State Goods and Services Tax (SGST) may be levied on any specified goods or services or any specified class of goods or services by the Central or a particular State Government as the case may be. (Government of India 2015a)

There were also discussions that a maximum of 1–2 per cent deviation from the floor rate should be allowed.

The committee also recommended the establishment of a Goods and Services Tax Compensation Fund under the administrative control of the GST Council into which the central government would deposit the GST compensation.

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GST and Revenue Neutrality

Like every tax reform, it was envisaged that GST would be revenue neutral – that means revenue from GST would be equal to the present collection of revenue on account of taxes that would be subsumed under the GST. The TFC estimated the GST base for 2007–08 as INR 31,25,325 crore (INR 31,253.25 billion) and recommended that the GST rate of 12 per cent (that is, 5 per cent CGST and 7 per cent SGST) would be revenue neutral.

In December 2015, the committee headed by the Chief Economic Adviser (CEA), Ministry of Finance, brought out the *Report on the Revenue Neutral Rate and Structure of Rates for the Goods and Services Tax (GST)* (hereafter *CEA Report*) (Government of India 2015a). Earlier to the *CEA Report*, the Empowered Committee of State Finance Ministers had sponsored a study to the National Institute of Public Finance and Policy (NIPFP) for estimating the RNR and the same report was discussed in several meetings on GST. However, the report of the study was not put in the public domain.

The report submitted to the Empowered Committee is included in the present volume as Chapter 5.

Comparing the methodologies of both the studies (the *CEA Report* and the Empowered Committee Study), Rao (2016) carried out an in-depth comparative assessment of the reports and the suggested RNRs. For the benefit of the readers, the same result is presented in Table 1.2.

GST Administration

Unlike the design of GST, the administration of GST did not receive much focus in the recommendations of the committees/commissions on tax reforms.

Table 1.2 A Comparison of the Tax Rates Proposed

	NIPFP		CEA	
Single rate		17.69%		15.05%–15.5%
Multiple rate	Gold and other high-value items	2%	Gold, etc.	2%–6%
	Lower rate on 45% of GST base	12%	Lower rate (Not clear how much of the base is taxable at lower rate)	12%
	Standard rate for all other supplies	22.8%	High rate on luxuries	40%
			Standard rate on all other supplies	16.9%–18.9%

Source: Rao (2016).

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The Indirect Taxation Enquiry Committee (1977–78) observed that

> [t]here is a more important problem to be faced, namely, the administrative problem of enforcing VAT at the wholesale and retail stages, because, firstly, the number of tax-payers to be dealt with gets larger as we move further down the line in the chain of transactions; and secondly, the smaller dealers in a developing country and even in developed countries, maintain only a primitive form of accounting and may find it extremely difficult to cope with the accounting requirements of VAT. There is also the further consideration that wholesalers, and even more the retailers, are likely to be dealing in variety of commodities so that the matching of output and input taxes becomes difficult. (Government of India 1977, para 18.11)

Bagchi et al. (1994) observed that

> [e]ffective administration of a concurrent system would call for a degree of coordination between the Centre and the States that is lacking at present and would be difficult to achieve even with the best of intentions. (Bagchi et al. 1994)

The 'Comments of the DoR on the First Discussion Paper on GST' are also worth mentioning here:

> Since the tax base is to be identical for the two components, viz., CGST and SGST, it is desirable that any dispute between a taxpayer and either of the tax administrations is settled in a uniform manner. The possibility of setting up a harmonized system for scrutiny, audit and dispute settlement may be developed.
>
> The provisions related to dispute resolution, advance rulings and other business processes need to be harmonised between Centre and States.

The introduction of GST has resulted in the harmonisation of tax policy across states. Though it has resulted in the centralisation of some functions of tax administration (such as registration, return filing and payment), other functions (such as assessment, audit and recovery) still remain within the domain of the respective tax administrations. The GST Network (GSTN) has helped in minimising the burden of tax administration for both the central and state tax administrations. The system of online registration, return filing and payment through GSTN has enabled a common harmonised system of tax administration across tax jurisdictions. The system of a harmonised tax base, tax rates and thresholds is a commendable achievement of the GST system. Among other functions of tax administration, the most important is scrutiny assessment/audit, and it has been decided that there will be a vertical assignment of taxpayers (depending on annual turnover) between the centre and state authorities. Ninety per cent of the registered entities (including service providers) having an annual turnover of up to INR 1.5 crore (INR 15 million) will be assessed by the state tax administration and the rest by the central tax administration. For taxpayers having an annual turnover above INR 1.5 crore, there will be an equal distribution of assessees between the state and the central tax administrations. The proposed system is expected to reduce

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compliance burden for small taxpayers and also encourage a cooperative environment in tax administration. However, there is no clarity on the criteria for selection of cases/assessees for assessment under state or central tax administration. It has also not been discussed whether uniform criteria (risk parameters) will be applied across all states for selection of cases for scrutiny assessment. Some states have developed extensive methods for selection of cases for scrutiny assessment; it would be desirable that the states shared their expertise with others.

There is further scope for coordination in tax administrations for functions such as appeal, demand and recovery, and so on. With the unification of the tax base under GST, the possibility of the unification of the tax administration as well is explored in Chapter 8 of this volume.

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