Ahmad and Stern (1991) analyze the optimal pattern of tax rates implied by a given degree of aversion to poverty and concern for the poor. At high levels of concern for the poor, one would reduce the tax on cereals (but not dairy products) and increase the taxes on non-food items (durables). Thus, a differentiated overall structure appears desirable for a country in which the government has consistently expressed a concern for the poor.

However, individual taxes should not be highly differentiated, as that complicates administration and makes it difficult to evaluate the overall effects of the tax design. This applies particularly to value-added type of taxes. In principle, a single rate (or at the most two-rate) VAT, together with excises and spending measures could achieve the desired distributional effects, for reasonable degrees of inequality aversion of policy makers.

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

The neutrality principle would suggest that:

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

**Ahmad, Poddar et al, (2008)**

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

**Amaresh Bagchi Report (1993)**

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

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

These changes have yielded significant dividends in economic efficiency of the tax system, ease of compliance, and growth in revenues.
Central Excise Act, 1944, (Bare Act), as amended

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

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

Central Sales Tax Act, 1956, (Bare Act), (as amended)

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

Constitution of India, 1950, (as amended)
The current division of taxation of powers under the Constitution is constraining for both the Centre and the States. Neither is able to design a comprehensive and neutral tax on goods and services of the type found in modern tax systems. The Constitution divides taxation powers between the Centre and the States by sector (e.g., agriculture, manufacturing, and land and property) or type of taxes (e.g., luxury tax, tax on the sale or purchase of goods, and excise duty). A notable feature of the current division is that the two levels of government have no area of concurrent jurisdiction, with the exception of stamp duties. This approach, while it may have served the country well in the past, is no longer optimal for modern economies where the traditional dividing lines between sectors are blurred, and new social, environmental, and economic issues emerge which require new forms of taxation instruments. The need for a substantial realignment of taxation powers is also emphasized by Rao (2008):

“Paradigm shift in tax policy is necessary to recognise that tax bases of central and state governments are interdependent. The principle of separation of tax bases followed in the Constitutional assignment does not recognise the interdependence. It is therefore desirable to provide concurrent tax powers to Centre and States in respect of both income and domestic consumption taxes. In the case of personal income tax, separation of tax powers between the centre and states based on whether the income is from agricultural or non-agricultural sector has been a major source of tax evasion. As agriculture is transformed into a business it is important to levy the tax on incomes received from all the sources both for reasons of neutrality and to minimise tax evasion. At the same time, both centre and states could be allowed to levy the tax with the latter piggybacking the levy on the central tax subject to a ceiling rate. Similarly, it is important to unify multiple indirect taxes levied by the central and state governments into a single goods and services tax (GST) preferably with states piggybacking on the central levy with clearly defined tax rooms for the two levels of government. The transition to such a concurrent tax system requires integrating the existing CENVAT and service taxes and extending the tax to the retail level which would, inter alia, entail amendment of the Constitution. The states could piggyback on the levy.”
Thus, the current search for options for tax reform warrants a review of the existing Constitutional arrangements, which may well require a substantial realignment. For example, the dual GST would require giving the Centre and the States concurrent indirect taxation powers, subject to prohibition on extra-territorial taxation, i.e., that the incidence of tax be restricted to consumption within the territory of the taxing jurisdiction. While such a review is beyond the scope of this paper, discussion of alternative options proceeds with the assumption that suitable constitutional amendments would be made to enable the implementation of the chosen option.

**Maharashtra Value Added Tax Act, 2002**

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

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

1. Taxation at Manufacturing Level

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

Manufacturing itself forms a narrow base. Moreover, the effective burden of tax becomes dependent on the supply chain, i.e., the taxable value at the point of manufacturing relative to the value added beyond this point. It is for this reason that virtually all countries have abandoned this form of taxation and replaced it by multi-point taxation system extending to the retail level.
Australia is the most recent example of an industrialized country replacing a tax at the manufacturing or wholesale level by the GST extending to the retail level. The previous tax was found to be unworkable, in spite of the high degree of sophistication in administration in Australia. It simply could not deal with the variety of supply chain arrangements in a satisfactory manner.

2. Exclusion of Services

The States are precluded from taxing services. This arrangement has posed difficulties in taxation of goods supplied as part of a composite works contract involving a supply of both goods and services, and under leasing contracts, which entail a transfer of the right to use goods without any transfer of their ownership. While these problems have been addressed by amending the Constitution to bring such transactions within the ambit of the State taxation (by deeming a tax on them to be a tax on the sale or purchase of goods), services per se remain outside the scope of state taxation powers. This limitation is unsatisfactory from two perspectives. First, the advancements in information technology and digitization have blurred the distinction between goods and services. Under Indian jurisprudence, goods are defined to include intangibles, e.g., copyright, and software, bringing them within the purview of state taxation. However, intangibles are often supplied under arrangements which have the appearance of a service contract. For example, software upgrades (which are goods) can be supplied as part of a contract for software repair and maintenance services. Software development contracts could take the character of contracts for manufacturing and sale of software goods or for rendering software development services, depending on the roles and responsibilities of the parties. The so-called ‘value-added services (VAS) provided as part of telecommunication services include supplies (e.g., wallpaper for mobile phones, ring tones, jokes, cricket scores and weather reports), some of which could be considered goods. An on-line subscription to newspapers could be viewed as a service, but online purchase and download of a magazine or a book could constitute a purchase of goods. This blurring also clouds the application of tax to transactions relating to tangible property. For example, disputes have arisen whether leasing of equipment without transfer of possession and
control to the lessee would be taxable as a service or as a deemed sale of goods. The traditional distinctions between goods and services (and for other items such as land and property, entertainment, and luxuries) found in the Indian Constitution have become archaic. In markets today, goods, services, and other types of supplies are being packaged as composite bundles and offered for sale to consumers under a variety of supply-chain arrangements. Under the current division of taxation powers, neither the Centre nor the States can apply the tax to such bundles in a seamless manner. Each can tax only parts of the bundle, creating the possibility of gaps or overlaps in taxation.

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

3. Tax Cascading

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

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

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

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

4. Complexity

In spite of the improvements made in the tax design and administration over the past few years, the systems at both central and state levels remain complex. Their administration leaves a lot to be desired. They are subject to disputes and court
challenges, and the process for resolution of disputes is slow and expensive. At the same
time, the systems suffer from substantial compliance gaps, except in the highly organized
sectors of the economy. There are several factors contributing to this unsatisfactory state
of affairs. The most significant cause of complexity is, of course, policy related and is due
to the existence of exemptions and multiple rates, and the irrational structure of the levies.
These deficiencies are the most glaring in the case of the CENVAT and the Service Tax.
The starting base for the CENVAT is narrow, and is being further eroded by a variety of
area-specific, and conditional and unconditional exemptions. A few years ago the
Government attempted to rationalize the CENVAT rates by reducing their multiplicity but
has not adhered to this policy and has reintroduced concessions for several sectors/products.

The complexities under the State VAT relate primarily to classification of goods
into different tax rate schedules. Theoretically, one might expect that the lower tax rates
would be applied to basic necessities that are consumed largely by the poor. This is not the
case under the State VAT. The lowest rate of 1% applies to precious metals and jewellery,
and related products—hardly likely to be ranked highly from the distributional
perspective. The middle rate of 5% applies to selected basic necessities and also a range of
industrial inputs and IT products. In fact, basic necessities fall into three categories –
exempted from tax, taxable at 5%, and taxable at the standard rate of 12.5%. The
classification would appear to be arbitrary, with no well accepted theoretical
underpinning. Whatever the political merits of this approach, it is not conducive to lower
compliance costs. Most retailers find it difficult to determine the tax rate applicable to a
given item without referring to the legislative schedules. Consumers are even less aware of
the tax applicable to various items. This gives rise to leakages.

Another source of complexity under the State VAT is determining whether a
particular transaction constitutes a sale of goods. This problem is most acute in the case of
software products and intangibles such as the right to distribute/exhibit movies or time
slots for broadcasting advertisements.
Compounding the structural or design deficiencies of each of the taxes is the poor or archaic infrastructure for their administration. Taxpayer services, which are a lynchpin of a successful self-assessment system, are virtually nonexistent or grossly inadequate under both central and state administrations. Many of the administrative processes are still manual, not benefiting from the efficiencies of automation. All this not only increase the costs of compliance, but also undermines revenue collection. However, of late realizing the loss some of the developed States have started the process of automation.

**OBJECTIVES OF TAX REFORM**

1. **Basic Objectives**

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

   Multiple VAT rates become a source of complexity, and disputes, adding to the costs of tax administration and compliance. It is for this reason that countries like New Zealand, Singapore, and Japan have chosen to apply the tax at a low and uniform rate, and address any concerns about vertical equity through other fiscal instruments, including spending programs targeted to lower-income households.

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

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

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

2. Fiscal Autonomy and Harmonization

An important consideration in the design of reform options is the degree of fiscal autonomy of the Centre and the States. It goes without saying that the power to govern and to raise revenues go together. The Constitution of India lays down a clear division of powers between the Centre and the States, including the power to levy taxes. Should the Centre and the States then have complete autonomy in levying and collecting the taxes within the parameters specified in the Constitution, or should they voluntarily or otherwise conform to certain common principles or constraints? Should they collectively agree to have their individual taxes consolidated into a single national tax, the revenues from which get shared in some agreed manner among the constituent units? Such a system would have much to commend itself from the perspectives of economic efficiency and the establishment of a common market within India. Indeed, such political-economy compromises have been adopted by China and Australia. China moved to a centralized VAT with revenue sharing with the provinces — ensuring that provinces got as much revenues as under the prior arrangements, plus a share of the increment. In Australia, the GST is a single national levy and all the GST revenues collected by the center are returned to the states. However, such a compromise is unlikely to find much favor with the States in India, as is already revealed in their preference for the Dual GST.
To give political substance to the federal structure in India, the States (as well as the Centre) are likely to insist that they have certain autonomy in exercise of their taxation powers. Full autonomy would mean that:

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

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

The elements of harmonization can be divided into three broad sets: tax rates, tax base and tax infrastructure, i.e., the administration and compliance system. The first two elements could be viewed as important levers on which States would want to have some degree of control to achieve their social, economic, and fiscal policy objectives.

However, the experience of other countries as well as their sub-national governments suggests that changes to the GST base are not a suitable instrument for social and economic policy (the treatment of food). While the tax base is a subject of intense debates at the time the tax is introduced, changes in the base after its introduction have been infrequent. This has especially been the case where the tax was initially levied on a broad and comprehensive base. Where the tax was initially levied on a narrow base, subsequent changes in the base have then been felt necessary to minimize anomalies, distortions, and revenue leakages created by the narrow base. Achieving such changes once the tax has been brought in, however logical, is invariably politically contention
because of vested interests. It is thus important to get the structure right at the outset, as the base (and quite often the rate) cannot be easily changed, ex post facto.

The VAT in the European Union is an example reflecting these policy considerations. The base for the EU VAT is uniform, as codified in the EU Directive, which is binding on all Member States. There are important variations in the base, but these are essentially in the form of deviations granted for the arrangements existing at the time of introduction of the tax, and were intended to be temporary (though this has not always been the case). The tax rates are specified as floor rates (with some provision for reduced rates and maximum rates), below which Member States cannot set their rates.

Administration and compliance is an area where the need for harmonization is the greatest, and where Centre-State or inter-state variations are unlikely to serve any social or economic policy objective. This includes items such as the taxpayer registration system, taxpayer identification numbers, tax forms, tax reporting periods and procedures, invoice requirements, cross-border trade information systems and IT systems.

Harmonization of these elements would result in significant savings in costs of implementing the GST (by avoiding duplication of effort in each government), as well as recurring savings in compliance costs. Harmonization would also permit sharing of information among governments, which is essential for effective monitoring of cross border transactions. A common set of tax identification numbers across states and the central government is a key element in the efficient exchange of information.

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

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

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