

CHAPTER 5

Goods and Services Tax

Introduction

5.1. This Commission is required to consider ‘the impact of the proposed implementation of Goods and Services Tax with effect from 1st April 2010 including its impact on the country’s foreign trade’, while formulating its recommendations. The changeover to the Goods and Service Tax (GST) will be a game-changing tax reform measure which will significantly contribute to the buoyancy of tax revenues and acceleration of growth, as well as generate many positive externalities. Three other items of consideration in our Terms of Reference (ToR), viz. (i) ‘...estimation of the resources of the Central and State Governments’; (ii) ‘... the objective of not only balancing the receipts and expenditure on the revenue account but also to generate surpluses in the capital account’; and (iii) ‘... to improve the tax- gross domestic product ratio of the Center and the States’ will also be influenced by the GST. This Commission therefore recognised the need to holistically examine all the issues relating to the implementation of GST.

5.2. The first phase of reform of indirect taxation occurred when the Modified Value Added Tax (MODVAT) was introduced for selected commodities at the central level in 1986, and then gradually extended to all commodities through Central Value Added Tax (CENVAT). The introduction and integration of service tax into CENVAT deepened this effort. Reform at the state level occurred through introduction of Value Added Tax (VAT) by all the states in the country in a phased manner between April 2003 and January 2008. Buoyed by the success of VAT, and mindful of the need for further improvement, the Government of

India (GoI) indicated in Feb 2007 that a roadmap for introduction of destination-based GST in the country by 1 April 2010 would be prepared in consultation with the Empowered Committee (EC) of state Finance Ministers. This commitment was reiterated in February 2008 and July 2009. The origin-based Central Sales Tax (CST) was successively reduced from 4 to 3 per cent and 2 per cent during 2007 and 2008, respectively, as part of this reform process. In November 2007, a Joint Working Group consisting of representatives of the Empowered Committee and the Government of India prepared a report on the changeover to GST. This report was discussed by the EC, which then prepared ‘A Model and Road Map for Goods and Service Tax in India’ in April 2008. The model and roadmap, while recommending that a dual GST be put in place, also provided preliminary views on the state and central taxes to be subsumed within the GST. The model detailed the operational issues which needed to be addressed, including the number of rates, the exemptions and exclusions from GST, as well as the treatment of inter-state transactions. The roadmap outlined the legal and administrative steps which needed to be taken in order to comply with the April 2010 time line. The Government of India’s response to this document formed the basis of the second round of discussions and reviews. This culminated in the release of the ‘First Discussion Paper on Goods and Service Tax in India’ in November 2009. This discussion paper provides details of the taxes to be subsumed, while at the same time, outlining the modalities of implementation of the tax. It also makes recommendations on a number of building blocks of the GST, including taxation of inter-state trade,

provision of compensation, treatment of area based schemes and the additional steps required to be taken. It, however, does not provide any guidance on the Revenue Neutral Rates (RNR) which need to be adopted at the central and state level. This discussion paper is expected to spark a public debate, leading to possible modification of the design and implementation modalities of the GST.

5.3 Commendable progress has been made over the past three years in generating a national consensus on GST. Agreement on the broad framework of this tax has now been reached. GST will be a dual tax, with both central and state GST components levied on the same tax base. All goods and services, excluding the agreed upon exemptions, will be brought into this base. No distinction between goods and services will be made, with a common legislation applying to both. However, a number of issues remain to be resolved. These need to be addressed carefully. Only if a model GST is put in place, can all its potential benefits be fully exploited. Given the large positive economic and fiscal externalities of the GST reform, putting in place an incentive structure to motivate all stakeholders to design and implement such a model GST was, therefore, a prime concern of the Commission. A number of State Governments and industry associations communicated to the Commission their concerns on the design and implementation of GST. To address these and other GST related issues including the mandate in our ToR, the Commission sponsored three independent studies. One, undertaken by the National Council for Applied Economic Research (NCAER) studied the impact of GST on international trade. The second was undertaken by a task force (TF) which examined the whole gamut of GST-related issues, from design to implementation and made suitable recommendations. Both these studies have been published on the website of the Finance Commission.¹ We review below their main findings and recommendations after briefly highlighting the concerns expressed by the State Governments.

Views of State Governments

5.4 The State Governments expressed their views on the structure of GST as well as its implementation modalities to the Commission during our state visits. Nine State Governments gave their views in their respective memoranda and some expressed their views through letters to the Commission. While all the states broadly supported the introduction of GST, the major concerns expressed by them are detailed hereunder.

5.5 *Determination of the tax base:* Some State Governments pointed to the importance of accurately assessing the tax base that would be available to them under GST. They noted that with regard to service tax, figures presently available were those pertaining to the point of collection, rather than to the point of incidence. Also, the rules of supply for services have not yet been finalised. States which presently have a high tax effort apprehended that the RNR finally agreed upon would not be favourable to them. Manufacturing states would suffer additionally due to the abolition of CST. They suggested that the GST rates should, therefore, be used as a floor rate.

5.6 Low income states argued that as their consumption base was low, and they had increased their tax effort significantly after implementing VAT, there was little scope for them to increase their revenues under the proposed GST regime.

5.7 *Vertical imbalance:* It was apprehended that the GST could possibly accentuate the vertical imbalance in favour of the Centre through a proportionally larger Central Goods and Services Tax (CGST) rate and access to a larger consumption base, hitherto unavailable to the Centre.

5.8 *State autonomy:* The GST requires a commitment to a stable rate structure. This will compromise the fiscal autonomy of State Governments and deprive them of the only lever of macro-economic policy available to them.

5.9 *Single rate:* A single GST tax rate would be regressive, with the tax levied on items of common

¹ The final report of the third study was awaited at the time of writing. It will also be put on the FC website after receipt.

consumption increasing, while providing needless relief to the higher taxed luxury goods.

5.10 *Compensation mechanism:* Some states currently having a high tax effort noted the possibility of suffering losses upon implementation of GST. They requested that an objective compensation mechanism to support such losses be put in place. Compensation on loss of CST should also be part of this package.

5.11 *Small enterprises:* Small enterprises manufacturing specified goods with an annual turnover of less than Rs. 1.5 crore are presently exempt from excise. The GST will bring them into the tax net, rendering them uncompetitive and enhancing their compliance cost.

5.12 *Cesses and surcharges:* All cesses and surcharges levied by both the Centre and the states should be subsumed into the GST.

5.13 *Taxes to be excluded from GST:* Electricity duties; purchase tax; and taxes on crude oil, motor spirit (MS), high speed diesel (HSD), alcohol and tobacco should be excluded from the purview of GST.

5.14 *Compliance mechanism:* The GST law should be subject to rigorous compliance and deviations should not be permitted. Changes should be made only with the consent of all the states.

5.15 *Selective rollout:* States should be given the option to adopt GST at their convenience and the possibility of implementation of GST in only some states should be incorporated in the design.

5.16 *Dispute Resolution:* An independent dispute resolution mechanism should be put in place.

5.17 *Implementation modalities:* All tax returns, assessment and audit procedures should be harmonised across the country. A comprehensive information technology (IT) based infrastructure should be put in place to track inter-state transactions.

5.18 Adequate preparation for the changeover, rather than an arbitrary fixed schedule, should be the sole criterion for deciding the timing for introduction of GST.

5.19. The CST Act should be abrogated such that the provision for notifying declared goods is not available to the Centre.

5.20. The rules of supply for inter-state sales should be finalised expeditiously, in an objective manner. Further, the modalities for levying GST on imports, textiles and sugar should be agreed upon.

Views of the Central Government

5.21. During our consultations with the Central Government, they expressed concerns about the following issues:

- i) The recommendation in the Discussion Paper that GoI maintain the CGST threshold at Rs. 1.5 crore, while the State Goods and Services Tax (SGST) composition threshold would be Rs. 40 lakh.
- ii) The importance of agreeing upon a uniform and limited list of exempted items for the Centre and for all the states.
- iii) The criticality of promoting the power sector and the importance of subsuming electricity duty into GST.
- iv) The need to subsume purchase tax into GST to ensure that it remains a consumption-based tax and is not exported across tax jurisdictions.

Impact of GST on Foreign Trade

5.22. A NCAER study, commissioned by us, evaluates the possible impact of GST on India's international trade in a Computable General Equilibrium (CGE) framework. It notes that the differential multiple tax regimes across sectors of production are leading to distortions in the allocation of resources as well as production inefficiencies. Complete offsets of taxes are not being provided to exports, thus affecting their competitiveness. It estimates that implementation of a comprehensive GST across goods and services will enhance the nation's Gross Domestic Product (GDP) by between 0.9 and 1.7 per cent. This works out to between Rs. 52,600 crore and Rs. 99,450 crore on the basis of GDP figures for 2009-10. Such

benefits would accrue every year. It would also lead to efficient allocation of the factors of production, with a fall in the overall price level. The report identifies a number of sectors which would directly benefit from the implementation of GST. The study estimates the gain in exports to vary between 3.2 and 6.3 per cent. Imports are expected to gain between 2.4 per cent and 4.7 per cent, thus improving the trade balance.

5.23. The study estimates the revenue-neutral GST rate across goods and services to be between 6.2 and 9.2 per cent, depending upon the assumptions made. This value was conservatively arrived at, ignoring the existence of tax thresholds and composition limits. The study assumes that the GST adopted will be a truly consumption based tax which will: (i) eliminate all origin based taxes; (ii) subsume all the other presently levied indirect taxes on goods and services (excluding customs) and (iii) will not be exported across tax jurisdictions. To exploit the benefits of GST fully, we also need to ensure that tax compliance costs are low and tax credits are available seamlessly across tax jurisdictions. Apart from uniform tax rates, this will also require harmonisation of procedures for levy, assessment, appropriation and even audit, between the states and the Centre, as well as amongst the states themselves. This is best done through a model GST, the characteristics of which are outlined in Para 5.25.

Report of the FC -XIII Task Force

5.24. The task force, appointed by this Commission, comprehensively analyzed all GST related issues and made a number of recommendations. The Task Force Report is available on the Commission's website. The key points are summarised below:

- i) Following the present VAT, the GST should be levied on consumption and computed on the basis of the invoice credit method.
- ii) All major indirect taxes (excluding customs) and all cesses and surcharges should be subsumed into the central and state GST.

Specifically, stamp duty, taxes on vehicles, taxes on goods and passengers and taxes and duties on electricity should be subsumed into the GST.

- iii) Transmission fuels, High Speed Diesel (HSD), Motor Spirit (MS) and Aviation Turbine Fuel (ATF) should be brought under a dual levy, of GST and an additional levy, with no input tax credit available on the additional levy. This would protect the existing revenues from these sources. However, all other petroleum products should be brought within the ambit of the GST, as should natural gas.
- iv) The sumptuary goods of tobacco and alcohol should be taxed through GST as well as an additional levy, with no input tax credit being provided on the additional levy.
- v) The entire transportation sector should be included in the GST base, and taxes on vehicles, goods and passengers should be subsumed into the GST. Similarly, the power sector should be included in the tax base and electricity duty subsumed.
- vi) The real estate sector (both residential and commercial) should be included in the tax base and stamp duty levied by State Governments should be subsumed into GST. A threshold of Rs. 10 lakh in this regard will permit exemption of small residential and business properties.
- vii) The entire financial services sector should be brought under the GST tax base.
- viii) Capital goods should be treated like all other goods and services, with no restrictions on avilment of input tax credit at purchase, and a corresponding liability for GST on subsequent sale.
- ix) No exemptions should be allowed, except for a common list applicable to all states as well as the Centre, which should only comprise : (a) unprocessed food items; (b) public services provided by all governments

- excluding railways, communications, public sector enterprises; (c) service transactions between an employer and employee and (d) health and education services.
- x) 'Place of supply' rules for goods and services should be based on international best practice, and be carefully framed to ensure consistency, credibility and relevance.
- xi) An exemption threshold of Rs. 10 lakh should be adopted, with a composition limit of Rs. 40 lakh, above which GST would be mandatorily applicable. The present excise exemption upto Rs. 1.5 crore should be withdrawn. However, in the case of certain high value goods comprising: (i) gold, silver and platinum ornaments; (ii) precious stones and (iii) bullion, the dealers may, subject to the threshold limit of Rs. 10 lakh but without the ceiling of Rs. 40 lakh, also be allowed to opt for the composition scheme.
- xii) Area-based exemptions should be withdrawn and the tax paid reimbursed wherever considered necessary.
- xiii) Inter-state transactions should be treated through a mechanism which permits sellers in one state to charge SGST from buyers in another state. The seller shall furnish the transaction related information and composite payment of tax in respect of both intra and inter state transactions, to nodal bank. This SGST should then be immediately credited to the consuming state by the bank where such payment is made.
- xiv) Harmonisation should be ensured in registration, return filing, assessment, and audit across states.
- xv) The GST tax base has been estimated at Rs. 31,25,325 crore. This is the average of five different estimations of the tax base obtained by following as many approaches. These estimates are given in Table 5.1.
- xvi) The consequent Revenue-Neutral Rate works out to 11 per cent (5 per cent for CGST

Table 5.1: Estimates of the Tax Base of GST by Different Approaches

	(Rs. crore)
1. Subtraction Method	30,73,037
2. Consumption Method	
a. Task Force Method	37,43,077
b. NCAER Method	30,77,952
3. Shome Index Method	27,82,809
4. Revenue Method	29,49,748
Average	31,25,325

and 6 per cent for SGST). This excludes the additional levies which would be imposed on petroleum and sumptuary goods. The task force has recommended that all goods and services should be subject to tax at the single positive GST rate of 12 per cent (that is, 5 per cent for CGST and 7 per cent for SGST) other than exports.

The Model GST

Outline of the Model GST

5.25. Keeping in mind the recommendations of the task force, we outline the design and modalities of a model GST law. Such a model GST would not distinguish between goods and services. It should be levied at a single positive rate on all goods and services. Exports should be zero-rated. Tax compliance costs should be low and tax credits should be available seamlessly across tax jurisdictions. The other design and operational modalities of a model GST are outlined below.

Taxes to be Subsumed

5.26. For the GST to be purely consumption based, all related indirect taxes and cesses should be subsumed into it. Thus, the Central GST portion would subsume the following taxes:

- i) Central excise duty and additional excise duties
- ii) Service Tax
- iii) Additional Customs Duty (Countervailing Duty)
- iv) All surcharges and cesses

5.27. The SGST portion would subsume the following taxes:

- i) Value Added Tax
- ii) Central Sales Tax
- iii) Entry Tax, whether *in lieu* of octroi or otherwise
- iv) Luxury Tax
- v) Taxes on lottery, betting and gambling
- vi) Entertainment Tax
- vii) Purchase Tax
- viii) State Excise Duties
- ix) Stamp Duty
- x) Taxes on vehicles
- xi) Tax on goods and passengers
- xii) Taxes and duties on electricity
- xiii) All state cesses and surcharges

Special Provisions for Certain Goods

5.28 The taxation of petroleum products and natural gas would be rationalised by including them in the tax base. HSD, MS, and ATF could be charged GST and an additional levy by both the Central and State Governments. No input credit would be available against either CGST or SGST on the additional levy. A similar treatment would be provided to alcohol and tobacco. Such an arrangement would ensure protection of existing revenues while taking care of environmental concerns.

Exemptions

5.29 No exemptions should be allowed other than a common list applicable to all states as well as the Centre, which should only comprise: (i) unprocessed food items; (ii) public services provided by all governments excluding railways, communications and public sector enterprises and (iii) service transactions between an employer and employee (iv) health and education services.

5.30 A threshold of Rs. 10 lakh and a composition limit of Rs. 40 lakh have been agreed upon by the EC for SGST in the first discussion draft. It is

desirable that these limits be applied to CGST as well. Sales of goods of local importance will fall within these threshold limits, thus keeping them out of the ambit of GST.

5.31 Dealers with turnover below Rs 1.5 crore were previously exempt from CENVAT. As thresholds need to be consistent across SGST and CGST, such exemptions should not continue. Under the GST regime, dealers with turnovers between Rs. 10 lakh and Rs. 40 lakh will have to pay both CGST and SGST. Their compliance burden will increase. This issue can be addressed if both CGST and SGST are levied and collected from such dealers by a single agency, viz. the State Government, which would then remit the CGST portion to the Central Government. State Government will be responsible for assessment, levy, collection and audit, with Central Government retaining it right to exercise these functions in respect of CGST in specific cases. State Governments could be reimbursed the collection charges for this effort. Wherever the additional levy is likely to cause hardship, a scheme for reimbursement to economically vulnerable dealers could be considered by the government.

5.32 The present area-based exemption schemes are not consistent across the states where they are applicable. They differ in the admissibility of CENVAT credit as well as the sunset clause. Since it would be difficult to subsume these schemes into the GST structure, it is recommended that they be terminated. The existing schemes should not be grandfathered. Alternative options like refunding taxes paid by industries in these locations could be considered.

Treatment of Inter-state Sales

5.33 All transactions across tax jurisdictions should be free from tax. While exports will be zero rated, inter-state transactions should be effectively zero-rated so as to ensure that the tax is collected by the consuming state consistent with the destination principle. Therefore, any model adopted must allow accurate determination and efficient transfer of input tax credit across tax jurisdictions. Further, the model should not impose any undue restrictions on tax credit set-off or increase in compliance costs.

Formulation of Rules of Supply

5.34 The 'place of supply' rules for services need to be carefully framed to ensure consistency and credibility. It should be based on international best practice.

GST on Imports

5.35 Imports from outside the country would be subject to GST on the destination principle. This will require that proof of consumption at a pre-determined destination state should be provided. The procedure for collection and appropriation of this tax needs to be put in place. Rules for transferring this tax burden in the case of importers who sell to a consumer in a third state after the import is made, need to be clarified.

Operational Modalities

5.36 To reduce compliance costs and increase collection efficiency, all state GST laws should be harmonised. All stages of the taxation chain, from levy of the tax to its assessment, collection and appropriation, should be similar across states. This would involve similar rules across states, dealing not only with assessments, audit and refunds, but also with more basic issues like registration, filing of returns, treatment of transportation of goods, etc.

5.37 While CST will be reduced to zero, the necessity of stipulating documentation for inter-state trade needs to be carefully examined. The model for taxing inter-state sales finally adopted should provide clarity on the jurisdiction of states while facilitating inter-state trade and stock transfers. Given the volume of such transactions, this system necessarily has to be IT-based. Such an IT network should enable the sharing of information between states and assist in the plugging of revenue leakages. A system to facilitate inter-state verification of dealers and transactions is also necessary. The present system, viz. Tax Information Exchange System (TINXSYS), does not appear to be fully operational across all states. There are asymmetric benefits to states in putting in place such infrastructure and this appears to be affecting their incentives to do so. A system which will

uniformly incentivise all states to participate in and contribute to the verification system needs to be put in place. Alternately, one central agency could be charged with maintaining this system. The existing TINXSYS infrastructure should be updated and strengthened.

Dispute Resolution and Advance Ruling Mechanism

5.38 An effective, efficient and uniform system for redressal of anomalies in the legislation should be put in place. This could be an independent and quasi-judicial authority with full powers to look into all disputes related to GST implementation, both at the Centre and state level. Such an authority could issue guidelines, administer and enforce agreement between states and the Centre, and between the states themselves. A common Advance Ruling Authority for both the Centre and the states should also be put in place.

Refunds

5.39 Prompt refunds form the core of an effective GST framework, especially as cross-utilisation of input tax credit across CGST and SGST, are not envisaged. Delayed payment of refunds enhances the cost of dealer operations and reduces the efficiency of the tax system. The experience with refunds under the VAT regime is not reassuring, even though VAT laws in a number of states mandate payment of interest for delay. State Governments must adopt a more effective refund system. They could consider an electronic system where refunds are directly credited to the eligible dealer's bank account.

Selective Rollout

5.40 VAT was introduced in a phased manner by State Governments over a period of nearly three years, between April 2003 and January 2008. VAT dealt purely with the treatment of intra-state sales and states were not explicitly disadvantaged if they did not implement VAT. Transactions between VAT and non-VAT states did not warrant special treatment. However, GST changes the rules of the game. It requires inter-state trade to be zero rated.

It empowers states by including services as well as the manufacturing stage in their tax base. It thus creates an uneven balance between states which implement GST and those which do not. Goods and services sold between complying and non-complying states would thus require to be treated differently in the wake of selective implementation of GST. If CST were to continue to apply in non-complying states, inter-state sales would become further complex. Goods passing through a non-complying state, to be finally sold in a complying state, would be burdened by a cascading tax which would adversely affect the price to the final consumer. The seamless flow of Input Tax Credit (ITC) on inter-state transactions would be interrupted. Further, rate mismatches may encourage trade diversion and cost of compliance would become extremely high for inter-state dealers. This would discourage economies of scale. We, therefore, feel that the model GST should be implemented by all states and the Centre at one time, and not be partially implemented in some states. It is for this reason that we recommend that proper preparation for the GST and generating of a consensus amongst all states is a greater priority than complying with the 2010 deadline. However, as has been suggested in some quarters, it is possible for the Centre alone to transform the CENVAT into a GST at the manufacturing stage at any time. It could unify the CENVAT rates and impose a general tax on all services, while adopting a common threshold. As mentioned earlier, a dual tax on petroleum products, tobacco and alcohol could be levied—a GST component and an additional levy component with no input credit being provided on the latter.

Transition Provisions

5.41 A number of transitional issues will arise. Provisions to address such issues must be consistent with the model GST.

Benefits from Supporting the Model GST

5.42 This Commission supports the implementation of a model GST for the following reasons:

- i) The NCAER study computed the present value of GST-reform induced gains in GDP as the present value of additional income stream based on the discount rate of 3 per cent representing the long-term real rate of interest. The present value of total gain in GDP is estimated as between Rs. 14.69 lakh crore and Rs. 28.81 lakh crore. The corresponding dollar values are US \$325 billion and \$637 billion. This represents between 25 and 50 per cent of the 2009-10 GDP gained through this major tax reform. The all-government tax revenue will also increase by about 0.20 per cent of GDP, a significant increment to revenues through implementation of the model GST.
- ii) The Task Force report estimated that such a GST would have a tax base of around Rs. 31,00,000 crore. It further estimated that this would require a revenue-neutral rate of only 12 per cent (5 per cent for the Central GST and 7 per cent for the State GST). This is a substantial decrease from the present 20.5 per cent (8 per cent for CENVAT and 12.5 per cent for VAT). This should be the target.
- iii) Adoption of such a model GST would make India a dynamic common market and also result in generation of positive externalities. Despite lower levels of taxes, the revenue of the Union and the states will be buoyant. Subsumation of all major indirect taxes will result in removal of inefficient taxes. Our manufactures will become more competitive and consequently exports will grow. Provision of seamless input tax credit across all transactions will avoid tax cascading, eliminate double taxation and improve resource allocation. It will foster a common market across the country, reorient supply chains and remove the present bias towards backward integration. Further, it will also inhibit tax induced migration of investment. It will, thus, support the growth of lagging but resource-rich regions. A single rate across all goods and services will eliminate

classification disputes and make tax assessment more predictable. The harmonisation of tax assessment, levy and collection procedures across states proposed under the GST will reduce compliance costs, limit evasion, enhance transparency and improve collection efficiency.

- iv) Successful implementation of GST also offers the possibility of strengthening the revenue base of local bodies that form the third tier of government.
- v) The inclusion of real estate in the GST tax base will constrain the parallel economy with consequent positive spillovers into governance and the development of land markets.
- vi) The NCAER model suggests that GST could lead to better environmental outcomes.

Concerns of State Governments

5.43 We address below the principal concerns of states relating to revenue from certain products, loss of autonomy in a GST framework, possibilities of states entering GST in a phased manner and treatment of small enterprises.

Revenue from Certain Products

5.44 The model GST will accommodate the concerns of governments with regard to maintenance of their revenues from transmission fuels and sumptuary goods by allowing the imposition of an additional levy over and above the GST.

Dilution of Fiscal Autonomy of States

5.45 Concerns have been expressed by some state governments that the GST regime will constrict their fiscal autonomy and further tilt the vertical imbalance. However, this argument should be viewed in the following perspective:

- i) While the states will normally not be able to deviate from the nationally agreed model for the GST, such constraints will apply to the Centre as well. Further, the states still have

fiscal headroom available. They can impose an additional levy on transmission fuels as well as sumptuary goods and the authority to levy temporary cesses and surcharges in case of emergencies, remains. They can also continue to levy user charges for services provided to citizens. Expenditure policy will continue to remain as a powerful fiscal instrument. Further, the strengthening of their fiscal base will improve their access to capital markets, enhancing their borrowing capacity.

- ii) The tax base of State Governments will significantly increase with the inclusion of the tax on services as well as the tax on manufacture. The tax base of the Centre, on the other hand, will increase only to the extent of tax on sales. Thus, it cannot be said that the vertical imbalance will increase in favour of the Centre.
- iii) States will benefit from the abolition of the cesses and surcharges presently being levied by the Centre, as the size of the divisible pool will rise. Presently this amounts to about 15 per cent of the divisible pool.
- iv) Tax policy is tax administration, and significant scope exists for improving tax collection efficiency through implementation of GST.
- v) The GST grant recommended by this Commission compensates for the seeming limitation in fiscal autonomy by enhancing expenditure autonomy through compensation payments and additional formulaic transfers.
- vi) The GST will be a landmark effort by the states and the Union to further co-operative federalism with all stakeholders contributing to national welfare by accepting its framework.

Compensation Mechanism

5.46 An objective compensation mechanism incorporated in the 'Grand Bargain' will provide

reassurance to both the Central and State Governments. This has been proposed in Para 5.60.

Checkposts

5.47 Most states have put in place a system of checkposts on their border roads. There are a number of reasons for putting in place such physical barriers to trade. These include (i) enforcement of state excise, market cess, forest and vehicle fitness regulations (ii) applicability of lower taxes on inter-state trade than on intra-state trade (iii) there being no tax on stock transfers (iv) levy of entry tax on specified goods (v) levy of octroi by some municipalities and (vi) internal security. The onset of GST will not obviate all these reasons, and therefore, check posts on state borders may remain. However, it must be recognised that such checkposts, by the very nature of their operations, generate enormous delays in road traffic. The arrangement also encourages rent-seeking behaviour. It may be difficult to eliminate checkposts, given the valid concerns of State Governments. But what appears to be egregious is that the same vehicle has to pass through two checkposts—the exporting state’s checkpost and the importing state’s checkpost—while crossing one border. Both these checkposts are often located within a couple of kilometres of each other and a transport vehicle has to spend considerable time at both. Perhaps, it may be possible for both states to put up a combined checkpost. Officials of both states could sit together and conduct their verifications in a single check post. Alternately, one state could handle traffic in one direction and the other state in the other direction, essentially ensuring that there would be only one check per border for a goods vehicle. Such an arrangement would significantly reduce travel time and we recommend it for consideration. There is an overwhelming rationale for minimising delays and thus reducing transaction costs. States could be encouraged to consider user-friendly options like electronically issued passes for transit traffic in order to reduce truck transit time through their states.

The Grand Bargain

5.48 We propose that both the Centre and the states conclude a ‘Grand Bargain’ to implement the

model GST. Keeping the experience of the implementation of VAT in mind, we suggest that the six elements of the Grand Bargain comprise: (i) the design of the GST; (ii) its operational modalities; (iii) binding agreement between Centre and states with contingencies for change in rates and procedures; (iv) disincentives for non compliance; (v) the implementation schedule and (vi) the procedure for states to claim compensation. The design of the model GST is suggested in paras 5.25 to 5.35. The operational modalities are outlined in paras 5.36 to 5.41. The proposed agreement between the Centre and states, with contingencies for changes in the agreement, is described in paras 5.49 to 5.51. The disincentives for non-compliance are described in paras 5.52. The implementation schedule is described in paras 5.57 to 5.59. The procedure for claiming compensation is at Para 5.60.

Binding Agreement between Centre and States

5.49 Compliance of states with the previously agreed upon guidelines for VAT has not been very uniform. A number of states have deviated from the three-tier VAT rates, thus indicating the need to put in place an enforcement mechanism. States are equally apprehensive that the Centre may unilaterally raise tax rates without consulting them. The Constitution does not envisage sharing of tax bases. Taxation powers are listed either in the State List or in the Central List, but not in the Concurrent List. For the first time since the Constitution was enacted, a tax base is proposed to be shared between the Centre and the states. It is, thus, necessary that a firm arrangement be put in place for implementing the GST to prevent deviations from the agreed upon model by either the Centre or the states.

5.50 One option is the possibility of a Constitutional provision to facilitate a tax agreement between the Centre and the states on the lines of the erstwhile Article 278. One suggestion is that the new Article 278 could read: ‘Notwithstanding anything in this Constitution, the Government of a state may enter into an agreement with the government of any other state or the union

government with respect to the levy and collection of any tax or duty leviable by them, and during the period such agreement is in force, the power of such states and union as the case may be, to make laws to impose any tax shall be subject to the terms of such agreement.’ It has been argued that such a provision will eliminate the need to amend the taxing powers entrusted to the Union and the states through Schedule VII of the Constitution.

5.51 Such an agreement (between the 28 states and the Centre as parties) could specify the tax rates adopted as well as the conditions under which the agreed tax rates can be changed. The agreement can be made part of Goods and Service Tax laws which the Centre and all the states will separately enact. The agreement will, amongst other things, specify the rates to be adopted in these enactments and the implementation schedule. For amending the rates subsequently, it is proposed that all states would need to agree to a proposal to decrease rates. Only three quarters of the number of states would need to agree if the rates have to be increased. The Centre would have a veto power. All amendments to the agreement should be consistent with (i) maintaining the integrity of the GST base; (ii) providing for administrative simplicity and (c) minimising compliance costs for taxpayers. The agreement will need to be monitored by the Empowered Committee which could be transformed after the implementation of GST into a Council of Finance Ministers with statutory backing.

Disincentives for Non Compliance

5.52 Keeping in mind the experience under VAT it may become necessary to deter violations of agreement by visiting a penalty on non-complying states. We recommend that Finance Commission’s state specific grants and the state’s share of the GST incentive grant be withheld for the period during which a state is in violation of the agreement. If a state is in violation for only part of a year, its grant should be reduced to a proportionate extent.

Compensation/Incentive Grants

5.53 This Commission is aware that the tenor of the ongoing discussions on the GST model and

implementation modalities does not include some of the major elements of the model GST outlined above. In our view, any major deviation from the concept of the model GST would dilute its positive externalities, significantly reduce its benefits and reduce the incentive to switch over. For the reasons outlined in Para 5.42, this Commission strongly urges that any GST model adopted be consistent with the Grand Bargain described in Para 5.48. To incentivise implementation of such a Grand Bargain between the states and the Centre, this Commission recommends the sanction of a grant of Rs. 50,000 crore to be provided to all states in the aggregate, subject to the GST framework adopted being consistent with the Grand Bargain. We recognise that while GST on the whole will be revenue neutral, there may be some winners and losers during the initial years of implementation. This grant will accommodate claims for compensation from the adversely affected states and balance will be distributed amongst states as per the devolution formula.

5.54 The grant of Rs. 50,000 crore would be used for meeting the compensation claims of State Governments between 2010-11 and 2014-15. Unspent balances in this pool would be distributed amongst all the states as per the devolution formula, on 1 January 2015. To allow for the possibility of implementation of GST during 2010-11, we propose that the grant be initially allocated as given in Table 5.2:

Table 5.2- Scheduling of GST Grant

2010-11	Rs. 5000 crore
2011-12	Rs. 11250 crore
2012-13	Rs. 11250 crore
2013-14	Rs. 11250 crore
2014-15	Rs. 11250 crore

5.55 We see this allocation as substantial for two reasons. First, the Task Force estimation of RNR provides assurance that such a level of compensation may not be required. Second, the amount of compensation required will depend upon the year in which GST is implemented. The total amount of Rs. 50,000 crore may be earmarked for

GST compensation and incentive provided the model GST is implemented before 31.3.2013. Unspent grants at the end of a year will be carried forward to the next year if GST is implemented before 31.3.2013. If GST is implemented during 2013-14, the grant will be restricted to Rs 40, 000 crore. If GST is implemented during 2014-15, the grant will be restricted to Rs 30,000 crore.

5.56 To be eligible to draw down this grant, all the elements of the Grand Bargain outlined in Para 5.48 will need to be adopted. If the GST framework adopted is not consistent with this, then this Commission recommends that this grant of Rs. 50,000 crore not be disbursed. Thus, if the Grand Bargain is not concluded, this grant will not mean any net fiscal outgo. If a model GST is implemented and the grant is disbursed, then the resultant increase in GDP and tax revenue will fully finance it. If the Grand Bargain is not put in place, then the grant lapses. There are, thus, no fiscal risks with this grant— only advantages.

Implementation schedule of the Model GST

5.57 We recognise that building consensus on implementing the model GST may be an involved process but equally appreciate that the requirement of a good design is paramount and should not be subordinated to a deadline. International experience tells us that flaws in design are extremely difficult to correct subsequently. We therefore recommend that marginal rescheduling of the timetable for implementation should be acceptable if the design adopted is consistent with the model GST.

5.58 The objective of the model GST is to optimise tax collection with minimal economic distortions. The Model GST should, inter alia, comprise of (i) a uniform rate for goods and services (ii) a uniform rate across states (iii) a zero rate for exports and (iv) for all other goods and services a single rate, excluding the rate for precious metals. There could be two possible approaches to the implementation of the Model GST: the 'big-bang' approach and the 'incremental' approach. The introduction of the GST is the last mile in the reform of the indirect tax

system of this country initiated in 1986 with the introduction of the MODVAT. All stakeholders stand to gain from a swift comprehensive changeover to the GST. To the extent the switchover is staggered, the potential gains from the comprehensive GST outlined in Para 5.42 would remain unrealised. Therefore, we recommend that all the elements of the model GST should be implemented comprehensively at one instance.

5.59 However, we are aware that two essential elements of the model have not yet been formally discussed by the states and consensus needs to be built before they are adopted. These are the inclusion of stamp duty in the GST tax base to enable the taxation of real estate and the use of a single rate in the GST framework. More time may be required for these elements to be included in the GST framework. Given that the terminal year of the period covered by our recommendations is 2014-15, we propose as follows. If found necessary, the GST may be initially implemented without these two elements provided that

- i) At the time of its implementation, the road map for their inclusion in the framework before 31 December 2014 is announced.
- ii) The GST is introduced with not more than two rates.
- iii) Properties other than individually owned residential properties are brought into the ambit of GST within two years of its implementation.

This contingency does not preclude the possibility of the Centre implementing GST at an accelerated pace.

Modalities for Disbursing Compensation

5.60 As mentioned in Para 5.10, states had requested that an objective compensation mechanism to support possible revenue losses after implementing GST be put in place. We recommend the following:

- i. The present Empowered Committee be transformed into a statutory Council of Finance Ministers with representation from

the Centre and states. A GST Compensation Fund should be created under the administrative control of this Council.

- ii. The Central Government shall transfer to the GST Compensation Fund amounts as indicated in Table 5.2 and subject to the conditionalities indicated in paras 5.55 and 5.56.
- iii. The amounts in the Fund should be used for compensating states for any revenue loss on account of adoption of the model GST and the Grand Bargain as indicated above. The balance, if any, remaining on 1 January 2015, will be distributed amongst the states on the basis of the devolution formula indicated in Chapter 8 of our report, used for distributing resources in the divisible pool amongst states.
- iv. The amount will be disbursed in quarterly instalments on the basis of the recommendations made by a three-member Compensation Committee comprising of the Secretary, Department of Revenue, Government of India; Secretary to the EC and chaired by an eminent person with experience in public finance. This person would be appointed by the Union Government.

The Way Forward

5.61 A number of legal and administrative steps need to be taken prior to the implementation of GST. These include stakeholder consultations, amendments to the Constitution and state laws, administrative reorganisation, preparation of GST registration, assessment and audit manuals, staff training and conduct of awareness campaigns amongst stakeholders. We have not touched upon these milestones in our discussion, but are aware that these processes may take substantial time. This is also a reason why we have earlier recommended that the putting in place an excellent design and operational framework for the GST should be given priority, even if this implies rescheduling the previously announced implementation timetable.

5.62 We recognise that the process of generating a consensus to implement the Grand Bargain as outlined by us may be difficult and involved. However, we believe that such a consensus can, and should be, generated to fully exploit the potential of GST and reap the benefits of its positive externalities. While we would like to support this model GST, which is fully consumption based, has provision for seamless credit and imposes low compliance cost, we must allow for the possibility that political economy considerations may will otherwise. In the unlikely event that such a consensus cannot be achieved and the GST framework finally adopted is different from the Grand Bargain suggested by us, this Commission recommends that the grant amount of Rs. 50,000 crore shall not be disbursed.

Impact of GST on Projections made by the Finance Commission

5.63 Though GST requires that all cesses and surcharges be abolished, and this Commission recommends that GST be implemented as early as possible, we have, in our projections, assumed continuing revenue for the Central Government from cesses for the period 2010-15. This has been done for the following reasons.

- i. Ignoring the positive externalities of GST, the Commission has conservatively assumed that GST will be revenue-neutral. Thus, income from cesses and surcharges will be included in the computation of RNR. In the scenario when GST is implemented, the aggregate revenue figures in our projections will remain unchanged, though the accounting heads under which they are reported may change. Since the catalysing effect of GST on the economy has not been factored in our projections, they can be seen as conservative.
- ii. A number of critical sectors, including roads, education, and calamity relief, are being funded from the proceeds of cesses levied by the Government of India. The transition plan to the GST must ensure that budget provisions are made to support such initiatives.

5.64 The model, the modalities as well as the timing of implementation of the GST have not yet been finalised. Making projections over a five-year period, assuming the implementation of the GST during this period, would, be a hazardous exercise. This Commission has, thus, for the purpose of our financial projections, assumed that the impact of GST will be revenue-neutral and that the gross revenues of the Centre and states will not be lower than those projected even after GST is implemented.

Summary of Recommendations

5.65 Both the Centre and the states should conclude a Grand Bargain to implement the model GST. The Grand Bargain comprises five elements: (i) the design of the model GST is suggested in paras 5.25 to 5.35; (ii) the operational modalities are outlined in paras 5.36 to 5.41; (iii) the proposed agreement between the Centre and states, with contingencies for changes is at paras 5.49 to 5.51; (iv) the disincentives for non-compliance are described in paras 5.52 (v) the implementation schedule is described in paras 5.57 to 5.59. (vi) the procedure for claiming compensation is at Para 5.60 (Para 5.48).

5.66 Any GST model adopted must be consistent with all the elements of the Grand Bargain. To incentivise implementation of the Grand Bargain this Commission recommends the sanction of a grant of

Rs. 50,000 crore which will taper down to Rs. 40,000 crore and Rs. 30,000 crore if GST is implemented after 1.4.2013 and 1.4.2014 respectively. The grant would be used for meeting the compensation claims of State Governments for revenue losses on account of GST implemented, consistent with the Grand Bargain, between 2010-11 and 2014-15. Unspent balances in this pool would be distributed on 1 January 2015 amongst all the states as per the devolution formula (paras 5.54 and 5.55).

5.67 The EC should be given formal authority. The compensation should be disbursed in quarterly instalments on the basis of the recommendations by a three-member Compensation Committee comprising of the Secretary, Department of Revenue, Government of India; Secretary to the EC and chaired by an eminent person with experience in public finance to be appointed by the Central Government (Para 5.60).

5.68 In the unlikely event that a consensus to implement all the elements of the Grand Bargain cannot be achieved and the GST mechanism finally adopted is different from the model GST suggested by us, this grant of Rs. 50, 000 crore shall not be disbursed. (Para 5.62).

5.69 States should take steps to reduce the transit time of cargo vehicles crossing its borders by combining checkpoints with adjoining states and adopting user friendly options like electronically issued passes for transit traffic (Para 5.47).