Will a True GST Ever Come to India?

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Abstract
India considers the introduction of a uniform, comprehensive Goods and Services Tax (GST) extending through the retail stage and levied concurrently, albeit independently, by the Centre and the States. This requires a constitutional change that would allow the Centre to tax wholesalers and retailers and States services. So far, however, States insist that various items, such as petroleum products, immovable property, electricity and alcohol, should be excluded from the new GST-base. Exclusion would cause serious economic distortions and raise complex administrative and compliance issues. To allow the Centre and the States access to the full GST-base, this paper proposes to separate the empowerment issue (who should tax?) from GST-design issues (what should be taxed?). In addition, it recommends abandoning the idea of a uniform GST for the Centre as well as the States that already have a VAT on goods with a dual-rate structure. Instead, following the resolution of the empowerment issue, it is suggested that the Centre should proceed to introduce a broad-based best-practice GST modelled on the New Zealand and South African example. The States could emulate the Centre’s model or adopt their own version of a best-practice GST. Finally, an integrated GST to tax transactions between States is not needed. Broadly, this resembles the route that Canada successfully took in solving intergovernmental tax assignment issues.

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1. **Introduction**

India’s system of indirect taxation at the central and state level is a serious obstacle to the formation of a single common market in which businesses source anywhere, manufacture anywhere and sell anywhere. Its complexity is baffling and its incidence highly capricious and indeterminate. The system’s multiple tax-on-tax effects cascade throughout the production-distribution chain with harmful economic consequences. These effects are compounded by the lack of coordination between various forms of indirect taxation (sales taxes, excise duties, import duties) and between different levels of government (Centre vs. States, and States vs. other States), as well as by the uneven enforcement of the respective tax administrations.

At the state level real progress has been made through the introduction of value-added taxes (VATs), but unfortunately the Constitution prescribes that the VAT-base must be confined to goods. Further, interstate exports continue to be subject to Central Sales Tax (CST) in violation of the common market principle. The Centre levies an extended system of excise duties at the manufacturers’ level. Again, the Constitution does not allow the system’s extension through to the retail level. Further, the Centre also taxes services under an excise type of approach, i.e. selectively, without integrating the levy with the taxation of goods. Beyond that, the Centre and the States both collect a fast array of revenue and stamp duties, which resemble cascading turnover taxes. Traditional excisable activities are levied by the States (drinking, gambling), the Centre (tobacco), or both levels of government (petroleum products, motor vehicles). It may be surmised that, without reason, the effective tax burden on various goods and services varies widely across India.

Many expert analyses have been made of the system’s shortcomings but so far no real breakthrough has been achieved. The Empowerment Committee of State Finance Ministers charged with the reform process, the Thirteenth Finance Commission, and various think tanks and scholars have written superb reports on the design of a best-practice GST. Most proposals call for the introduction of a broad-based dual-GST, levied concurrently by the Centre (CGST) and each of the States (SGST). In addition, most reports insist that the base of the CGST and the SGSTs should be identical, although independently administered, and that uniformity of assessment and collection procedures should be pursued.

As the discussions between the Centre and the States evolve, there appears to be agreement that services should be included in the GST-base on a comprehensive basis. But the States insist that petroleum products, immovable property, electricity and alcohol, which are important sources of revenue for them, should be left out of the

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1 Basically, a GST is identical to a VAT, but in India the consumption taxes of the States are called VATs, while the acronym GST, which stands for Goods and Services Tax, is reserved for the broad-based consumption tax proposed for the Centre (CGST) and the States (SGST). Throughout this paper, references to ‘States’ should be deemed to include ‘Union Territories.’

2 See, among others, Empowered Committee (2005 and 2009), Thirteenth Finance Commission (2009), and Poddar and Ahmad (2009). Much early pioneering work was done by a team under the able leadership of Amaresh Bagchi (1994).
GST-base, although this would seriously jeopardize the efficiency gains of the reform. In fact, the empowerment issue (who should tax?) has become entangled with GST-design issues (what should be taxed?) to the detriment of sound tax policy. In this author’s view, the only way out of this dilemma is to separate the empowerment issue from GST-design issues. Both the Centre and the States should be allowed to tax all goods and services under their GSTs, including imports and excisable goods. But, in contrast to other recommendations, this author does not believe that the tax bases of the CGST and the SGSTs (and the administrative procedures) should be identical, although approximation (and cooperation) would be useful.

Following the resolution of the empowerment issue, the Centre should proceed to introduce its own GST on as broad a base as possible and apply a single, uniform low rate of, say, 5 percent. It would then be up to the States to introduce a similar GST (mainly by extending the coverage of the existing VATs to services), piggyback their GST to the Centre’s GST (in other words, ask the Centre to collect the SGST for them), or retain their current VAT. In view of the Centre’s compliance control over all GST transactions, there would be no need for an integrated GST (IGST), which would not yield any revenue, but merely increase administrative and compliance burdens.

This is exactly the way the constitutional logjam was addressed in Canada. After an abortive attempt to harmonize the federal manufacturers’ sales tax and the provincial retail sales taxes (RSTs), the federal government went ahead and introduced its own broad-based GST. Subsequently, Québec adopted its own independently administered GST based on the federal example (it also collects the federal GST and transfers the proceeds to Revenue Canada). Ontario and three Atlantic provinces decided to piggyback the federal GST in the form of a surtax collected by the federal GST administration. This tax is called the Harmonised Sales Tax (HST); its revenue is allocated to the HST-provinces on the basis of consumption statistics. Thus, inter-provincial exports do not have to be zero-rated unlike exports from Québec whose inputs have been subject to its provincial GST. Four provinces have retained their retail sales tax (RST), while oil-rich Alberta stayed out of the GST/HST/RST game altogether. This arrangement provides maximum taxing autonomy for the provinces (particularly Québec), does not interfere with inter-provincial trade (there is no IGST), and minimizes (extra) administrative and compliance costs (particularly for HST provinces) – all under the compliance-control umbrella of the federal GST.3

The remainder of the paper dwells in greater detail on each of the major issues raised above. To set the stage, the second section surveys and evaluates India’s current indirect tax system − sales taxes, excises and import duties − at the central and state level. Following, the third section discusses the objectives and criteria that should govern the design of the GST and the excise duties, whether levied by the Centre or the States. It emphasises that the tax assignment rules have to be changed to meet the requirements of a modern single market. In fact, it would be better to wait with the introduction of the dual-GST than to try to design it without rationalizing the empowerment issue. Subsequently, the fourth section examines the implications of the criteria and objectives for the design of the bases and rate structures of the CGST and the SGSTs. Also, it attempts to shed some light on GST coordination issues between the States. The fifth section deals with traditional excise duties, which can be important.

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3 For more on the Canadian situation, see Bird and Gendron (2010) and Smart and Bird (2012).
exchangeable revenue tools, and the luxury goods taxes levied by the States. The sixth section summarizes the main findings and concludes with some final thoughts.

2. Existing System of Indirect Taxation

This section reviews and evaluates the tax systems of the Union and the States. For this purpose, table 1 lists the taxing powers vested in the Union and the States, divided into the broad categories found in tax classifications used by, e.g. the OECD, the IMF and the World Bank, but listed in reverse order in view of the topic of the paper. Widely agreed criteria – neutrality, equity and feasibility – are applied to evaluate the various taxes and duties.

a. General taxes

More or less general taxes on goods and services comprise the central excise duties (CENVAT) and the tax on some one hundred services which, by default, are taxed by the Centre,\(^4\) plus the taxes on the sale and purchase of goods (VAT) levied by the States.

CENVAT is collected from manufacturers, generally at rates of 8 percent or 16 percent. The tax on consumer goods is mostly imposed on presumptive retail values, because the Centre is constitutionally barred from taxing actual distribution margins. To prevent cascading, a tax credit is allowed for the tax paid on inputs, but the tax on capital goods has to be spread over a 2-year period. Services attract tax at 12 percent, but there is no credit for the tax on inputs. Also, the tax on services cannot be credited against the CENVAT.

Under their VATs, States tax goods for their full value up to the consumer stage, but basic necessities and goods of local importance are exempted. The standard rate is generally 12.5 percent, but a lower 4 percent rate applies to essential items and industrial inputs. One percent is payable on precious stones and metals. Effective rates differ between States on account of differences in surcharges and cesses. Petroleum products, electricity and alcohol are not subject to VAT but to excise duty. A tax credit is available for prior-stage VAT, but not for the CENVAT which is included in taxable value. The VAT was recommended by the Empowered Committee, but according to the Auditor General of India (2010, p. v) there are “wide scale differences between the basic design proposed in the White Paper and the corresponding provisions included in the different State VAT Acts and Rules.” By implication, VATs should differ between States.

The Union’s CENVAT, imposed through the manufacturing stage, does not include actual trading margins in the tax base. Instead, excise duty is levied on presumptive retail values which may differ widely across the country. Given the same rate, therefore, the tax discriminates against products sold below their presumptive values and in favour of goods whose value is higher. Accordingly, the effective tax rate (the tax as a percentage of retail price) differs even with regard to the same product. The excise tax system’s cascading effects have been mitigated by permitting a credit for taxes on

\(^4\) Under Entry 97 in the Constitution which assigns the residual taxing powers to the Union (see table 1).
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**Table 1. Union and State Taxing Powers**
inputs, but other cascading effects remain, particularly regarding producer goods, such as road transport, office equipment, computers and similar items bought by non-taxable wholesalers and retailers which cannot get a tax credit for them.

The reach of both the CENVAT and the services tax is unnecessarily limited by the enumeration of taxable goods and services rather than the taxation of all goods and services (except those explicitly exempted), which would promote equal treatment and accord best with administrative feasibility. An important shortcoming, too, is that imports are not included in the domestic tax base. This can be corrected by subsuming a CENVAT-equivalent customs duty in the import duty proper, but this blurs the important difference in the role that each tax plays in the tax system. Last but not least, vexatious valuation and legal issues arise under the CENVAT, because presumptive values tend to be disputed, while the definition of what constitutes manufacturing is not always easily made, e.g. in the case of products whose value derives mainly from brand names owned by non-taxable entities.

The exclusion of services is a serious shortcoming of State-VATs and so is the selective taxation of services under the CENVAT. While services were few and could be easily defined at the time the Indian Constitution was drafted, presently they contribute a sizable portion of the nation’s product. It is widely agreed that services should be taxed under the CGST and the SGSTs, while a comprehensive approach is preferred over a selective approach which is not found in other countries with a best-practice GST/VAT. These GSTs/VATs include all services in the base, including laundry and dry cleaning, personal care services, hotels and restaurants, amusement and entertainment, the supply of electricity and gas, telecommunication services, public transportation of passengers, transportation and storage of goods, leasing and letting of movable property as well as immovable property (except residential premises), repair and maintenance of movable immovable property (including residential premises), engineering and architectural work, publicity, advertising, marketing and administrative services, legal, accountancy, consulting and other professional services, and, last but not least, the transfer and exploitation of copyrights, trademarks and other proprietary rights.

b. Revenue and stamp duties

Further, the Centre and the States tax various specific goods, services and activities, mainly for revenue reasons. Thus, the Centre imposes tax on transport, stock exchange transactions, newspapers and advertisements. In addition to advertisements, the States also raise revenue from selective taxes on electricity, animals and boats. In most best-practice GST-systems, these taxes would be subsumed by the GST. Most revenue duties tend to be nuisance levies, i.e. the bulk of the revenue that they raise goes to pay for the administrative machinery installed to collect them. This may not be true of taxes on electricity which can be important revenue-raising instruments and for taxes on entertainment which are used to finance local governments.

Stamp duties regardless of on what legal documents (bills of exchange, bonds, leases, marketable securities, etc.) they are imposed are archaic levies that should be abolished – the sooner the better. If imposed widely, stamp duties can be compared with

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5 These and other problems were also noted regarding Canada’s federal manufacturers sales tax, which was levied prior to the introduction of the GST. For arguments why manufacturers’ sales taxes are inferior to comprehensive GSTs, see Cnossen (2012).
multistage turnover taxes because they are levied whenever (successive) transactions are documented. Consequently, they suffer from the same cascading effects. Often, the revenue from stamp duties does not match the cost of collecting them. The duties, moreover, can easily be avoided by changing the form of business arrangements. Evasion is possible by misstating values, by using fake stamps or none at all, particularly of small transactions. Not surprisingly, modern tax systems do not have them, but have folded them into the GST.

c. Traditional excise duties
Of the traditional excise duties, the Centre imposes duty on tobacco, while the States tax alcohol and gambling. Petroleum products and motor vehicles are taxed by both levels of government, either explicitly or under the manufacturers’ excise tax. In addition, the States impose tax on luxury goods. In contrast to a best-practice GST, excisable goods are not included in the VAT bases of the Centre and the States. As argued below, traditional excise duties, which tend to be revenue-productive, are important elements in the reform of a rational tax system in India, because they introduce additional flexibility in the range of taxing powers available to the States and the Centre.

d. Taxes on national and international trade
Taxes on national and international trade must also be brought into the picture, because imports, whether from third countries or other States, should be included in the union and state VAT and excise tax bases, which is not now the case. Import duties are levied by the Centre at an average rate of approximately 24 percent (subject to CENVAT credits, if applicable). Central Sales Tax (CST), not allowed as credit against State-VATs, is imposed on interstate exports at the rate of 2 percent. Concurrently, a tax is levied on the purchase or consignment of goods in the course of interstate trade or commerce. Finally, there are entry taxes into local areas (octroi).

Common markets and federations stay away from taxes on the sale or purchase (or consignment) of goods in the course of inter-state trade or commerce, because these taxes violate the principle of free trade in a single market. The same applies to taxes on the entry of goods into a local area for consumption, use or sale. Tolls are acceptable if they charge for the cost of road and waterways, but not if they are imposed on trade and people in general. Further, in the pursuit of trade liberalisation, import duties are being phased out under the auspices of the World Trade Organization (WTO). To protect the revenue that they raise, most countries embed them in their GSTs by increasing the latter’s rate.

f. Conclusion
All of the above taxes enter into the discussion on the most appropriate GST system either because they should be subsumed by the CGST and SGST (revenue duties), their role should be rationalized and strengthened (excise duties), they should be included in the domestic tax bases (imports and excisable goods), they should be abolished (taxes on interstate trade and stamp duties), or because they should be retained as local sources of revenue (taxes on entertainment).

The remaining tax categories – taxes on property and taxes on income, profits and capital gains – are shown, because the design of the CGST and SGST should be viewed in the context of the entire tax system. It will be noted that the power to tax income,
other than agricultural income, is vested in the Centre. In other words, the Centre, unlike the States, has an important taxing instrument to pursue equity objectives. In turn, this implies that measures to mitigate the regressivity and promote the progressivity of the State-VATs and excise duties deserve attention.

3. Objectives and Criteria for Reform

The selective and haphazard approach to the taxation of goods and services, described above, indicates that serious reflection on the principles of taxing goods and services, whether generally (GST) or specifically (excise and customs duty) is required before embarking on specific reform proposals.

a. General considerations

GSTs must be distinguished from excise duty systems which can be defined to encompass the traditional taxes on tobacco products, alcoholic beverages, petroleum products, motor vehicles and pollutants, as well as the non-traditional duties on items regarded as luxuries and other goods and services selected for specific taxation – whether imported or produced domestically. The basis of assessment for traditional excise duties is often some quantitative amount, for example, volume, weight or strength, to which a specific rate (an absolute amount per unit of measurement) is applied. Usually, the duties are levied at the manufacturing stage, primarily because the basis of assessment and the higher rates require some form of physical control over production. This contrasts with GSTs which are imposed on actual transactions and prices throughout the entire production-distribution chain, and whose compliance is monitored through accounting controls.

Furthermore, GSTs must be distinguished from duties on imports, which, generally, are levied at \textit{ad valorem} rates (except imports of excisable goods). Similar to excisable goods, imports are subject to physical controls and goods are not released before duty has been paid or adequate surety provided. Taxpayer cooperation, essential for the adequate functioning of a GST, generally is not required. In sharp contrast to the GST too (but similar to excise duties), collection arrears do not arise. In theory, import duties should not be used as a major revenue source, because of their non-neutral effects, although, exceptionally, a small number of carefully designed duties may be used to provide protection to infant industries that cannot yet compete with foreign firms.

Logically, in terms of coordination, the allocative role of the import duties should be given priority over the externality-correcting role of the excise duties and the revenue role of the GST. Protective import duties create a level playing field between domestically produced commodities and foreign goods. Secondly, the social cost of the use or consumption of harmful goods should be internalized in price through the application of selected excise duties on domestic as well as imported goods. And lastly, the GST should be used to apply equally to all goods and services, whether imported or of domestic origin, harmful or not. Consequently, excisable imported goods should be included in the domestic excise tax base along with domestically produced goods, while

\footnote{This definition of excise duties goes beyond the usual Anglo-Saxon definition of excises as taxes imposed on the manufacture, sale or consumption of certain domestically produced goods. For an extensive treatment of excise duties, see Cnossen (2005).}
all imports and all excisable goods, imported or not, should be included in the domestic GST-base. This means that the import duty should be imposed on the import duty c.i.f. value of goods, that the excise duty should be imposed on the import-duty inclusive value of excisable goods, and that the GST should be levied on the excise-and-import-duty inclusive value of goods.

This discussion of the role of each of the indirect taxes in the overall tax system implies that the GST should not be used to protect domestic industry, because that role, if any, should be assigned to the import duty proper. Similarly, the GST should not attempt to differentiate against socially harmful activities since better targeted excise duties should be used for that purpose. Also, the GST should not try to influence the tax burden distribution, because the income tax (and expenditure system) is better placed to pursue that goal. Further, the GST should not be used to promote one industry or activity over another, again because the income tax and/or expenditure programs are better equipped to serve that end.

b. What is a best-practice GST?
Against this background, the following features may be said to be characteristic of a best-practice GST.\(^7\)

- The GST is a multistage transactions tax that covers all stages of production and distribution, including the retail stage. The GST threshold (often called small-business exemption) is the criterion for determining whether or not a business firm is liable to GST – not the stage at which the firm conducts its transactions. For this reason, the CENVAT, which excludes wholesalers and retailers from tax coverage, is not a best-practice GST, although it has a similar tax credit mechanism.

- A best-practice GST includes all goods and services, domestically produced or imported, in its base, unless specifically exempted. This implies that the taxation of services is fully integrated with the taxation of goods. Admittedly, a GST which enumerates a broad range of services that are taxable may not differ much from a GST which taxes all services (and lists those that are exempted), but in practice enumeration involves delineation problems which a true VAT avoids. The Centre’s tax on services is at odds with this point.

- The GST eliminates cascading or cumulative effects by allowing taxable firms a full and immediate tax credit or deduction for the tax paid in respect of inputs (purchases), whether intermediate products or capital goods, from other taxable firms, against their own GST payable on sales. (The 2-year phase out of the tax on capital goods violates this rule.) In principle, the right to a tax credit arises at the same time that the taxable supplier has to account for the GST on sales. Accordingly, no good or service anywhere within the taxable production-distribution chain has GST attached to it and inventories are held fully free of GST.

- Furthermore, the GST is destination-based, that is, goods and services are taxed in the country or state of destination or consumption, not the country or state of

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\(^7\) For a primer on GST/VAT, see Chossen (2009).
origin or production. This means that the GST on inputs for exports to third
countries or other states is refunded without delay (in other words, exports are
zero-rated) and that domestic purchasers of imported goods and services receive
an immediate credit (and refund, if necessary) for the equivalent GST levied at
the import stage. The CST does not meet this criterion.

- A best-practice GST limits administrative and taxpayer discretion to a
  minimum. End-use exemptions, e.g. an exemption for tractors used by farmers,
  are frowned upon, as well as exemptions for products that are subject to another
tax (electricity and petroleum products, for example) or products bought by, say,
government agencies. Basically, taxable suppliers should always charge GST,
regardless of the status of the purchaser.

- The GST is based on self-assessment. Taxable persons file returns and pay GST
  at their own initiative in accordance with their statutory obligations. It is
  important, therefore, that the GST is easy to comply with and that it interferes as
  little as possible with the free functioning of business and trade. For this
  purpose, it should be closely attuned to actual business transactions and
  accounting methods. This should keep the costs of complying and enforcing the
  GST as low as possible. Under a GST based on self-assessment, the tax
  administration’s task should be confined mainly to providing taxpayer
  education, monitoring late filers and late payers, and auditing taxpayers’
  accounts. In short, classification and valuation methods for assessing CENVAT
  would become redundant.

- For administrative reasons, the GST should exclude small firms, which tend to
  have less reliable books of account, from registration. Although a GST is simple
  to comply with – basically requiring a spike on which sales invoices can be
  pinned and one on which purchase invoices can be put – full compliance control
  requires a cash and bank book from which a balance sheet and profit and loss
  account can be drawn up. These accounts might be difficult to maintain for
  illiterate traders. Hence, these traders should be exempted, although an option
  for tax should be provided for small traders that wish to pass their GST on
  inputs on to registered firms. These considerations imply a much larger small-
  firm exemption than prevalent in other countries with high literacy levels and
  which can ensure GST compliance control in conjunction with the business
  income tax. The proposed threshold of 10 lakh is way too low.

c. **Principles of excise taxation**

While the GST’s role is to raise revenue, the main function of the excise duties is to
enhance social and market outcomes (although the revenue is a most welcome side
effect, of course). Seven points can be identified that may be kept in mind to attain this
objective.

- Excise duties should improve the allocation of economic resources by
  internalizing the external costs associated with the consumption or production of
  the excisable products. External costs are the financial, physical or
  psychological costs that smoking, drinking, gambling, polluting and driving
  impose on other people without being charged, directly or indirectly, to the
  perpetrators (for example, through higher insurance premiums). Charging
consumers or producers for external costs should induce them to reduce their activities to the socially optimal level. Accordingly, traditional excise duties should not be subsumed by the GST.

- The presence of external costs implies a preference for specific as opposed to ad valorem duties. The damage caused by socially harmful activities is at any point in time independent of the price at which the products are sold, so that correction of externalities, which implies an absolute monetary amount, favors specific over ad valorem taxation. This specific tax can be imposed at the manufacturer’s or importer’s stage where it is easiest to collect. Of course, further choices have to be made about the precise form of the duty, for example, whether it should be levied on the basis of the number of excisable products, their weight, content or volume, or some combination of these attributes. Specific rates should be indexed for inflation.

- If excise duties cannot adequately control for external costs, they should be supplemented by regulations. Tobacco excise duties cannot prevent second-hand smoke from harming non-smokers, but smoking bans in public areas can achieve this goal. Similarly, alcohol duties cannot prevent inebriated people from getting behind the wheel of their car, but drunk-driving tests are more successful.

- Externality-correcting excise duties should be levied on consumer as well as producer goods, whichever generates the externality. A carbon dioxide levy, for instance, should be imposed on both kinds of goods (including, say, industrial fuels) depending on the source of the pollution. By contrast, revenue-raising excise duties should not be imposed on producer goods since this is more distortionary than imposing them on consumer goods.

- Since excise duties are imposed to account for external costs, imported excisable products should be taxed at the same rate as domestically produced items. Excise duties at import should not be used to protect domestic industry, which is the non-revenue function of import duties.

- Excise duties should not be raised beyond the level of external costs if the marginal cost of collecting them is higher than for other taxes. If a country has a well-administered GST, the rate of that tax should be increased if more revenue is needed. If administrative capacity is limited, however, excises may have to be raised beyond the level of external costs. In India, excise duties on tobacco, alcohol, petrol and motor vehicles are good potential sources of revenue.

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8 Ideally, this would be achieved by imposing an excise duty equal to the marginal cost of the damage caused to other people. Marginal costs are often difficult to identify and measure, however, because they depend on who does what, where, and under what circumstances. In practice, therefore, average external costs are estimated and a ‘pooling’ approach (akin to insurance) is adopted in charging for these costs. A uniform excise is then calculated as the total external costs divided by, say, the number of packs of cigarettes, drinks consumed, or liters of gasoline used.

9 This contrasts with the recommendation of the Thirteenth Finance Commission (2009, p. iii) which suggests that industrial fuels should not be subject to excise duty.

10 In the tax literature, this is known as the Diamond/Mirrlees (1971) theorem.
because the products are easy to identify, the volume of sales is high, and the fact that there are few producers – wine excepted – simplifies collection. Also, there are few substitutes that consumers would find equally satisfactory, so that consumption, and by extension revenue, do not fall despite excise-induced prices rises.

- The foregoing considerations do not apply to excise duties imposed to improve the progressivity of the tax system. Such excises should be imposed at *ad valorem* rates on income-elastic items of consumption that are regarded as proxies for ability-to-pay. Luxury goods taxes are indicated if there are limitations on administrative capacity in enforcing the income tax which being comprehensive should do a better job in taxing according to ability-to-pay.

### d. Which way forward?

Above it has been argued that the empowerment issue (who should tax?) should be separated from GST-design issues (what should be taxed?), because a prerequisite for meaningful reform is that both the Centre and the States should have access to the full GST-base. The CGST, applicable to all goods, should extend down to the retail stage and encompass all services. Likewise, the SGST, applicable to all goods, should include all services in its base. Further, the CGST should include all third-country imports and excisable goods in the base, while the SGST, in addition, should include goods and services supplied by out-of-state firms in its base. Full access to the GST-base by both the Centre and the States would avoid contentious discussions about the power to tax various parts of the base. Instead, the level of the GST-rate rather than its base would be the subject of negotiations between the Centre and the States. While the CGST-rate would be uniform for the whole country, the SGST-rates could vary between States, although a maximum rate should perhaps be agreed to, so that States would not fully pre-empt the GST domain of the Centre and vice versa.

Various reports and authors have emphasized the desirability of introducing uniform GST statutes, procedures, forms, methods and organizations for the Centre and the States. This would minimize conflict, ease interpretation issues, and generally make GST-life easier for registrants. By and large this is true, but the aim ignores the fact that States have already introduced their own VATs, different from each other, and, perhaps more importantly, that best-practice GSTs should differ from one State to another State. States whose economy is mainly agricultural will want a somewhat different GST from States whose economy is largely industrial. States that have a well organized trade sector can perhaps do with a somewhat lower threshold than States with many small establishments. Further, the effective GST in States with wide-scale evasion is different from the GST in States with a high level of tax compliance.

On this basis, this author believes that India would not be served by fully identical GST-systems, at least initially. Such a system would be very time-consuming to negotiate and might not suit differing conditions and preferences. Also, it might lock the Centre and the States into an undesirable system, de facto subject to unanimity

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11 According to the Thirteenth Finance Commission (2009, p. 2): "... the VAT, like its predecessor Sales Tax continues to be characterised by narrow bases, plethora of exemptions, multiple rate structures and cascading effect on account of breaks in the input-credit chain. The introduction of VAT is, at best, a toddler’s tentative step towards indirect tax reform."
requirements like the EU’s common directive, which has not been changed since 1977 and is in danger of becoming an anachronism. Instead, the Centre should endeavor to design and implement a full best-practice GST modeled after, say, the New Zealand and South African GST. The CGST should be a model for the States to emulate if they wish to do so, but no doubt State GST-reform would take many more years than the introduction of a Centre GST. This would and probably should be a process of learning by doing. Reform would be easier with an overarching best-practice GST at the central level.

Last but not least, the independent role of the externality-correcting excise duties should be maintained and strengthened.

4. Implications for GST design

The criteria for a best-practice GST have implications for GST-design, which are discussed below. In considering the base and rate issues, it should be remembered that experience shows that governments get only one chance to do it right: at the beginning when the GST is introduced. Once the GST is in place, attempts to change it tend to be futile. This section dwells on a few issues which are common to the CGST and the SGSTs, namely the treatment of services, exemptions, rate aspects, and intergovernmental coordination issues.

a. Treatment of services

In considering the taxation of services, it should be emphasized that no satisfactory borderline can (or should) be drawn between goods and services on philosophical, economic or legal grounds. Both kinds of commodities satisfy consumer wants. Often, services are readily substitutable for goods and vice-versa. Hence, compliance and administration are greatly eased if both are taxed at the same rate. Taxing services comprehensively, like taxing all goods, obviates the need for fine legal distinctions that add to administrative complexity, keep people busy, but generate no revenue. Services should only be exempted if there are weighty social considerations (health care, education) or decisive administrative reasons (banking, insurance, rents and rental values). The bottom line is that a GST functions best if all goods and services are taxed and equally, if, subject to the small-business exemption, all persons selling such goods or services are liable to GST.

There are also weighty social and economic arguments for the comprehensive taxation of services. First, since the consumption of services as a percentage of income tends to rise faster than income, the inclusion of services would have a progressive incidence. Secondly, omitting services from the VAT-base means that the VAT-rate on goods must be higher to raise the same amount of revenue; this increases the excess burden of the VAT. Thirdly, as economic development proceeds, productivity gains are likely to be larger in the industrial sector than in the services sector. It would then not be good tax policy to tax the economic gains in the industrial sector higher than is necessary. Fourthly, efficiency is promoted by taxing intermediate services, such as transportation, storage, professional services and communications under the VAT, because the tax on inputs can be passed on to the ultimate consumer and does not become a distortionary element in the tax system. Fifthly, services have become largely indistinguishable from goods implying that tax avoidance and evasion is curtailed by taxing both goods and
services comprehensively. Finally, the integration of professional services into the VAT-base would obviate the need for a separate tax on professions.

Services constitute an important part of national product. In national accounts, services comprise (a) transportation, storage and communications, (b) wholesale and retail trade, (c) banking, insurance and real estate (rents), (d) ownership of dwellings (rental values), (e) miscellaneous services: restaurants, hotels, business services, community, social and personal services, and (f) public administration and defence. In calculating the share of services in national product, wholesale and retail trades would have to be excluded, because their value is already included in the base for goods of the State VAT and the CENVAT’s presumptive retail value base. The same applies to intermediate services provided to business (for which a tax credit should be available if they are taxed). Banks, insurance and the ownership of dwellings would only be taxed partially (rental values through the tax on new dwellings). Further, most social services would be considered outside the GST-base, while any tax on inputs for public administration and defence would be in the nature of an in-and-out transfer, and, hence, not yield any net revenue. On the other hand, the portion of electricity, gas and water (considered industry in national accounts) purchased by consumers should be added. If allowance is made for these items, consumer spending on services in India would probably comprise 20-25 percent of national product. This is too large a proportion of national product to be ignored under a comprehensive GST.

b. Exemptions

Exemptions violate the logic and functionality of the VAT. It does not make sense and is highly inefficient to define the tax burden on a particular product as the tax on the value of its inputs rather than in terms of the final consumer or user price. Exemptions involve double taxation for upstream firms (the tax on inputs cannot be passed on) or undertaxation for firms selling at retail (the value added beyond the inputs is not taxed). They inhibit outsourcing, say of food, cleaning and administrative services, and harm exports due to the tax on inputs which cannot be rebated.

How should food be treated?
The most contentious issue under any GST is the treatment of food. Under a best-practice GST, food should not be exempted. Experience in South Africa, for instance, shows that in money terms the rich benefit six times as much from an exemption for food than the very poor (Katz Commission, 1994), because they buy more expensive varieties of food, eat out more often, and tend to throw more food away. Incidence studies in other countries, developing and developed alike, reach similar conclusions. Taxing basic foodstuffs at the standard rate would raise an amount of revenue far in excess of what would be needed to offset the regressive impact of the VAT on low-income households. Further, the income tax and the social benefit system are better targeted instruments to help the poor. So are government expenditure programs on health, education and employment. In South Africa, the Katz Commission (1994) concluded that “providing relief to the poor through exemptions and VAT zero rating is likely to be both unsound tax policy and ineffective social policy.”

12 This is lower than the estimate of 54 percent of the Thirteenth Finance Commission (2009, p. 59).

Nonetheless, in countries, like India, with limited capacity to administer a comprehensive income tax and social benefit system, concessionary treatment of food may be the only instrument a government has to mitigate the GST’s impact on the poor. In line with the recommendation of the Thirteenth Finance Commission (2009, p. iii), therefore, this paper recommends that unprocessed food covered under the public distribution system regardless of the outlet through which it is sold should not be taxed. In combination with a high threshold (higher than the proposed 10 lakh), which would automatically exempt food sold through unorganized distribution channels, this should be all that is needed to effect meaningful GST-burden relief for the poor.

In other countries with Anglo-Saxon taxing traditions, GST relief for (unprocessed) foodstuffs is effected by zero-rating rather than exempting them. It is strongly recommended, however, not to follow this route. A zero rate (other than on exports) on food involves a significant increase in compliance costs for businesses, particularly small businesses, which have to register and file returns in order to obtain refunds. Moreover, a firm that deals in products with different rates – for example, a grocery that sells zero-rated milk along with standard-rated soft drinks and snack foods – has to keep separate accounts for the different kinds of items to calculate his GST liability. If this cannot be done, the tax liability must be determined by applying presumptive methods (which, in turn, increases the difficulty of monitoring the taxpayer’s compliance). Further, there is substantial evidence that the increase in compliance costs is distributed regressively with respect to income. Small businesses bear proportionately more of the increase than larger ones and if these costs are passed on to the consumer, the latter might be worse off than under an exemption.

In addition, zero rating increases administrative costs. The number of voluntary registrants is likely to go up because they are anxious to obtain refunds of GST. Refund returns must be monitored with particular care even though no revenue is realized. In the United Kingdom, for instance, the number of voluntary GST registrants on account of the zero rate on food is 13 percent higher than it would be if there was no zero rate (Cnossen, 1994). In addition to using up administrative resources, a zero rate is likely to increase the chance of tax evasion. Not surprisingly, less than 10 percent of all countries in the world with GST have adopted a zero rate for (basic) foodstuffs.

The exemption for unprocessed foodstuffs would imply an exemption for agriculture, fishery and forestry. Some GST would enter into the price of foodstuffs, however, if the inputs to these primary sectors are taxed. Accordingly, the treatment of these inputs is of interest in evaluating the exemption for foodstuffs. Elsewhere feed and seed are widely exempted, but fertilizers, pesticides, equipment and implements are often taxed. To minimize the impact of the GST on exempt foodstuffs further (i.e. beyond the exemption), fertilizers and pesticides might be zero-rated. This would not be advisable regarding equipment and implements in view of their dual nature, i.e. their potential to be used for taxable as well as nontaxable activities.

Other exemptions

Regarding other exemptions, this paper follows the recommendations of the Thirteenth Finance Commission (2009) and the Poddar and Ahmad report (2009).

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14 Externality-correcting excise duties are indicated if the production or use of fertilizers and pesticides is harmful to the environment.
• Administrative and other services provided by central, state and local governments should be exempted. Presumably, taxation of state and local governments, as in New Zealand, by the Centre would not be acceptable to the lower tiers of the civil administration. An issue arises regarding the CGST on purchases by state and local governments which might be rebated by the Centre, i.e. effectively zero-rated. Exemption appears indicated if these inputs are currently taxed under CENVAT. In any case, the exemption should be narrowly interpreted and not extend to public utilities and enterprises, transportation, communications, and commercial departments.

• Most countries with GST exempt health services and education, whether provided by government or non-governmental agencies. Taxation avoids the outsourcing issue but would require an increase in subsidies for government-provided health services and education if the cost and fee level is to stay the same after the imposition of the GST. Prescribed medicines are often exempted along with health services, but freely available pharmaceutical products are often taxed because they are sold along with other taxable products.

• Non-profit organizations should be exempted, except regarding activities, such as food and building services, which compete with private sector activities.

• On administrative grounds, rents and rental values of residential premises, as well as sales of used residential property and land, are universally exempted. But the construction, renovation and repair of immovable property is usually taxed and it is strongly recommended that India should follow this practice. Expenditures on immovable property constitute a sizable part of national product that should not be left out of the GST-base. Moreover, the taxation of new housing and the renovation, maintenance and repair of the existing housing stock is likely to have a progressive incidence. The charge to tax should extend to social housing, because the subsidy mechanism can be used to pay for the GST-induced increase in cost, while taxation would not make it worthwhile for constructors to evade GST by listing taxable building materials under the cost of untaxed projects.

• Financial services are the most difficult to tax under a GST, because the intermediation charge which should be taxed cannot be separated from the rate of interest or return on capital which should not be taxed. All countries with GST or VAT, therefore, exempt financial services. This means that consumers of financial services will be undertaxed but also that business users will be overtaxed because the financial institution cannot pass the tax on its inputs on to these users. For this reason, New Zealand, Australia and Singapore zero rate financial services provided to business users, while they exempt consumer use.

15 By contrast, the Thirteenth Finance Commission (2009) recommends the taxation of rental charges (not rental values) of immovable property also if used for residential purposes. In addition, it recommends the taxation of the sale of residential premises on the difference between the sale price and the cost of acquisition. On feasibility grounds, I find it difficult to support this proposal, although I have recommended it for the EU. See Cnossen (2011). Further, I would exempt land, except if used for building purposes.
Emphatically, there is no case for exempting other goods, services or activities, such as transportation and communications, postal services (which compete with taxable private letter carriers), or cultural services and radio and television broadcasts (which compete with taxable newspapers). Gambling might also be taxed under the GST as well as casualty and property insurance. In both cases the value of the intermediation service should be taxed but not the capital transfer from the contributors to the pool from which payouts are made. This can be done – New Zealand, Australia, and South Africa are examples – by taxing insurance premiums and gambling stakes in full, but allowing a presumptive GST credit to insurance companies or gambling establishments for payouts, and to require business users of insurance to report the payout and the tax in their GST return.¹⁶

Last but not least, as noted above, there are no good arguments to maintain the exemptions for small-scale industries, area-based exemptions, or exemptions for developers in Special Economic Zones. The GST is a tax on consumption, not on business, while the income tax is the best targeted instrument to favour one form of industrial activity over another (although its use for this purpose is not recommended).

c. Rate and threshold aspects

The Thirteenth Finance Commission (2009) has calculated the Centre’s GST-rate using five different methods based on estimates of final consumption or the gross value addition by producers of goods and services with appropriate adjustments for imports and exports. The Commission estimates the revenue neutral rate (RNR) for the CGST at 5 percent and the RNR for the States at 6 percent, for a combined rate of 11 percent. As is well known, the Commission favours a uniform rate for both levels of government which it views as “a collective decision of all States and Centre to harmonize the tax rates, arrived at on the basis of consensus in the Empowered Committee of State Finance Ministers” (Thirteenth Finance Commission, 2009, p...). Currently, however, States have a dual VAT-rate structure and it may be difficult to reverse that decision. So as not to stall progress on the introduction of the CGST and the reform of the SGSTs, it is recommended that the Centre should adopt a uniform rate but that the States continue with their dual rate structures for the time being.

Most reports suggest a GST threshold of 10 lakh (US$20,000) turnover below which businesses do not have to register, but would unnecessarily clog the administration small taxpayers. An appropriate exemption should be four or five times higher if the GST administration is to be manageable.¹⁷ Little revenue would be lost because the VAT on inputs of the exempt firms would still be collected from their taxable suppliers. A common rule of thumb is that 80 percent of the tax is collected from 20 percent of the taxable firms. In other words, it is not worth the cost to dealing with hundreds of thousands small businesses that contribute very little to revenue. In any case, over time inflation would erode the size of the threshold.

¹⁶ The arguments for taxing insurance and the method for doing so can be found in Cnossen (2012).

¹⁷ For an analysis, see Keen and Mintz (1998).
d. Integrated GST (IGST)

Tax coordination primarily between the States but also between the Centre and the States should ensure that free trade within the Indian single market and equal conditions for competitors are not distorted by discriminatory GSTs. At the same time, however, the States should retain as much tax autonomy as possible in order to be able to pursue their own social and economic policy goals. Tax neutrality and tax autonomy, moreover, should be pursued so as to minimize the costs imposed on taxpayers and tax administrations. Currently, the principle of free trade and free competition is distorted by the Central Sales Tax (CST), essentially an export duty collected under federal legislation by producing states. Fortunately, it is widely agreed that the CST should be abolished upon the introduction of a dual GST.

Free trade and free competition can best be ensured by collecting the GST on a destination basis. Interstate exports would then be zero-rated and interstate imports taxed on par with instate produced goods and services. But without some form of monitoring system, it is argued, exports from one State to another State (zero-rated for the SGST, not the CGST) might be diverted to the exporting state’s local market, while imports might not be reported for SGST purposes. To keep a check on interstate trade, it has been proposed, therefore, to levy the full SGST (in addition to the CGST) on interstate exports under what is called the Integrated GST (IGST). Exporters would collect the IGST from importers, pay the tax to the Centre, which in turn would refund the destination state for the SGST-credit allowed to importers. In essence, therefore, the IGST would not raise any revenue but would solely be used to monitor interstate trade through an automated reporting and verification process administered by a central clearing agency. At least 9 models have been developed to track payments and refunds.

A similar proposal, called Compensating VAT (C-VAT) has been made in the tax literature. Under the C-VAT interstate trade (zero rated under state VATs) would be subject to an export tax administered by a central agency which would use the revenue to finance an equivalent tax rebate on imports. Essentially, the C-VAT solves the problem of fraudulent export and import invoices for the state VAT administrations (apparently for goods only, not for services!) by performing audits at the central level through a charge-and-refund system. Under another, similar proposal, called Viable Integrated VAT (VIVAT) (Keen and Smith, 1996), developed for the EU but never adopted, a uniform tax would be imposed on all intermediate (non-retail) transactions between VAT registered traders within and between member states. Interstate exporters would be taxed and interstate importers would be allowed a credit at the same uniform rate. A clearing mechanism would be installed for payments from net exporting states to net importing states, based on export and import statistics (derived from VAT returns!) with the revenue allocated to member states on the basis of consumption statistics.

18 None of the proposals addresses the problem of non-arm’s length transactions between branches of the same business, for instance, except to say that the “transfer price shall be determined in the enabling legislation.”

19 See the power point presentation by Rajeev Ranjan, Principal Secretary to the Government of Tamil Nadu, entitled, Treatment of Inter State Transactions in Goods and Services Tax (GST).

It has been pointed out, however, that VIVAT does nothing to repair the break in the VAT audit trail in the EU, which is the real problem (Cnossen 2010). Instead of fraudulent export invoices (to get refunds), VAT administrations would be faced with fraudulent import invoices (to get credits). In the event, it is necessary to establish bilateral or multilateral audit agencies to which cases can be referred on a selective basis for investigation. C-VAT, of course, does perform cross-border audits, but here the question is way this needs to be done under the aegis of a no-revenue raising tax.

In India, by contrast, there already is a central audit agency in the form of the CGST administration, which can monitor interstate transactions. Essentially, VAT fraud with respect to interstate or instate transactions, for that matter, should be detected through well-designed audit programs based on risk assessments, selective cross-checking, intelligence gathering, and targeted fraud investigation. States can then continue to zero rate exports. Getting a refund for the GST on inputs would then solely be a matter between the instate business and its government. In essence, there is no break in the input tax credit chain, only in the state audit trail, a break that is repaired by the Centre’s audit trail, as in Canada. The CGST is the common thread that binds interstate transactions. Why weave another one?

Although an IGST would not be necessary (and would unnecessarily increase administrative and compliances costs), it would be advisable to design appropriate place of supply rules under which recipients of out-of-state goods and services would be obliged to report their out-of-state purchases, charge GST on them and permit themselves a credit at the same time. (This reverse charge mechanism should also be put in place for services rendered from abroad.) Further, to be able to remove physical border checks between States, the SGSTs should stipulate that motor vehicles, boats and airplanes should be taxed in the state of registration, that mail order firms should change and remit the SGST of the destination state, and that exempt entities should report their out-of-state purchases which would be taxable in the destination state.

5. Excise duties

a. Traditional excise duties

Without further analysis, this is not the place to discuss the traditional excise duties in detail. The States impose excise duties on drinking, gambling, polluting, driving, and electricity, while the Centre taxes tobacco. Looking at the excise duties and the proposed dual-GST in combination, it is obvious that the States will be allocated part of the Centre’s tax base by being able to include services and tobacco in their VAT-bases. The Centre, on the other hand, will share part of the States’ GST base by including trading margins and excisable goods in its GST-base. Without further analysis of the revenue implications, it is difficult to say which level of government gains most from this arrangement. It may be noted, however, that the traditional excise duties can be

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21 In its latest Communication, the European Commission indicates that it will pursue the establishment of cross-border audit units. In Europe, moreover, the mismatches, mostly non-fraudulent, between returns for interstate exports and returns for imports totalled €80 billion in 2007 (15 percent of VAT collections), which does not augur well for the automated interstate processing and verification system envisaged for India.
adjusted to compensate for any revenue shortfall or surplus if the reform is to be implemented on a revenue neutral basis.

b. Luxury goods taxation

Excise duties on luxury goods and services can be used to impart some progressivity to the tax system. By definition, luxury goods and services are mainly bought by higher income groups. Accordingly, a tax on them implies that, proportionately, they pay more tax than lower income groups. The goods that are often singled out for higher taxation are the following: non-alcoholic beverages (coffee, tea, soft drinks, fruit juices, mineral water); salmon, caviar; toiletries, cosmetics, perfumes; jewelry, precious stones and metals; leather and fur products; watches, clocks; cameras, binoculars; radios, TVs, recorders, videos; motor vehicles, pleasure boats; firearms and, ammunition. Presumably, these goods also feature prominently in the luxury goods schedules of the Indian States.

However, the case for higher excises on luxury goods and services is weak for the following reasons.

- Experience elsewhere shows that the coverage of the usual luxury products (net of expenditures on traditional excise goods and motor vehicles) tends to be extremely narrow, hardly comprising more than one or two percent of total household consumption expenditures. Consequently, the effect on progressivity or revenue is insignificant. Luxury excises on e.g. jewellery, furs, perfumery, cosmetics, clocks, and watches are truly nuisance levies.

- Class-differentiated consumption patterns that are helpful in tax design for imparting progressivity may not exist for some luxury products (unlike basic foodstuffs). In some countries most of the revenue is collected on toiletries, although lower-income households tend to spend a larger share of their income on these items than high-income households.

- Some luxuries are incentive goods which induce low-income households to work harder. On economic grounds, therefore, they should not be discriminated against. Beauty products are an example.

- Separate excises add to the costs of administration and compliance. The definitional refinements that are required to tax luxury items higher usually give rise to casuistically natured disputes on interpretation. Sound equipment is an example. Cheap items and spare parts are difficult to exempt and must therefore be taxed along with expensive items. The complexities of administering and complying with excises on luxury goods resemble those of manufacturers excise taxes, such as CENVAT.

- Many luxury products, such as cameras, can easily be purchased abroad, particularly by higher-income groups. Subsequently, their importation could be concealed or would fall within the limits of the personal exemption.

- Finally, the income tax can better ensure progressivity than can higher CT rates, because generally it reaches households that buy luxury goods. In contrast, the income tax cannot take over the role of the exemption or zero rate for basic
foodstuffs for the simple reason that it does not reach the very poor. Hence, the case for exempting basis foodstuffs is stronger than the case for imposing excises on luxury goods.

In conclusion, the disadvantages of luxury goods taxation outweigh the possible redistributive gains. Accordingly, a case can be made for abolishing most excises on luxury products. However, the motoring field is a notable exception to this conclusion. The demand for passenger cars and gasoline is usually highly income elastic, expenditures comprise a sizeable part of household budgets, motor vehicles can easily be broken down in subgroups which would roughly correlate with purchasing patterns of high and low income groups, and related excise levies are easy to administer and meet socially with a high degree of acceptance.

6. Summary and Concluding thoughts

India is at a crucial crossroad in its fiscal history. Following years of having to make do with archaic systems of excise duties and sales taxes, it now has the opportunity to introduce a modern GST at the central and state level. There are 150 countries with a GST or VAT around the world to learn from. Some of these countries, such as New Zealand, Australia, Singapore and South Africa, have good GSTs with broad bases and (nearly) uniform rate structures. Other countries, such as the Member States of the European Union, have bad VATs with many exemptions and multiple rates. Still other countries – Brazil is an example – have ugly VATs with a manufacturers level of VAT at the federal level (similar to India’s CENVAT), origin-based VATs (exports taxed, imports not taxed) at the state level, and separate taxation of goods and services. Choosing an ugly GST over a good GST could easily cost India 1-2 percent of national income due to unwarranted administrative and compliance costs, and avoidable economic distortions.

In India, a best-practice GST would greatly promote the workings of the single market, and serve as a stable and reliable source of revenue for the Union as well as the States. Separation of the empowerment question from GST design issues would enable the Centre and State governments to have full access to a modern GST. Its hallmarks are a broad base with the fewest possible exemptions, single rate, a sizable threshold, and tax collection in the jurisdiction of consumption: States for their SGST, India for its CGST. In principle, exemptions should be limited to government administration, health, education, rents and sales of used residential premises, and financial services. Unprocessed foodstuffs should not be zero-rated which requires registration and compliance control. The threshold should at least be the equivalent of US$80,000 and possibly as high as US$100,000. The cost in foregone revenue is small, because small businesses would still pay GST on inputs. Interstate trade should not be subject to a

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22 This should also apply to higher-than-standard SGST rates, which tend to be more difficult to administer (because they extend through the retail stage) than luxury goods taxes levied at the manufacturing stage.

23 A system of properly designed road user charges, moreover, can do a good job in identifying consumer preferences and reducing excessive use of public facilities.

24 This estimate is based on the calculations of the Thirteenth Finance Commission (2009, p. xv), which expects the gains to India’s GDP to lie in the range of 0.9 to 1.7 percent.
separate tax, but interstate transactions should be monitored selectively by the CGST’s administration.

The case for a broad-based GST deserves to be emphasized. It is widely agreed that a GST should not be used to influence the tax burden distribution (for which the income tax, the social benefit system, and perhaps selected excise duties on luxury goods are more appropriate instruments), to protect domestic industry (for which import duties should be used, if at all), to favour labour-intensive production processes over capital-intensive processes (which, again if desirable, can be done through the income taxes), to promote economic development (which, as has been demonstrated, cannot be stimulated through the tax system), or any other “worthy” socioeconomic goal. The GST simply is a revenue-raising instrument which can be used to finance socially and economically desirable expenditures.

Perhaps, the negotiations between the Centre and the States over the most appropriate GST have started at the wrong end of the issue, that is, the tax base, whereas the right end is the tax take, that is, the rate. Both the Centre and the States should be interested in the broadest possible base. This implies that petroleum products, electricity, alcohol, immovable property, tobacco, and most foodstuffs should all be in the GST base. Leaving these goods out of the base has serious distortionary consequences (because of the denial of GST-input tax credits with subsequent cascading effects), and would greatly complicate administration and compliance (because of the necessity to allocate input GST between exempt and taxable transactions). Likewise, services should be taxed comprehensively and not be the subject of a positive list, which would raise contentious legal issues and distort economic decisions.

If basic, unprocessed foodstuffs are to be treated favourably, exemption, perhaps in conjunction with the zero rating of selected agricultural inputs, would be preferable to a zero rate on the foodstuffs. In theory, the effect might not seem as neat as under zero rating, but in practice the result would be very similar. Administrative and compliance costs, however, would be much lower under the exemption approach. Exemption might also be more of a deterrent to political pressures to increase the number of favoured products. Exemption is the route that most countries at a similar level of economic development as India have taken.

Last but not least, GST compliance control differs from CENVAT control. CENVAT is about classification and valuation: defining manufactured goods by reference to some nomenclature, imputing a presumptive retail value to them, and applying the GST-rate. But this excise tax approach to assessment and collection is a world apart from the audit approach under the GST. Under the GST, compliance control should be exercised through checks on books of account similar to the income taxes. In other words, auditors are needed, not excise tax officers. Auditors are familiar with flow-of-funds analysis, net worth statements, and with cross-checks between the entries in the books of one company against the entries made by another company. By contrast, excise officials are more akin to customs staff who inspect goods, classify them and appraise their value for import duty purposes. Emphatically, the new GST needs an accounting approach not excise tax methods for compliance control and enforcement. In terms of compliance control, the GST is akin to the business income tax and it would be advisable to maintain close liaison with the income tax department at the central level.
The implications of this change in organisation and methods should not be lost on policy makers.

References


Shome, Parthasarathy. The taxing reforms, *Indian Express*.


GSTIN or Goods and Services Tax Identification Number is your unique business identity with the GoI (Government of India) that contains 15 digits alpha-numeric PAN based code. Why is it important to verify GSTIN or GST Numbers? Verifying GST Number or GSTIN is very important as there are many cases where individuals manipulate GST Number (GSTIN). In addition to this, the GST Number search will help you to maintain transparency in all the business transactions and will ensure that you are filing correct GST Returns for the particular tax period. Further, GSTIN verification will also help you to