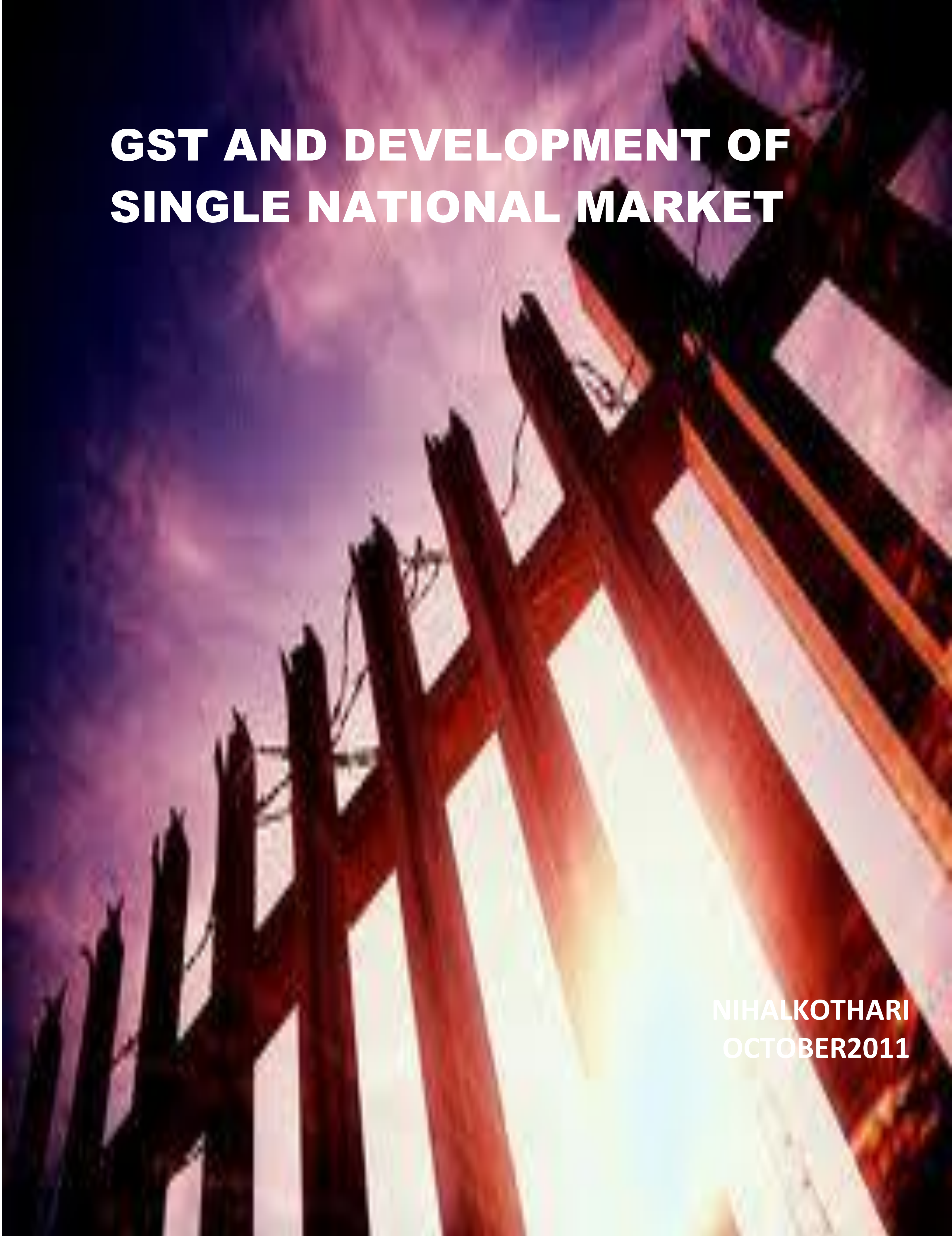
GST AND DEVELOPMENT OF SINGLE NATIONAL MARKET



NIHALKOTHARI

OCTOBER2011

CONTENTS

EXECUTIVE SUMMARY

Independent India's focus on centralized power and control has been instrumental in shaping its markets.With the bulk of tax revenues going to the center, state governments levied multiple indirect taxes for revenue at varied rates and resorted to taxing the entry of goods at their borders. Central Sales Tax on inter-stated sale of goods and restricting input tax credit by states on inter-state sale created tax barrier among states to fragment the Indian market leading to competitive disadvantage. Even at the center, the socio political agenda of successive governments led to multiplicity of taxes on different sectors and activities over the years. As each state used its taxation powers under Article 246 of the Constitution to tax different commodities at different rates, India created a patchwork quilt of taxes that came in the way of the smooth flow of goods between states. *It was with thisapprehension of the trade barriers likely to be raised by the Indian states in exercise of their legislative powers, that the Constitution makers framed the Articles 301 to 307 in Part XIII. The main object of Art 301 obviously was to allow the free flow of the stream of trade, commerce and intercourse throughout the territory of India.Since the safeguard provided in the constitution were not in operation effectively, the governments at center and states used flexibilities provided in Article 302 and 304 to levy multiple taxes which led to fragmentation of the Indian market. Therefore today in reality:*

- A single unified market doesn't exist within India and there are significant inter-State tax and non tax barriers to trade. There is a need to develop a national level single market by removing all the existing barriers to trade, multiplicity of acts, fiscal policies and marketing arrangements across the country

- There exist barriers, both fiscal and otherwise, which hinder interstate trade. These restrictions tend to fragment the national market which not only heightens the possibility of indulgence in trade practices which adversely affect competition but also dent freedom of trade.

- There is an urgent need to look into the impediments that hinder efficient trading and identify measures to integrate Indian market and create competitive environment. We need to turn the general perspective of India as a "complex tax destination" to "competitive destination" for which there is a need for considerable improvement in the tax structure and tax administration.Such a move will not only improve the competitiveness but would also immensely benefit all stake holders and accelerate the economic growth.

There are many economic areas of state legislations, regulations and policies that impact or inhibit competition in the markets. The existing complex and multilayered indirect tax structure has fragmented Indian market into 29 state markets by tax barriers which adversely affected India's competitiveness. For example while the Central Sales Tax is a tax on the export of goods from one state to another, the levies such as entry tax and octroi are in the nature of taxes on import of goods into a local area. Administration of these taxes requires the erection of check posts or physical barriers and this violates the principle of common market within the country.The central and state governments also resort to granting plethora of product and area based tax exemption from time to time under pressure which create distortion and hinder competition. For an instance at present 330 products are exempted under central taxes (excise duty/ Customs duty) and nearly 100 products under state VAT. Certain geographical areas exempt taxes on all products. The impact analysis of these exemptions is not known as to whether they achieve stated objective in long run. Whereas, the loss of revenue to the exchequer due to such tax exemptions leads to fiscal deficit and high tax rates on other products and activities adding to market distortion and inflation.

The Central and the State Governments need to undertake a review of existing policies, laws or regulations from the competition perspective and also undertake a competition impact assessment of proposed policy, law and regulations before these are finalized. Coordinated calibration of tax reform, is extremely important to evolve a competitive tax system in the country.

This report highlights the problems in existing tax structure and its adverse impact on the Indian market and completion. It also suggests the way forward for rational tax structure.

Problems in the existing Indirect tax system in India:

The existing Indirect tax structure and its administrative mechanism poses various problems such as (a) cascading effect on cost of products and services adversely affects competitiveness of indigenous goods and services; (b) different tax treatment for manufacturing and service sectors leads to litigation; (c) high cost of compliance and tax administration add to the cost of doing business in India and discourage investment and; (d) uncertainty of tax incidence on investment in manufacturing and servicesand litigation due to frequent changes in tax laws and proceduresdiscourage new investment and leads to high cost economy. The complex tax structure discourages economy of scale and efficiency in the supply chain which has adverse impact on economic growth. The present tax system is also prone to tax avoidance and excessive litigation which results into unexpected delays in supply chain and business processes. There is also a problem of double taxation by central and state government on same tax event. These have led to substantial distortions in economy and loss of revenue to the Government. In the above context, the indirect tax reform has to address following aspect to realize full economic potential of India

- The existing tax structure has fragmented the Indian market in to 29 state markets by tax barriers which discourages efficient production and supply chain models and restricts trade. Stand alone multiple taxes have cascading effect on cost leading to competitive disadvantage to Indian industry. Central Sales Tax (CST) on interstate movement of goods is not integrated with Value Added Tax hence CST paid on inter-state procurement is not eligible as a credit and continues to be an extra cost of doing business. Similarly, manufacturers are unable to avail themselves credit of state taxes and miscellaneous central taxes, such as VAT entry tax, octroi, etc against excise duty and vice versa and these become added costs along the supply chain adversely affecting exports and encouraging imports. These distortions in the tax structure need to be removed.

- It is important to have simple tax structure with one or two uniform tax rates across country on all tradable goods and services. Uniform compliance and administrative procedure need to be adopted in all States.

- Dispute between Central and States in terms of mutual agreement on taxability is one major issue which needs to be resolved.

- Differential treatment of the manufacturing and service sectors is a persistent problem of existing tax system. The line between goods and services is also getting blurred by the day, giving rise to immense disputes incapable of being resolved either through circulars or courts. The problem is further aggravated with the advent of digital technology. There should be uniform tax rate on goods and services and same tax treatment for availing input tax credit at central as well as state level.

- Stand-alone taxation of both goods and services by federal and state governments is structurally inconsistent with the scheme of input credit across goods and services in a supply chain, which is so vital in eliminating cascading effects of taxes on the cost. Further, both administrative and compliance cost considerations necessitate integration.

Introduction of GST is imperative for competitiveness and growth

In the above context replacement of existing complex multilayer indirect tax system by a rational Goods and Service Tax on all tradable goods and services is imperative for India's growth and competitiveness. In the proposed GST regime, manufacturers should be entitled to input tax credit of all taxes levied on inputs and capital goods purchased from within the State as well as inter-state, from a registered dealer for setting off the output tax liability on the sale of their finished products. Similarly, distributors should also be able to pass on the duty burden to their customers. This would ensure that there is no cascading effect of taxes and would result in the reduced cost of doing business. In the medium term, this is likely to result in reduction in the prices of commodities as manufacturers and distributors would pass on the benefits of the lower costs of carrying on their businesses to the consumers in a competitive environment.

The case for having uniform tax on goods and services across India becomes even more compelling in view of India implementing number of free trade agreements (FTAs) with its neighbors, Asean countries and the Gulf nations. With so many FTAs in operation, there is immense pressure on India to rationalise its local tax regime to ensure a level-playing field for domestic manufacturing. This has made imperative for India to move to a uniform goods and services tax regime with seamless input tax credit, to be competitive. GST will help to overcome various indirect tax issues under present taxation system in India. It will facilitate a single national common market leading to economy of scale and efficient and cost effective supply chain

Impact of National GST on stake holders:

GST will benefit all stake holders like Industry, Central and State Government and trade and consumers. The key highlight of such impact is given below:

- On competitiveness and Growth:

  GST will eliminate the cascading impact of taxes on production and distribution cost of goods and services. This will significantly improve the competitiveness of indigenous goods and services leading to accelerated GDP growth. GST without tax barriers will facilitate economy of scale in manufacturing and reduce the supply chain cost. It is expected that rational GST structure with seamless input tax credit would reduce the average cost of manufacture by 10% to 15%. GST isexpected to increase GDP growth by 1.4 to 1.6% and help achieving the targeted 8 to 9% GDP growth.

- On Consumers and demand for goods:

  GST is expected to reduce the overall production cost by 10% to 15% of several products in view of the removal of cascading impact of multiple taxes under present tax regime and allowing full input tax credit. This will have favourable impact on the prices of product increasing the demand for goods and benefit to the consumers. Thus GST will bring down inflation in the prices of manufactured goods.

- On Government Revenue:

  GST will widen the tax base and improve the tax compliance leading to higher tax: GDP ratio. The Tax: GDP ratio is expected to increase by 2% as per FRBM report. The additional annual revenue to the central and state governmentsworks out to rupees 150,000 crores p.a. at the present level of GDP and tax collection.

- On Investment and Economic Efficiency:

  GST will remove the tax distortions from the economy. This will lead to sustainable higher growth based on competitive strength of the country. Simple tax system will attract more productive investment for growth.

  These significant benefits are possible only if all existing taxes on tradable goods and services are integrated in to GST and it is applied uniformly across the country.

****

REPORT

INTRODUCTION:

Today it would not be incorrect to say that the world market is shrinking. The countries are nowmore open in trade than they ever were in the recent history. Independent nations have come together to form economic unions to reap the advantages of a large internal market within their region that allowsfree play of market forces in competitive environment with unfettered flow of products and services within the union enabling all constituents to grow according to their comparative advantage.

In such an international scenario, it is not only important for India to open its economy to foreign trade but is also equally important to internally create a competitive single Indian national marketin which there are no restrictions or barriers on the movement of goods and services within the country. Such free slow of trade will enable different states of the country to specialize in areas in which they have the minimum opportunity cost and thereby increase economic efficiency.

The architects of Indian constitution understood the vital importance of free trade within the country. Part XIII of the Constitution that deals with country's internal trade, opens with the mandate: "Subject to the other provisions of this Part, trade, commerce and intercourse throughout the territory of India shall be free" (Article 301 of the Constitution of India).Although constitution providesfor parliament and state legislatures to impose reasonable restrictions on trade if it is felt necessary in public interest, care has been taken in Articles 302 to 304 that such powers are exercised with the utmost circumspection and presumably in exceptional circumstances.

The actual situation in the country however, is dismalon this count. When the entire world is integrating into one market, India is sacrificing the advantage of one large domestic market by pursuing polices, laws and regulations which lead to its fragmentation. There are several tax and non tax legislations, regulations and orders that prevent the free flow of goods and services within the nation. Though the intentions behind most of these were logical, they have failed to achieve their long term goals and are in fact leading to market distortions.

The major problem today India is facing in creating a single national market is the diversity of controls excercised by multiple authorities at different levels, tax barriers created to meet short term revenue targets, restrictions on inter-state and intra-state movement of goods, lack of uniformity in standards and procedures laid down by different authorities. All these have led to breaking up Indian market into a large number of smaller regional markets. The paperwork involved in complying with the various regulatory procedures and controls, the compliance cost involved in terms of time and resources and the inevitable corruption and malpractices that have served as big drag on the efficiency of trading operations in the country. There is an urgent need to look into the impediments that hinder efficient trading and identify measures to integrate Indian market and create competitive environment.

The broad objectives of this study is to focus on the distortive provisions in tax policies, indirect tax laws, regulations, practices within the countryand analyze their impact, in order to develop a strategy for competition advocacy.It evaluates the implementation of the statutes, rules/regulations, policies and practices which limit competition or have the potential to limit competition and recommends changes in the regulations to address the competition related issues.

This study also evaluates how introduction of ‘Goods and Service Tax’ (GST) will improve India’s competitiveness in the international market and its impact on distribution of tax resources among states as compared to present system of indirect tax structure. GST will also improve competitiveenvironment within India on removal of distortions created in the market place by existing tax system. The results and conclusions of this study are comparative static in nature and may not be interpreted as forecasts of the variables under analysis.

PRESENT TAX REGIME WHICH LED TO FRAGMENTED MARKET:

During the period of 1950 to 1990 when India had a controlled economic regime, several tax laws were enacted by Parliament and State legislaturesunder Articles 246 of the Constitution using the flexibility provided in Articles 302 and 304 of the constitution. These led to fragmentation of Indian Market in to small regional markets. India at present has a highly complex and multilayered indirect tax regime under which multiple taxes are levied by the federal and State Governments at different levels of supply chain.

In the existing Indian constitution framework, taxes on goods are levied by the Central Government at the manufacturing level as excise duty, on services through the Finance Act, and on inter-state sale of goods via the Central Sales Tax Act. States levy taxes on the sale of goods within a state independently under their respective State laws and specific taxes on certain sectors. There are other minor indirect taxes by both centre and states. Though some degree of uniformity has been achieved after the introduction of the Value Added Tax at state level, differences do persist. Multi layered indirect taxes in India can be broadly classified as follows:

Indirect Taxes in India

Central Taxes

- Customs Duty –On Import of goods
- Excise Duty –On manufacture of goods
- Service Tax –On provision of specified services
- Central Sales Tax – On inter-state sale transactions

State Taxes

- Central Sales Tax –On inter-state sale transactions
- Luxury Tax on hotels
- Entry tax / Octroi – On entry of goods in specified areas
- Ancillary taxes like entertainment tax

Adverse impact of present tax structure

Present multiple tax structure leads to high compliance cost, excessive litigation and uncertainty about ultimate tax incidence at the time of investment or business transactions. Cascading effect of multilayered taxes increases the cost of indigenous manufacture which adversely affects competitiveness of Indian Industry. The inefficiency of the existing indirect tax structure and consequent adverse impact on our economic growth are summarised below:

Impact on competitiveness of indigenous goods & services:

The present tax structure has cascading impact on cost of indigenous manufacture of goods and services. For example VAT is levied on the sale value of a product which includes excise duty element Thus VAT is also charged on excise duty amount. Similarly when VAT paid raw material is used in manufacture,it forms part of the excisable value (cost of manufacture) on which excise duty is levied. Thus excise duty is also charged on VAT element. Similar is a case of service tax levied on services and central sales tax levied on inter-state sale of goods. This cascading of taxes at each stage in a supply chain makes Indian goods artificially expensive compared to other competing countries which have adopted GST or National VAT. In the case of some indigenous products the resultant competitive disadvantage due to cascading taxes alone can be as high as 10% to 15% of the price. Such tax disadvantage reduces the competitiveness of indigenous goods and does not allow us to tap full export potential of manufactured goods and agro based processed foods.

Fragmentation of market resulting in inefficient production/ distribution models:

The taxes on inter-state movement of goods (CST, entry tax etc.) and the rate differentials and credit restriction in the value added tax of different states, create tax barriers within India. Manufacturers thus encouraged to source inputs from the same state and distributors are encouraged to have depots in each state for stock transfer to avoid CST. The present tax system holds back India from becoming a single national market. The combined effect of CST, Entry tax and restricted credit under state VAT is reflected in fragmenting India into 29 state markets. The present structure discourages scale economy due to non-vat able CST on interstate movement of inputs and finished goods from producing state to consuming state. It also promote setting up separate warehouse in consuming states to avoid CST thus leads to unsustainable high cost distribution models. The present tax structure does not allow us to take economic advantage of our large market size and consumer base and in fact make indigenous goods less competitive due to cascading taxes imbedded in the cost of production compare to imports.

Creates economic distortions:

The multiple rate structure of different taxes interferes with the producers' input-output choices as well as the consumers' consumption preferences, thereby leading to severe economic distortions. The wide spread taxation of inputs at different stages encourages vertical integration of firms only for tax purpose and not based on economic consideration.

High compliance and administration cost:

In the existing framework of taxation, multiple taxes are being levied on goods and services at different stages in a supply chain. These are levied under different legislations by the Central and state Governments, at different rates and are administered differently. Such multiple taxes with different rates and different tax bases make Indian tax structure quite complex to comply and administer. Such complex tax structure results in high cost of compliance and tax administration, leads to tax arbitrage, wastage of time and efforts, prone to tax avoidance and litigation, results into unexpected delays in supply chain and business processes. It slows down the economic growth. Complexity discourages tax compliance and it affects investment.

High selective tax incidence suppresses demand:

There is over-lapping of tax base in the case of several taxes. For example several intangible goods are subject VAT as well as Service tax as some time there is thin line between goods and service especially in the case of items like software, Intellectual properties, rentals etc. This leads to significantly higher tax incidence on selected products and services where VAT as well as excise/service tax is also levied on the same base value. Similarly, items like white goods and automobiles are taxed under VAT as well as Excise on the same sale price at a high tax rate (12.5% and 10 to 20% respectively + cascading tax on tax). The high tax incidence suppresses the demand for such goods/ services due to demand elasticity with resultant adverse impact on the growth of such sectors. There is empirical evidence to demonstrate that moderate and affordable tax increases demand for goods leading to higher industrial growth. High tax incidence also leads to tax avoidance resulting in lower government revenue.

Increases litigation, uncertainty and harassment:

Separate and independent taxation of goods and services under different legislations increases tax disputes. There is a strong interdependence of goods and services in the supply chain until any goods or service reaches ultimate consumer. The line between goods and services is getting blurred by the day such as in the case of intangibles, telecom and IT products. The problem is further aggravated with the advent of e-commerce and software transactions. Goods and services have become indistinguishable in several cases and can be subjected to tax simultaneously under goods and services. This gives rise to excessive disputes incapable of being resolved either by circulars or through courts. The lengthy litigation process with consequent uncertainty increases business risks and creates unfavourable investment climate. Most of the disputes invariably end up in the Supreme Court. Even after Supreme Court decision, it is difficult to give effect to the principles enunciated by the highest court in many cases. Such uncertainty also leads to harassment of tax payers.

Tax inefficiencies influence policy of protectionism leading to high cost economy:

The above inefficiencies in the domestic tax structure influences government to continue with the policy of high rate of custom duty or levy of high safeguard duty to protect domestic industries. Such policy make India high cost economy and makes Indian exports less competitive. It also impact prices resulting in high rate of inflation affecting living standard of a large section of population.

TAX REFORM IS IMPARATIVE:

In spite of best intention and efforts, it is difficult to design a perfect tax system which is universally applicable for all times to come. The ability to adapt to changing realities is crucial for a good tax system to sustain and be relevant. Tax Policy and Tax Administration are no exception and do require to move with time and place reflecting the social, economic, cultural and political realities.

In the emerging highly competitive world market, the continuation of existing inefficient tax structure would hold back India's growth aspirations as it creates uncompetitive environment for Indian enterprises.We need to seriously consider replacing the existing tax structure with efficient and rational Goods and Service Tax (**GST**) structure, without disturbing country's federal democratic structure. We are far behind in tax reforms compared to other competing countries. Any further delay will result in missed opportunities in many economic sectors.

The sovereign nations who are members of the European Union have successfully aligned there tax systems and implemented uniform VAT which has significantly benefited all the member countries and more so the developing countries of Eastern Europe where the living standard of people has gone up due to free flow of goods and services within the region.

EXISTING ANTI-COMPETITIVE LAWS AND PROVISIONS:

PROVISIONS IN CONSTITUTION OF INDIA, 1950:

The Indian Constitution adopted in 1950 was with the spirit freedom of profession, occupation, business or trade to all citizens as fundamental right under 19(1) (g) and further reinforced in Article 301 which states that “trade, commerce and intercourse throughout the territory of India shall be free”. However both these Articles 19 and 301 are subject to certain restrictions. The indirect reference to absence of any barrier to trade also comes from Article 14 of the Constitution which guarantees equality before the law and equal protection of the laws.

Article 19(2) and 301 of the Constitution allows a State legislature to “impose such reasonable restrictions on the freedom of trade, commerce or intercourse with or within that State as may be required in the public interest”.

Article 302 of the Constitution authorizes Parliament to impose by law, restrictions on the freedom as described in Article 19 in the public interest. Parliamentary power under Article 302 is also subject to the restriction imposed by Article 303(1). This prohibits the enactment of any law (by Parliament or State legislature), which gives preference to one State overanother, or a law discriminating between the States regarding trade and commerce.Under Article 303(2) of the Constitution, however, the aforesaid restriction can be relaxed by Parliament through law, for dealing with a situation arising from the scarcity of goods in any part of India. In view of this flexibility under Article 302, Parliament enacted origin based Central Sales Tax Act in 1956 which is levied on interstate movement of goods. This resulted into fragmentation of the market and encouraged large manufacturers to resort to stock transfers by setting up state wise warehouses to avoid such tax.

The State Governments are empowered by the constitution to legislate on trade andcommerce on subjects under the State list. The provisions of Article 301 are also applicable to trade andcommerce within the State. According to Article 303(1) neither the Statelegislature nor Parliament shall have power to make any law, which discriminates between States regarding trade and commerce in any of the lists inthe Seventh Schedule. However, there is overriding provision in Article 304 (b) under which reasonable restrictions can be put in public interest.

Article 304(a) provides that a State legislature may, by law, impose on goodsimported from other States or the Union Territories, any tax where similar goodsmanufactured or produced in that State also receive similar treatment. However,there should be no discrimination between the imported and manufacturedgoods. This provision permits State legislatures, by law, to impose such reasonablerestrictions on the freedom of trade, commerce or intercourse with or within thatState, as may be required in the public interest. At the same time, by theconstitutional provision, no Bill or amendment for the purpose of Article 304(b)shall be introduced or moved in a State legislature, without the prior sanction ofthe President. Article 304(b) applies only if the restriction is “reasonable”. The term ‘public interest’ however can be used in such a way which leads to fragmentation of the market or creates uncompetitive environment. Many states had enacted entry tax, some of which were later struck down by respective high courts.

By dint of these constitutional provisions, the Indian states usually impose taxesand other measures on imports of products from other States and Union Territories.Therefore, these provisions act as a barrier on the inter-state movement ongoods, the extent of which depends on the amount of taxation.

Due to the Constitutional overlap, the Centre cannot overrule the StateGovernments. This constitutional overlap led to thepersistence of the barriers on internal trade.

The statement in this context by Justice Gajendragadkar in thecelebrated case of Atiabari Tea Co. Ltd. Vs The state of Assam, (1960) 1 SCR 809 is quite noteworthy:

> *"It is with the knowledge of the trade barriers which had been raised by the Indian states in exercise of their legislative powers that the Constitution makers framed the Articles in Part XIII. The main object of Art 301 obviously was to allow the free flow of the stream of trade, commerce and intercourse throughout the territory of India.*
>
> *In drafting the relevant Articles of Part XIII the makers of the Constitution were fully conscious that economic unity was absolutely essential for the stability and progress of the federal policy which has been adopted by the Constitution for the governance of the country. Political freedom which had been won, and political unity which had been accomplished by*

the constitution, had to be sustained and strengthened by the bond of economic unity. It was realized that in course of time different political parties believing in different economic theories or ideologies may come in power in the several constituent units of the Union, and that they may conceivably give rise local and regional pulls and pressures in economic matters. Local or regional fears or apprehensions raised by local or regional problems may persuade the State Legislatures to adopt remedial measures intended solely for the protection of regional interests without due regard to their effect on the economy of the nation as a whole. The objective of Part XIII was to avoid such a possibility."

In order to ensure that free flow of trade and commerce within the country across thestates is guaranteed without any barriers, Article 307 empowers Parliament to appointan appropriate authority for the purpose of monitoring and ensuringthat theConstitutional guarantee on free flow of trade throughout the country is adhere to bythe states. Such authority however has not yet been appointed.

The above provisions under the Constitution, promote India as common market with free flow of trade and commerce without any barrier within our federal structure. It is also important to note that Parliament alone possesses <u>exclusive power</u> to legislate on matters relating to inter-state trade and commerce (item 42 of Union List in VII Schedule) keeping the above objective in mind.

In spite of such clear mandate under the constitution to keep India as one commonmarket, the centre as well as states allowed the Indian market to fragmentNon vat-able tax on interstate sale (CST) @ 4% to 12.5% fragment the market and havesubstantial adverse impact on India's competitiveness. Entry tax by states ranging upto 13% has the same impact. Even though the states have introduced VAT but due toco-existence of CST and non refund of input tax up to 4% on inter-state transfer ofstocks, the Indian market remains segmented. These tax distortions continue to affectIndia's competitiveness. The constitutional mandate under Part XIII is ignored and theCentral did not take steps to create institutional framework provided under Article 307.

In view of the above provisions and the strong measures provided in the Constitutionto ensure the free flow of trade and commerce in a common Indian market, theintroduction of GST is compatible with the spirit of the IndianConstitution and its federal structure. In fact it would be a step in the right direction toensure constitutional mandate given under Part XIII. It is possible to integrate existingtaxes and replace them by GST, especially after the 95th constitutional amendment in 2003which inserted Article 268A and entry 92C about taxation of services in the Central listof Seventh Schedule. The key issue therefore is to examine the appropriate structureof GST which is in harmony with Part XIII of the Constitution andwhich also protects India's federal structure of governance. Such GST model shouldimprove India's competitiveness, facilitate sustainable economic growth and augmentgovernment revenue.

<u>Need for setting up Authority contemplated under Article 307 of the Constitution:</u>

There is need to precise guidelines for the term “public interest” often used to enact laws which put restrictions on free flow of trade using the legislative power under Article 302 and 304.There is a need to ensure that such flexibility under Article 302 and 304 is not misused by either Parliament or state legislature to fragment the market.**This can be ensured if Parliament constitutes an authority as**

contemplated in Article 307 which ensures that the purpose provisions of Articles 301 to 304 is carried out as contemplated. Punchi Commission, 2010 on Centre State Relations has also strongly recommended setting up of such in Authority based on the detailed study done by one of its take force for creating Indian common market.

ENTRY TAX

Entry 52, List II of the Seventh Schedule of the Constitution of India enables the states to enact law providing for levy of entry tax into a local area for consumption, use or sale therein. Entry 52 provides as follows:

"Taxes on entry of goods into a local area for consumption, use or sale therein"

This taxation power needs to be examined in the context of Part XIII of the Constitution deals with Trade, Commerce and Intercourse within the territory of India.

<u>Analysis of the relevant provisions of the Part – XIII:</u>

(1) <u>Article 301 of the Constitution: Freedom of trade, commerce and intercourse:</u>
Subject to the other provisions of this Part, trade, commerce and intercourse throughout the territory of India shall be free.

(2) <u>Article 304 of the Constitution: Restriction on trade, commerce and intercourse among States</u>

Notwithstanding anything in article 301 or article 303, the Legislature of a State may by law -

(a) impose on goods imported from other States or the Union territories any tax to which similar goods manufactured or produced in that State are subject, so, however, as not to discriminate between goods so imported and goods so manufactured or produced; and

(b) impose such reasonable restrictions on the freedom of trade, commerce or intercourse with or within that State as may be required in the public interest:

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

Based on the above provisions, any state legislature can legally impose entry tax. However if such entry tax directly and immediately impedes free flow of trade and commerce, then it would violate Article 301.

Article 301 is subject to the limitations and conditions stated in Articles 302, 303 and 304 i.e. Article 301 is binding upon the Union legislature and the State legislature, but the Parliament can get rid of the limitation imposed by Article 301 by enacting a law under Article 302. Similarly, a law made by the State Legislature in compliance with the conditions imposed by Article 304 shall not be hit by Article 301.

Hence, in case entry tax provisions enacted by the state are able to satisfy the conditions imposed by Article 304, it can be held legal.

Article 304 (a) allows the state legislatures to impose any tax to which similar goods manufactured in its own state are subjected so as not to discriminate between imported goods and manufactured in its state; andArticle 304 (b) allows the state legislatures to impose reasonable restrictions on the freedom of trade, commerce or intercourse, provided they fulfill the following three conditions:

- Such restrictions shall be in public interest;
- They shall be reasonable; and
- They shall be subject to the procurement of prior sanction of the president.

At this juncture, it will be appropriate to evaluate various judicial pronouncements delivered by Honorable Supreme court from time to time providing guidelines in relation thereto:

Hon'ble Supreme Court in case of Atiabari Tea Company Limited vs. State of Assam and Others [1961-(048)-AIR -0232 –SC], has held that power to tax vested by the legislative list in the Parliament or State legislatures, is circumscribed by Part XIII (Trade, Commerce and intercourse within the territory of India) of the Constitution and if the exercise of that power does not confirm to the requirements of Part XIII, it will be regarded as invalid. Hence, vide this judgment, Hon'ble Supreme Court has confirmed that even tax legislation would have to bear the scrutiny of Part – XIII and in case the tax legislation infringes with the Part XIII of the Constitution, then the same will be held invalid and unconstitutional.

An exception to the Article 301 and its operation was judicially crafted by the seven member bench of Hon'ble Supreme Court in the case of Automobile Transport (Rajasthan) Ltd. vs. State of Rajasthan [AIR 1962-(049)-AIR -1406 –SC]. In that case, the challenge was to the Rajasthan Motor Vehicles Taxation Act, 1951. The challenge to Article 301 was rejected by holding that "the taxes are compensatory taxes which instead of hindering trade, commerce and intercourse facilitate them by providing and maintaining the roads". It further observed that "if a statute fixes a charge for a convenience or service provided by the State or an agency of the State, and imposes it upon those who choose to avail themselves of the service or convenience, the freedom of trade and commerce may well be considered unimpaired." Thus, the concept of "compensatory taxes" was propounded. Therefore, taxes which would otherwise interfere with the unfettered freedom under Article 301 were protected from the vice of unconstitutionality if they are compensatory. Hence, based on this judgment, the working test for deciding whether a tax is a compensatory or not was to enquire whether the trade is having the use of certain facilities for the better conduct of its business and paying not patently much more than what is required for providing the facilities".

Hence, these judgments emphasized that the imposition of compensatory tax must be with definite purpose of meeting the expenses on account of providing or adding to the trading facilities either immediately or in future provided quantum of tax is based on a reasonable nexus to the actual or projected expenditure on the cost of the service or facility.

However in the case of M/s. Bhagatram RajeevKumar vs. Commissioner of Sales Tax, M. P. and others [1995-(SU1)-SCC -0673 –SC], wherein the challenge was to the M.P. Sthaniya Kshetra Me Mal Ke Pravesh Par Kar Adhiniyam, 1976, the Hon'ble Supreme Court went on to say, that "the concept of compensatory nature of tax has been widened and if there is substantial or even some link between the tax and the facilities extended to dealers directly or indirectly the levy cannot be impugned as invalid". The pronouncement in Bhagatram's case was relied on by a Bench of two Judges in the case of State of Bihar vs. Bihar Chamber of Commerce [1996-(009)-SCC -0136 –SC], which reiterated the position that "some connection" between the tax and the trading facilities extended to dealers directly or indirectly is sufficient to characterize it as compensatory tax. The Court further went to hold that the State provides several facilities to the trade, such as, laying and maintenance of roads, waterways, markets etc. and on this premise it was held that the entry tax was compensatory in nature. The learned Judges did not consider it necessary to put the burden on the State to furnish the details of facilities provided to the traders and the expenditure incurred or incurable thereafter.

This decision clearly expanded the scope of the judicially evolved compensatory taxes and were in contrast with the doctrine of direct and immediate benefit as propounded in the Automobile Transport (Rajasthan) Ltd. vs. State of Rajasthan [AIR 1962-(049)-AIR -1406 –SC].

Subsequently, The Hon'ble Supreme Court in a five member bench in the case of Jindal Stainless Ltd. and another vs. State of Haryana and others [2006 – 145 – STC-0544 – SC], while dealing with the issue on constitutional validity of Local Area Development Tax in Haryana has laid down the following principles to verify whether a particular tax enactment is valid on the grounds of it being a compensatory tax:

- Compensatory tax is a compulsory contribution levied broadly in proportion to the special benefits derived to defray the cost of regulation or to meet the outlay incurred for some special advantage to trade, commerce and intercourse. It might incidentally bring in net revenue to the government but that cannot be an essential ingredient of the compensatory tax.

- Whenever any law is impugned as violative of Article 301 of the Constitution, the courts have to verify whether the impugned enactment facially or patently indicates quantifiable data on which compensatory tax is sought to be levied. The Act must facially indicate quantifiable or measurable benefit.

- If the provisions are ambiguouseven if the Act does not indicate facially the quantifiable benefit, the burden will be on the State as a service/facility provider to show by placing the material before the Court, that the payment of compensatory tax is a reimbursement/recompense for the quantifiable/measurable benefit provided/to be provided to its payers.

- Once it is shown that the enactment invades freedom of trade, it is necessary to enquire whether the State has proved that the restrictions imposed by it by way of taxation satisfy the conditions laid down in Article 304(b):

    - Such restrictions shall be in public interest;
    - Such restrictions shall be reasonable and

- Such enactment shall be subject to the procurement of prior sanction of the president.

Hence, Honorable Supreme Court in its abovementioned judgment upheld the doctrine of direct and immediate effect as propounded in the Automobile Transport case and gave a clear direction to verify all the entry tax enactments by applying this doctrine.Based on the above principles, various appellate authorities and high courts have held respective State's Entry Tax Act's as unconstitutional.

Certain State governments in their respective High Courts took a view that entry taxes levied in their states, though are not compensatory and are not complying with the Article 304 (b), are covered under the Article 304 (a) i.e. on account of introduction of such entry tax, there is no discrimination in the provisions of the Act between the goods imported from outside the state and those manufactured or produced in the state.

Reading of relevant provisions under Constitution of India and various pronouncements as explained above, it can be seen that there is a lot of confusion across all the states on the legality of the levy.

With Globalization, Industries require larger markets. As a Country we cannot develop this if we try and fragment every state and give liberty to levy entry taxes as per their wishes. Entry tax is one of the major barriers restricting free flow of goods from one state to another and sometimes within the state.

Further Central Government and Empowered Committee of State Finance Ministers need to ensure that they do not allow such controversies to rope in the proposed Goods and Service Tax (GST) scenario and it is made clear while implementing GST that states do not levy non vat-able entry tax on goods received within the state for consumption, use, or sale therein so that India can indeed be regarded as one market and assure free flow of goods.

There is also a need to remove the present system of transit permit for entry of goods where in many states the stationery for such permits has to be procured from the tax department which may times is not issued on time leading to delays in movement of goods and harassment at the check posts.

OCTROI

Maharashtra is the only State where Octroi has been in force where municipal corporationscollect octroi at the time of physical entry of specified goods in city limit. Octroi rates vary from 1% to 7% of the value of goods. Levy of Octroi on goods entering the city limit increases the cost of the product directly since the tax levied is not available for set-off. Moreover the method of collection at the check post by stopping the vehicle carrying goodsrestricts free flow of goods.

Further, from this year following 4 municipal corporations have replaced 'octroi'withan account based levy called 'Local body tax' (LBT):

- Kolhapur Municipal Corporations
- Solapur Municipal Corporations

- Vasai-Virar City Municipal Corporations
- Aurangabad Municipal Corporations

The levy provides that above mentioned Municipal corporations shall levy LBT on entry of specified goods in to the limits of city for consumptions, use or sale therein in lieu of octroi. Hence, only the levy has changed from octroi to LBT, however, the charge remains the same. The rate of duty under LBT is as high as 2.75% on various goods mentioned in LBT Schedule. Both Octroi and LBT arenon-vatable and becomes added cost of the product.Hence, the present system of levy and collection of octroi / LBT needs to be abolished. This can be done by providing greater grants by the central/ State government or by adding the incidence of the same in VAT rates. This will not only ease interstate trade but also impart some degree of uniformity to the tax system.

Octroi which delays the movement of goods at check post apart from creating tax barrier should be discontinued at the earliest. In any case on introduction of GST, Octroi as well as Local Body Tax should be abolished.

CENTRAL SALES TAX (CST)

CST is the root of many distortions and inefficiencies in the current indirect tax system. It is unjust, difficult to enforce and prone to evasion. The barriers created are a blot on the common market of India. Being an origin-based tax, CST violates the principle of inter-jurisdictional equity. It is an extraterritorial tax by the producing states on the residents of the consuming states. Thus, as a buyer, one would always want to buy locally within the state so that VAT paid thereon could be availed as credit.As a seller of goods from outside the state, is constantly challenged to identify alternate distribution mechanisms to be able to finally strike the right price with the buyer.In this regard, making a stock-transfer of the goods to the destination state and thereafter making a local sale to the customer is widely applied.Butthat makes the supply chain complex and expensive.The enhanced costs create a competitive disadvantage for the Indian suppliers.

Currently, in India, the continuance of CST by the Central Government has to a significant extent impacted the trade between states. The Central sales tax, which obstructs easy trading between different states, should be terminated in order to boost inter-state trade and facilitation of free interstate movement of goods and curtailment of cascading effect of taxes.

Consequently, it appears to be the right time for the Government to abolish the CST as a move towards a complete abolition with the proposed introduction of GST.

DISTORTIONS IN VALUE ADDED TAX (VAT)

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. On implementation under the directive of the 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. VAT also reduced the number of tax rates and applied uniform rate structure in all states when it was implemented.

Prima-facie principle based on which VAT was introduced in the country was to have non-discrimination of taxes between goods manufactured/produced in a State and goods imported from another State and to have free flow of goods throughout the country.VAT was introduced in the country keeping following features as backbone:

- Uniform schedule rates of VAT for all states to make the tax system simple and uniform and prevent unhealthy tax competition among states;
- The provisions of input tax credit to help in prevent cascading effect of tax;
- The zero – rating of exports thereby increasing the competitiveness of Indian exports;

VAT Rates

The following VAT rates were agreed by the states when VAT was introduced:

- 0% - on few Goods of social importance
- 1% floor rate for gold, silver, precious and semi- precious store.
- 4% for goods of basic necessities, industrial and agricultural inputs, declared goods, Medicine and drugs ; textiles and sugar, capital goods
- 12.5% RNR(Revenue Neutral Rate) on other goods

However, in reality the above principles were not followed after lapse of 3 years and almost all the States differed by introducing different VAT rates than agreed. Further, each state introduced its respective negative list of goods on which input tax credit was denied. Various states also notified location based / entity based exemptions providing privilege to specific class of dealers over others. Some states also restricted input tax credit in the case of inter-state movement of goods.

Current Status

- 6 States have introduced new 3rd slab of 15% or 20% on few products
- 21 States have increased standard rate ranging from 13% to 14.5% and more states are deviating
- 19 States have increased lower rate to 4.5% or 5%
- One state has linked input tax credit to output tax for each transaction

Provided below is a chart highlighting different VAT rates charged by different states thereby differing the initial agreed rates of 4% and residual rate of 12.5%.

Various States and Difference in VAT Rates than agreed rate of 4%

STATES	GENERAL VAT RATE (%)
Andhra Pradesh	5.00

Assam	5.00
Arunachal Pradesh	4.00
Bihar	5.00
Chattisgarh	5.00
Dadra and Nagar Haveli	4.00
Daman and Diu	4.00
Delhi	5.00
Gujarat	4.00
Goa	5.00
Haryana	5.00
Himachal Pradesh	5.00
Jammu and Kashmir	5.00
Jharkhand	5.00
Karnataka	5.00
Kerala	4.00
Maharashtra	5.00
Madhya Pradesh	5.00
Manipur	4.00
Meghalaya	4.00
Mizoram	4.00

Nagaland	4.75
Orissa	4.00
Punjab	5.00
Puducherry	4.00
Rajasthan	5.00
Sikkim	4.00
Tamil Nadu	5.00
Tripura	5.00
Uttar Pradesh	4.00
Uttaranchal	4.00
West Bengal	4.00

States still charging agreed VAT rate of 4%
States who have differed from charging initial agreed rate and now charging 4.75%
States who have differed from charging initial agreed rate and now charging 5%

Various States and Difference in VAT Rates under Residual Category

STATES	VAT RATE UNDER RESIDUAL CATEGORY (%)
Andhra Pradesh	14.50
Assam	13.50
Arunachal Pradesh	12.50
Bihar	13.50

Chattisgarh	14.00
Dadra and Nagar Haveli	12.50
Daman and Diu	12.50
Delhi	12.50
Gujarat	12.50 + 2.5 Additional
Goa	12.50
Haryana	12.50 + 5% Surcharge
Himachal Pradesh	13.75
Jammu and Kashmir	13.50
Jharkhand	14.00
Karnataka	14.00
Kerala	12.50
Maharashtra	12.50
Madhya Pradesh	13.00
Manipur	13.50
Meghalaya	13.50
Mizoram	12.50
Nagaland	13.25
Orissa	13.50
Punjab	12.50+10% Surcharge

Puducherry	12.50
Rajasthan	14.00
Sikkim	12.50
Tamil Nadu	14.50
Tripura	13.50
Uttar Pradesh	13.50
Uttaranchal	13.50
West Bengal	13.50

States still charging agreed VAT rate of 12.5%
States who have differed from charging initial agreed rate and now charging 13.00%
States who have differed from charging initial agreed rate and now charging 13.25%
States who have differed from charging initial agreed rate and now charging 13.50%
States who have differed from charging initial agreed rate and now charging 13.75%
States who have differed from charging initial agreed rate and now charging 14.00%
States who have differed from charging initial agreed rate and now charging 14.50%& 15%

Above list clearly indicates as to how almost all the States have differed from initial agreed VAT rates thereby distorting the very purpose of introduction of VAT to create India as a single market.

Moreover, tax competition has increased among states to attract investment. Different states provide different location based / entity based exemptions thereby limiting the scope for competition. The entities which are entitled for availment of such location based / entity based exemption are placed at better position as compared to entities which could not avail such exemption. For instance, State of Maharashtra has provided exemption frompayment of tax in excess of 4% on sale of motor spirit made by specified list of oil companies. Similarly State of Kerala has provided exemption from levy of surcharge on specified commodities to specified dealers thereby differentiating one class of dealers from others. Many states refund VAT as subsidy for capital investment in selected areas/ sectors.

These are significant barriers inducing competition distortions in India, dividing India into various parts and thereby restricting seamless trade in the country.

The creation of the internal market as a seamless, single market is an ongoing process and as a nation we cannot be regarded as single market if we fragment every state and give liberty to them to charge different VAT rates for the same commodity or restrict credit on interstate movement of goods. The rationale behind introduction of VAT to create a single market and to have free flow of goods throughout the country has been completely distorted. It requires a relook / reframing of provisions so that the purpose to have India as a single market can be achieved.

Service Tax

Service tax is levied on rendering of specified services. Service tax being a central levy is uniform throughout the country and hence assures free flow of services throughout the country.

However, service tax is levied on specified services only and not on all the services. Hence, services which are covered under service tax net are required to pay service tax at applicable rate which is presently 10.30%. The services which are not covered under the gamut of service tax bears no such tax burden. There is also selective exclusion of certain entities form service tax for same service. For example transport by rail is exempted whereas by road is taxed. Similarly air condition restaurants are taxed but not the non-air condition restaurants. Services used in creating some infrastructures like road, bridges etc are not taxed whereas same services for some infrastructures are taxed like power plant.

As a nation, we should treat all the services equally and should bear the same tax burden excepting few services in the negative list which are of strategic national importance. Hence, to that extent, service tax levy is not uniform across all service sectors thereby distorting the principle of uniformity in taxes throughout the country.

NEED TO INTRODUCE GOODS AND SERVICE TAX (GST)

There is broad national understanding that the current multiple indirect tax structureneeds to be replaced by a common Goods and Service tax across India. The foundation for the same has already been laid by the introduction of the Constitution Amendment Bill in the Parliament in March 2011. A nationwide GST is intended to usher in a uniform market for goods and services, cut business costs andboost government revenues.

Implementation of GST is imperative for India to sustain high growth:

The existing tax structure has fragmented Indian market in to 29 state markets through tax barriers which discourages efficient production and supply chain models and restricts trade. Stand alone multiple taxes have cascading effect on cost leading to competitive disadvantage to Indian industry. Central Sales Tax (CST) on interstate movement of goods is not integrated with Value Added Tax hence CST paid on inter-state procurement is not eligible as a credit and continues to be an extra cost of doing business. Similarly, manufacturers are unable to avail themselves credit of state taxes and miscellaneous central taxes, such as VAT entry tax, octroi, etc against excise duty and vice versa and these become added costs along the supply chain.

In the proposed GST regime, manufacturers would be entitled to input tax credit of all taxes levied on inputs and capital goods purchased from within the State as well as inter-state, from a registered dealer for setting off the output tax liability on the sale of their finished products. Similarly, distributors would also be able to pass on the duty burden to their customers. This would ensure that there is no cascading effect of taxes and would result in the reduced cost of doing business. In the long run, this is likely to result in reduction in the prices of commodities as manufacturers and distributors would pass on the benefits of the lower costs of carrying on their businesses to the consumers in a competitive environment.

The case for having uniform tax on goods and services across India becomes even more compelling in view of India implementing number of free trade agreements (FTAs) with its neighbors, Asean countries and the Gulf nations. With so many FTAs in operation, there is immense pressure on India to rationalise its local tax regime to ensure a level-playing field for domestic manufacturing. This has made imperative for India to move to a uniform goods and services tax regime to be competitive. GST will help to overcome various indirect tax issues under present taxation system in India.

How does GST work?

GST is a comprehensive value added tax on goods and services which is collected on value added at each stage of sale and purchase in the supply chain across a tax jurisdiction. There is no difference in taxing goods and services. In GST regime, as the goods and services move through the supply chain, GST is collected on the value added at each level of the supply chain. A fundamental feature of GST is the ability of taxpayers to claim a full credit for ‘input tax’.

Goods and Service Tax (GST) is a multi-stage consumption tax imposed on a broad range of goods and services. It is a tax on each transaction and the end customer who ultimately consumes the goods / services will be the one who bears the tax

To understand how input tax credit mechanism works, let us take example of a manufacturer who pays GST on purchases that he makes. The GST paid on purchases will be his GST input tax. When such manufacturer subsequently sells the manufactured goods to his customers, the manufacturer will charge GST on the value of the manufactured goods sold. The GST levied by the manufacturer is his GST output tax. The manufacturer will have to pay/ account to tax authority the difference between the GST output tax that he charges to his customers and the GST input tax that he incurred on his purchases.

GST rate has been assumed to be 10%.

	Sale Price (before GST)	GST levied on supply of goods	GST incurred on purchases	Net GST to be remitted to tax authorities
Supplier	200	20	-	20
Manufacturer	500	50	20	30
Wholesaler/retailer	700	70	50	20

End customer	Total GST collected by Government	70

From the above illustration, it can be noted that GST is collected on the value added at each level in the supply chain. At the supplier level, the supplier charges and collects GST of 20 on his sale value of 200 to the manufacturer. The GST charge of 20 will be his output tax. As he does not incur any GST on his purchases, he has no GST credit against his GST output tax of Rs. 20 and will pay the same to the Government. As for the manufacturer, he will charge GST on his sale value of 500 to wholesaler/retailer. Since he has incurred GST of 20 when he purchased the raw material from supplier, he will be allowed to take credit of 20 against his output tax liability of 50. Essentially, he will pay GST of 30 which represents the amount of GST on his value added (50 - 20). The same applies to wholesales and retailer level. The final consumer will pay a total sum of 70 GST when he purchases the goods from wholesaler/ retailer.

Is it feasible to implement GST in India in near future?

Integration of multi layered indirect taxes in India in to single GST is not easy under India's federal structure and constitutional framework which gives sovereign taxation powers to the Central Government and 29 State Governments. These taxation powers cut across supply chain. As per Indian constitution, State Governments can levy tax on 'sale of goods' in the state, on immovable property, entertainment activity, luxury hotels, manufacture of alcoholic products, vehicles and certain other specific taxes. Federal Government can levy tax on manufacture of goods, services, import and export of goods and other miscellaneous taxes.

Therefore replacement of present tax structure by GST will necessitate amendment to the Indian constitution. **This can be done only if the Indian Parliament approves such amendment by two third majority of members and it is also ratified by over 50% of the 29 State assemblies.** This process has already been initiated in March 2011 by introduction of the Constitution Amendment Bill in the Indian Parliament. Although there is broad consensus within India to implement GST in a framework which does not conflict with country's federal structure of Governance, there are several issues which needs to be addressed and the entire legal process takes time to complete.

Proposed Dual GST model in India:

The GST model proposed to be introduced in India is dual GST structure which is compatible with India's federal structure. It would integrate most of the existing indirect taxes currently levied by federal and state governments on tradable goods and services such as excise duty, service tax, state VAT/ sales tax, countervailing custom duty, luxury tax, and entertainment tax etc except basic customs duty on import. Indian GST model will meet all the basic features of GST as explained hereinabove; however there is one major difference compared to the GST models operating in most other countries. In India, GST will be levied by both centre and state on the same tax base at pre-determined tax rates, at each stage of supply chain. Input tax credit will also be allowed on the same basis. Thus, a tax payer will simultaneously pay Central GST and State GST separately on transactions at each level of value addition.

Progress on the GST Structure:

- Empowered committee of all 29 State Finance Ministers (EC) which is spearheading GST initiative had constituted Joint Working Groups in 2007 consisting of the tax officials from central and state Government, to study various administrative and procedural aspects. These groups have submitted their reports to EC.

- EC issued first discussion paper in March 2008 outlining GST model for public debate. It has to now finalise Indian GST structure in consultation with Central Government and prepare the road map for its implementation.

- Phase out of origin based inter-state tax (CST) started in April 2007 and CST rate reduced from 4% to 2% in 2 stages. Thereafter further phase out discontinued.

- Central Government started aligning taxation of goods and services under CENVAT and Finance Act in 2011. Point of taxation Rules implemented for taxation of service on accrual basis from April 2011.

- Information Technology platform has been created at pilot scale by an independent agency for processing of transactions and tax returns under GST.

- Constitution amendment Bill introduced in March 2011 in the Parliament to facilitate introduction of dual GST.

- Model legislation for Central GST and State GST is being prepared.

Although significant progress has been made for introduction of GST in India during last 5 years, still there are certain road blocks which need to be cleared to facilitate implementation of GST. Moreover, the proposed exclusion of certain products and taxes from GST needs to be reconsidered.

Road blocks to be cleared before implementing GST in India

- Indian constitution demarcates the power of the Union and State Governments to independently impose and collect taxes within their domain. The tax rates and tax base is determined by them based on revenue requirement and socio political considerations. In the democratic set up different political parties may rule the central and some states Governments. Hence there has to be agreement on the basic frame work of GST and the administrative mechanism. While the broad consensus has been achieved, the detailed mechanism is yet to be agreed.

- Any change in the taxation powers of federal or state governments requires amendment to the Indian constitution. This can be done only if Indian Parliament approves such amendment by two third majority of its members present and it is also to be ratified by more than 50% of the 29 State legislative assemblies. The Amendment Bill has already been introduced in the Parliament; however the legal process is time consuming and will require support of Parliament and state assemblies.

- The phased elimination of the 'origin based' non vat-able taxes on interstate trade such as CSTand Entry tax are to be completed before introduction of GST. If entry tax has to continue to finance local municipalities, it should be made Vat-able and there should be reasonable ceiling on its rate.

- Centre and States have to agree on common threshold limits, common list of exempted goods and services and common list of products with negative externalities for the levy of excise duty and sales tax.

- Agreement on treatment and taxability of imports and exports of goods and services yet to be reached. Many Indian states are land-locked hence their imports meant for these states takes place though few coastal states.

- The centre and states have to synchronies their administrative procedures and IT infrastructure. This process has been initiated but need to be completed before implementation of GST and communicated to tax payers.

- Uniform GST legislation at central and the State level which will subsume existing cascading taxes has to be prepared and approved by center and states before GST is implemented. This is to be introducedsimultaneously.

- A Central dispute resolution institution has to be set up to settle legal disputes between different states and between centre and states relating to operation of GST which also has to ensure that tax barriers are not created after introduction of GST.

Positive impact of GST on Indian economy:

- The implementation of GST will positively reshape the Indian economy and the business structure and processes and make them more efficient and competitive.

- Uniform GST with just one or two tax rates as proposed on all goods and services across the entire supply chain will be quite simple tax structure. This will significantly reduce the transaction cost for the tax payers in their tax compliance and for the government to administration it.

- GST will be levied on all goods and services across entire supply chain (with a few exceptions). This will enhances the tax base with consequent increase in tax revenue due to wider tax base & better compliance. There is a built-in control mechanism to ensure tax compliance since the input tax credit is allowed at the next stage only if the supplier from whom goods or service is purchased issues tax paid invoice. More over its simplicity also encourages voluntary compliance. This will increase tax-GDP ratio and bring buoyancy in tax revenue.

- GST will allow full credit of all input taxes across supply chain and across states within a tax jurisdiction. Thus, it eliminates cascading effect of all taxes on production and distribution costs of goods and services. This seamless credit mechanism under GST will improve cost competitiveness of indigenous producers of goods and service providers.

- GST will make Indian exports more competitive on account of zero rating of all taxes paid on inputs and services used in export production and export of services.

- GST will enhance manufacturing and distribution efficiency of Indian enterprises. It will facilitate economy of scale in view of seamless input tax credit in a supply chain across states. It will also reduce distribution cost as there will be no tax barrier in proposed GST on inter-state movement of goods.

- GST is a more structured and transparent form of indirect taxation. It has proven itself in more than 140 countries as the most efficient and effective method of providing revenues to the government, while encouraging economic growth and efficiency. In turn, it will improve productivity and is expected to reduce price of goods and services for the Indian consumers. Once it is implemented, it will make India one common market which is currently fragmented by tax barriers.

GST will replace most of the existing multiple taxes such as excise duty, service tax, VAT with a single tax. The states and the union government will impose the tax on almost all goods and services produced in India or imported. Exports will not attract GST. Eliminating a multiplicity of existing indirect taxes will simplify the tax structure, broaden the tax base, and create a common market across states and federally administered districts.

Impact of GST on different stake holders:

Replacement of the existing multiple tax structure by single Goods and Service Tax will have significant beneficial impact on all stake holders.

- GST will eliminate the cascading impact of taxes on production and distribution cost of indigenous manufactured goods to extent of 10 to 15% on average. This will significantly improve the competitiveness of Indian industry.

- GST will widen the tax base on covering all most all goods and services and entire value chain and will improve the tax compliance due to its simplicity. This is likely to increase tax-GDP ratio by 2%.

- GST will remove distortions in the economy. It will encourage economy of scale and efficiency in business models due to its tax neutrality to different models.This is expected to increase economic growth by 1.4% to 1.6% on account of efficient use of resources.

- Simple tax system and less litigation will attract more investment and productive employment in India.

- Lower cost of production and compliance cost will reduce prices of goods and services in the medium term thereby benefitting the consumers and its favourable impact of their living standard.

Thus GST is expected to provide significant benefits to all stakeholders. GST is crucial for India's international competitiveness, revenue buoyancy and economic growth. GST will ensure free flow of goods and services across the country and will make India a competitive market internally as well as externally.

Risks and shortcomings in proposed GST Structure:

- The expected benefits and gains may get reduced if all the existing taxes on tradable goods and services are not replaced by GST. There is resistance by the center and states to merge all such indirect taxes. For instance crude petroleum, natural gas and electricity which are input in a large number of industries are proposed to be kept out of GST. This will continue to have negative impact on cost of product in India where these are used.

- Local taxes are proposed to be kept out of GST. Such non vat-able taxes like entry tax, octroi, local entertainment tax etc if kept out these will create tax barrier in making India a common market and also add to the production cost if these are levied on inputs. In due course the existing rates of such local taxes can be increased by states leading to fragmentation of market and litigation under Article 301 for creating tax barrier.

Taxes proposed to be excluded from GST are stated below:

CENTRAL TAXES:

- Duty on 3 Petroleum Products (petrol, diesel, aviation fuel) and crude oil
- Excise Duty on Tobacco Products (In addition to GST)

STATE TAXES:

- Tax on Natural Gas
- Electricity Duty
- Tax on 3 Petroleum Products and crude oil
- Tax on Alcoholic Beverages
- Entertainment tax by local bodies
- Entry tax/ Octroi for local bodies
- Stamp Duty/ Property tax

Such exclusion will continue to have multiple taxes thereby distorting the tax structure. Such a move is likely to result in cascading of taxes, which needs to be avoidable so as to make India a single and competitive market.

- The mechanism to ensure stability of GST structure after its implementation is not provided in the proposed Constitution Amendment Bill. Therefore there is a possibility that in due course, the states or center may deviate from the original structure and resort to multiple tax rates or restriction on tax creditsusing their taxing power, as has been happening recently in the case of state VAT. There is a need for a binding agreement among the states to have uniformity in the tax structure or setting up of an empowered council of states who ensures uniformity and certainty in tax structure among all states and whose decisions are binding on all states.

CONCLUSION:

The existing tax structure has fragmented Indian market in to 29 state markets through tax barriers which discourages efficient production and supply chain models and restricts trade. Stand alone multiple taxes have cascading effect on cost leading to competitive disadvantage to Indian industry. Central Sales Tax (CST) on interstate movement of goods is not integrated with Value Added Tax hence CST paid on inter-state procurement is not eligible as a credit and continues to be extra cost of doing business. Similarly, manufacturers are unable to avail themselves credit of state taxes and miscellaneous central taxes, such as VAT entry tax, octroi, etc against excise duty and vice versa and these become added costs along the supply chain. Therefore it is imperative that the existing multilayer complex tax structure is replaced by a rational Goods and Service Tax structure merging all the existing indirect taxes on tradable goods and services.

The proposed GST will replace most of the existing multiple taxes such as excise duty, service tax, VAT with a single tax. The states and the union government will impose the tax on almost all goods and services produced in India or imported. Exports will not attract GST. Eliminating a multiplicity of existing indirect taxes will simplify the tax structure, broaden the tax base, and create a common market across states and federally administered districts.

Implementation of Comprehensive GST would be the ultimate finale of the fiscal reform process in India which was embarked upon a decade ago. Once implemented, it will accelerate economic growth and take India to a commanding position in the world economy. GST will have positive impact on all stake holders. It is expected to:

- Increase in GDP growth by 1.4% to 1.6%;
- Increase Tax GDP Ratio up to 2% ;
- Reduce overall cost of indigenouslymanufactured goods by 10% leading to reduction in price of manufactured goods;
- Significantly reduce tax compliance and administration cost due to simple uniform structure;
- Provide horizontal equity at national and business entity level;

This will be a win- win situation for all stake holders and for the country as a whole.

****

Annexure 1 – The Constitution of India, 1950 (‘the Constitution’)

Article 19 of the Constitution:

(1) All citizens shall have the right—

(*a*) to freedom of speech and expression;
(*b*) to assemble peaceably and without arms;
(*c*) to form associations or unions;
(*d*) to move freely throughout the territory of India;
(*e*) to reside and settle in any part of the territory of India; [and]
(*g*) to practise any profession, or to carry on any occupation, trade or business.

(2) Nothing in sub-clause (*a*) of clause (1) shall affect the operation of any existing law, or prevent the State from making any law, in so far as such law imposes reasonable restrictions on the exercise of the right conferred by the said sub-clause in the interests of the sovereignty and integrity of India, the security of the State, friendly relations with foreign States, public order,decency or morality, or in relation to contempt of court, defamation or incitement to an offence.

(3) Nothing in sub-clause (*b*) of the said clause shall affect the operation of any existing law in so far as it imposes, or prevent the State from making any law imposing, in the interests of the sovereignty and integrity of India or public order, reasonable restrictions on the exercise of the right conferred by the said sub-clause.

(4) Nothing in sub-clause (*c*) of the said clause shall affect the operation of any existing law in so far as it imposes, or prevent the State from making any law imposing, in the interests of the sovereignty and integrity of India or public order or morality, reasonable restrictions on the exercise of the right conferred by the said sub-clause.

Article 301 of the Constitution

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

Article 302of the Constitution

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

Article 303 of the Constitution

(1) Notwithstanding anything in article 302, neither Parliament nor the Legislature of a State shall have power to make any law giving, or authorising the giving of, any preference to one State over another, or

making, or authorising the making of, any discrimination between one State and another, by virtue of any entry relating to trade and commerce in any of the Lists in the
Seventh Schedule.

(2) Nothing in clause (1) shall prevent Parliament from making any law giving, or authorising the giving of, any preference or making, or authorising the making of, any discrimination if it is declared by such law that it is necessary to do so for the purpose of dealing with a situation arising from scarcity of goods in any part of the territory of India.

Article 304 of the Constitution

Notwithstanding anything in article 301 or article 303, the Legislature of a State may by law—
(*a*) impose on goods imported from other States or the Union territories any tax to which similar goods manufactured or produced in that State are subject, so, however, as not to discriminate between goods so imported and goods so manufactured or
produced; and

(*b*) impose such reasonable restrictions on the freedom of trade, commerce or intercourse with or within that State as may be required in the public interest:

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

Entry 52, List II, Seventh Schedule of the Constitution

52. Taxes on the entry of goods into a local area for consumption, use or sale therein.

Annexure 2 – Various pronouncements delivered by Honorable Supreme Courts (will be provided separately)

Annexure 3 - Value Added Tax (VAT)

Maharashtra Notification No. VAT.-1505/CR-107/Taxation-1

In exercise of the powers conferred by sub-section (4) of section 41 of the Maharashtra Value Added Tax Act, 2002 (Mah. IX of 2005) and in supersession of Government Notification, Finance Department, No. VAT-1505/ CR-107/ Taxation-1, dated the 1st April 2005, the Government of Maharashtra hereby exempts, from payment of tax in excess of 4 per cent. of the turnover of sales, the sales of motor spirits made by any of the oil companies listed below when made to any other oil company in the said list, namely:-

(1) The Indian Oil Corporation Limited,
(2) The Bharat Petroleum Corporation Limited,
(3) The Hindustan Petroleum Corporation Limited,
(4) The I.B.P. Limited,
(5) The Kochi refinery Limited,
(6) The Mangalore Refinery and Petrochemicals Limited,
(7) The Tide Water Oil Company (India) Limited,
(8) The Oil and Natural Gas Commission,
(9) The Chennai Petroleum Corporation Limited,
(10) Reliance Industries limited,
(11) Essar Oil Limited.

By order and in the name of the Governor of Maharashtra

Kerala Notification G.O (P)No:161/2008/TD. Dated,Thiruvananthapuram, 4th August,2008.

S.R.O. No: 817/2008.—In exercise of the powers conferred by sub-section (IA) of section 3 of the Kerala Surcharge on Taxes Act, 1957 (Act No:11 of 1957), and having considered it necessary in the public interest so to do, the Government of Kerala hereby exempt dealers who are Public Sector Undertakings, Co-operative bodies, single commodity chains and who exclusively deals in the commodities mentioned below from the levy of surcharge, namely"-

(a) Live Chicken
(b) Automobile
(c) Readymade garments
(d) Plywood
(e) Glass
(f) Cement
(g) Marbles, Granite and Tiles
(h) Timber
(i) Paints.

By order of the Governor