

GST Reforms and Intergovernmental Considerations in India

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Foreword

The Economic Division in the Department of Economic Affairs has initiated a Working Paper series with the objective of improving economic analysis and promoting evidence based policy formulation in its mandated areas of work. The themes to be covered in the series include macro-economic and sectoral issues of relevance for national policy, strategy for addressing emerging global and national development concerns and the agenda for economic policy reforms. While the issues identified for the Working Papers have relevance as inputs for the flagship publications of the Department, namely Economic Survey and the Mid-Year Review, issues that are related to the larger work responsibility of the Department of Economic Affairs, including the economic aspects of financial services, revenues and expenditure are also the subject matter of this initiative. Papers prepared by the staff or commissioned by the Economic Division as well as other Divisions in the DEA will be included in the Working Paper series on suitable peer review.

The paper by Mr. Satya Poddar and Mr. Ehtisham Ahmad on *GST Reforms and Intergovernmental Considerations in India* is the first Working Paper for 2009 and the third since the initiation of the series. This paper discusses the contractual issue of carrying forward the sub-national tax reform agenda and throws light on the principles, issues and procedures related to the objective of achieving a common goods and services market.

The introduction of the State level VAT in 2005 was the first sub-national tax reform that provided for greater competitiveness of Indian industry and trade. The goods and service tax first proposed in the Budget speech of 2006-07 and now under active discussions of the Empowered Committee of State Finance Ministers is the next logical step in this quest for a common market. The Paper by the authors raises certain key issues in the objective of the tax, its design with tradeoffs in the available choices, administrative infrastructure and the tax base and rates. The paper has references to international best practices and may prove useful in the context of evolving the broad design of the tax.



(Arvind Virmani)

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1. Introduction

The replacement of the state sales taxes by the Value Added Tax in 2005 marked a significant step forward in the reform of domestic trade taxes in India. Implemented under the leadership of Dr. Asim Dasgupta, Chairman, Empowered Committee of State Finance Ministers, it addressed the distortions and complexities associated with the levy of tax at the first point of sale under the erstwhile system and resulted in a major simplification of the rate structure and broadening of the tax base. The state VAT design is based largely on the blueprint recommended in a 1994 report of the National Institute of Public Finance and Policy, prepared by a team led by late Dr. Amaresh Bagchi (hereinafter, the “Bagchi Report”).¹ In recommending a state VAT, the Bagchi Report clearly recognized that it would not be the perfect or first best solution to the problems of the domestic trade tax regime in a multi-government framework. However, the team felt that this was the only feasible option within the existing framework of the Constitution and would lay the foundation for an even more rational regime in the future.

Buoyed by the success of the State VAT, the Centre and the States are now embarked on the design and implementation of the perfect solution alluded to in the Bagchi Report. As announced by the Empowered Committee of State Finance Ministers in November 2007, the solution is to take the form of a ‘Dual’ Goods and Services Tax (GST), to be levied concurrently by both levels of government.

The essential details of the dual GST are still not known. Will it necessitate a change in the constitutional division of taxation powers between the Centre and the States? Will the taxes imposed by the Centre and the States be harmonized, and, if so, how? What will be treatment of food, housing, and inter-state services such as transportation and telecommunication? Which of the existing Centre and State taxes would be subsumed into the new tax? What will be the administrative infrastructure for the collection and enforcement of the tax? These are issues which ultimately define the political, social, and economic character of the tax and its impact on different sectors of the economy, and households in different social and economic strata.

It is some of these aspects of the proposed GST that are the subject matter of this paper. We focus on the essential questions relating to the Dual GST design, and first discuss the need for, and the objectives of GST reform. We then describes alternatives to the Dual GST already endorsed by the Empowered Committee, not because they are superior in any way to the Dual GST, but to allow a fuller discussion of the trade-offs involved in the choice among them. Subsequent sections consider the question of tax base and rate, and proper treatment of various components of the tax base (e.g., food, housing, and financial services) in light of international best practices. The last section provides a discussion of the issues that arise in the taxation of cross-border transactions, both inter-state and international. An important question in this regard is the feasibility of, and the rules for, taxation of inter-state supplies of services.

¹ Bagchi, Amaresh et al (1994)..

2. The Current Taxes and Their Shortcomings

The principal broad-based consumption taxes that the GST would replace are the CENVAT and the Service Tax levied by the Centre and the VAT levied by the states. All these are multi-stage value-added taxes. The structure of these taxes today is much better than the system that prevailed a few years ago, which was described in the Bagchi Report as “archaic, irrational, and complex – according to knowledgeable experts, the most complex in the world”. Over the past several years, significant progress has been made to improve their structure, broaden the base and rationalize the rates. Notable among the improvements made are:

- the replacement of the single-point state sales taxes by the VAT in all of the states and union territories,
- reduction in the Central Sales Tax rate to 2%, from 4%, as part of a complete phase out of the tax,
- the introduction of the Service Tax by the Centre, and a substantial expansion of its base over the years, and
- rationalization of the CENVAT rates by reducing their multiplicity and replacing many of the specific rates by ad valorem rates based on the maximum retail price (MRP) of the products.

These changes have yielded significant dividends in economic efficiency of the tax system, ease of compliance, and growth in revenues.

The State VAT eliminated all of the complexities associated with the application of sales taxes at the first point of sale. The consensus reached among the States for uniformity in the VAT rates has brought an end to the harmful tax competition among them. It has also lessened the cascading of tax.

The application of CENVAT at fewer rates and the new system of CENVAT credits has likewise resulted in fewer classification disputes, reduced tax cascading, and greater neutrality of the tax. The introduction of the Service Tax has been a mixed blessing. While it has broadened the tax base, its structure is complex. The tax is levied on specified services, classified into one hundred different categories. This approach has spawned many disputes about the scope of each category. Unlike goods, services are malleable, and can and are often packaged into composite bundles that include taxable as well as non-taxable elements. Also, there is no standardized nomenclature for services, such as the HSN for goods.

The design of the CENVAT and state VATs was dictated by the constraints imposed by the Constitution, which allows neither the Centre nor the States to levy taxes on a comprehensive base of all goods and services and at all points in their supply chain. The Centre is constrained from levying the tax on goods beyond the point of manufacturing, and the States in extending the tax to services. This division of tax powers makes both the CENVAT and the state VATs partial in nature and contributes to their inefficiency and

complexity. The principal deficiencies of the current system, which need to be the primary focus of the next level of reforms, are discussed below.

A. Taxation at Manufacturing Level

The CENVAT is levied on goods manufactured or produced in India. This gives rise to definitional issues as to what constitutes manufacturing, and valuation issues for determining the value on which the tax is to be levied.² While these concepts have evolved through judicial rulings, it is recognized that limiting the tax to the point of manufacturing is a severe impediment to an efficient and neutral application of tax. Manufacturing itself forms a narrow base.

Moreover, the effective burden of tax becomes dependent on the supply chain, i.e., the taxable value at the point of manufacturing relative to the value added beyond this point.³ It is for this reason that virtually all countries have abandoned this form of taxation and replaced it by multi-point taxation system extending to the retail level.⁴

Australia is the most recent example of an industrialized country replacing a tax at the manufacturing or wholesale level by the GST extending to the retail level. The previous tax was found to be unworkable, in spite of the high degree of sophistication in administration in Australia. It simply could not deal with the variety of supply chain arrangements in a satisfactory manner.

B. Exclusion of Services

The States are precluded from taxing services. This arrangement has posed difficulties in taxation of goods supplied as part of a composite works contract involving a supply of both goods and services, and under leasing contracts, which entail a transfer of the right to use goods without any transfer of their ownership. While these problems have been addressed by amending the Constitution to bring such transactions within the ambit of the State taxation⁵ (by deeming a tax on them to be a tax on the sale or purchase of goods), services per se remain outside the scope of state taxation powers. This limitation is unsatisfactory from two perspectives.

² A detailed discussion of the problems can be found in the Bagchi Report.

³ See Ahmad and Stern (1984) for the definition of effective taxes and applications to India. Bagchi (1994) provides estimates of effective excise tax rates, which are shown to vary from less than one percent to more than 22%.

⁴ For example, these were precisely the reasons for the replacement of the federal manufacturers' sales tax by the Goods and Services Tax in 1991. See Canada Department of Finance (1987), and Poddar, Satya and Nancy Harley (1989).

⁵ The Constitution (46th Amendment) Bill 1982 amended Article 366 (29A) of the Constitution to deem a tax on six items to be a tax on the sale or purchase of goods.

First, the advancements in information technology and digitization have blurred the distinction between goods and services. Under Indian jurisprudence, goods are defined to include intangibles, e.g., copyright, and software, bringing them within the purview of state taxation. However, intangibles are often supplied under arrangements which have the appearance of a service contract. For example, software upgrades (which are goods) can be supplied as part of a contract for software repair and maintenance services. Software development contracts could take the character of contracts for manufacturing and sale of software goods or for rendering software development services, depending on the roles and responsibilities of the parties. The so-called 'value-added services (VAS) provided as part of telecommunication services include supplies (e.g., wallpaper for mobile phones, ring tones, jokes, cricket scores and weather reports), some of which could be considered goods. An on-line subscription to newspapers could be viewed as a service, but online purchase and download of a magazine or a book could constitute a purchase of goods. This blurring also clouds the application of tax to transactions relating to tangible property. For example, disputes have arisen whether leasing of equipment without transfer of possession and control to the lessee would be taxable as a service or as a deemed sale of goods.

The traditional distinctions between goods and services (and for other items such as land and property, entertainment, and luxuries) found in the Indian Constitution have become archaic. In markets today, goods, services, and other types of supplies are being packaged as composite bundles and offered for sale to consumers under a variety of supply-chain arrangements. Under the current division of taxation powers, neither the Centre nor the States can apply the tax to such bundles in a seamless manner. Each can tax only parts of the bundle, creating the possibility of gaps or overlaps in taxation.

The second major concern with the exclusion of services from the state taxation powers is its negative impact on the buoyancy of State tax revenues. With the growth in per capita incomes, services account for a growing fraction of the total consumer basket, which the states cannot tax. With no powers to levy tax on incomes or the fastest growing components of consumer expenditures, the States have to rely almost exclusively on compliance improvements or rate increases for any buoyancy in their own-source revenues. Alternatives to assigning the taxation of services to the states include assigning to the states a share of the central VAT (including the tax from services), as under the Australian model.

C. Tax Cascading

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

Similarly, under the State VAT, no credits are allowed for the inputs of the exempt sectors, which include the entire service sector, real property sector, agriculture, oil and gas production and mining. Another major contributing factor to tax cascading is the Central Sales Tax (CST) on inter-state sales, collected by the origin state and for which no credit is allowed by any level of government.

While no recent estimates are available for the extent of tax cascading under the Indian tax system (although see Ahmad and Stern 1984 and 1991, and Bagchi for earlier work), it is likely to be significant, judging by the experience of other countries which had a similar tax structure. For example, under the Canadian manufacturers' sales tax, which was similar to the CENVAT, the non-creditable tax on business inputs and machinery and equipment accounted for approximately one-third of total revenues from the tax. The extent of cascading under the provincial retail sales taxes in Canada, which are similar to the State VAT, is estimated to be 35-40% of total revenue collections. A priori, one would expect the magnitude of cascading under the CENVAT, service tax, and the State VAT to be even higher, given the more restricted input credits and wider exemptions under these taxes.⁶ The Service Tax falls predominantly on business to business (B2B) services and is thus highly cascading in nature.

Tax cascading remains the most serious flaw of the current system. It increases the cost of production and puts Indian suppliers at a competitive disadvantage in the international markets. It creates a bias in favor of imports, which do not bear the hidden burden of taxes on production inputs. It also detracts from a neutral application of tax to competing products. Even if the statutory rate is uniform, the effective tax rate (which consists of the statutory rate on finished products and the implicit or hidden tax on production inputs) can vary from product to product depending on the magnitude of the hidden tax on inputs used in their production and distribution. The intended impact of government policy towards sectors or households may be negated by the indirect or hidden taxation in a cascading system of taxes.

D. Complexity

In spite of the improvements made in the tax design and administration over the past few years, the systems at both central and state levels remain complex. Their administration leaves a lot to be desired. They are subject to disputes and court challenges, and the process for resolution of disputes is slow and expensive. At the same time, the systems suffer from substantial compliance gaps, except in the highly organized sectors of the economy. There are several factors contributing to this unsatisfactory state of affairs.

The most significant cause of complexity is, of course, policy related and is due to the existence of exemptions and multiple rates, and the irrational structure of the levies. These deficiencies are the most glaring in the case of the CENVAT and the Service Tax.

⁶ Kuo, C.Y., Tom McGirr, Saya Poddar (1988), "Measuring the Non-neutralities of Sales and Excise Taxes in Canada", *Canadian Tax Journal*, 38, 1988, provide estimates of tax cascading under the Canadian federal manufacturers' sales tax and the provincial retail sales taxes.

The starting base for the CENVAT is narrow, and is being further eroded by a variety of area-specific, and conditional and unconditional exemptions. A few years ago the Government attempted to rationalize the CENVAT rates by reducing their multiplicity but has not adhered to this policy and has reintroduced concessions for several sectors/products.

The key problem with the service tax is the basic approach of levying it on specified services, each of which generates an extensive debate as to what is included in the base. Ideally, the tax base should be defined to include all services, with a limited list of exclusions (the so-called “negative list”).⁷ The Government has been reluctant to adopt this approach for the fear that it could bring into the tax net many services that are politically sensitive.

The complexities under the State VAT relate primarily to classification of goods to different tax rate schedules. Theoretically, one might expect that the lower tax rates would be applied to basic necessities that are consumed largely by the poor. This is not the case under the State VAT. The lowest rate of 1% applies to precious metals and jewellery, and related products—hardly likely to be ranked highly from the distributional perspective. The middle rate of 4% applies to selected basic necessities and also a range of industrial inputs and IT products. In fact, basic necessities fall into three categories – exempted from tax, taxable at 4%, and taxable at the standard rate of 12.5%. The classification would appear to be arbitrary, with no well accepted theoretical underpinning. Whatever the political merits of this approach, it is not conducive to lower compliance costs. Most retailers find it difficult to determine the tax rate applicable to a given item without referring to the legislative schedules. Consumers are even less aware of the tax applicable to various items. This gives rise to leakages and rent seeking.

Another source of complexity under the State VAT is determining whether a particular transaction constitutes a sale of goods. This problem is most acute in the case of software products and intangibles such as the right to distribute/exhibit movies or time slots for broadcasting advertisements.

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

⁷ For a detailed discussion of the flaws of the current approach to taxation of services, see Rao (2001), which recommended replacement of taxation of selected services by a general tax on all services (other than excluded services).

3. Objectives of Tax Reform

A. Basic Objectives

The basic objective of tax reform would be to address the problems of the current system discussed above. It should establish a tax system that is economically efficient and neutral in its application, distributionally attractive, and simple to administer.

As argued in Ahmad and Stern (1991), distributional or sectoral concerns have been at the heart of the excessive differentiation of the Indian tax system—but that the objectives are negated by the cascading effects of the taxes. While an optimal design of the consumption tax system, taking into account both production efficiency and distributional concerns, would not imply uniformity of the overall tax structure, the desired structure can be achieved by a combination of taxes and transfers.

Ahmad and Stern (1991) analyze the optimal pattern of tax rates implied by a given degree of aversion to poverty and concern for the poor. At high levels of concern for the poor, one would reduce the tax on cereals (but not dairy products) and increase the taxes on non-food items (durables). Thus, a differentiated overall structure appears desirable for a country in which the government has consistently expressed a concern for the poor. However, individual taxes should not be highly differentiated, as that complicates administration and makes it difficult to evaluate the overall effects of the tax design. This applies particularly to value-added type of taxes. In principle, a single rate (or at the most two-rate) VAT, together with excises and spending measures could achieve the desired distributional effects, for reasonable degrees of inequality aversion of policy makers.

In particular, it is important from an administrative perspective that close substitutes should not be taxed at very different rates—to avoid leakages and distortions. Revenue considerations suggest that the tax base should be broad, and comprise all items in the consumer basket, including goods, services, as well as real property.

The neutrality principle would suggest that:

- the tax be a uniform percentage of the final retail price of a product, regardless of the supply-chain arrangements for its manufacturing and distribution;
- the tax on inputs be fully creditable to avoid tax cascading; and
- the tax be levied on the basis of the destination principle, with all of the tax on a given product/service accruing in the jurisdiction of its final consumption.

Multiple VAT rates become a source of complexity, and disputes, for example, over borderlines, adding to the costs of tax administration and compliance. It is for this reason that countries like New Zealand, Singapore, and Japan have chosen to apply the tax at a

low and uniform rate, and address any concerns about vertical equity through other fiscal instruments, including spending programs targeted to lower-income households.⁸

Another important objective of tax reform is simplification of tax administration and compliance, which is dependent on three factors. The first determining factor for simplicity is the tax design itself. Generally, the more rational and neutral the tax design, the simpler it would be to administer and encourage compliance. If the tax is levied on a broad base at a single rate, there would be few classification disputes and the tax-specific record keeping requirements for vendors would be minimal. The tax return for such a system can be as short as the size of a postcard. It would simplify enforcement, and encourage voluntary compliance.

The second factor is the infrastructure for tax administration, including the design of tax forms, data requirements, system of tax rulings and interpretations, and the procedures for registration, filing and processing of tax returns, tax payments and refunds, audits, and appeals. A modern tax administration focuses on providing services to taxpayers to facilitate compliance. It harnesses information technology to enhance the quality of services, and to ensure greater transparency in administration and enforcement.

The third factor in a federation such as India is the degree of harmonization among the taxes levied by the Centre and the States. The Empowered Committee has already indicated a preference for a dual GST, consisting of a Centre GST and a State GST. Under this model, harmonization of the Centre and State GSTs would be critical to keep the overall compliance burden low. Equally important is harmonization of GSTs across the states.

B. Fiscal Autonomy and Harmonization

An important consideration in the design of reform options is the degree of fiscal autonomy of the Centre and the States. It goes without saying that the power to govern and to raise revenues go together. The Constitution of India lays down a clear division of powers between the Centre and the States, including the power to levy taxes. Should the Centre and the States then have complete autonomy in levying and collecting the taxes within the parameters specified in the Constitution, or should they voluntarily or otherwise conform to certain common principles or constraints? Should they collectively agree to have their individual taxes consolidated into a single national tax, the revenues from which get shared in some agreed manner among the constituent units? Such a system would have much to commend itself from the perspectives of economic efficiency and the establishment of a common market within India. Indeed, such political-economy compromises have been adopted by China and Australia. China moved to a centralized VAT with revenue sharing with the provinces — ensuring that provinces got as much revenues as under the prior arrangements, plus a share of the increment. In Australia, the

⁸ Canada provides a refundable tax credit, GST Credit, lower-income households through the personal income tax system. The credit is paid in quarterly installments and income-tested for higher-income households.

GST is a single national levy and all the GST revenues collected by the center are returned to the states. However, such a compromise is unlikely to find much favor with the States in India, as is already revealed in their preference for the Dual GST.

To give political substance to the federal structure in India, the States (as well as the Centre) are likely to insist that they have certain autonomy in exercise of their taxation powers. Full autonomy would mean that:

- retain the power to enact the tax,
- enjoy the risks and rewards of ‘ownership’ of the tax (i.e., not be insulated from fluctuations in revenue collections),
- be accountable to their constituents, and
- be able to use the tax as an instrument of social or economic policy.

Notwithstanding the above, there is a clear recognition of the need for harmonization of the Centre and State Taxes. Fiscal autonomy is important to allow the Centre and the States to set the tax rates according to their revenue needs. Harmonization of tax laws and administrative procedures is needed to simplify compliance and enforcement. It is also necessary to ensure that inter-state differences in policies and procedures do not generate additional economic distortions. An important question then is the desired degree of harmonization and the mechanism for achieving it.

The elements of harmonization can be divided into three broad sets: tax rates, tax base and tax infrastructure, i.e., the administration and compliance system. The first two elements could be viewed as important levers on which States would want to have some degree of control to achieve their social, economic, and fiscal policy objectives. However, the experience of other countries as well as their sub-national governments suggests that changes to the GST base are not a suitable instrument for social and economic policy (as discussed in greater detail in a later section in considering the treatment of food). While the tax base is a subject of intense debates at the time the tax is introduced, changes in the base after its introduction have been infrequent. This has especially been the case where the tax was initially levied on a broad and comprehensive base. Where the tax was initially levied on a narrow base, subsequent changes in the base have then been felt necessary to minimize anomalies, distortions, and revenue leakages created by the narrow base. Achieving such changes once the tax has been brought in, however logical, is invariably politically contentious because of vested interests. It is thus important to get the structure right at the outset, as the base (and quite often the rate) cannot be easily changed, *ex post facto*.

The VAT in the European Union is an example reflecting these policy considerations. The base for the EU VAT is uniform, as codified in the EU Directive⁹, which is binding in all Member States. There are important variations in the base, but these are essentially in the form of derogations granted for the arrangements existing at the time of introduction of the tax, and were intended to be temporary (though this has not always

⁹ The Commission Directive on the Common System of Value Added Tax, which replaced the Sixth Directive.

been the case). The tax rates are specified as floor rates (with some provision for reduced rates and maximum rates), below which Member States cannot set their rates.

Administration and compliance is an area where the need for harmonization is the greatest, and where Centre-State or inter-state variations are unlikely to serve any social or economic policy objective. This includes items such as the taxpayer registration system, taxpayer identification numbers, tax forms, tax reporting periods and procedures, invoice requirements, cross-border trade information systems and IT systems. Harmonization of these elements would result in significant savings in costs of implementing the GST (by avoiding duplication of effort in each government), as well as recurring savings in compliance costs. Harmonization would also permit sharing of information among governments, which is essential for effective monitoring of cross-border transactions. A common set of tax identifier numbers across states and the central government is a key element in the efficient exchange of information.

Harmonization of tax laws is also critical. Variation in the wording and structure of tax provisions can be an unnecessary source of confusion and complexity, which can be avoided by having the Centre and the States adopt a common GST law. An alternative is to agree on the key common elements if separate laws are chosen. Some of the critical elements for harmonization include common time and place of supply rules, as well as common rules for recovery of input tax, valuation of supplies and invoicing requirements. There would then be merit in harmonizing the system of tax interpretations and rulings as well (e.g., about classification of goods and services, determination of what constitutes taxable consideration, and definition of export and import).

These considerations suggest that harmonization of virtually all major areas of GST law and administration would be desirable. There is merit in keeping even the GST rate(s) uniform, at least during the initial years until the infrastructure for the new system is fully developed (see Ahmad, Poddar et al, 2008 for the GCC proposals). Harmonized laws would mean lower compliance costs for taxpayers and may also improve the efficiency of fiscal controls.

The Central Sales Tax (CST) in India provides a very useful for model for such harmonization. The CST is a state-level tax, applied to inter-state sales of goods, based on the origin principle. The tax law (including the base, rates, and the procedures) is enacted by Parliament, but the States collect and keep the tax. It is a perfect example of absolute harmonization, with the States enjoying the risks and rewards of ownership of the tax.

It is worth emphasizing that harmonization should not be viewed as constraining the fiscal autonomy of the Centre or the States. Rather, this is a framework that facilitates more efficient exercise of taxation powers, and all jurisdictions would be worse off without harmonization. This was the case under the previous State sales tax system, under which inter-state tax rate wars became a race to the bottom. Even today, they all suffer because of lack of harmonization of information and technology architectures, as a

result of which they are unable to share information on inter-state trade. Harmonization should allow greater exploitation of the benefits of a common market.

C. Centre and State Taxation Powers

As noted earlier, the current division of taxation of powers under the Constitution is constraining for both the Centre and the States. Neither is able to design a comprehensive and neutral tax on goods and services of the type found in modern tax systems. The Constitution divides taxation powers between the Centre and the States by sector (e.g., agriculture, manufacturing, and land and property) or type of taxes (e.g., luxury tax, tax on the sale or purchase of goods, and excise duty). A notable feature of the current division is that the two levels of government have no area of concurrent jurisdiction, with the exception of stamp duties. This approach, while it may have served the country well in the past, is no longer optimal for modern economies where the traditional dividing lines between sectors are blurred, and new social, environmental, and economic issues emerge which require new forms of taxation instruments. The need for a substantial realignment of taxation powers is also emphasized by Rao (2008):

“Paradigm shift in tax policy is necessary to recognise that tax bases of central and state governments are interdependent. The principle of separation of tax bases followed in the Constitutional assignment does not recognise the interdependence. It is therefore desirable to provide concurrent tax powers to Centre and States in respect of both income and domestic consumption taxes. In the case of personal income tax, separation of tax powers between the centre and states based on whether the income is from agricultural or non-agricultural sector has been a major source of tax evasion. As agriculture is transformed into a business it is important to levy the tax on incomes received from all the sources both for reasons of neutrality and to minimise tax evasion. At the same time, both centre and states could be allowed to levy the tax with the latter piggybacking the levy on the central tax subject to a ceiling rate. Similarly, it is important to unify multiple indirect taxes levied by the central and state governments into a single goods and services tax (GST) preferably with states piggybacking on the central levy with clearly defined tax rooms for the two levels of government. The transition to such a concurrent tax system requires integrating the existing CENVAT and service taxes and extending the tax to the retail level which would, inter alia, entail amendment of the Constitution. The states could piggyback on the levy.”

Thus, the current search for options for tax reform warrants a review of the existing Constitutional arrangements, which may well require a substantial realignment. For example, the dual GST would require giving the Centre and the States concurrent indirect

taxation powers, subject to prohibition on extra-territorial taxation, i.e., that the incidence of tax be restricted to consumption within the territory of the taxing jurisdiction.¹⁰

While such a review is beyond the scope of this paper, our discussion of alternative options in the next section proceeds with the assumption that suitable constitutional amendments would be made to enable the implementation of the chosen option.

4. Options for the Centre and State GSTs

In defining options for reform, the starting point is the basic structure of the tax. For purposes of this discussion, we start with the assumption that any replacement of the current taxes would be in the form of a classical VAT, which is consumption type (allowing full and immediate credit for both current and capital inputs attributable to taxable supplies) and destination based (i.e., the tax levied on the basis of the place of consumption of the goods and services, not the place of production). Under this system, credits for input taxes are allowed on the basis of invoices issued by the vendors registered for the tax. This is the most common type of structure adopted around the world. Its superiority over other forms of consumption taxes is well accepted in India as well as other countries.

The choices that remain then relate essentially to the assignment of powers to levy the tax to the Centre and the States, and the tax base and rates. In the remainder of this section we deal with the question of assignment, and then turn to the question of tax base and rates in the next section.

The main options for the VAT assignments include:

- Concurrent Dual GST,
- National GST, and
- State GSTs.

All these options require an amendment to the Constitution. For the sake of completeness of discussion, we also consider an additional option, Non-concurrent Dual VAT, that does not require an amendment to the Constitution. We now discuss each of these options in turn below.

¹⁰ The division of taxation powers between federal and provincial governments in Canada provides an interesting example of such concurrent powers. Under the Canadian Constitutions, the federal government can levy any tax, and the provinces have the power to levy any direct tax within the province. A tax is considered to be a direct tax if its incidence falls on the person on whom it is levied. Thus, it includes all forms of income and wealth taxes. A sales tax or VAT is also viewed to be a direct if it is levied on the buyer/consumer, but not on the vendor. The tax can be collected and remitted by the vendor, acting as an agent of the government, but it has to be levied on the buyer. As a result, the two levels of concurrent powers for all types of taxes, subject to the condition that the provincial taxes can only be levied on persons within the geographical boundary of the provinces.

A. Concurrent Dual GST

Under this model, the tax is levied concurrently by the Centre as well as the States. Both the Central Government and the Empowered Committee appear to favor this model.

While full details of the model are still awaited, two variants have been identified in public discussions so far. The initial variant, discussed in November, 2007, entailed both the Centre and the States levying concurrently the GST on goods, but most of the services (except services of a local nature) remaining subject to the Centre GST only. The Central GST would thus apply to both goods and services, extending to the entire supply chain, including wholesale and retail trade. The State GSTs would largely be confined to goods only, with minor changes from the current State VATs.

Under the more recent variant,¹¹ both goods and services would be subject to concurrent taxation by the Centre and the States. This variant is closer to the model recommended by the Kelkar Committee in 2002.¹²

The main difference between the two variants is in the treatment of services, reflecting apprehensions about the feasibility of defining the place of supply (i.e., destination) of inter-state services. Even the more recent variant recognizes that there would be a set of inter-state services for which the place of destination would be difficult to determine. The State tax on these services would be collected by the Centre, and then apportioned among the States in some manner.

Other notable features of this variant are as follows:

- There would be a single registration or taxpayer identification number, based on the Permanent Account Number (PAN) for direct taxation. Three additional digits would be added to the current PAN to identify registration for the Centre and State GSTs.
- States would collect the State GST from all of the registered dealers. To minimize the need for additional administrative resources at the Centre, States would also assume the responsibility for administering the Central GST for dealers with gross turnover below the current registration threshold of Rs 1.5 crores under the central Excise (CENVAT). They would collect the Central GST from such dealers on behalf of the Centre and transfer the funds to the Centre.
- Procedures for collection of Central and State GSTs would be uniform. There would be one common tax return for both taxes, with one copy given to the Central authority and the other to the relevant State authority.
- Other indirect taxes levied by the Centre, States, or local authorities at any point in the supply chain would be subsumed under the Central or the State GST, as long as they are in the nature of taxes on consumption of goods and services.

¹¹ See Empowered Committee of State Finance Ministers (2008).

¹² Kelkar, Vijay, et al (2004).

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

The apprehension about feasibility of application of State GST to inter-state services is understandable, given the complete absence of any framework in India for determining their place of supply. However, the task of developing of such a framework is not insurmountable. In fact, such frameworks do already exist for application of national VAT to international cross-border services, which could be adapted for inter-state services. Canada has developed such a framework for application of provincial sales taxes or GST to services.

Another point to note is that inter-state services are provided predominantly by the organized sector (e.g., telecom and transportation services), which is generally tax compliant. Once the rules are framed, they would program their accounting and invoicing systems to collect and remit the tax accordingly.

Admittedly, there are inter-state services which have no unique place of supply. Take for example the supply of group health insurance to a corporation with employees throughout India, or auditing or business consulting services provided to a corporation or conglomerate with business establishments in several States. The determination of place of supply of such services is going to be somewhat arbitrary. However, such services are almost entirely B2B supplies, the tax on which is fully creditable to the recipient under a comprehensive taxation model. The arbitrariness in the rules would thus have no impact on the final tax collections of the Centre or the States.

The Empowered Committee proposal is silent on the treatment of land and real property transactions in the description of this option. Assuming this omission is deliberate, it is a major drawback of the option. As discussed further in the next section, modern VATs apply to all supplies, including supplies of land and real property. The Service Tax has already been extended to rentals of commercial property and construction services. There are no compelling social or economic policy reasons for excluding these services from the scope of the GST.

B. National GST

Under this option, the two levels of government would combine their levies in the form of a single national GST, with appropriate revenue sharing arrangements among them. The tax could be controlled and administered by the Centre, States, or a separate agency reporting to them. There are several models for such a tax. Australia is the most recent

example of a national GST, which is levied and collected by the Centre, but the proceeds of which are allocated entirely to the States.¹³

In China, the VAT law and administration is centralized, but the revenues are shared with the provinces. In going to this model, the Centre had assure the provinces that they would continue to get what they did under the previous arrangement and that changes in revenue shares would be phased in over an extended period of 15 years—see Ahmad 2008.

Under the Canadian model of the Harmonized Sales Tax (HST), the tax is levied at a combined federal and provincial rate of 13 percent (5% federal rate, 8% provincial rate) in the three participating provinces. Tax design and collection are controlled by the Centre, but the provinces have some flexibility to vary their tax rate. The revenues from the tax are shared among the participating provinces on the basis of consumer expenditure data for the participating provinces.

In Austria, and Germany, the tax design is controlled by the Centre, but states collect the taxes. This has led to incentive problems, as some of the Länder have begun to use tax administration measures to achieve tax policy goals. In Mexico, the establishment of a VAT at the center replaced state sales taxes, but had to be part of a political-economy compromise that assured the states an automatic share of the revenues generated from all federal taxes.

A single national VAT has great appeal from the perspective of establishment and promotion of a common market in India. However, the States may worry about the loss of control over the tax design and rates. Indeed, some control over tax rates is a critical issue in achieving accountable sub-national governance and hard budget constraints (Ambrosiano and Bordignon, 2006). The States may also be apprehensive that the revenue sharing arrangements would over time become subject to social and political considerations, deviating from the benchmark distribution based on the place of final consumption. The Bagchi Report also did not favor this option for the fear that it would lead to too much centralization of taxation powers.

¹³ The Australian constitutional situation is that both the States and the Commonwealth (the Federal Government) have power to tax supplies of goods and services. The constitution prevents laws interfering with interstate trade (including tax laws) and gives the power to collect Customs and excise taxes exclusively to the Federal Government. It is forbidden for the Commonwealth to tax State Property. To meet this requirement, the GST implementation laws, of which there are 6, simply state that they do not impose tax on State properties and the States accept that view, at least at the moment. The GST was introduced on the pretence that it was a State tax being collected by the Commonwealth in order to (a) secure the States' agreements to abolish some of their preexisting transaction taxes, in particular certain stamp duties, financial institutions duties, etc and (b) to ensure that the States wouldn't start a round of attempts to challenge the constitutional validity of the law (as was done, unsuccessfully, in the past with income tax, which both States and Commonwealth also have power to collect. The current Government has acknowledged that GST is in fact simply a Federal Tax that it uses to make grants to the States and as a result of this acknowledgement, the Auditor General has for the first time since 2000 agreed to approve the Commonwealth accounts.

These concerns can be addressed partially through suitable administrative arrangements and centre-state agreements. The tax design could be made subject to joint control of the Centre and the States. The States would necessarily lose the flexibility of inter-state variation in tax design, but that is also the perceived strength of this option. Given that the Centre does not have the machinery for the administration of such a tax, the States would presumably play a significant role in its administration. The revenue sharing formula could also be mandated to be based on the destination principle, as under the Canadian HST.

The key concerns about this option would thus be political. Notwithstanding the economic merits of a national GST, will it have a damaging impact on the vitality of Indian federalism? With no other major own-source revenues, will individual States become too dependent on collective choices and feel disempowered to act on their priorities? Will it be possible for the governments with such diverse political interests and philosophies to reach a consensus and adhere to it?

While one can have a healthy debate on each of these issues, international experience suggests that discretionary use of broad-based consumption taxes for social, political, or economic policy purposes tends to be limited. The dominant consideration in their design is their neutrality and efficiency in raising revenues. This is also reflected in the design of the State VATs in India. In spite of vast political and economic differences among them, States have been able to forge a consensus on a common VAT design. A national GST would extend this consensus to the Centre. But participation of the Centre could fundamentally alter the delicate balance of interests that currently prevails in the Empowered Committee and make the consensus harder to achieve.

C. State GSTs

Under this option, the GST would be levied by the States only. The Centre would withdraw from the field of general consumption taxation. It would continue to levy income taxes, customs duties, and excise duties on selected products such as motor fuels to address specific environmental or other policy objectives. The loss to the Centre from vacating this tax field could be offset by a suitable compensating reduction in fiscal transfers to the States. This would significantly enhance the revenue capacity of the States and reduce their dependence on the Centre. The USA is the most notable example of these arrangements, where the general sales taxes are relegated to the states.

There would be significant hurdles in adopting this option in India. First, it would seriously impair the Centre's revenues. The reduction in fiscal transfers to the States would offset this loss, but still the Centre would want to have access to this revenue source for future needs. Second, the option may not be revenue neutral for individual States. The incremental revenues from the transfer of the Centre's tax room would benefit the higher-income states, while a reduction in fiscal transfers would impact disproportionately the lower-income states. Thus the reform would be inequality

enhancing—and against the traditions of successive governments in India (of all political shades). Third, a complete withdrawal of the Centre from the taxation of inter-state supplies of goods and services could undermine the States' ability to levy their own taxes on such supplies in a harmonized manner. In particular, it would be impractical to bring inter-state services within the ambit of the State GST without a significant coordinating support from the Centre.

D. Non-concurrent Dual VATs

Under the concurrent dual GSTs, the Centre and State taxes apply concurrently to supplies of all goods and services. It poses two challenges. First, it requires a constitutional amendment. Second, a framework is needed for defining the place of supply of inter-state services and for the application of State GST to them. Both of these hurdles can be circumvented if the GST on goods were to be levied by the States only and on services by the Centre only. The States already have the power to levy the tax on the sale and purchase of goods (and also on immovable property), and the Centre for taxation of services. No special effort would be needed for levying a unified Centre tax on inter-state services.

This option would not address any of the deficiencies of the current system identified in Section 2 above, if the taxes on goods and services were to be levied in an uncoordinated manner as two separate partial taxes. It would perpetuate the difficulties in delineating supplies of goods and services, and compound tax cascading.

The main appeal of this option is as a variant of the State GST option discussed immediately above. In levying the VAT on services, the Centre would essentially play the coordinating role needed for the application and monitoring of tax on inter-state services. The Centre would withdraw from the taxation of goods. Even the revenues collected from the taxation of services could be transferred back to the States, partially or fully.

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

The discussion above suggests that the design of a GST is going to be a challenge, regardless of the option chosen. All options require significant Centre-State coordination and harmonization, and there may be very little room for variance in rate setting by States at least in the near future. The best option would appear to be a national GST (either through the constitution or on a voluntary basis), with an appropriate Centre-State and inter-State revenue sharing arrangement. If a framework for taxation of inter-state services can be devised, then the concurrent dual VAT could be the most supportive of the objective of fiscal autonomy. To ensure harmonization of tax base, rules and procedures, it would be desirable to have a single common legislation enacted by Parliament, following the model for the CST. The law would delegate the collection of

tax to the Centre and States on their respective tax bases, i.e., the Centre to collect the central GST on supplies of goods and services any where in India, and the States to collect the state GST on supplies within their states (as per the place-of-supply rules specified in the legislation).

5. Tax Base and Rates

We turn now to the question of the tax base and rates, within the broad structure of a consumption-type, destination-based, credit-invoice GST. Ideally, the tax should be levied comprehensively on all goods and services at a single rate to achieve the objectives of simplicity and economic neutrality. However, governments often deviate from this ideal either because of concerns about distribution of tax burden (e.g., food), or because of administrative and conceptual difficulties in applying the tax to certain sectors of the economy (e.g., health care, education, and financial services). These concerns are likely to be paramount at both Centre and State levels and there will inevitable be calls to exempt, or tax at a reduced rate, items of importance to the poor or other particular groups.

As noted earlier, reduced rates or exemptions for basic necessities may not be an efficient way of helping the poor, because of a significant spillover of their benefits to the rich. Although the rich spend a smaller *proportion* of their income on such goods than do the poor, because their income is higher they are also likely to spend a larger *absolute* amount. As a result, the rich might gain most from applying a reduced tax rate to such goods. The needs of the poor could be more effectively addressed through spending and transfer programs. Distributional concerns should be seen as part of the overall balance of all fiscal instruments and not solely for the GST. Moreover, multiple rates and exemptions increase the costs of administration and compliance. They give rise to classification disputes, necessitate additional record keeping, and create opportunities for tax avoidance and evasion through misclassification of sales.

Notwithstanding the virtues of a single-rate and comprehensive base, debates about the proper treatment of food and a variety of other items are inevitable. In what follows, we discuss some of the most critical aspects this debate, starting with a discussion of the revenue neutral tax rates in the absence of any exemptions or other preferences.

A. Tax Rates

In discussions on the GST design for India, it has been suggested that the tax would need to be levied at a combined Centre-State tax rate of 20 percent, of which 12% would go to the Centre and 8% to the states (vide, for example, the Kelkar Task Force Report). While they fall below the present combined Centre and State statutory rate of 26.5% (Cenvat of 14%, and VAT of 12.5%), GST at these rates would encounter significant consumer resistance, especially at the retail level, and would give rise to pressures for exemptions and/or lower rates for items of daily consumption. With the notable exception of

Scandinavian countries, where the tax is levied at the standard rate of 25%, few countries have been successful in levying and sustaining a VAT/GST at such high rates.

Successful GST models adopted by other countries had a very broad base and a relatively modest tax rate, especially at the time of inception. For example, the New Zealand GST was introduced at the rate of 10%, with a base consisting of virtually all goods and services (with the exception of financial services). The Singapore GST was introduced at 3%, but the rate has now been raised to 7% as inefficient excises and customs duties have been progressively eliminated.

Table 1 provides a comparison of the tax base and rates in selected international jurisdictions with ‘modern’ VAT/GST. It provides data on C efficiency, which is a widely-used measure of the comprehensiveness of the tax base. It is calculated as the ratio of the share of GST revenues in consumption to the standard rate. Any deviation from a 100 percent C-efficiency indicates deviation from a single tax rate on all consumption. Zero-rating of some consumption items would lead to a C-efficiency of less than 100 percent while inclusion of investment or a break in the GST chain could lead to a C-efficiency higher than 100 percent. While a C-efficiency of 100 does not imply a perfect VAT, it can serve as a useful indicator of the productivity of GST revenue per percentage point of GST rate. The last column in the table shows revenue productivity of GST in these countries, measured as GST revenues per point of the standard rate divided by the GDP (i.e., (Aggregate Revenues/Standard Rate)/GDP).

Table 12

Comparison of GST Base and Rates, Selected Jurisdictions					
Country	Year	Standard Rate %	Consumption % of GDP	C Efficiency	Revenue Productivity
Canada	2005	7	74.8	0.46	0.34
Japan	2004	5	75.5	0.67	0.50
New Zealand	2005	12.5	76.0	0.94	0.73
Singapore	2004	5	54.2	0.70	0.40

Source: Various IMF reports and authors’ own estimates

As shown in Table 2, the New Zealand GST, which is levied at a single rate on virtually all goods and services, has the highest C efficiency. The Canadian GST, also levied at a single rate, has low C efficiency because of zero-rating of food and medicines, and rebates for housing and non-profit sector. Japan and Singapore levy tax at a single rate to a comprehensive base, including food. Yet, their C efficiency is lower than in New Zealand mainly on account of exemptions for supplies by non-profit organizations. The C efficiency of European VATs is generally much lower, in the range of 50%, as these taxes are levied at multiple rates, and with exemption for land and housing, financial services, and supplies by public bodies. In general, VATs that have been introduced around the world in the last few years have a higher C efficiency than the ‘old’ VATs.

A low C efficiency translates into lower revenue productivity of tax, as shown in the last column of the table.

With this background, we turn to an estimation of the size of the GST base in India and the GST rates that would be required to replace the current indirect tax revenues of the Centre and the States.

Poddar and Bagchi (2007) calculations show that if the GST were to be levied on a comprehensive base, the combined Centre-State revenue neutral rate (RNR) need not be more than 12%. This rate would apply to all goods and services, with the exception of motor fuels which would continue to attract a supplementary levy to maintain the total revenue yield at their current levels.

Here are some basic ingredients of the RNR calculations for 2005-06, the latest year for which the necessary data are available. The total excise/service tax/VAT/sales tax revenues of the Centre and the States in that year was Rs.134 thousand crore and Rs.139 thousand crore respectively. Assuming that approximately 40% of the central excise revenues and 20% of the state VAT/sales tax revenues are from motor fuels, the balance of the revenues from other goods and services that need to be replaced by the GST are Rs 89 thousand crore for the Centre and Rs 111 thousand crore for the states, making up a total of Rs 200 thousand crore.

In 2005-06, the total private consumer expenditure on all goods and services was Rs.2,072 thousand crore at current market prices. Making adjustments for sales and excise taxes included in these values and for the private consumption expenditure on motor fuels, the total tax base (at pre-tax prices) for all other goods and services is Rs 1763 thousand crore.

These values yield a revenue neutral GST rate of approx. 11% (200 as percent of 1763 is 11.3%). The RNR for the Centre is 5% and for the states 6.3%. Allowing for some leakages, the combined RNR could be in the range of 12%. The Centre excise duty rates have been reduced substantially (the standard rate reduced from 16% to 10%) since 2005. At the current duty rates, the Centre RNR is likely to be in the range of 3%, bringing the combined RNR to below 10%.

These estimates are by no means precise. Even so, they give a broad idea of the levels at which the rate of a national GST could be set to achieve revenue neutrality for both levels of government. An important question for policy makers is the costs and benefits of deviating from this benchmark of single rate GST. While there would be pressing calls for all kinds of exemptions and lower rates, the economic benefits of a single rate are enormous. The experience of countries like New Zealand, Japan and Singapore suggests that it is feasible to resist such calls by keeping the tax rate low. There is increasing political support for such an option. It would mark a clean break from the legacy structures and herald a new era of simple and transparent tax administration.

There is virtue in keeping the GST rate in the 10% range, especially at inception. Any revenue shortfall at this rate could be made up by the use of supplementary excises on select demerit goods (e.g., tobacco, and alcohol), besides motor fuels. Excises could also be used for select luxury items which do already attract tax at higher rates. This would help minimize undesirable shifts in the distribution of tax burden (see the discussion in Ahmad and Stern, 1984 and 1991). Clearly, such excises should be limited to a very small list of items which are discrete and not amenable to tax avoidance and evasion.

B. Food

The main issue in the application of GST to food is the impact it would have on those living at or below subsistence levels. In 2005, data, food accounted for one-third of total private final consumer expenditures. For those at the bottom of the income scale, it doubtless accounts for an even higher proportion of total expenditures and incomes. Taxing food could thus have a major impact on the poor. By the same token, a complete exemption for food would significantly shrink the tax base.

There are additional considerations that are pertinent to the treatment of food.

- Food includes a variety of items, including grains and cereals, meat, fish, and poultry, milk and dairy products, fruits and vegetables, candy and confectionary, snacks, prepared meals for home consumption, restaurant meals, and beverages. In most jurisdictions where reduced rates or exemptions are provided for food, their scope is restricted to basic food items for home consumption. However, the definition of such items is always a challenge and invariably gives rise to classification disputes. In India, basic food, however defined, would likely constitute the vast bulk of total expenditures on food.
- In India, while food is generally exempt from the CENVAT, many of the food items, including food grains and cereals, attract the state VAT at the rate of 4%. Exemption under the state VAT is restricted to unprocessed food, e.g., fresh fruits and vegetables, meat and eggs, and coarse grains. Beverages are generally taxable, with the exception of milk.
- In the rural sector, the predominant distribution channel for unprocessed food would be either a direct sale by the farmer to final consumers or through small distributors/retailers. Even where food is within the scope of the GST, such sales would largely remain exempt because of the small business registration threshold.
- Given the large size of farm community in India, which is mostly unorganized, consideration needs to be given to whether it is advisable to exempt (with no right of input tax deduction) all unprocessed farm produce sold by them at the farm gate. In the case of cash crops (produce for further manufacturing or processing, e.g., cotton, coffee beans, and oil seeds), it would not be in the interest of the farmers to be exempted from tax. They should thus be allowed the option of voluntary registration to pay the tax. It is recognized that an exemption for first sale at the farm gate would be difficult to administer and create inefficiencies in distribution and marketing of farm produce.

These considerations pose some difficult policy issues. Given that food is currently exempt from the CENVAT, the GST under a single-rate, comprehensive-base model would lead to at least a doubling of the tax burden on food (from 4% state VAT to a combined GST rate of 10-12%). It would call for some tangible measures to offset the impact on the lower-income households. One would be to limit the exemption only to cereals (see Table 1) as some of the other food items have lower distributional characteristics.

The alternative of exempting food altogether (or zero rating) would not be any better. First, the revenue neutral rate would jump from 10-12% to 18%. While the poor would pay less tax on food, they would pay more on other items in their consumption basket. Whether and to what extent they would be better off would depend on the composition of their consumption basket. The higher standard rate would, in turn, lead to pressures for exempting other items (e.g., medicines, books, LPG, and kerosene). Third, it could preclude unification of the tax rate on goods with that on services, which are currently taxable 12.36%. Imposition of tax rate at 18% on hitherto exempt services (e.g., passenger travel, health, and education) would encounter significant political resistance. Fourth, one cannot expect any improvement in taxpayer compliance at such high rates. To the contrary, greater visibility of the Centre tax at the retail level could have a negative impact on compliance. Thus, an exemption for food has the potential to totally unravel the simplicity and neutrality of GST.

One could consider a lower rate for food, instead of complete exemption. If the lower rate were to be 5%, the revenue neutral standard rate (based on 2005 rate structure) would be pushed up to 16%. This may be a reasonable compromise, provided all other goods and services are made taxable at the single standard rate of 16%. The risk is that the lower rate for food would become the thin edge of the wedge which would create irresistible demands for the opening the door wider.

An important question is the definition of food that would be eligible for the lower rate. To keep the base broad, and limit the preference to items of consumption by the lower-income households, the lower rate should be confined to 'unprocessed' food items (including vegetables, fruit, meat, fish, and poultry). Its scope can be further restricted by excluding from the preference food pre-packaged for retail sale. . This definition would not be without problems, especially where the processing value added is small. For example, if wheat were taxable at 5% as unprocessed food, but flour taxable at 16% as processed food, it would encourage consumers to buy wheat and then have it processed into flour.

Overall, the preferred option would appear to be a single-rate, comprehensive-base GST. While no option is perfect, it has the advantage of simplicity and neutrality. As noted earlier, sales of unprocessed food in rural India would largely remain exempt under this option because of the small business exemption. The poor can be further insulated from its impact through direct spending programs, and/or exempt from tax any sales under the Public Distribution System (PDS).

C. Land and Real Property

Under the ‘old’ VATs (such as those in Europe), land and real property supplies are excluded from the scope of the tax. To minimize the detrimental impact of an exemption under a VAT, business firms are given the option to elect to pay tax on land real property supplies.

Under a modern GST/VAT (e.g., in Australia, New Zealand, Canada, and South Africa), housing and construction services are treated like any other commodity. Thus, when a real estate developer builds and sells a home, it is subject to VAT on the full selling price, which would include the cost of land¹⁴, building materials, and construction services. Commercial buildings and factory sales are also taxable in the same way, as are rental charges for leasing of industrial and commercial buildings. There are only two exceptions: (1) resale of used homes and private dwellings, and (2) rental of dwellings:

- A sale of used homes and dwellings is exempted because the tax is already collected at the time of their first purchase, especially for homes acquired after the commencement of the tax. If the sale were to be made taxable, then credit would need to be given for the tax paid on the original purchase and on any renovations and additions after the purchase. Except where the prices have gone up, the net incremental tax on resale may not be significant. Theoretically, this system does create a windfall for the existing homes build and acquired prior to the commencement of the tax. In practice, the windfall is not significant as the home construction would have attracted other taxes on construction materials and services that prevailed at the time.
- Residential rentals are also exempted for the same reason. If rents were to be made taxable, then credit would need to be allowed on the purchase of the dwelling and on repairs and maintenance. Over the life of the dwelling, the present value of tax on the rents would be approximately the same as the tax paid on the purchase of the dwelling and on any renovation, repair, and maintenance costs. In effect (and as with other consumer durables), payment of VAT on the full purchase price at acquisition is a prepayment of all the VAT due on the consumption services that the house will yield over its full lifetime. A resale of a dwelling is exempted for the same reason: the tax was pre-paid when the dwelling was initially acquired.
- Many private individuals and families own residential dwellings (including their homes and summer residences) which they may rent to others. They are generally not in the VAT system, so do not get a credit for the VAT paid when they initially

¹⁴ Actually, in Australia and New Zealand, this is not always the case. In New Zealand, land (like any other “goods”) is the subject of a deemed input tax credit under the “second hand goods” scheme, which has the effect that the tax on a development of land acquired from an unregistered person is the margin of the supplier. This provision affects mainly the land held by individuals outside a business at the commencement of the GST. Such land is permanently sheltered from tax, even where it subsequently enters a commercial supply chain. In Australia, a margin scheme for land is used to work out the taxable value in similar circumstances: the margin scheme operates as a second hand scheme and as a transitional rule to prevent the value of most (but not all) of the value of land as at 1 July 2000 entering into the tax base.

acquire their new home. Nor do they claim any credit for any repairs or renovations they may have made to the existing homes. If the rental of such dwelling were subject to tax, owners should also be given a credit for the taxes paid on such costs—which would be complex, and difficult to monitor.

Thus, virtually all countries exempt long-term residential rents and resale of used residential dwelling. However, short-term residential accommodation (in hotels, for example) is normally subject to VAT. Any commissions charged by the agents and brokers for the sale or rental of a dwelling are treated as a service separate from the sale or rental of the dwelling and attract tax regardless of whether paid by the buyer or the seller.¹⁵

Sale or rental of vacant land (which includes rental of car parking spaces, fees for mooring of boats and camping sites) is also taxable under the ‘modern’ VAT system.

It would make sense to incorporate these concepts in the design of GST in India as well.

- Conceptually, it is appropriate to include land and real property in the GST base. To exclude them would, in fact, lead to economic distortions and invite unnecessary classification disputes as to what constitutes supply of real property.
- In the case of commercial and industrial land and buildings, their exclusion from the base would lead to tax cascading through blockage of input taxes on construction materials and services. It is for this reason that even under the European system an option is allowed to VAT registrants to elect to treat such supplies as taxable.
- Housing expenditures are distributed progressively in relation to income and their taxation would contribute to the fairness of the GST.
- The State VAT and the Service Tax already apply to construction materials and services respectively, but in a complex manner. For example, there is significant uncertainty whether a pre-construction agreement to sell a new residential dwelling is a works contract and subject to VAT. Where the VAT does apply, disputes arise about the allocation of the sale price to land, goods, and services. While land is the only major element that does not attract tax, the tax rates applicable to goods and services differ, necessitating a precise delineation of the two. Extending the GST to all real property supplies, including construction materials and services, would bring an end to such disputes, simplify the structure, and enhance the overall economic efficiency of the tax.

One potential argument against the levy of GST to land and real property would be that they already attract the stamp duty. This argument can be quickly discarded as the purpose and structure of the stamp duty is quite different from that of the GST. Stamp duty is a cascading tax on each conveyance of title to real property, whereas the GST is a tax on final consumer expenditures. The GST does not impinge on commercial property transactions, after taking into account the benefit of input tax credits. It does not result in tax cascading. Under the model described above, in the case of residential dwellings, the

¹⁵ Poddar(2009) provides a more detailed discussion of the options for taxation of housing under VAT/GST.

GST would apply to the first sale only. Thus, the two taxes cannot be viewed as substitutes. However, the application of GST to real property transactions does warrant a review of the structure and rates of stamp duties and registration fees. The rates should be lowered and the structure rationalized when the GST is introduced.

D. Non-profit Sector and Public Bodies

Historically, supplies made by governmental bodies and non-profit organizations (including religious institutions, social welfare agencies, and sports and cultural organizations) have been exempted from VAT on the grounds that such bodies are not engaged in a business and their activities are not commercial in nature. But this is often, and increasingly, not the case. Public enterprises are involved in a wide range of industrial and commercial activities. As deregulation proceeds, the dividing line between public administration and industrial/commercial activities becomes increasingly blurred. For example, postal and telecommunication services were historically viewed as public administration, but this is no longer the case. Government agencies/enterprises provide such services in competition with private firms. The same is true for other activities such as local and inter-city transit, operation of airports, radio and television broadcasting, and provision of water, sewer, and sanitation services. Moreover, the public sector in India, as in many other countries, is large and pervasive.

Under the EU VAT Directive, activities of the public sector are divided into three categories: non-taxable, taxable, and exempt. A public body is in principle eligible to claim input tax deductions only in respect of the VAT paid on inputs acquired for use in making taxable supplies (though a number of member states pay refunds of VAT by matching grant). While this approach may have provided the EU Member States with the needed flexibility in dealing with their domestic environment, it falls short of achieving the principal criteria of an efficient VAT system identified above. The exempt or non-taxable status of a wide range of supplies by public bodies violates the criterion of economic neutrality. Biases are created in favor of the self-supply of services within the public sector to minimize the amount of non-deductible VAT on inputs. Consumers may be influenced in their purchasing decisions by the fact that the VAT does not apply to certain public sector goods and services. The non-deductible input VAT embedded in the prices of public sector goods and services is passed along to persons in the production-distribution chain who are not final consumers.

The application of a value added tax requires identification of a supply and the consumer or buyer to whom the supply is made, and valuation of consideration for the supply. Determination of each of these elements gives rise to issues in the public sector due to the nature of the way services are delivered by governments and the manner in which the services are funded. For example, a public body may provide its services for no explicit charge (e.g., museum admissions, water, health, and education) and there may not be any identifiable buyer or consumer for certain services provided on a collective basis (e.g., sanitation, and police protection). In addition, the political sensitivity to the taxation of certain services, and the methods of inter-governmental funding may detract from a neutral application of tax to the public sector activities. As a result, the public sector is

subject to special rules in almost all VAT systems currently in place throughout the world.

This is a matter that cannot be dealt with satisfactorily without a systematic review of all of the activities of the governmental bodies and non-profit organizations. However, at this stage it is useful to describe the two broad approaches that other countries have followed.

First, the highly-regarded VAT system in New Zealand (and later Australia¹⁶) treats all activities of public sector and non-profit bodies as fully taxable.¹⁷ They thus collect the VAT on all of their revenues, with the sole exception of revenues from taxes, interest and dividends, and gifts and charitable donations. Under this broad and comprehensive approach, no distinction is made between public administration and commercial/industrial activities of the state or non-profit organizations. By the same token, these bodies are eligible to claim a full credit for their input VAT in the same manner as private enterprises. This system is conceptually simple, and consequently is in some respects easy to operate. And—by putting public and private sectors on an equal footing—it minimizes potential distortions of competition. In Australia, certain basic medical and educational supplies, and supplies by non-profit organizations below market value (i.e., subsidized supplies) are zero-rated.¹⁸ Other supplies are taxable under the standard GST rules, as in New Zealand.

¹⁶ The Australian system is structured quite different from the New Zealand one, even though the net outcome is similar. New Zealand's GST is designed to tax all flows of money through the Government, whereas Australia's is complicated by the Federal Structure. The Commonwealth does not in fact pay GST or claim ITCs-- it just does so notionally--, whereas the States actually do pay and claim. New Zealand taxes appropriations, whereas Australian says that they are not taxed. In addition, a range of Government provided services are GST-free or exempt.

¹⁷ See Peter Barrand (1991), for a description of the New Zealand system. Aujean, Michel, Peter Jenkins and Satya Poddar provide an analytical framework for such a system .

¹⁸ Zero-rated (called GST-free) supplies are defined as follows:

38-7 Medical services

(1) A supply of a medical service is GST-free.

(2) However, a supply of a medical service is not GST-free under subsection (1)

if:

(a) it is a supply of a professional service rendered in prescribed circumstances within the meaning of regulation 14 of the Health Insurance Regulations made under the Health Insurance Act 1973

(other than the prescribed circumstances set out in regulations 14(2)(ea), (f) and (g)); or

(b) it is rendered for cosmetic reasons and is not a professional service for which medicare benefit is payable under Part II of the Health Insurance Act 1973.

[medical services are defined by cross-reference to services covered by a health and health insurance law]

38-85 Education courses

A supply is GST-free if it is a supply of:

(a) an education course; or

(b) administrative services directly related to the supply of such a course,

The second is the traditional approach followed in most other countries. Under this approach, the activities of public and non-profit bodies are divided into two lists: taxable and exempt. There are no simple or mechanical rules for this division, which in practice is based on a variety of economic, social, and practical considerations. For example, public enterprises engaged in industrial or commercial activities are generally taxable, especially if their revenues from their clients are expected to exceed their costs. Some countries exempt all other fees and charges, while others tax them on a selective basis (including postal charges, airport landing fees, port loading and unloading charges, sale of statistical and other publications, and fees for licenses and permits). Given that not all of the activities of an organization are considered taxable under this approach, an input tax credit is allowed for only those inputs that relate to the taxable activities of the organization.

This latter approach creates difficulties in determining what is taxable and what is exempt, and also in allocating the input taxes between the two (since credit would be given only in respect of taxable activities). It also creates a distortion in the form of a bias against the use of outside contractors by public bodies in their exempt activities. For example, if a municipality used a contractor for construction of a road or a bridge, it would pay the VAT on the contractor's fees, and not be eligible to claim a credit for the tax. However, it could avoid the tax if it hired its own employees to do the construction work. As noted above, some countries provide a full or partial rebate of the tax related to minimize this 'self-supply' bias.

There is little doubt that the New Zealand approach is conceptually superior. It does, however, lead to a larger number of taxpayers, many of which will be entitled to refunds. Since the management of refunds is an especially problematic aspect of the VAT, particularly in developing countries, the control issues may be a significant drawback.

If governments and public bodies are partially exempted, then one other issue that needs to be considered is the treatment of supplies to governments. This is especially important in a federation. Should one government apply its non-creditable tax to supplies to another government? Or should all governments be immune from taxation as sovereign bodies? In India, CENVAT and State VAT currently apply to government procurement.

but only if they are supplied by the supplier of the course.

[education course defined as a course leading to a diploma or degree from a primary, secondary or tertiary school with cross-references to recognition by the appropriate state education authority]

38-250 Nominal consideration etc.

(1) A supply is GST-free if:

(a) the supplier is a charitable institution, a trustee of a charitable fund, a gift-deductible entity or a government school; and

(b) the supply is for consideration that:

(i) if the supply is a supply of accommodation – is less than 75% of the GST inclusive market value of the supply; or

(ii) if the supply is not a supply of accommodation – is less than 50% of the GST inclusive market value of the supply.

Likewise, the GST could be made applicable to supplies to governments with no special rules. However, as noted earlier, this then would create a self-supply bias for public bodies where they buy inputs for an exempt activity.

E. Financial Services

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

It would be straightforward to levy the tax on this implicit fee if the reference ‘pure rate’ were easily observable—but it is not. The spread between borrowing and lending rates, could be measured, and taken as measuring the *total* value added by the intermediary. But in order for the crediting mechanism to work properly, it is necessary to go further and *allocate* this value-added to borrower and lender (with a credit on the tax paid due only to registered taxpayers)—which again raises the problem of identifying a reference pure interest rate.¹⁹

Some financial services are, of course, charged for by a direct and explicit fee, examples being an account charge or foreign exchange commission. Services provided for an explicit charge could be subjected to VAT in the normal way with the taxable recipient having a right of deduction, and a growing number of countries do this. Nevertheless, some countries exempt them all, while others limit the exemption to banking and life insurance. The exemption avoids the need to measure the tax base for financial transactions, but gives rise to other distortions in the financial markets. The denial of credit to the exempt financial institutions for the VAT charged on their inputs creates disincentives for them to outsource their business process operations. Where they render services to business clients, the blockage of input tax credits results in tax cascading, adversely affecting their competitive position in the international markets.

Taxing explicit fees for financial services, but treating margin services as exempt, is a possible answer, but it is conceptually flawed (as the same service will be treated differently for VAT purposes depending on how the remuneration for it is taken) and runs

¹⁹ These concepts are discussed in greater detail in Poddar, S. and M. English (1997) and Poddar, Satya (2003).

the risk that there will be some arbitrage between the two methods of charging to lessen the VAT charge (particularly in the case of supplies to final consumers with no right of deduction).

In China, financial services are taxable under their business tax, which is a tax on turnover with no tax credits allowed on inputs. Because it is a turnover tax, it can be applied to the total spread for margin services, with no need to allocate the spread between borrowers and depositors. Israel, and Korea also apply tax in such alternative forms.

Under the Service Tax, India has followed the approach of bringing virtually all financial services within the ambit of tax where the consideration for them is in the form of an explicit fee. It has gone beyond this by bringing selected margin services (where the consideration is the spread between two financial inflows and outflows) within the Service Tax net. The following are principal examples of such taxable margin services:

- Merchant discounts on credit/debit card transactions are taxable as a consideration for credit card services, as are any explicit fees or late payment charges collected from the card member.
- In foreign currency conversion transactions without an explicit fee, tax applies to a deemed amount of consideration equal to 2% of the amount converted.
- The tax applies to that portion of life insurance premiums that represents a cover for risks.

As there are no compelling economic or social policy reasons for exempting financial services (other than the practical difficulties of defining the consideration for margin services), it would be appropriate to continue this approach under GST. There are, however, certain technical flaws in the measurement of consideration that need to be addressed when switching over to GST. For example, in the case of insurance, the tax applies to the gross amount of risk premium, while a proper measure would be the premiums net of any claims (whether the claim is settled in cash or in kind). This can be accomplished by allowing a credit in respect of any claims paid.

Consideration could also be given to bringing interest margin on non-commercial loans and deposits within the next net on an aggregate basis, as opposed to for each transaction separately.²⁰ This could be done by computing the aggregate interest margin and apportioning it between the margin from B2B and B2C transactions. The B2B margin could then be zero-rated, and the tax applied to the B2C margin.

In some countries, transactions in gold, silver and other precious metals are also treated as part of the financial sector, given that these metals are often bought as investments, and not for consumption. They are exempted from tax. However, unlike the approach followed in India of applying a reduced rate of 1% to such metals and articles made of

²⁰ For a more complete discussion of the system in India and how it can be modified and extended, see Poddar, Satya (2007).

such metals, the exemption is confined to only metals of investment-grade purity levels. Jewellery and other articles made of such metals remain taxable at the standard rate.

6. Treatment of Inter-State and International Trade

Treatment of inter-state and international supplies of goods and services is one of the most crucial elements of the design of a Dual GST. A set of rules is needed to define the jurisdiction in which they would be taxable under the destination principle. Further a mechanism is needed for enforcing compliance to those rules.

The rules can be relatively straightforward for the application of the Central GST. However, there is a concern that, under a sub-national destination-based VAT, taxation of cross-border transactions could be a significant challenge in the absence of any inter-state fiscal border controls. Even if such border controls were to exist, they would be ineffective for taxation of services, which entail no physical inter-state movement. This concern has been a topic of increased discussion over the recent years due to the growth in internet sales and transactions. Cross-border VAT leakage is also a growing concern in the EU because of the removal of border controls between member countries.

In what follows, we first start with the basic framework for defining the place of supply, then look at the policy options for ensuring proper compliance. This discussion draws on Ahmad, Poddar et al (2008) for the GCC Secretariat.

A. Place of Taxation, International Transactions

In virtually all countries, VAT is levied on the basis of the destination principle. For this purpose, some countries follow the practice of prescribing a set of rules for defining the place of taxation or place of supply. A supply is taxable in a given jurisdiction only if the supply is considered to take place in that jurisdiction. An alternative approach followed by other countries is to first define what supplies are potentially within the scope of the tax, and then provide criteria for determining which of those supplies would be zero-rated as exports. The two approaches yield the same result, even though one excludes exports from the scope of the tax, while the other zero-rates them, having first included them in the scope. The Service Tax in India follows the second approach.

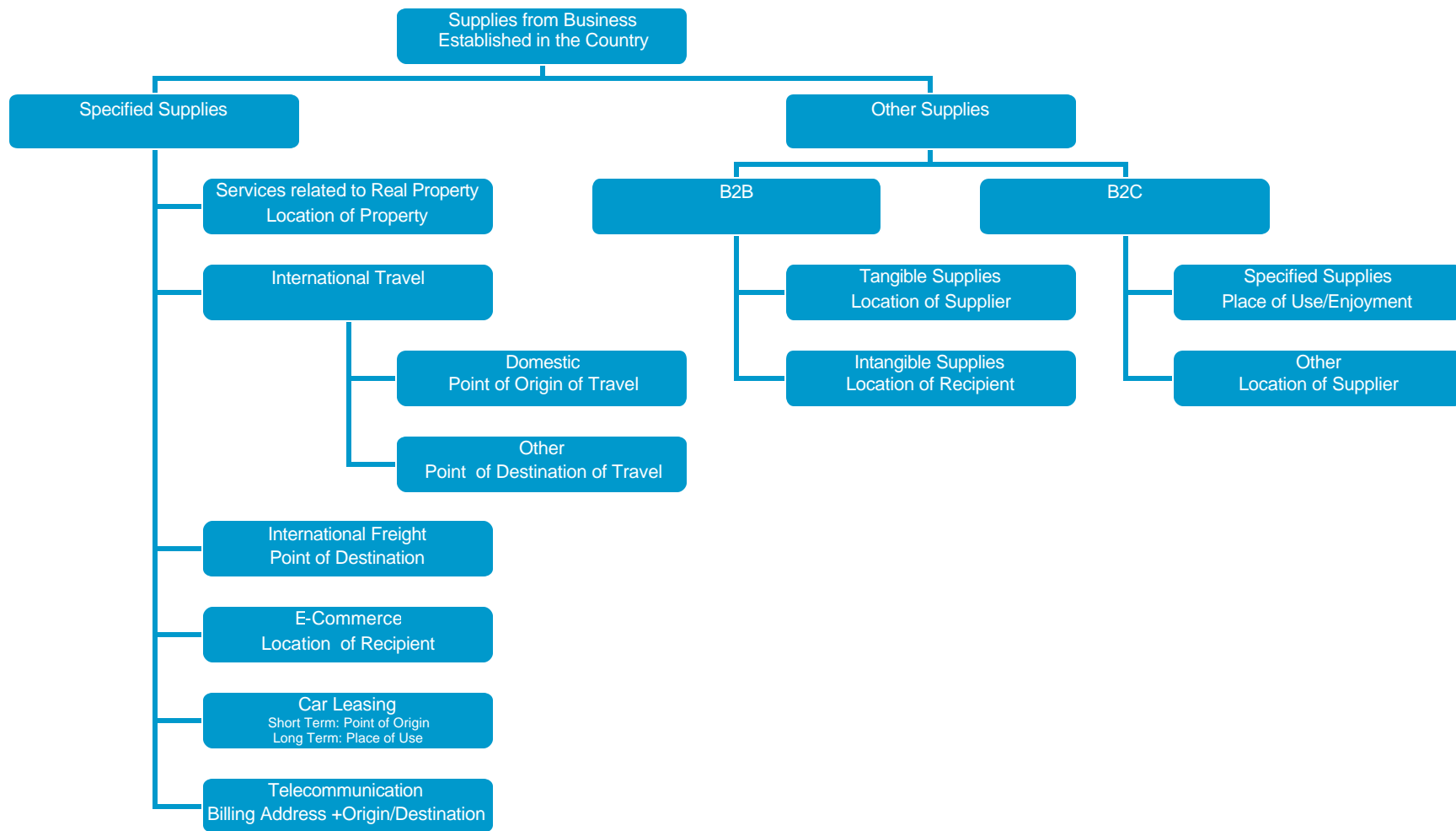
While the rules and approaches vary from country to country, the basic criteria for defining the place of taxation are as follows (approaches for taxation of services depicted in Chart 1):²¹

- A sale of goods is taxable if the goods are made available in or delivered/shipped to that jurisdiction (i.e., on the basis of place of delivery or shipment to the recipient)

²¹ What are discussed below are only the basic concepts. The actual rules can be complex, and highly varied from one jurisdiction to the next. For a more rigorous discussion of the approaches being followed in selected international jurisdictions, see Millar, Rebecca (2007).

- A sale of real property is taxable if the property is located in that jurisdiction (i.e., on the basis of place of location of the property). Services directly connected with real property are also taxable on this basis (e.g., services of estate agents or architects).
- A supply of other services or intangible property is taxable in that jurisdiction depending on one or more of the following factors:
 - Place of performance of the service
 - Place of use or enjoyment of the service or intangible property
 - Place of residence/location of the recipient
 - Place of residence/location of the supplier
- Special rules apply for certain supplies (also referred to as mobile services) for which there is no fixed place of performance or use/enjoyment, such as:
 - Passenger travel services
 - Freight transportation services
 - Telecommunication Services
 - Motor vehicle leases/rentals
 - E-commerce supplies

Chart 1 Place of Taxation (of supplies other than goods)



In defining the place of taxation of services and intangible property, a distinction is often made between supplies made to businesses (B2B) and final consumers (B2C). B2B supplies are generally defined to be made where the recipient is located or established, regardless of where the services are performed or used. This is particularly the case for the so-called intangible services (e.g., advisory or consulting services) for which the place of performance is not important. Thus, all such services rendered to nonresidents become zero-rated, and subject to a reverse charge in the country of the recipient, which charge is deductible as long as the recipient is fully taxable. This avoids tax cascading, which would otherwise occur.

By contrast, B2C services are deemed to be made in the jurisdiction where the supplier is located. Many B2C services tend to be tangible or physical in nature, e.g., haircuts, and admissions to place of amusement, which are used/consumed at the place of their performance. In some countries, B2C intangible services are treated in the same manner as B2B services, i.e., they are zero-rated when rendered to nonresident customers.

Special rules apply to the so-called mobile services. For transportation services, the place of supply is defined by reference to the point of origin or destination. In Europe, rail passenger transportation is taxed based on distance traveled in the taxing jurisdiction. For telecommunication, e-commerce and satellite broadcasting services, the origin rule (taxation in the country of the supplier) can lead to non-taxation, and various solutions have been followed to prevent this. For example, in the EU, e-commerce suppliers to EU final consumers are required to register and account for tax in the country of their customer, using a 'one stop shop' registration facility, if they wish. This rule is being extended to intra-EU supplies of telecommunications, e-commerce and satellite broadcasting from 1/1/2015 to present suppliers obtaining an arbitrage advantage by setting up their business in a low rate member state. In Canada, a two-out-of-three rule is followed, i.e., the supply is made in the jurisdiction if the points of origin and termination are in that jurisdiction, or if one of the points is in the jurisdiction and the supply is billed to an account in the jurisdiction. The rules for e-commerce are varied, but generally follow the rules for telecommunication services. Internet connectivity services are in fact telecommunication services. Goods and services bought and sold online are generally taxed on the same manner as those bought offline.

For short-term car rentals, in Europe the place of supply is where the car is first made available to the customer, regardless of the place of its subsequent use. For long-term leases, place of supply could depend on the place of use of the vehicle or the residence of the customer; the EU is adopting such a rule from 1/1/2010 to prevent 'rate shopping'. Often, similar rules are adopted for leases and rentals of other goods also.

In addition to the above, there are a variety of other complex cross-border transactions' for which supplementary rules are required. They relate to global transactions (or master service agreements) for individual supplies to legal entities of a corporate group around the world, triangular transactions, supplies among branches and between branches and head office, and cost reimbursement/ allocation arrangements. The complexity of the

rules for such transactions has been an issue under discussion by working groups at the OECD, with a view to developing a framework or guidance for uniformity and consistency in the treatment of international services and intangibles in different jurisdictions.²²

It is recognized that under these rules tax could be charged to nonresident business customers on supplies of an intermediate nature (i.e., not for final consumption) which would lead to cascading and create competitive distortions. To address this concern, many countries have provisions to provide a rebate of the tax charged to business customers.²³ Such rebates can also be extended to non-business customers, e.g., rebates to foreign tourist for the tax paid on goods bought locally for subsequent export when they return back.

Generally, these rules apply in a symmetrical manner to define exports and imports. Thus, where the supply of, say, consulting services by a domestic supplier is zero-rated because it is supplied to a business located outside the country, the supply of such services by a foreign supplier to a business located in the country would be taxable as an imported service. Imports generally attract tax at the customs border. For services and intangibles, the tax is self-assessed by the recipient under the reverse-charge mechanism.

The combined result of these rules (including the system of rebates for nonresident customers) is to define the place of destination of services and intangibles as follows:

- For B2B supplies, the place of destination is the place where the recipient is established or located.
- For B2C supplies of a tangible/physical nature (e.g., hair cuts, hotel accommodation, local transportation, and entertainment services), the place of destination is the place where the supplier is established or located, which is generally also the place where the service is performed. For highly mobile B2C supplies of an intangible nature (e.g., telecommunication, e-commerce and satellite broadcasting services, for which the place of performance is not linked to the rendering of the service), the place of supply could be the place of residence of the customer (as for B2B supplies), or the place where the services are used or enjoyed. But, because it is wholly impractical to subject final consumers to the reverse charge, in Europe the non-resident supplier is required to register and account for VAT to customers resident in the European Union.
- Special rules for specific supplies are generally designed to yield a result similar to that for other supplies. They serve the purpose of providing greater certainty and clarity in situations where the place of location or residence of the supplier or the recipient may not be well defined or easily ascertainable at the time of the supply.

²² For discussion of the issues and approaches, see OECD (2004).

²³ For example, such rebates are provided under Article XXX. of the EU VAT Directive.

B. Place of Taxation, Inter-State Transactions

An important question in the context of the Dual GST is whether these rules for international cross-border supplies can be adopted for domestic inter-state supplies also. Conceptually, there are no compelling reasons to deviate from them for defining the place of supply at the sub-national level. The only precedent available of a destination-based VAT at the sub-national level is that of Harmonized Sales Tax (HST) in Canada. (The precedent of the EU is different because it is a community of 27 sovereign member states rather than a single nation made up of a union of states in a federation. The EU solution of taxing intra-EU B2B supplies of goods and services by means of zero-rating and then reverse charge accounting in the member state of the taxable recipient may not be the right answer—and has led to the problem of carousel fraud). Surprisingly, Canada deviated from these rules in defining the place of supply in a province in one important respect. In defining the place of supply of services at the provincial level, the primary criterion used in Canada is the place of performance of the service. Thus, if all or substantially all of a service is performed in a province, then the place of supply of the service is considered to be that province, regardless of whether it is a B2B or B2C supply, and where it is used or enjoyed. There appear to be two reasons for it, which are also relevant for the design of the Dual GST in India.

First, it is recognized that the place where the supplier or the recipient is established cannot be defined uniquely at the sub-national level within a common market. A supplier may have establishments/offices in several States and one or more of them could be involved in rendering the service. At the national level, the country of residence of the counter parties to a transaction needs to be determined for direct tax as well as other regulatory purposes. However, at the sub-national level, such determination is not necessary, especially where there is no direct tax at that level. The basic rules outlined above for international supplies cannot be applied in the absence of supplementary rules for defining the place where the supplier and the recipient are located or established. Take, for example, an HR consulting firm with offices in several States providing recruitment services to a corporate entity with operations through India. In this case, the basic rule of defining the place of supply of the service to be where the recipient is established cannot be applied as the recipient is established in more than one State.

Second, under the Canadian HST, any input tax paid by a business can be claimed back as an input credit under the federal GST or the HST regardless of where it is established, as long as the inputs are used in a taxable activity. Thus, there is no adverse consequence of collecting the HST on services rendered to businesses located in other provinces. The HST is integrated with the GST to such an extent that it best fits the description of as a national GST, not a Dual GST.

Given these considerations, Canada defines the place of supply of services (other than those subject to special rules) to be the place where they are performed. If they are performed in more than one province, supplementary rules are employed to determine the place of supply. The main supplementary rule defines the place of supply/taxation to be the place to which the employee/officer of the supplier, who had responsibility for negotiating the service contract with the recipient, reports. In effect, under these rules the

sub-national tax on services is applied on the basis of the origin principle, i.e., where the services are performed.

The Canadian approach does not appear to be suitable for the Dual GST in India where the Centre and State GSTs would be harmonized, but not integrated. It would be desirable to tax B2B supplies of services (and intangibles) in the State of destination, and not of origin.

Given that any tax on B2B supplies would generally be fully creditable, excessive sophistication would not be warranted for defining the place of destination of such supplies. For multi-establishment business entities, the place of destination could be defined simply as the place of predominant use of the service. Where there is no unique place of predominant use, the place of destination could be simply the mailing address of the recipient on the invoice, which would normally be the business address of the contracting party. The risk of misuse of this provision would be minimal if it is limited to B2B supplies where the tax is fully creditable.

For B2C services, the tax should apply in the State where the supplier is established, which, in turn, could be defined as the place where the services are performed. Where there is no unique place of performance of the service, the place of taxation could be defined to be the State where the supplier's establishment most directly in negotiations with the recipient is located. This would be similar to the Canadian rule.

C. Taxation of Imports by the States

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

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

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

D. Monitoring of Inter-State Supplies

We turn now to the design of a suitable mechanism for payment and collection of tax on inter-state supplies. As noted earlier, there is a concern that a sub-national destination-based VAT could be subject to substantial leakages in the absence of effective inter-state border controls. Many policy prescriptions have been made to deal with the issue, but none implemented so far at the sub-national level.²⁴

In our view, these concerns are exaggerated, especially under a dual GST, harmonized between the Centre and the States and across the States. It is possible to design suitable mechanisms for proper application of tax on inter-state supplies, without resorting to border controls. The current border controls for goods, in the form of inter-state check posts have not been effective in the past. Border controls would not even be feasible for services and intangibles, which involve no physical inter-state movement.

As noted by Bird and Gendron²⁵, under a dual GST, the application of the Centre GST to all domestic supplies would automatically serve as an audit control for reporting of inter-State supplies for purposes of the State GST. The aggregate of the turnovers reported for the State GSTs must equal the total turnover reported for the Centre GST. Dealers can misclassify the turnover to different States, but would not be able suppress the turnover for State GST below the level reported for the Centre GST. Where the GST design, rate and the base is harmonized across the States, the dealers would have little incentive to misclassify the turnover. Under such a system, the focus of the authorities should be on proper reporting of the total turnover, not inter-State turnover.

Notwithstanding the above, a mechanism is needed for proper application of sub-national tax on inter-State supplies of goods as well as services. For reasons outlined elsewhere²⁶, zero-rating of inter-State supplies is not advisable. Instead, the preferred approach would be to require the vendors to collect the destination state GST on inter-State supplies (of goods and services) and remit the tax directly to the destination state. The tax would then be creditable in the destination state under the normal rules, i.e., if it relates to inputs for use in making taxable supplies.

This mechanism, referred to as Prepaid VAT (PVAT), is similar to the mechanism of the CST. Under the CST, the tax on inter-state sales is charged and remitted to the origin state. Under PVAT, the tax on inter-state supplies would be charged and remitted to the destination state.²⁷ It preserves the destination principle of VAT. Vendor in the origin state collect tax on all of their domestic supplies, whether intra-State or inter-State. The

²⁴ See, for example, McLure, Charles (2000); Keen, Michael and Stephen Smith (2000), and Poddar, Satya (1990).

²⁵ See Bird and Gendron (1998).

²⁶ See Poddar, Satya, Eric Hutton, (2001).

²⁷ The PVAT mechanism as originally developed by the authors entailed a prepayment of the destination state VAT before the goods are shipped. However, under a harmonized Dual GST, such prepayment may not be necessary. There would be enough safeguards in the system to enforce payment of tax on inter-state supplies at the same time as on intra-state supplies.

tax collected on inter-state supplies would be that of the destination state and remitted to that state by the vendor. On intra-state supplies, the tax collected would be that of the origin state and paid to that state.

Buyers who are GST registrants (in B2B transactions) would have a strong incentive to ensure that the vendor properly applies the destination tax, which would then be creditable against their output tax in the state of destination. Otherwise, the goods would be subject to the tax of the origin state, which would not be creditable in the state of destination.

Most supplies of services and intangibles to consumers and other exempt buyers (in B2C transactions) would be taxable in the state of origin, without the benefit of zero-rating. However, inter-state shipments of goods to consumers would be zero-rated in the state of origin and attract the tax of the destination state (including, for example, mail order supplies of goods). An inducement could be created for consumers also to ensure that the vendor charges the destination state tax on such shipments. This could be done by imposing a self-assessment requirement in the destination state on any inter-state purchases on which the vendor has not charged and remitted the destination state tax.

The PVAT mechanism establishes the output-tax-and-input-credit chain for inter-state transactions and, thereby, strengthens the audit trail property of the VAT system. Unlike the system of zero-rating, it creates strong incentives for both the origin and the destination states to monitor compliance independently of each other, as revenues of both are affected by the zero-rated sales declared by the vendor. This is a unique feature of PVAT, and perhaps it is most significant. Under the traditional system of zero-rating, the quantum of zero-rated sales reported by the vendor affects the revenues of the origin state, but not of the destination state. PVAT creates a simple and effective link between the two.

7. Harmonization of Laws and Administration

The need for Centre-State and inter-State harmonization is paramount under the Dual GST. The ultimate goal would be a unified base and one set of rules for the two taxes.

What should be the mechanism for achieving this harmonization? Different options have been adopted in other federations or trading blocks. At one extreme is the example of Australia where the GST is imposed and administered as a single unified tax levied by the national government. All the revenues from the tax are then distributed to the states. Another such example is that of Harmonized Sales Tax (HST) in Canada, which is levied in three of the ten provinces. The tax is levied and administered under a unified law by the national government, much like the Australian GST. The key difference is in the revenue allocation system. Under the Canadian system, provincial participation in the HST is elective, not mandatory. The tax is levied at the national rate of 7 percent (now reduced to 5%), which is increased by 8% percent in those provinces which have elected to participate in it. The revenues attributable to the supplementary rate of 8 percent are then distributed among the participating provinces on the basis of a statistical calculation

of the tax base in those provinces (which approximates the revenues they would have collected if they had levied a separate tax of their own). In Australia, there is no State “participation”. The tax is a federal tax that is distributed to the States under a political agreement. The revenues are distributed as grants to the States, taking into account factors such as fiscal capacity and need of individual States. In terms of the operation of the law, the enactment of the law, and the jurisdiction of law, it is exclusively a federal tax.

The system in the Province of Quebec in Canada offers another model of harmonization of the national and sub-national taxes. Quebec levies a goods and services tax, called Quebec Sales Tax (QST), the legislation for which follows very closely the model for the federal GST. The two taxes have the same base, definitions, and rules, but levied under two separate statutes. To ensure harmonization of administration, the two governments have entered into a tax collection agreement under which the collection, administration and enforcement of the federal GST is delegated to the provincial government. The agreement defines the role and responsibilities of the two governments and the policies and procedures to be followed in administering the tax. The federal government retains the power to make any changes in the legislation and to issue rulings, and interpretations, which are adhered to by the province in administering the federal GST. In practice, the province accepts the federal rulings and interpretations for both GST and QST, given the similarities in the two statutes.

The EU model is yet another example. This model is quite distinct from the Australian and Canadian models. The focus in the EU model is on minimization of distortions in trade and competition, and not on harmonization of administration. Thus, the VAT base (subject to continuing derogations) is harmonized, as are the basic rules governing the mechanism and application of VAT (time of supply, valuation, place of supply etc). The rates are harmonized only within broad bands (e.g., the standard rate may not be less than 15%) and administration is largely a matter for the member states to decide (but must respect basic principles such as neutrality).

As noted earlier, the CST in India also offers an interesting model of the harmonization mechanism. The CST law is central, but the tax is administered and collected by the States. Indeed, this appears to be most suitable model for India. The GST law for both the Centre and the States would be enacted by Parliament under this model. It would define the tax base, place of taxation, and the compliance and enforcement rules and procedures. The rates for the State GST could be specified in the same legislation, or delegated to the State legislatures. The legislation would empower the Centre and the States to collect their respective tax amounts, as under the CST.

If the governments fail to reach a political compromise on the CST model, the Quebec model would appear to be the next best alternative. It respects fiscal autonomy of the two levels of government, yet facilitates harmonization through the mechanism of binding tax collection agreements between the Centre and the States. These agreements would, in turn, encourage adoption of a common GST law.

The Centre can play an important role of providing a forum to discuss and develop the common architecture for the harmonized administration of the two taxes. It would have responsibility to develop policies and procedures for GST, in consultation with the Empowered Committee, e.g., on the place of supply rules, taxpayer registration and identification numbers, model GST law, design of tax forms and filing procedures, data requirements and computer systems, treatment of specific sectors (e.g., financial services, public bodies and governments, housing, and telecommunications), and procedures for collection of tax on cross-border trade, both inter-State and international. The proposal made by the Empowered Committee (for delegation of administration of the Centre GST for smaller dealers to the States) is very similar, even though the contractual framework for it is yet to be developed.

8. Conclusion

The Empowered Committee describes the GST as “a further significant improvement – the next logical step - towards a comprehensive indirect tax reforms in the country.” Indeed, it has the potential to be the single most important initiative in the fiscal history of India. It can pave the way for modernization of tax administration - make it simpler and more transparent – and significant enhancement in voluntary compliance. For example, when the GST was introduced in New Zealand in 1987, it yielded revenues that were 45% higher than anticipated, in large part due to improved compliance. Its more neutral and efficient structure could yield significant dividends to the economy in increased output and productivity. The Canadian experience is suggestive of the potential benefits to the Indian economy. The GST in Canada replaced the federal manufacturers’ sales tax which was then levied at the rate of 13% and was similar in design and structure as the CENVAT in India. It is estimated that this replacement resulted in an increase in potential GDP by 1.4%, consisting of 0.9% increase in national income from higher factor productivity and 0.5% increase from a larger capital stock (due to elimination of tax cascading)

However, these benefits are critically dependent on a neutral and rational design of the GST. The discussion of selected issues in this paper suggests that there are many challenges that lie ahead in such a design. The issues are not trivial or technical. They would require much research and analysis, deft balancing of conflicting interests of various stakeholders, and full political commitment for a fundamental reform of the system.

Opportunities for a fundamental reform present themselves only infrequently, and thus need to be pursued vigorously as and when they do become available. As the choices made today would not be reversible in the near future, one needs a longer-term perspective. Achieving the correct choice is then a political economy balancing act that takes into account the technical options and the differing needs and constraints of the main partners. Fortunately, there is a very substantial consensus among all stakeholders in the country for a genuine reform. In the circumstances, an incremental or timid response would be neither politically expedient, nor would it serve the needs of India of

the 21st century. Experience of countries with modern VATs, such as New Zealand, Singapore, and Japan suggests that a GST with single-rate and comprehensive base can be a win-win proposition for taxpayers and the fisc alike.

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