# Concept Note

Budget balance and optimal allocation considerations led the Kelkar Committee to propose in July 2004 a "Grand Bargain" between the Union and the States on the manner of levy and collection of central and state indirect taxes on transactions resulting in the supplies of all goods and services on a value-added basis at 'destination'. Since 2004 consensus has evaded law makers on an acceptable basis for the reform of indirect taxation policy as a component of the budget policy of 'the State' and on the requisite redefinition of the respective legislative competences of the Union and the States in the Constitution. There is a cleavage in the approaches of the two main national level political parties, one of which believes in being path-dependent in retaining the concepts defined in the Central Sales Tax Act, 1956; the other believing in a path-breaking approach in calling for repeal of that Act.

Reform may be taken as a transition from a perceived social disorder (such as tax-induced distortions in the prices of goods and services discovered by markets) to securing and protecting a social order in which social, economic and political justice prevails in the functioning of every relevant institution of national life. The institutions of national life include the institution of law and the institution of market. Institutions, which help reduce uncertainties in national life, are taken as relevant in aligning law making with the directive principles of 'State' Policy stipulated in Article 38 of the Constitution of India. 'State' Policy, whether relating to budget or any other matter, implies complete specification of its particulars after comparing the comparable alternatives taking into consideration the likely impact of all the relevant policy instruments to which all the entities subsumed by the institution of 'the State'( defined in Article 12 of the Constitution) are credibly committed. 'The State' is required to secure and protect a just social order in striving to promote welfare of the people of India. Welfare implies optimality in the allocation of resources, such as goods and services supplied to every recipient who, in assuming the risks involved in the receipt of the supply by overcoming other competing potential recipients, agrees in respect of any given transaction with the corresponding supplier (who outbids other competing potential suppliers in making the supply) on a price for the value of the supply in relation to its best use as determined by competition.

Tax-induced distortions in the prices of goods and services are avoided by providing for a legal incentive of either a current-stage tax suspension payable by a supplier at the 'origin' or a prior-stage tax credit for taxes paid by the tax payer in receiving supplies made to him. The tax payable by a tax payer out of the tax due on account of the supplies made by him is computed by allowing such legal incentive. The incentive of prior-stage tax credit is allowed when tax is collected, as envisaged by Kelkar Committee, on a value-added basis at 'destination'. The law makers need to agree on the choice of a uniform type of incentive (either a current-stage tax suspension or a prior-stage tax credit but not a mix of both) in respect of every transaction in the complex chain connecting the importer or domestic producer on the one hand with another domestic producer or domestic consumer or exporter on the other. They need to further agree on how a central primary tax authority may allow incentives envisaged in a state law and vice versa in case both central and state tax authorities are to be conferred concurrent jurisdiction to assess and collect central and state taxes respectively in respect of every transaction.

The seminar seeks to discuss all relevant issues with a view to help identify an acceptable basis after appropriate inquiries into the likely consequences of alternative policy options for the selection of the best of the alternatives of sets of policy instruments using which a reformed policy on indirect taxes as a component of the budget policy of 'the State' may be implemented by the rule of law. The discussion is expected to draw from the received wisdom in many disciplines including philosophy, law, welfare economics, new institutional economics, political science, public economics, and mechanism design.

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## CONTENTS

# Directive principle: sentiment or sense?*

WHEN THE people of independent India gave to themselves a new Constitution, they chose to embody in part IV of the Constitution a set of provisions entitled 'Directive Principles of State Policy'. The Constitution-makers were obviously inspired by the Irish Constitution which contained a similar set of provisions; but in framing the provisions they did make departures from the Irish model. Ever since, there has been a debate about the utility of the provisions as wel1 as their 'justiciability'. Their 'justiciability' was tested mostly in relation to the fundamental rights and the directives were relegated to a subordinate position.[1] The 25th amendment to the Constitution sought to place at least one directive superior to the fundamental rights. This would go to suggest that the directives have not received the recognition they should have got. And, this indeed looks to be the case.

At the time these directives were drafted into the Constitution, opinions on them varied from "a vegetable dustbin of sentiment"[2] to "the Instrument of Instructions"[3]." It was said in their favour that whoever captured power would not be free to do what he liked with them. In the exercise of power, he would have to respect this instrument of instructions.[4] He cannot ignore these directive principles. He may not have to answer for their breach in a court of law and though the directive principles have no legal force behind them, yet it cannot be said that the directives have no binding force.[5] According to B. R. Ambedkar, the directives were meant to be the fundamental principles which should necessarily be made the basis of all the executive and legislative action in future in the governance of the country. He further observed that in enacting part IV the Constituent Assembly was giving certain directions to the future legislature and future executive to show in what manner they are to exercise the legislative and the executive power which they will have ... these principles... should be made the basis of all executive and legislative action that they may be taking hereafter in the matter of the governance of the country.[6]

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[1] This appears to be due to the fact that in the view of the courts it was a conflict between 'right-duty' and 'power-liability' in the Hohfeldian sense.

[2] Per T.T. Krishnamachari, VII C.A.D 583 (1948-49).

[3] Id. at 473.

[4] The comparison with 'Instrument of Instructions' is significant in regard to their obligatoriness. 'The Instrument of Instructions' was a set of executive instructions binding subordinates, subject only to law. The directives, similarly, should be regarded as binding on the state, yielding only before other provisions of the Constitution.

[5] Supra note 2 at 476.

[6] Ibid.

It was on the basis of these affirmations of their intended scope that they were included in the Constitution. These aspects have not, however, received satisfactory judicial notice largely because judicial practice this country does not generally consult the *travaux preparatoires.*[7]

A comparison of article 45 of the Irish Constitution with part IV of the Indian Constitution would, however, reveal differences which are significant,[8] particularly since the Irish Constitution served as the inspiration and the model.

> Articles 45 of the Irish Constitution reads in relevant parts thus:
> The principles of social policy set forth in this Article are intended for the general guidance of the Oireachtas. The application of those principles in the making of laws shall be the case of the Oireachtas exclusively, and shall not be cognisable in any Court under any of the provisions of this Constitution.

The elaborate lengths to which the Irish Constitution has gone to exclude judicial cognizance cannot be ignored as mere verbiage.

> Article 37 of the Indian Constitution reads:
> The provisions contained in this Part shall not be enforceable by any Court, but the principles therein laid down are nevertheless fundamental in the governance of the country and it shall be the duty of the State to apply these principles in making laws.

*Non-enforceability* and not *non-cognizance,* is the Indian provision. Moreover, the directives are declared fundamental in the governance of the country and the state is given the duty of applying these principles in making laws. This duty, however, would not be less onerous; though the duty is made not compellable, a departure from the duty can be prevented.[9]

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[7] It is unfortunate that there is still adherence to the principle of excluding the *travaux preparatoires.* Its judicious use can considerably aid in arriving at the legislative intent.

[8] Upendra Baxi considers the differences to be minor. See Upendra Baxi, Directive Principles and Sociology of Indian Law – A Reply to Dr. Jagat Narain, 11 J.I.L.I.245 at 254 (1969). K.P. Krishna Shetty also considers the difference as not material. He observed:

> The only significant change made by the Drafting committee in the provisions contained in the Supplementary Report was the substitution of the phrase "shall not be enforceable" for the words "shall not be 'cognizable", The ambit and scope of the provisions, therefore, remained almost the same.

K.P Krishna Shetty, Fundamental Rights and Socio-Economic Justice in the Indian Constitution. 80 (1919)

[9] Thus when the fundamental rights are suspended under emergency powers it is held to be not an authorisation for enacting unconstitutional laws.

A. Gledhill makes the point that laws contravening directive principles can be challenged as unconstitutional by the opposition. And this point is well taken, as the opposition is part of the constitutional scheme for law making by the legislature and as the duty is cast on the state to follow the directives in law making.

This writer would go to the extent of suggesting that clear departures from or oppositions to the directives can be prevented by court action, for, what is contemplated by article 37 is only *non-enforcement.* It is conceivable to think of state action in furtherance of the directives, neutral *vis-a-vis* the directives, and opposed to the directives. Preventing state action which is opposed to the directives would not amount to the enforcement of the

The Irish Constitution places all the directives under one article while the Indian Constitution frames them separately in sixteen articles. Even this cannot be dismissed as verbiage or an inexpert exercise in drafting, for, clearly different consequences would be inferable. The provisions spread out in different articles would, thus, receive separate construction unlike when they are placed together in one article. In addition, the homogeneity of language formulating the directives in the Irish Constitution contrasts with the diversity of expressions chosen in the Indian Constitution. The discretion in timing the action in regard to the directives in the Indian Constitution is quantified in the respective articles themselves, thus providing the necessary elasticity in devising and timing methods for reaching the given socio-economic objectives. It is a packet of directives aimed at pragmatic socialism,[10] not doctrinaire socialism and is for that reason all the more commendable in that it seeks to avoid the well-known extremes in other attempts at social welfare.

The pattern of distinction followed in framing parts III and IV separately has been to back part III provisions with the enforcing power of the law (justiciability) while withdrawing it from the provisions in part IV. This device can only be said to be a matter of policy for there is no compulsion that every rule[11] of law should be backed by a sanction. Indeed it is accepted now that 'authoritativeness' and not 'coercion' is the test for law. Even this distinction dwindles into nothing in effect because the provisions of part III are generally framed in the negative while those of part IV are generally in the positive style. Enforcement of the negative and non-enforcement of the positive come to the same result. Even without article 13 the doctrines of eclipse and severability, the constitutional position would have been the same. This view has been rightly pointed out by the Supreme Court of India in *A.K. Gopalan's* case[12] which view was a re-statement of the principle established by Marshal, C.J., in *Marbury* v. *Maidison*

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directives. It would indeed promote the chances of realising the constitutionally given socialistic values.

[10] The only scheme of values that this writer is able to see in the Constitution is pragmatism. This is, in his opinion, a just course to choose if one were to avoid the errors felt in other constitutional schemes elsewhere.

[11] It does not appear necessary to resort to -Pound's delimitation of a 'rule' as Upendra Baxi does, see *supra* note 8. Even in part III provisions, the only action constitutionally contemplated is annulment of the contrary act in question. In fact there is no "sanction" behind either Articles 18 or 24, for example. Neither do they appear to be 'enforceable'. There is no "definite detailed legal consequence to a definite detailed state of facts", as Pound puts it, to any of the provisions except articles 104 and 193 of the Constitution (emphasis added). The scheme of the Constitution is to secure conformity to its provisions and the only thing that the courts can do is to strike down any act, executive, legislative or judicial, which is opposed to the constitutional provisions. No "consequence" follows. The Act is simply regarded as no act,

[12] *A.K. Gopalan v, State ofMadras,* A.I.R. 1950 S.C. 27, the Supreme Court has confined its opinion to the fundamental rights, presumably as the case concerned fundamental rights. It is submitted that this principle would equally be applicable to every provision of the Constitution.

That part IV provisions are law can be seen from the following characteristics.

*Firstly* : they are embodied-[13] in the Constitution.

*Secondly:* they can be altered only by a constitutional amendment.

*Thirdly* : they confer power[14] to the state to legislatively formulate restrictions on part III provisions.

Being thus, law and paramount law, as held in *Marbury* v. *Madison,* any legislative or executive act opposed to its provisions has to be unconstitutional, and for that reason, illegal.[15]

The approach now convassed would make for more purposeful action to reach the social objectives enshrined in part IV. It would not be necessary for the state itself to take these steps towards the goals: it can reach them by effective regulation of individual conduct as well. It would, however, not be possible for any government to act pursuant to the passions of the moment or the whims of the chance majority of the time. The governments would, of necessity, have to faithfully follow the directives and implement them by appropriate legislative and or executive action.[16] It would also not be

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[13] This writer begs to differ from Upendra Baxi's view, *(supra note* 8 at 257) that the directive principles can be considered "a massive footnote to the Preamble". Not merely by position and details but it is an accepted cannon of interpretation that the text of the law is a more deliberate exercise of power than the preamble, which is considered a draftman's preface to the statute. K,P. Krishna Shetty is also of the view that the directives are "imperative and mandatory obligations imposed upon the State". *Supra* note 8 at 84.

[14] This writer is unable to agree with A.R. Blackshield quoted by Upendra Baxi, in *supra*note 8, that the directives confer no power. Though the distribution of legislative power has been done by article 246 and the seventh schedule, the directives do constitute specific heads of ancillary power. Hence laws made pursuant to part IV directives art, treated as reasonable restrictions for part III, *e.g. Bijay Cotton Mills v, State of Ajmer,* A.I.R., 1955 SC 33; *State of Bihar v, Kameshwar and others,* A.I,R. 1952 S C. 252.

[15] This writer is again unable to agree with Upendra Baxi *(supra* note 8 at 261) that a law contravening part ,IV can only be unconstitutional but not illegal. As the only, prohibition by the constitutional law is of conduct opposed to its provisions, unconstitutionality will be illegality. There is no need to use 'Illegality' in a narrower connotation.

[16] Thus viewed,Art.38 becomes vitally important. The social, economic and political standards it contemplates can well be reached within the ambit of the provisions in arts. 14 to III, 19, 23, 29, 30 and 31 with scientific and objective legislation and executive action. "As effectively as it may" it is the elastic limit in this article and would call for honest and objectively sincere efforts on the part of the state, all limbs of it. It would, therefore, not be open even to the Courts to act contrary to the behests of part IV so long as the express commands of part III are not violated. All the six commands of article 39 similarly would have to receive unremitting attention. It is interesting that no elasticity is allowed by this article. This article is no mandate for any brand of socialism in the doctrinaire sense but contemplates an objective and pragmatic approach oriented to the common good. Art. 40 allows no discretion except in the selection of powers and authorities to be conferred on the *panchayats-a* limited discretion. This would also require of the state to ensure that *panchuyats* while being given the freedom to govern actually exercise their powers according to the Constitution and the laws. Art. 41 frames the mandate elastically "Within the limits of its economic capacity and development". Art, 42 would empower regulation of even private employment for its purposes. Art. 43 demands only honest effort (endeavour) and would allow the reasonable freedom to fashion the standards as may be suitable to the

material which party is in power for the time being, for the directives are elastic enough to accommodate the divergence, in methods for social welfare. Here, however, the implementation of the directives would be controlled by part III provisions which have been designed expressly to ensure individual liberty and dignity;

The Constitution of India has postulated its value concepts essentially in parts III and IV and the two have to operate as complimentary to each other.[17] The cases that have followed *Champakam Dorairajan*'[18] have mostly been where the acts of the state ran counter to the express prohibitions of part III. It would be perfectly feasible to frame state action in conformity with the behests of parts IH and IV. Closely looked at, the supposed confrontation between these two parts would be seen to be a myth.

According to Austin:

> [T]he state, in addition to obeying the Constitution's negative injunctions not to interfere with certain of the citizen's liberties, *must*

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time and circumstances. Similarly, Art. 44 directs the drive: the attainment can be so long as the direction is maintained. Art. 45 has been perhaps the most neglected for even after Twenty-five years, the target has not been reached. Art. 46 has received some working and it does not allow any discretion. The first part of art. 47 has not received proper attention as the relevant law does not appear to work. Baby foods have become dearer as though only the rich need nourish their babies on them; public health measures are not backed by sufficient health inspection. The second part of Art. 47 has been mistaken for a mandate for total prohibition while all it suggests in as an endeavour aimed at total prohibition. While addicts cannot be weaned in all cases the Swiss example could have been emulated with advantage. Free sale of liquor would, however, be opposed to Art. 47. Art. 48 similarly commands an endeavour; this has received some satisfactory attention. The prohibition of cattle slaughter appears to contradict its earlier part and ought to be removed. Art. 49 is a command to protect the evidences of the nation's cultural, political and religious history. Art. 50 is a command undiluted by any discretion while Art. 51 is, understandably, a direction of effort only. The principle that in the ultimate resort, in existing international order, force is the arbiter is impliedly recognised. This approach involves a concept of state action different from what has been worked so far. This, however, is the subject of a separate detailed investigation. The enlarged view of state action is supported by *Balwant Raj v, Union of India,* A.I.R. 1968 All. 14 where Dhawan, J., rested his selection of values on the given values of part IV. It is submitted this is clearly right. The directives, being addressed to the state, are meant to provide the courts with a scheme of values for their judicial exegesis. It would not be open to the court to travel outside the directives for their premises where one of the values claiming recognition in the case comes *in* the given values of part IV. in this respect C.H. Alexandrowicz saw years ahead when he said

> "Legislation implementing Part IV must be regarded as permitted restrictions on Part III" (emphasis added).

See CH. Alexandrowicz, *Constitutional Development in India* 106-7 (1957). K.P. Krishna Shetty also observed "[Tlhe Judiciary obliged to make use of them in interpreting legislation". See *supra* note 8 at 85.

[17] This view is also expressed by Subba Rao, c.J., "The Fundamental Rights and Directive Principles enshrined in the Constitution formed an 'integrated scheme', and were elastic enough to respond to the changing needs of the society", *Golaknath v, State of Punjab,* (1967) 2. *S.C.J. 486.*

[18] *State of Madras v, Sm. Champakam Dorairajan,* A.I.R. 1951 S.C. 226.

*fulfil its positive obligation*'[19] to protect the citizen's rights from encroachment by society. The Fundamental Rights, therefore, were to foster the social revolution by creating a society egalitarian to the extent that all citizens were to be equally free from coercion or restriction by the state, or *by the society privately....*
The Directive Principles... aim at making the Indian masses free in the positive sense ....

By establishing these positive obligations of the state, the members of the Constituent Assembly made it the responsibility of future Indian governments to find a middle way between individual liberty and public good.[20]

The framers of the Constitution had thus devised a constitutional scheme to secure a committed government for which implementation of the constitutionally selected values would be a continual and challenging engagement. The government would have been then really a trust and the body politic would have been free of the ills that plague it now. Unfortunately, a restricted view of state action distorted the sights-but it can still be better late than never.

*T. Devidas**

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[19] On this matter, however, there has been a failure to take any meaningful action largely owing to a restricted view of state action which it is submitted, is inconsistent with the constitutional scheme

[20] Austin *Indian Constitution : Tile Corn srstone of a Natlon* 51-2 (1966) (emphasis added)

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"The reality of a political-economic system is never known to anyone, but humans do construct elaborate beliefs about the nature of that reality...the dominant **beliefs**-those of political and economic entrepreneurs in a position to make policies-over time result in the accretion of an elaborate structure of institutions that determine economic and political performance"

- Douglas C.North in '*Understanding the Process of Economic Change*', 2005, p.2

"**Acceptance** may have a **social** dimension. In a cooperative inquiry, a dialogue or debate, what **we** accept may be more important than what I accept"

- Robert C. Stalnaker, distinguishing 'acceptance' from 'belief', to harness the "power of **we**", in '*Inquiry*', 1984, p.80

# Implementation of 'State' Policy on Indirect Tax Reform in India: THE POWER OF "WE" AND THE CHOICE OF POLICY INSTRUMENTS[21]


***Abstract***

*This paper notes the need for the evolution of an Institution for Negotiating the Reallocation of Political Space between the Union and the States in India to enable the acceptance by the political entrepreneurs of the choice of a set of policy instruments by which they credibly commit themselves collectively to implement the 'State' Policy on Indirect Tax Reform as a component of an acceptable Budget Policy of 'the State' in accordance with the Constitution.*


## *The Power of "We", Rule of Law and Good Governance*

"We" is the potent word with which the Preamble to the Constitution of India begins. It christens the set of individuals who at any time since the 26th of January, 1950 are assumed to ***accept*** the contents of that living document (as validly amended from time to time) as "the People of India". The word represents a bulwark founded on the power of "we" against illegitimate attempts known to have been made before 1947 by the rulers to "divide and rule".

I assume that the experience of independence from colonial rule has taught the People of India and their representatives that unlike *ruling* which was/is an easier option for the rulers, ***governance*** is a difficult occupation. In governing themselves according to the ***rule of law***, the People of India are represented by political *entrepreneurs* directly elected by them

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from territorial constituencies respectively to ***law-making*** forums constituted from time to time at two levels (national and State levels), in addition to others indirectly elected to provide continuity of deliberations in permanently constituted forums. The governments of the day and an "opposition" to every government of the day are formed from time to time on the basis of "mandates" of the People (to provide 'State' Policy initiatives based on appropriate assumptions or to question those assumptions by appropriate alternatives) as recognized by subsets of elected representatives who cohere to form such governments or opposition-groups at either level.

Neither the attitude of "belonging" to a specific *level of law-making* nor the attitude of "subscribing" to a specific ideological *belief*, of any representative of the People ought to result in the loss or weakening the power of "we", if 'the State', created by the People of India as an ***institution*** to formulate and implement public policies for the ***common good***, is to function justly and efficiently. It is easy for any political entrepreneur representing an assembly constituency in a State to realize that he/she may be called upon to represent a Parliamentary constituency later and *vice versa*. It is as important for every subset of elected representatives forming any government of the day at any level to take any 'State' Policy initiative only after wide consultations with other elected representatives at the same and other levels, as for every elected representative to avoid *blind* opposition to any 'State' Policy initiative for the creation of a "possible world" and to oppose any such initiative only on specific innovative visions of alternative "possible worlds"; This leads to a cooperative and objective inquiry into the consequences for social order, welfare and "just" institutional environment if the possible world envisaged in any approach is created by implementing any candidate 'State' Policy.

The Constitution of India does not envisage any public policy other than ***'the State' Policy***; It requires 'the State' to formulate its Policies in conformity with the stipulations in Article 38 and other Articles in Part IV, especially relating to ***social order, welfare and justice***. 'The State' is not synonymous with the Government of India or with any State Government. 'The State', in relation to any Policy, refers to a subset of entities constituting it according to Articles 36 and 12 (including *entities other than Government of India*), the ***credible commitment*** of each of which entities to the Policy is a necessary and relevant requisite to ensure the effective governance of the implementation of the Policy; in particular, the ***Budget Policy of 'the State'*** would require the credible commitment of the Government and Parliament of India and the Government and Legislature of every State in order to achieve ***Budget-Balance*** in which the Union and the States ought to recognize a ***common interest***. 'The State' without the credible commitment of the relevant entities constituting it to implement a cooperatively formulated Budget Policy is bound to be a weak institution which ignores the stipulation (referred to below) of securing a social order in which ***political justice*** ought to prevail; on the other hand 'the State' which functions by implementing such a cooperatively formulated budget policy would be an institution that enables India, the *Union of States*, to be strong and self-

reliant on the one hand and ensures the likelihood of a social order founded on political justice in the institutional environment on the other.

If 'ruling', 'opposition' and 'autonomy' are thought of by sub sets of the set: "**we**, *the law makers*" as ***ends*** in themselves, no thought can be spared by them collectively for ***'good governance' according to the rule of law*** as an end[22] envisaged by the Constitution. Ruling, opposition and autonomy, to be socially relevant, have to be ***means*** with a purpose. The main purpose has been elaborated, in consonance with *the resolution of the People of India referred to in the Preamble*, in Article 38 in the Constitution to which all law makers are assumed to owe allegiance; its achievement depends significantly on the ***acceptance***, by all relevant law makers, of a well-formulated 'State' Policy as a "remedy" to deal with a well-recognized social "mischief" by well-chosen policy instruments to implement the policy according to the rule of law. The People of India, who envisage a "Welfare State", assume that every law-maker credibly commits himself to the following stipulation as a "Directive Principle" of 'State' Policy in clause (1) of Article 38 of the Constitution (to which he is required to swear allegiance both before and after being *elected* to his office), every time a Money Bill or any other Bill is introduced for his consideration in the appropriate legislature:

> "The State shall strive to promote the ***welfare*** of the people by securing and protecting as effectively as it may, a ***social order*** in which ***justice***, ***social***, ***economic*** and ***political***, shall inform all the ***institutions*** of the national life"

***Reforms, Institutional Environment and Well-being***

Whatever the media may construe as "reform", it follows logically from the stipulations made in Article 38 of the Constitution that ***reform is a transition form a well-recognized social disorder to a "just" social order*** based on inductive logic in the pursuit by 'the State' of the goal of promotion of welfare of the people. For purposes of deduction in interpreting law made by the Legislatures, the foregoing logic is consistent with the rule of interpretation of statutes known as "***Mischief Rule***". The rule, evolved by the Resolution of the Barons of Exchequer in "Heydon's Case" many centuries ago, is stated in Francis Bennion's *Statutory Interpretation* as follows:

> "That for the sure and true interpretation of all statutes in general (be they penal or beneficial, restrictive or enlarging of the common law), four things are to be discerned and considered:

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[22] The end of law-making has been unequivocally identified as governance in accordance with the Directive Principles of 'State' Policy, vide *the Peoples' Law of Law Making* in Article 37 of the Constitution of India, in the following words:

> "The provisions in this Part (*that is to say, Part IV of the Constitution*) shall not be enforceable by any court, but the principles therein laid down are nevertheless *fundamental in the governance of the country* and it shall be the duty of the State to apply these principles in making laws."

As long as the Directive Principles are adhered to by all the entities comprised in 'the State', the resulting governance would be recognized by the People as good governance according to the rule of *law* (so made by 'the State').

1) What was the common law before the making of the Act;
2) What was the mischief or defect for which the common law did not provide;
3) What remedy the Parliament hath resolved and appointed to cure the disease of the commonwealth; and
4) The true reason for the remedy

And then the office of all the judges is always to make such construction as shall-

a) Suppress the mischief and advance the remedy, and
b) Suppress subtle inventions and evasions for the continuance of the mischief *pro bono commodo* (for private benefit), and
c) Add force and life to the cure and the remedy according to the true intent of the makers of the Act *pro bono publico* (for the public good)"[23]

Classifying 'State' action logically as (i) in furtherance of the Directive Principles of State Policy; (ii) neutral *vis-à-vis* the Directive Principles and (iii) opposed to the Directive Principles, it may be argued, as is done by Devidas in *"Directive Principles: Sentiment or Sense?"*, that the courts, as entities comprised in 'the State', have the duty to prevent 'State' action opposed to the Directive Principles. At any rate in dealing with the facts and circumstances brought to its notice in relation to 'State' action in any matter, any Court has a duty to observe[24], if the case warrants such observation, that the social order secured and protected by the law made implies an institutional environment in which social, economic or political justice is not prevalent, leaving it to the rest of 'the State' to do something about it. It is as important for the law makers to ***correctly spell out the contours of the social mischief that justified the making of the law and the "true reason" for the remedy envisaged by the law*** enacted as for the courts to construe the same; It is difficult to ascertain the "true reason" for the remedy envisaged in law for any social disorder recognized as justifying the making of the law, unless the law makers discuss the implications of their alternative visions of "possible worlds" based on the conclusions of objective inquiries and such discussions are formally documented.

Welfare promoted by 'the State' by securing and protecting a social order based on institutions in which social, economic and political justice prevails, cannot but result in the ***well-being*** of every individual and household to which such individual belongs. Apart from the institution of a strong *'State'* capable of formulating and implementing, a Budget Policy and, ***subject to budget-balance***, Policies on any other matter(including on Indirect Tax Reforms) based on acceptable results of cooperative inquiries, institutions of "the national life" referred to in Article 38 include an institution for negotiation of the *allocation/reallocation of political space*

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[23] FAR Bennion, 'Statutory Interpretation',1984, Butterworth (pp.633-638)

[24] As was done, for example, by the Supreme Court in *Ashok Leyland Ltd vs. Union of India and Others* reported in (1997) 9 SCC 10, leading to corrective action by Parliament by the enactment of the Central Sales Tax (Amendment) Act, 2001.

*among law-making entities* included in 'the State', the institution of *law,* the institution of *multi-level governance* extending to local self-governing entities of 'the State' and the institution of *market.*

It is inadequate to measure the strength of 'the State' by the capacity of the State to defend the territory of India from external aggression. The real strength of 'the State' lies in its capacity to formulate and implement a Budget Policy so as to ensure budget-balance and limit the laws made to a meaningful few and to enforce strictly and fairly the few laws that are necessary and sufficient. A weak 'State' on the other hand engages in "pork-barrel" policies without regard to budget-balance and in making many laws without creating any effective capacity to enforce most of them. A still weaker 'State' engages itself in amending the Constitution itself from time to time (frequently not even bringing the amendments "into force") and shies away from creating capacities to ensure the credible commitment of all relevant 'State' entities at every level, including substantial, though partial, tentative or qualified, commitments of groups officially "opposed" to the governments of the day, for *essential* law making by resort to appropriate ***institutions for negotiations for the allocation/reallocation of political space among the Union and the States*** to help- (i) in the formulation, relating to any matter, of 'State' Policy and the law-making requisite for the implementation of the Policy on the basis of cooperative and objective inquiries and (ii) in well-coordinated implementation of that Policy by governance according to the rule of law so made.

Since tax revenues form part of the budgets of the functional governance entities at all levels, *including the local self-government levels,* reform of 'State' Policy on Indirect Taxation cannot logically be conceived of as a "stand-alone" Policy of 'the State' (and much less as a "stand-alone" *decision* of the Government of India) independent of any 'State' Policy relating to the budgets of ***all*** the entities. Thus it cannot but be a component of a Policy that may be christened Budget Policy of 'the State'. Compliance by 'the State' with the stipulations in Article 38 of the Constitution to promote welfare of the people by effectively securing and protecting a "just" social order, implies that, just as the 'State' Policy on any other matter, Indirect Taxation Policy of 'the State' also , along with other components of the Budget Policy of 'the State' (including 'State' Policy on Direct Taxation and on the Policy of 'State' Expenditure on the Provision of Access for individuals and households to public goods and services, subsidised 'merit' goods and services and/or Transfers/demogrants) ought to aim at securing and protecting a "just" social order conducive to promotion of welfare of the people by means of relevant institutions in which social, economic and political justice is prevalent ubiquitously. No entity included in the institution of 'the State' is thus "free" to act as it deems fit *without ensuring credible commitment on the part of all other relevant entities in support of such action,* but is required to function, as it were, "in chains" envisaged by the People of India by stipulations in Part IV of the Constitution in the form of "Directive Principles of State Policy" as part of ***the Peoples' Law of law-making by 'the State'*** referred to above.

While more discussion relating to the institution for the negotiation of the allocation/reallocation of political space among the Union and the States will follow, it must be made clear that institutions are not the same as organisations. They evolve by themselves as social systems by a process of *autopoiesis*, recognizing the "boundaries" with their respective "environments" and are not the same as organisations established allopoietically with specific material and human resources[25]. Douglas North points out[26] that the purpose served by institutions is to ***reduce uncertainties by providing guidance to every day life*** {referred to, for example, as '*national* life' in clause (1) of Article 38}.

Thus Law is a ***public*** institution in aid of good governance of the implementation of 'State' Policy in promoting welfare. The role of law is the reduction of uncertainty, in such promotional efforts, in the requirements of compliance and administration as far as possible, by *iterations of enactment and authoritative interpretation*. The *inputs* of the social system, in which the institution of law is embedded, are the differences in the interpretation of the provisions of statutes for purposes of compliance and administration and the *outputs* are declarations of law enabling the realization of a just social order in the social system by an *early and orderly resolution, at the least social cost, of disputes in interpreting the "intention" of the law-makers in the context of specific facts and circumstances*- leading to the discovery of a ***predictable undisputed intent of law that ought to guide future behaviour*** of individuals and firms in all conceivable circumstances in the long run.

Market is a time-sensitive ***private*** information-processing institution for the discovery of 'prices' for the exchange of values of the property and other rights that, *ceteris paribus*, are assumed to lead to an ***optimal allocation of scarce resources of the society*** for the best uses by the transfer, to the recipient of the rights, of the risk of estimating the money prices for the values of those rights *in relation to such uses*. The role of the market is reduction of uncertainty in ascertaining the best use in relation to the exchange of property and other rights between ***potential*** market-participants by enabling them to ascertain and, if possible, alter its 'states' from time to time by means of *iterations of promises and performance*. The *input* of the social system, in which the institution of market is embedded, is

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[25] Thus the Empowered Committee of State Finance Ministers (currently a Society registered under the Societies Registration Act) is an organisation included in 'the State'. The iterative process of communications exchanged between that Society and the Government of India by means of a series of "discussion papers" and "comments of the Ministry of Finance on such discussion papers" is an institution for negotiation of reallocation of political space. An "Inter-State Council", referred to in Article 263 of the Constitution is a 'State' organisation established in the manner specified in that Article, but the processes of investigations referred to in clause (b) of that Article, implying objective inquiries into the consequences for social order of every candidate policy under consideration and of negotiations leading to recommendations referred to in clause (c) based on the conclusions reached in such investigations constitute an institution for negotiation of reallocation of political space.

[26] Vide Douglass C. North, "Institutions, Institutional Change and Economic Performance", (1990) Cambridge University Press, pp.1-10

the matrix of the perceived values of property rights for best uses and *output* is the matrix of such money 'prices' discovered for those values as may prevail.

Levy of direct taxes on some subsets of incomes and non-levy of taxes on other subsets of incomes tend to create subsets of market participants who are or are not risk-averse in contravening the tax law relating to subsets of taxable incomes. The institution of market mediates to discover prices payable by domestic consumers and exporters by ensuring that the margins realised by market participants (who, in competition with other such market participants who take risks of contravening income tax laws, are risk-averse in such contravention) are adequate to enable them to continue to compete. The resultant distortions in the prices payable by the end-consumers (and exporters) are compounded by- (i) the "cascading" of the "shifting" of the incidence of indirect taxes on the prices for *taxable* supplies of goods and services payable by the domestic consumers and exporters; and (ii) exemptions/ non-levy of indirect taxes on the supplies of *other* goods and services . Price distortions adversely affect the competitiveness of products of India in the international trade and the well-being of every domestic consumer who is a member of the set designated "the People of India".

Multi-level governance is the institution to secure and protect a just social order by well-coordinated action in accordance with the rule of law to implement a cooperatively formulated 'State' Policy to which, ***subject to budget-balance,*** all the relevant entities comprised in 'the State' are credibly committed. The role of the institution of multi-level governance is reduction of uncertainty in achieving ***harmony*** in securing and protecting a just social order within the multi-order governance[27] envisaged by the laws, ***including laws enabling appropriation of moneys from the respective Consolidated Funds***, made by mutually autonomous law-making entities comprised in 'the State'. The *inputs* of a ***social system,*** in which the institution of multi-level governance is embedded, are perceived social disorders and the *output* is expected to be welfare based on a harmonious social order that ensures institutions in which social, economic and, most significantly, political justice prevails ubiquitously.

***Multi-level Governance: Harmony vs. Autonomy***

It is difficult to define uniquely the concept of a federation as a political organisation. The *de jure* concept of federation envisaged in the Government of India Act, 1935 could not become *de facto* even prior to Independence in 1947. The Constitution, while envisaging political "autonomy" between the Union and the States and between the States *inter-se* in the manner described subsequently, avoided using the term "federation" in the instrument as adopted in 1950 but defined the concept of 'the State' as in Article 12(and referred to in Article 36). The concept of

[27] The term 'multi-order governance' has been coined by Robin Boadway and Anwar Shah in *'Fiscal Federalism: Principles and Practice of Multiorder Governance'*, (2009) Cambridge University Press.

'State' includes local self-governing entities (christened 'Panchayats' and 'Municipalities') as units of decentralised governance providing the last-mile connectivity in the access of people to welfare implied by the provision of important local public goods and services essential to every day life. Governance by 'the State' thus implies decentralised *multi-order* governance, with significant implications for securing and protecting a "just" social order by well-coordinated action according to the rule of law.

Except for making laws relating to appropriations from the respective Consolidated Funds, law-making by the Union and the States is delineated, subject to ***precedence***, in accordance with Chapter I of Part XI (including Articles 246 and Article 254), of the law made by Parliament over the law made by the Legislature of any State. There is no precedence of a law made by Parliament appropriating moneys from the Consolidated Fund of India to meet the expenditures of the Government of India for the purposes referred to in clause (3) of Article 266 over a law made by the Legislature of a State appropriating moneys from the Consolidated Fund of the State to meet the expenditures of the Government of the State for the purposes referred to in the said clause; (there is also no precedence of a law made by the Legislature of any one State on any matter over the law made by the Legislature of another State or the law made by Parliament). The lack of precedence of any one Appropriation Act enacted by the Legislature at any level over another Appropriation Act enacted by another Legislature at any level as envisaged in the Constitution may thus be referred to as mutual "autonomy" of the States *inter-se* and of the States and the Union. Such autonomy is however subject, according to clause (3) of Article 266, to *the manner provided in the Constitution* (including compliance by 'the State' with Article 37). ***This implies credible commitment of the entities included in 'the State' to a "Budget Policy of the State'***, as evolved from time to time cooperatively by all the entities included in 'the State' in consonance with the provisions of the Constitution and ***acceptable*** to all such entities collectively harnessing the power of "***We***, the governors of the implementation of 'State' Policy".

"***Harmony***" envisaged as an aspect of 'State' Policy has to relate to the ***purposes*** envisaged in the Directive Principles of State Policy stipulated in Article 38 and other Articles in Part IV of the Constitution. ***Harmony without a purpose is meaningless***. In particular, in case of the levy of a central goods and services tax and a *similar* state goods and services tax *simultaneously* on the making of a supply of goods and services in any specific transaction one may logically infer *similarity* but not *harmony*. Any inference of mutual "autonomy" of the States and the Union in matters of taxation from the fact that *there is no taxation entry in the Concurrent List*, has to be qualified in the light of the provisions in Article 368 for amending the entries in the manner referred to therein for the larger purpose of compliance by 'the State' with the stipulations made in Article 38 and other Articles in Part IV of the Constitution. The purpose of compliance with the stipulation in Article 38 may be discerned as dealing with the social disorder of either "***direct-and-indirect-tax-induced distortions in the prices of goods***

***and services***" or "***cascading of the incidence of indirect taxes***" as the law makers may accept collectively. Any remedy which seeks to address the "mischief" of cascading can only partially address the "mischief" of direct-and-indirect-tax-induced ***price distortions***.

***Political Justice: The Relevance of an Institution for Negotiating the Allocation/Reallocation of Political Space between the Union and the States***

Instead of establishing appropriate Councils as envisaged in section 135 of the Government of India Act, 1935 or Article 263 of the Constitution for cooperative evolution, through appropriate institutions (including objective inquiries based on appropriate modelling) for negotiating changes in the allocation of legislative space, of 'State'Policies, the Government of India have been relying on Groups/ Committees of Provincial/State Finance Ministers as "sounding boards" for taking decisions on "policies" without ensuring credible commitment of the Provinces/States for the implementation of such "policies". The Taxation Enquiry Commission (Matthai Commission) chronicles the deliberations in 1948 of the entity of the Group of Provincial Finance Ministers with the political entrepreneurs seeking to represent the Government of India in evolving a Policy to minimize the administration and compliance costs of enforcing provincial-level levies of taxes on sale of goods (which had extra-territorial reach) by appropriate provisions in the Constitution being drafted by the Constituent Assembly. It notes the lack of consensus in such deliberations in the absence of appropriate institutions for negotiating changes in the specification of legislative space and how such lack of consensus lead the Constituent Assembly in independent India to enact Article 286 placing such restrictions on the legislative competences of the Legislatures of the States as had not been thought of even by the erstwhile colonial rulers in enacting the Government of India Act, 1935.

Prompted by the lack of consensus between the Government of India and the Group of Provincial Finance Ministers in 1948, the Matthai Commission, presumably realising the futility of politically negotiating any change in the allocation of legislative space between the Union and the States by resort to a Group of State Finance Ministers, relied instead on conferences of bureaucrats in 1953, in formulating its recommendations for tax reform in 1954. This led, *inter-alia*, to the abandonment of the "destination principle" of collection of state-level sales and purchase taxes which had been stipulated by the Constituent Assembly in Article 286 by resorting to the use of ***one*** legislative fictional phrase in the Explanation below clause (1) of that Article. As is well-known, the recommendations of the Matthai Commission resulted in, *first* the sixth amendment of the Constitution (including Articles 269 and 286) and *thereafter* the enactment of the Central Sales Tax Act, 1956 which had to resort to the use of ***many*** legislative fictional phrases in order to abandon the destination principle of collection. Overuse of legislative fictional terms in drafting legislation as a mere ***fiscal expediency*** resulted unwittingly in the ***discord*** between the taxation law (which mediates between every market participant liable to pay tax and the tax authorities)

and the general law relating to sale of goods (which mediates between market participants respectively supplying and receiving goods).

Implementing an important "reform" of indirect taxation without formal political negotiations between political entrepreneurs deputed to represent respectively the Union and the States in an appropriately established forum failed to ensure the credible commitment of the Union to be selective in the levy of excises on domestic production as assumed by the Matthai Commission. The concern of the Matthai Commission that the tax burden on the domestic consumer ought to be minimized by Tax Policy was ignored and the reach of the levy of central excise duties went on increasing and had become universal. This, in spite of the implementation of Jha Committee recommendations of 1977 for collection of central excise duties on a "value-added" basis, has contributed to very significant distortions in the prices payable for supplies received by the domestic consumers and exporters, since the amounts of central excises became part of the prices on which sales taxes had to be computed. The levy, since 1994, of a central service tax, conceived of as a tax on the provision of any defined "taxable" service and collected at the "origin", has exacerbated the distortions in prices.

In pursuance of a Resolution of a Conference of Chief Ministers and Finance Ministers of all States/Uts passed on 22nd June 2000, the Empowered Committee of State Finance Ministers (ECSFM) was created by a resolution of the Government of India on 17th July, 2000 with the following Terms of Reference:

(i) To monitor the implementation of uniform floor rates of sales tax by States and Union Territories.

(ii) To monitor the phasing out of the sales –tax based incentive schemes.

(iii) To decide milestones and methods for States to switch over to VAT.

(iv) To monitor reforms in the Central Sales Tax system existing in the country.

The Government of India is not represented at the political level in the Committee even though any inter-State agreement on floor-rates would have had to be implemented by law made by Parliament in the manner envisaged in Article 252 and applicable in common in the territories of the States concerned. The ECSFM concluded its deliberations and issued a White Paper in January 2005 spelling out the inter-State agreement reached. Instead of enabling the Parliament in the manner referred to in Article 252 to make a law for application in common in the territories of all the States, the States have enacted legislation enabling the collection of state-level sales taxes in their respective territories on a "value-added" basis.

Though the Terms of Reference of the ECSFM did not include any contribution to be made by the ECSFM for facilitating the introduction of legislation to levy a national level goods and services tax, the continued deliberations of the ECSFM are considered relevant by the Ministry of Finance, Government of India since in his budget speech presenting the Union Budget for 2007-08, the then Union Finance Minister referred to his

request to that Committee (which had completed the work envisaged in its formal terms of reference) to work with the central government *informally* to prepare a ***roadmap*** for introducing a national level Goods and Services Tax (GST). The statement of the Finance Minister on the occasion of presenting the Union budget for 2007-08 did not refer to any cooperative formulation of 'State' Policy on the reform of law relating to the levy of central as well as state and inter-state level indirect taxes; it made a reference to the introduction of a central Goods and Service Tax only. It is significant to note that even though reallocation of political space between the Union and the States is envisaged by the Government of India, that Government is not represented at the political level in any appropriate forum to negotiate such reallocation. It is also important to note that unless various candidate proposals are evaluated by objective inquiries by experts by simulating reality on the basis of appropriate models and by ascertaining the consequences for welfare of the people, for social order and for the prevalence of social, economic and political justice in the environments of all the relevant institutions, including market, law and multi-level governance, there cannot be any acceptable choice of a set of policy instruments for implementing any reform of 'State' Policy on Indirect Taxation.

Cooperative formulation of 'State' Policy on Indirect Tax Reforms as a component of Reforms of a Budget Policy of 'the State' by resort to an Institution for Negotiation of Reallocation of Political Space between the Union and the States on the basis of ***objective criteria*** for the choice of a set of policy instruments from among possible alternatives will help 'the State' realize the power of "We, the law-makers", by enabling the political entrepreneurs transcend their respective beliefs and ***accept*** a collective approach to promotion of welfare of the people. Such ***acceptance*** by all relevant entities included in 'the State' implies on the one hand credible commitment on the part of those entities in implementing the 'State' Policy on Indirect Tax Reform and on the other ratification of the requisite Amendment of the Constitution by all the States committed to the implementation of the 'State' Policy on Indirect Tax Reform.

## *Extract –I from L.K. Jha Committee on Indirect Taxation*[28]

### LONG TERM REFORM OF THE INDIRECT TAX STRUCTURE

**18.1** In the of our analysis of the weaknesses of the system of indirect taxation in the country (vide Chapter 5), bad indicated that given the magnitude of the problems .ind the interaction of taxes levied by different authorities, it would not be enough to consider limited reforms within each individual tax system, but it would be necessary to think of more far reaching changes to bring about a harmonious functioning of the various elements in this system. Chapter 8, we have outlined the principles that should guide the reform of the systems of and import duties, and in Chapter 13, we have indicated the lines of reform of the sales system of the State Governments, on the assumption that the sales tax would continue as a separate to be levied and collected by the Governments themselves.

**18.2** The reform a complex structure of taxes such as the one we have at present would naturally take time and would have to be carried out in stages. The kinds of changes that we have indicated the earlier Chapters should be thought of both as preliminary steps towards fundamental changes to be brought about in course of time and as measures of reform that would by themselves effect a significant improvement in the system. We have also taken care to ensure that the measures that we are recommending for immediate are consistent with the long-objectives that we have in view.

**18.3** We have emphasised more than once that the excise tax system at the Central Government level forms the bulwark of the entire structure of indirect taxes in the country and that unless it is placed on a sound footing, it would not be possible to bring about a full rationalisation of that structure. Particularly in regard to excises, the immediate steps that we have recommended can be said to go only part of the way towards resolving the basic problems created by an extended system of taxation, covering only consumer goods but also all kinds of inputs and capital goods. Moreover, in the longer run, we need to think also of a proper of import duties with excises so that their combined operation, while leading to a progressive distribution of the burden of taxes among consumers, would not militate against economic efficiency. Finally, we have to consider whether in due course of time we should work towards the creation of one integrated tax system which would replace most of the present indirect taxes on internal transactions including, in particular, excises and sales taxes.

### GENERALISED SET OFF AND TAX ON VALUE ADDED

**18.4** The lines of evolution of the system of internal indirect taxation in India are by no means unique several developed and other developing countries had also started with a simple system of selective excises. Over time, but owing to increasing need for revenue, they gradually extended the system of excises, often adding a general sales tax to their fiscal armoury. In the end,

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[28] CHAPTER 18 of L.K. Jha Committee on Indirect Taxation, 1978

they found themselves with complicated, cascade-type of sales taxes with or without extended excises. As such a system produced several harmful economic effects and seriously against the pursuit of rational economic objectives, a thorough reform of the system bad to be brought about sooner or later. In examining the lines of reform, it was realised that in order to avoid distortions, promote exports and to make intervention beneficent, selective and purposeful, ir was necessary to thin): of different system embodying a principle which would eliminate the above mentioned problems, even under an extended commodity tax system. This is the principle of generalised set off for taxation if inputs .The main reason why this principle becomes an essential requisite under an extended of indirect taxation is that, as we have indicated in Chapter 8, a simple reduction in the rates duties on raw materials and other inputs could only proceed up to a point; beyond that it not only involves huge losses in revenue but also relieves certain types of consumption and products from taxation. The system of tax credit does not suffer from these disadvantages.

**18.5** From the economic point of view and for easily achieving a determinate degree of progression, it is best to have a tax system which covers value added at all stages of processing and trade but which, however, does not create problems of cascading and distortions in relative factor prices. These characteristics are found in two types of taxes, namely, a comprehensive retail or last point sales tax on all goods and services and a comprehensive VAT. The retail sale tax, however, suffers from the disadvantage that there is a concentration of the entire burden at one stage -and that too at the last stage It is considered extremely difficult to administer a retail sales tax which should yield the major part of the indirect tax revenue needed by the Government. It is for this reason that many countries have turned to the VAT. Today, as indicated in the preceding Chapter, almost the whole of Western Europe (including the United Kingdom) as well as a number of developing countries, such as Brazil, Argentina and Ivory Coast have switched over to the VAT system.

**18.6** As observed earlier, our terms of reference require us to examine the feasibility of adopting some form of VAT in the field of indirect taxation in India. If the answer is in the affirmative, we have been asked further to indicate the appropriate stage at which the principle of VAT could be applied. When we elicited the views of trade and industry on the subject, we found that although there were several, who expressed doubts and reservations about the administrative feasibility of adopting VAT in India in the near future, there was an impressive measure of support for such a step, one of support being the Federation of Indian Chambers of Commerce and Industry itself. In accordance with our terms of reference, we shall now address ourselves to an examination of the merits of adopting some form of VAT in India and of the administrative and other implications of making such a change. In the light of our examination, we shall indicate the stage at which the principle could be adopted with advantage in the Indian context

**18.7** A detailed exposition of the VAT system has already been given in the preceding Chapter, Essentially, VAT in its comprehensive from is a tax on all goods and services (except exports and government services), its special characteristics being that it falls on the value added at each stage -from the stage of production to the retail stage. However, in practice, no attempt is made to directly ascertain the amount of value added, but instead each tax-payer is allowed to deduct from the tax payable on his output the taxes which has paid on his inputs. This is an indirect but simpler method of reaching value added. This method also clearly brings out the fact that the procedures are in effect freed from the taxation of inputs at every stage. Thus VAT enables a country to have an extended commodity tax system and yet avoid the familiar problems created by other general taxes like the cascade-type sales taxes and excises. It also relatively easy under the VAT to free exports almost completely of internal commodity taxation.

**18.8** The VAT, in its comprehensive form, extends from the mining and manufacturing stages to the retail stage. In principle, it can replace all other forms of internal indirect taxes, and can also be extended to cover imports in so as they are to be' taxed for revenue reasons. Protective duties, where needed, would levied; but from them, imports and domestic production would be put on a par and be subject to a single system of commodity taxation. There is great attractiveness in the simplicity and comprehensiveness of such a system of taxation, because it only would enable the country to get rid multiple forms of taxation but would also ensure coordination in the taxation of various products and services.

**18.9** The economic advantages of the VAT system are many and obvious. However, in considering the necessity or desirability of moving over to VAT system in India, we have to examine a number of important questions.

(a) First, after the recommendations that we have made in regard to excises, and import duties have been implemented, what would be the further benefits to be derived by the introduction of VAT?

(b) Second, should the long-term objective be the replacement of the existing systems of excises, sales taxation, octroi and certain other indirect taxes by a comprehensive VAT?

(C) Third; if a comprehensive VAT system is ruled out, to what stages should VAT be confined?

(d) Fourth, would the advantage to be gained be significant in quantitative terms so that the attempted reform would be worth the cost and efforts involved?

(e) And, finally, would the administration of VAT be feasible in India?

**18.10** As regards the first question, we have already expressed the opinion that while the measures of reform that we have recommended for immediate implementation are capable of bringing about a significant improvement in the system of indirect taxes prevailing in the country, they go only part of the way. Moreover, unless we put the excise tax system on a rational basis, it really not possible to rationalise the import duty structure. The major objectives we have had in reforming excise taxation are: (i) to achieve a determinate degree of progression; and (ii) to avoid cascading and

distortions. In attempting a rationalisation of the duty structure on final products, we came up against the problem of divergence between nominal rates and cumulative levies. We found that appropriate rates of duty on final products could not be determined on economic and social considerations unless we could find a way to deal in adequate fashion with the commutation of taxes at successive stages of production. As an interim measure, we have recommended that 'Wherever a marked divergence between cumulative and nominal rates is found to exist, input duty relief under rule 56-A of Central Excise Rules may be provided. We have also suggested a gradual extension of the application of this rule, but these at best are half-way measures. In the long run, it would certainly not be desirable that input relief be provided only in respect of certain lines of production while in others cascading and distortions would be allowed to continue. Such discrimination would produce its own harmful effects. To pursue our reasoning to its logical conclusion, we must think in terms of introducing a generalised form of tax credit. Such a system of tax credit would have to be made applicable not only to excises but also to import duties in course of time. Whether the system of tax credit should be operated under an explicit system of VAT or through full application of the procedures under rule 56-A is a matter that needs separate consideration and is dealt with later.

**18.11** As regards the second question, the introduction of a comprehensive VAT, which would replace at least the excises and sales taxes and which in course of time, cover also the revenue as distinct from the protective element of import duties, would indeed have several advantages from, the economic point of view. It would also be consistent with the oft-expressed desire of trade and industry to deal with a single tax authority in the indirect tax field, which in turn is at the root of the demand for the merger of sales tax with excises. There could be, however, two major arguments against the introduction of a comprehensive VAT in India: one is political and the other is administrative. The' political argument is the obvious 'one that the loss of power to levy sales seriously erode the fiscal autonomy of the State Governments and weaken federal principle that each subordinate level of Government should have the discretion to raise more or less revenue as the people of the State concerned desire. Without taking any side on this issue, we simply draw attention to the political judgment involved. The second argument points to the administrative problem of enforcing VAT at the wholesale and retail stages. Enforcement of VAT in relation to wholesalers and retailers is likely to create serious problems because, firstly, the number of tax payers to deal with gets larger as we move further down the line in the chain of transactions; and secondly, the smaller dealers in a developing country, and even in developed countries, maintain only a primitive form of accounting and may find it extremely difficult to cope with the accounting requirements of VAT. Besides, the wholesalers, and more so the retailers, are likely to be dealing in a variety of commodities so that the matching of output and input taxes becomes more difficult in their case.

**18.12** We, therefore, feel that it would not be to prudent think in terms of extending VAT to the retail and even wholesale stages in the near future. However, we recognise the validity of the argument that if the benefits of reform of the other parts of the tax system are not to be nullified, taxation at the wholesale and retail stages must be freed of the defects associated with the usual forms of sales taxation. Therefore, while not endorsing the plea for the abolition of sales tax, we have, in Chapter 13, urged that certain limitations be placed on the powers of the States to levy sales taxes and that sales tax systems themselves should be so re-oriented as to be in consonance with the reformed system of indirect taxation at the Central level.

**18.13** As regards the third question, it is our view that the VAT system should be introduced at the manufacturing stage. In the ultimate analysis, a satisfactory solution to the various distortions and problems that arise from an extended commodity tax system lies in the adoption of YAT at the manufacturing stage -the so-called MANVAT. The reformed systems of sales taxation would act as a necessary supplement to MANVAT; while the MANVAT itself could in course of time be made to replace the revenue element in import duties. Given our federal system and the administrative problems of enforcing VAT at the post-manufacturing stages, the right course of action, in our view, is not to pursue the theoretically best solution, namely, one integrated system based on the VAT principle but to adopt the second best solution of MANVAT combined with a reformed system of sales taxation, While this solution would not completely eliminate the problem of cascading and cumulation would reduce them to negligible proportions.

**18.14** There is considerable truth in the view that elimination of distortions and cascading under excise system alone would not serve much useful purpose. However, unless the excises are put on a rational basis, it would be difficult to justify placing restrictions on sales taxation so as to rid it of its major harmful effects. Elimination of levies on inputs under the sales tax is a necessary sequel to the conversion of the excise tax system into MANVAT. Thus, while formally VAT would be applied at the manufacturing, stage in lieu of the present excise system, it would be extended to cover imports; and the essential principle of VAT, namely, freeing of inputs from taxation, would get embodied in the sales, tax systems. This is the long-term objective towards which we should move in a time-bound programme. It must be made clear that under MANVAT, relief will be provided only in respect of MANVAT paid at earlier stages.

**18.15** As regards the fourth question, namely, whether there would be quantitatively significant benefits flowing from the adoption of MANVAT, we commissioned a study of the implications of applying VAT to the automobile industry with particular reference to the production and sale of trucks. An adapted version of the study is given in Appendix 22. Here, we refer to the main findings of the study.

**18.16** The cumulative levy of all indirect taxes on trucks and cars, sold in Bombay, are respectively 58.9 per cent and 50.2 percent of the tax exclusive

price, whereas the nominal rates add up to 31.9 per cent and 31.6 per cent respectively. Thus, without there being conscious intention, trucks and buses are taxed more than -passenger cars. Under the proposed MANVAT system, since the rate applicable to the final stage would reflect the total burden on it (presuming inputs are also freed of sales taxes), the Government can adjust the burden/rate according to its scale of preference.

**18.17** The benefits arising from the switch-over to VAT in replacement of all indirect levies could be quantified as follows in respect of trucks. The existing system results in two types of inflationary effects without adding to Government revenues. First, at each stage of production where the product changes hands, the mark-up is inflated to the extent that it is calculated on its total cost inclusive of taxes paid up to that stage; and second, higher interest costs are incurred because working capital is unnecessarily locked up as tax component of the cost of inventories of raw materials, work-in progress, indirect materials and finished goods. For a truck or bus chassis, the inflated mark up effect comes to about Rs. I, 500 per vehicle and the extra interest cost is estimated to be Rs. 1, 600 per vehicle. Thus, the increase in the ex-factory price of a truck or bus is RS. 3, 100 higher than the amount which accrues to the Exchequer by way of indirect taxes, simply because of the cascading effects produced by the present system. This amounts to about 5 per cent of the tax exclusive price of a truck/bus chassis. The reduction in the cost of production will still be sizeable even if MANVAT were to be adopted in lieu of excises alone.

**18.18** At present, export duty drawback is available at best for excise, customs and countervailing duties paid on direct material inputs. This is often much less than the total Central taxes paid inputs at different stages of production. Under the MANVAT, there will be no indirect tax component in the price of exports.

**18.19** There are other advantages that cannot be precisely quantified. At present, the cumulative tax burden on a product depends on the value added and the tax rate at the different stages as well as on the number of stages involved. The cumulative tax-burden will be higher if the value added is more at the earlier stages and also will increase with the number of stages at which taxes are levied. The MANYAT would not mete out such discriminatory treatment.

**18.20** Relative price distortions would also be eliminated under MANVAT because in effect inputs are freed from taxation. Manufacturers would, therefore, use factor combinations which would be most economical. The benefits in this case would accrue to the economy as a whole rather than to the industry as such and cannot, therefore, be easily quantified.

**18.21** Finally, as regards the administrative question, the enforcement of MANVAT should present insurmountable difficulties. In Brazil, a manufacturer's excise embodying the value added principle has been in operation for several years now and from all accounts has not caused any serious administrative problems. In India too, from the point of view of accounting, the larger manufacturers would not find it difficult to cope with

the requirements of VAT and the number of manufacturers to be dealt with would be manageable. The smaller manufacturers in certain industries would pose some administrative problems, but this should not be considered a serious hindrance in view of the fact that the major part of the excise revenue is collected from a relatively small number of large producers. We have got conducted certain field studies to assess the magnitude and nature of the administrative problem and to get an idea of the type of accounting which the different types of businesses keep. These and other details relating to the administration of MANVAT are discussed later in this Chapter.

**18.22** As explained in the previous Chapter, VAT can be applied in a number of ways. We would, however, recommend the tax credit method for adoption in India for MANYAT. The considerations behind this recommendation are as follows: First, it would always ensure that the actual rate of tax paid on a final product would be equal to the nominal rate of tax on it, because the entire tax paid on inputs is refunded at each stage. Per contra, under the alternative method, if there is more than one tax rate, the actual rate of tax on the final product will be the weighted average of the rates applied at the different stages of its production and would, therefore, not be equal to the nominal rate on it except for rare cases of coincidence second, many raw materials used by industry would not be subject to MANVAT. The sales minus purchase method would implicitly grant tax credit even in respect of those materials because the tax base is reduced by the cost of all raw materials including those on which no tax has been paid. This would mean not only loss in revenue but also an unwarranted exemption for certain materials from taxation at all stages. Third, the tax credit method is easier to operate because it does not require the computation of the precise amount of value added at different stages.

**18.23** The tax credit provision under VAT is intended essentially to ensure that no cascading arises and distortions in relative factor prices are avoided. Keeping these objectives in view, we need to consider whether (a) the tax credit should apply to all inputs and (b) investment goods should also be made eligible for tax relief. The existing provisions for input tax relief such as rule 56-A are applied only to physical ingredients. Under MANVAT our aim should be to provide relief in respect of, taxes on all current inputs including physical ingredients consumer good stores and packaging material. As regards the treatment of investment goods, as indicated in the previous Chapter, in most of the European countries that have adopted VAT, full tax credit is given at the time of investment 80 that capital investment is in fact freed of taxation. Such treatment is expected to boost capital formation in the country. The treatment, however, is not uniform in developing countries and there are instances where no credit for investment goods is allowed. Under Indian conditions, it would not be prudent to provide such relief not only because of revenue considerations but also because we have to avoid any action that would give encouragement to capital intensive methods of production.

**18.24** The intent and operation of rule 56-A under the present excise system has been explained earlier in the report. It provides for, in effect, an

adjustment of tax paid on inputs against the tax payable on the output under certain conditions. The tax credit available under the VAT is exactly of the same kind. The extension of the scope for relief under rule 56-A which we have earlier recommended would in fact be one of the preparatory steps for the introduction of MANVAT. In fact if the application of rule 56-A is generalised, it would amount to a virtual adoption of VAT at the manufacturing stage. However, a straight-forward adoption of MANVAT would have many advantages over full extension of the scope of the rule 56-A. Under the procedure lead down by rule 56-A, there are various requirements of maintenance of records and docum3ntary evidence, as well as physical verification by the excise authorities. In terms of records, commodity-wise accounts in form RG-23 have to be maintained. For a multiple product firm with a wide range of ancillary spares, the efforts and costs involved in the up keep of such records could be prohibitive. Besides, as at present, we are informed that any cancellation erasure (even though genuine) in documentation disqualifies the tax credit claim.

**18.25** As for physical verification, the rules specify that the manufacturer has to inform the proper officer within 24 hours of the receipt of duty paid Inputs, The officer can then come and verify quantity thereof. As the scope of application of rule 56-A gets extended, this process would entail considerable harassment to a manufacturer who receives his materials and components through various consignments every day. It is learnt that in the case of a particular truck manufacturing unit, for example, around 300 consignments' covering 300 different items are received dally. At present the departmental officers are required to verify the receipts where the duty involved exceeds a certain limit. The enforcement of this check under an extended operation of rule 56-A is bound to impose a severe burden on the tax administration and in a way it would be tantamount to re-imposition of physical control on all factories.

**18.26** To sum up, if the existing restrictions and checks are retained, a general application of rule 56-A to all or most of the inputs would involve several problems of administration and compliance. The system would become too cumbersome. If the restrictions are removed and more reliance 1s laid on accounts, we would, in fact, be moving towards the system of MANVAT. Therefore, while we have recommended a wider application of rule 56-A in the interim, we feel that in the long term solution lies in switching over to a system of MANVAT

**RATE STRUCTURE**

**18.27** As has been amply demonstrated by the experience of other countries, it would not be possible to work the VAT system with a plethora of rates of tax on different inputs and finished products. A single rate of VAT would greatly simplify the operation of the sys tem. It is also favoured by theorists who advocate complete neutrality in indirect taxation. However even most of the developed countries have found it necessary to have more than one rate of VAT and also to impose additional higher levies on a range of

products including luxuries. In some countries such as Sweden, instead of a formal increase in the number of rates, the tax is reduced by a given percentage in certain cases so that additional discrimination in favour of the concerned commodities is brought about with the same number of rates.

**18.28** It is sometimes argued that in a developing country like India, where taxation has to be used as a tool for achieving socio-economic objectives, it would not be possible to have a limited number of rates in our commodity tax system and that, therefore, VAT cannot be adopted here. We have endeavoured to show that a multiplicity of rates on final products is not necessary to achieve the social objectives of an adequately progressive distribution of the tax-burden among the different income or expenditure classes. In fact, we have favoured non-discrimination as between products belonging to the same class in the sense of being consumed predominantly by one income the group or another. In our view, the desired degree of progression is more easily achieved with .the basis limited number of rates than with a multiplicity of rates all of whose effects it is difficult to trace and control. Moreover, we have made a distinction between the basic long-term structures of rates on the one hand and additional taxes or rates that may .be imposed for special purposes or temporarily, on the other hand. The latter would, by and large, be kept out of the system. For example, if an additional duty on a scarce input is to be imposed in order to encourage economy in its use, then its very purpose dictates that it should not be eligible for tax credit under MANVAT. However, even these additional levies imposed for special reasons should be limited in number in order that the tax system does not become cumbersome once again, As far as the MANVAT is concerned, it could be operated on the basis of the four or five rates that would be applied to the vast majority of consumer products. The rationalisation of the duty structure on the basic raw materials and inputs would also have resulted in the reduction of rates on them. This would facilitate the operation of MANVAT.

**18.29** We have indicated in the previous Chapter that in European countries as well as in certain developing countries, such as Brazil, which has adopted VAT, while the system is made applicable tries, it to all industries, some products like petroleum, tobacco and liquor are in addition subjected to context. non-refundable excise duties. In some countries, such as West Germany, certain luxury commodities are added to this list and are subjected to additional duties known as consumption taxes. We are of the view that under Indian conditions it would be preferable to keep a certain number of industries' then outside the scope of MANVAT and continue on them the present system of excises. These would include industries in respect of whose final products not much cascading is involved as well as those whose products have to be taxed at special or at high rates for economic or sumptuary reasons. Taxation of such products has to follow its own logic and cannot be fitted into the general system. The industries of this kind that we have particularly in mind are petroleum products, tobacco and tobacco and tobacco products, sugar, coffee, tea and matches. Together they yielded in 1976-77 Rs. 2, 081 crore, which formed 46.4 per cent of total excise revenue.

**18.30** Theoretically it would be more satisfactory solution to follow the European practice and bring these industries also under MANVAT and then in addition subject them to non-refundable special duties. However we have favoured their exclusion from MANVAT for three reasons: (i) For safeguarding revenue; (ii) for reducing the administrative burden of the new system (iii) for avoiding complications that might arise in claiming and tax credits with two taxes in respect of a product, only one of which being eligible for relief.

**18.31** In other countries which have adopted VAT, except France which gradually evolved the tax, the switch-over to the new system was brought about at one stroke. This was considered necessary to avoid frequent changes in rates which would be necessitated by a piecemeal conversion to the new system. We should also avoid a step-by step extension of the. MANVAT system. At the same time, we would not recommend a general switch-over without proper experimentation. We would recommend a start should be three or four industries which produce final products (such as automobiles and diesel engines) in respect of which cascading and other ill-effects arising from wide-spread input taxation are pronounced. The introduction of MANVAT in the first instance over this limited area would enable Tax Administration to identify problem areas, test out procedures and study the reactions of tax-payers. On the basis of the experience so gathered, preparations could then be made to fully extend the system excluding the industries that we have listed above. On the basis of such evidence as we have been able to gather about the operation of VAT in a number of developed countries (some details of which have been presented in the preceding Chapter), it would appear that the administration of a VAT confined to the manufacturing level would not be beyond the capacity of tax authorities in India. However, we have recommended a cautious approach of starting with a pilot project because in the interest of safeguarding revenue, it is necessary to establish the workability of the new system before its widespread application is contemplated.

**PROBLEM AREAS**

**18.32** An important problem that would have to be faced in extending the system of MANVAT would arise on account of the fact that, as revealed by our-field studies (given in Appendix 21) several inputs are bought even by the bigger manufacturers through the medium of dealers who are not subjected to Central excise. Such a problem has been faced and successfully tackled by countries which have adopted VAT only at the importer's and manufacturer's level. France had to tackle this problem when, in 1954, VAT was initially experimented with at the manufacturing stage and special schemes were devised for this purpose. Based on the experience of other countries, it should not, therefore, be difficult to find an appropriate solution to the problem in the Indian context. The existing procedure under rule 56-A already allows tax credit there is only one dealer in between two manufacturers. One method of tackling the problem is to allow dealers to

register themselves voluntarily and to empower them to issue tax-vouchers. They would be expected to subject their books of accounts to verification by tax officials at the latter's discretion. A variant of the solution would be to permit the dealers, if they so choose, not only register themselves but also to pay MANVAT at the appropriate rate, tax credit as other MANVAT -payers. The payment of by the dealer would not, of course, increase the total burden of on the product concerned because the tax on the value added by him would, in any case, be collected at one stage or another. A 'better method may be to allow credit on a notional basis from the invoice prices a gross margin for the wholesale sector. Under this scheme, credit would be granted at rates, which would be related to the relevant rates of tax on the inputs as also to the pattern of production of the inputs the organised and small-scale sectors. A number of Collectors of Central excise in the country, whom we consulted on this issue, were of the view that a system of notional credit would be workable and that sufficient precautions could be taken to prevent its abuse. A critical study of the schemes operating in other countries would be of help in devising the most appropriate solutions in the Indian context.

**18.33** Before taking up the problems related to administration and acccunting, we need to consider the proper treatment of small producers under MANVAT. The major point here 1s that we need to ensure that MANYAT would not materially reduce the relative advantages enjoyed by the small producer under the present system. An erosion of the benefits enjoyed at present may come about, because under VAT, a total exemption from tax is not an unmixed blessing. Non-payment of tax at one stage would automatically break the chain of tax credit which would be denied to the consumers of the exempted producer. In considering this question, we might conveniently divide small producers into two categories (i) those who manufacture and sell final products which would not be bought at any later stage by a producer for further processing and (ii) those who manufacture and sell components used in further manufacture. As far as the category is concerned, total exemption would bring no diminution of benefit. But a mere exemption of the second category of small producers might place them at a disadvantage vis-a-vis the tax-paying larger manufacturer of components. Theoretically, the best solution is not to exempt the small producer of components, but to issue them licences under a special and to zero-rate their products. (In other words, tax payable would be zero but tax credit in respect of inputs would be positive). However, this would involve refund of duty paid on inputs to the small producers and might be thought subject to abuse. Alternatively, Instead of refunding the duty paid on inputs to the small manufacturer, a tax credit voucher could be issued to for an amount which would be encashable not by him but by the taxable manufacturer who buys from him. Even under this alternative, there could be inflation of input costs. A practical solution would be to grant tax credit on a notional basis to manufacturers in respect of inputs brought by them from smaller producers working under a special scheme to be introduced for that purpose.

**ADMINISTRATIVE FEASIBILITY**

**18.34** A point often made is that the book-keeping requirements under the VAT system are very rigorous and that even if VAT is to be introduced in lieu of excise, it would impose a severe burden on small and medium scale manufacturers. In the representations received by the Committee also several Chambers and Associations have in fact made a similar plea especially, the trading interests have voiced serious apprehensions about a wholesale switchover to VAT. As for VAT in lieu of sales tax, after considering the various issues and problems we have, as mentioned earlier reached the conclusion that the time is not yet ripe for a switch-over to VAT. However as for a value added tax at the manufacturer's stage in lieu of excise we felt that prima facie the additional documentation requirements may not be much. The Committee's secretariat undertook a feasibility study on a small sample of manufacturing units mainly to assess the extent of documentation that presently obtains in manufacturing units in relation to their sales purchases, stocks and production and make an evaluation of the gap in documentation between the present one and that required under a normal VAT system. Even though the sample study as such did not have a very wide coverage care was taken to include in the sample manufacturers with different sales turnovers ranging from less than Rs. 2 lakhs per annum to that exceeding Rs. 1 crore per annum. The results of the study are brought in Appendix 21.

**18.35** The main findings of the study are that in general. manufacturers whose turnover is in excess of Rs.I5-20 lakhs per annum get most of their inputs under cover of regular invoices due accounts of which is kept in the books of the manufacturers. These invoices evidencing purchase of various types of inputs contain by and large the particulars which are required in the invoice under the VAT system with the exception of a mention of the excise duty paid on the inputs. In the case of supplies received from the manufacturers which constitute the major portion of the purchases of inputs by units whose turnover exceeds Rs, 1 crore, even this information gap is made good by the duty particulars contained In the excise gate-pass. Thus in such cases, the invoice and the excise gate-pass together contain more than adequate particulars and if they could be suitably fused into one, the basic documentary requirement under MANVAT would be met and also result reducing scriptory work. However, invoices for purchases made from dealers do invariably fall short of one basic requirement under VAT in as much as they do not the excise duty amount therein. If the same practice is continued even under, the MANVAT, it would mean that purchases, made from dealers would not be eligible for tax unless alternative schemes of providing for such purchases are devised. (We have referred to this problem earlier). As regards the level and extent of coverage of book-keeping, we find that the present practice observed by units of this category should be adequate for VAT purposes also.

**18.36** In the case of manufacturers whose turnover is less than Rs. 15-20 lakhs per annum, we find that the records relating to purchases, production and sales cover basic details though the system of accounting itself may not

fully meet the requirements under a VAT system. To this extent it may be necessary for them to maintain books of accounts in a more elaborate manner; The major accounting problem in their case would arise on account of the fact that the majority of their purchases of inputs is from dealers who do not indicate the excise tax amount separately in their invoices.

**18.37** Thus, it could be assumed that manufacturers whose turnover exceeds Rs.15 to Rs, 20 lakhs per annum could be reasonably expected to conform to VAT documentation without much difficulty. As for the other manufacturers, there may be a need to free them from the normal rigorous of VAT accounting. As indicated earlier, in the countries which have a VAT system, special schemes have been devised for similarly placed small assessees, under which they have to maintain only simple accounts and submit returns and pay duty at longer intervals than usually required under VAT. For determining the eligibility to such schemes, the turnover of the unit is usually taken as the criterion. We feel that in cur country too, it should not be difficult to devise special schemes for the smaller producers whose turnover is below certain value limit, which could be about Rs. 20 1akhs as shown in the above-mentioned study or even higher if the circumstances so warrant. The Forfeit system as applied in France, Belgium and Brazil could be suitably modified and adopted in our country too. In fact, the simplified procedure scheme in regard to a few selected industries already in operation for collection of excise duty is quite similar to the Forfeit system. We have already suggested certain modifications to make the simplified procedure scheme more acceptable and also recommended its extension to most industries.

**18.38** Our study of the pattern of clearances and duty realisation for units under different value slabs (given in Appendix 17) has shown that manufacturers with outturn not exceeding Rs. 15 lakhs per annum contributed about 3 per cent of the total excise revenue collections in 1976-76 (leaving a few industries like tobacco and petroleum products). Therefore, devising special schemes for smaller manufacturers under MANVAT would not pose any serious risk to Government revenue either.

**18.39** In the MANVAT, as contemplated, there should not be much additional administrative burden as the number of units to be controlled under it will not increase. Besides, most of the smaller units would be covered by special schemes. It is, however, a fact that the control and audit will have to be qualitatively superior and, perhaps, more elaborate too. It would be wrong to suppose that VAT, even if confined to the manufacturing stage, could be administered solely or even mainly through the accounts method. While in some respects the system is self-policing, it is also opens up some avenues for evasion. Thus, since, unlike the excise levy based on gross value, VAT is assessed on net value, there could be an inducement to overstate input costs. Under the tax credit method, this would take the form of claiming more than the tax paid on the amount of inputs actually used, Such a possibility is somewhat limited by the fact that the extra amount of inputs can only be sold to the untaxed sectors. Nevertheless, tax evasion under VAT has been noticed not only in developing countries but even in European

countries. To prevent abuses of this kind apart from elaborate audit of accounts by trained personnel, periodic physical checking of inventories of goods on hand would be necessary under MANYAT. The magnitude of the additional administrative burden in this regard could be assessed while considering the pilot scheme referred to by us earlier and appropriate steps taken to strengthen the various aspects of tax adm.1nistration in case MANYAT is extended to other industries.

**18.40** The introduction of VAT in other countries was proceeded by a period of intensive training for tax administrators and education for tax-payers. As we contemplate the application of VAT only to the manufacturing stage in India and since in practice it would fall mostly on producers Who are also excise tax payers, the problem of educating the tax-payers would not assume such a large proportion as in countries like Brazil where the system bas been extended right up to the retail stage. Nevertheless, the importance of an adequate educational programme cannot be over-emphasised. Moreover, if our recommendation for the adoption of MANVAT is accepted by the Government, it would be necessary to send a small team to study the operation of VAT in some countries including a few developing countries. After that, a detailed programme of implementation should be worked out which would include, inter-alia, devising of appropriate invoice and return forms, making the concerned industrial units famil1ar with their use, transitional problems relating to the treatment to be given to inventories on which excise tax would already have been paid, and the modalities of computerisation,

**RELATION OF MANVAT TO IMPORT DUTIES AND SALES TAXES**

**18.11** If' the excise tax system were to be put on a value added basis, relief would be given only for excise taxes paid on inputs. Such a relief cannot be given either in respect of sales taxes or customs duties. We have bad occasion to point out that import duties on inputs often contribute significantly to escalation of costs and distortions in factor prices. Also sales taxation cannot be dismissed

as a minor offender because one and the same input is sometimes taxed by more than one state and further because sales taxation encourages vertical integration and militates against the policy of encouraging ancillary industries. In the long run therefore, relief in input taxation must be made available under all three major indirect taxes .in India. We would, therefore, like to reiterate our view that simultaneously with the-introduction of MANYAT, or even preparatory to it, the existing system of sales taxation would have to be reformed along the lines we have indicated in Chapter 13. As regards import duties, we recognise that they cannot immediately be brought within the ambit of MANYAT. One of the main reasons for this is that at present fairly stiff rates on imported raw materials or intermediates are levied to bring in a sizeable amount of revenue, Import duties on inputs would have to be first rationalised according to our recommendations. They would then consist of a revenue element plus a component needed to

protect domestic industry and to discourage the use of particular imported products (corresponding to the degree of import control). The revenue element in course of time should be made equivalent to MANVAT on the same or similar domestic products, which would thus become a true countervailing duty; and when revenue needs permit, relief under MANVAT should be made in respect of such countervailing duties.

**18.42** We conclude our discussion of Long-term Reform of the indirect taxation structure as well as of our Report as-a whole, by summarising very briefly how we envisage 'be process of change. Compulsions of mobilising resources on an adequate scale have led to a steady spread in the range or products covered by indirect taxation. In the process, since ad hoc changes were made from year to year with additions and super-impositions on a structure which was evolved during the phase of reliance on the taxation of inputs and selective taxation, a very complex tax structure has come into being in which the attempts to achieve progression by suitably fixing nominal rates on final products have been often eroded by the taxation of inputs; cascading has caused higher price increases than would be justified by the revenues accruing to Government; and there have been other distortions which are undesirable from the social, economic and administrative points of view. Distortions have also arisen as a result of the inter-action of independent indirect tax systems operated by two levels of Government independently of each other.

**18.43** As a first step in reform, there must be a reduction in the number of excise duty rates applicable to different finished products, along with a similar change in the rates applicable to inputs, and a widespread application of procedures for giving relief from the taxation of inputs to those products which are themselves subject to excise levies. Side by side, the sales-tax system should be reformed so that it does not get enmeshed into the manufacturing process but becomes an instrument of taxing consumers within each State at such rates as the state Government and the state legislatures decide. Similarly, customs duties should be so adjusted that in addition to the element needed to provide protection to domestic industries, any additionally on them is about same as the excise on like products of domestic origin. Once this kind of restructuring of the existing tax system has been done, we will be ready to move on to MANVAT so that the taxation of the manufacturing sector of the economy is done through a system which will automatically ensure that the kinds of distortions which have manifested themselves in the past do not appear. We have no doubt that MANVAT will be a vastly superior system over the existing regime. At the same time we recognise that MANYAT requires certain capabilities In the matter of accounting on the part of those subject to it as well as administrative procedures different from those currently in force. The process of change may, therefore, have to be phased one. To start with, MANVAT should be applied to industries in which the taxation of inputs has some definite dimensions and in which the manufacturers concerned are large. When the time comes to introduce MANVAT, which only be the requirements and particularly in regard to sales tax have been made, a number of industries

could be selected for the initial phase, to be brought under MANVAT. In making the choice apart from the criteria we have suggested, the willingness of the individua11ndustries to switch over could also be given due weight. Once MANVAT begun to function smoothly respect of a few well-chosen industries, it could be extended to others, though it may well be that even in the long run certain products, such as, tobacco and tobacco manufactures and petroleum may continue to be subject to excise rather than MANVAT.

## *Extract –II from L.K. Jha Committee on Indirect Taxation, 1978*[29]

### INTERACTION OF CENTRAL AND STATE TAXES

**INTRODUCTION**

5.1 We have had occasion to refer to the fact that indirect taxes in India fall both on final products and on inputs used in their manufacture. Often the term 'inputs' is thought of as raw materials and components which are physically embodied in the final product. We use the expression in a broader sense to cover the entire range of products, which get used for and during the process of, the manufacture of a product, whether they become physical ingredients of a final product (e. g., raw materials and components) or are used in marketing it (e. g., packaging materials and containers) or get consumed in the process of manufacture (e. g., fuel). Since excises and sales taxes fall both on the final products as well as on various inputs which are used in their manufacture, and as there are but limited provisions for relief from input taxation, there is a considerable divergence between the nominal rate of tax, which the consumer is aware of when he buys a product, and what we would call "cumulative levy", which would represent the, sum total of the burden of all the indirect taxes levied by different authorities at various stages before the final product reaches the consumer. The cumulative impact of excises alone, which are levied only at manufacturing stage, is itself significant as various inputs get taxed at successive stages of production. Such a structure of excises, taken together with the sales tax system built up by the State Governments, has created an extremely complex structure of internal indirect taxation in the country. The overlapping co-existence of two generalised systems of levy, the excise based on the principle of production or origin and the sales tax based, subject to some limitations, on principles of both and consumption, i.e., both origin and destination, each compounding the effects of the other through interaction, has given rise to uncontrolled and unintended incidence of taxation on different commodities. Because both sales taxation and excise duties are widely applicable to inputs, subject to the reliefs and limited exemptions indicated earlier, the impact of their interaction becomes much more serious than is generally realised. Octroi duties which are also levied on inputs aggravate the problem.

5.2 In addition to excise duties account must also be taken of import duties. Imported raw materials usually bear a duty of 45 per cent and in addition countervailing duty at varying rates. Various semi-processed intermediates which are also imported in large quantity get taxed at the much higher rate of 75 per cent, apart from the countervailing duty, which is levied on tax inclusive price. Unless the goods go directly to the manufacturers who use them as inputs, there may be sales taxes to be paid on the price 'inclusive of the import duty when the importer sells them to the manufacturer. If, after

[29] CHAPTER 5 of L.K. Jha Committee on Indirect Taxation, 1978

further processing, the raw materials/semi-processed intermediates are sold as a component to another manufacturer, both excise duties and sales tax become applicable to them and so the process goes on till it finally reaches the consumer.

**DEMERITS OF MULTIPLE TAXATION**

5.3 Multiple taxation adversely affects the costs and prices throughout the economy. When taxes fall both on inputs and on the final product, such of these taxes as are levied on an ad valorem basis fall not only on the value of the products but at each stage they fall on the taxes
that may have been earlier levied on them. Along side, there is an escalation of costs and profits at each stage. When an input is subjectcd to excise and/or sales tax, the manufacturer who uses it needs a larger amount of working capital to maintain the necessary stock of the inputs; hence a greater financial burden is imposed on him. In the process, cost of his final product gets raised. Besides, he works out his own profit margin as a percentage of his costs which include input taxes and arrives at a price by adding a higher quantum of profit. On this price, the excise on the finished product is worked out. Then comes the sales tax which is levied on the price inclusive of excise duty. Thereafter, the product goes to the wholesaler and then the retailer, each of whom once again, has to find a larger amount of finance which raises his costs and profits expectations. At each stage, the mark-up by producers and traders gets inflated because the profits which they seek to earn are related to the total capital which they employ, i.e., they would like to earn certain rate of return on capital employed, and the amount of capital employed, as explained above, inevitably increases if the costs of inputs are raised on account of the indirect taxes levied on them. This snow balling or pyramiding effect which is also referred to as 'cascading' raises the price of the final product to the consumers, by more than the sum total of the different taxes levied at intermediate stages. In other words, the increase in consumer prices due to cascading is not limited to what accrues to the Exchequer by way of revenue. The same amount of revenue may be raised with a smaller rise in the price of final product and, therefore, a lower burden on the consumer, if a non-cumulative type of tax was imposed at the final stage of production, that is, on the finished product.

5.4 The extent of cascading naturally differs from product to product but is serious enough in a very large number of cases to bring about a marked divergence between the nominal rates of excise and of sales tax on final products and the cumulative burden of import duty, excise and sales tax which they, in fact, bear on account of levies on inputs. As a result, the nominal rates give a misleading picture of the distribution of the tax burden among products and sections of the community.

5.5 There have been attempts in the past to measure the impact of taxation of inputs on different products. The National Council of Applied Economic

Research (NCAER) had conducted two selective studies, one with a data base relating to 1972 and another with that relating to 1975-76. In the former study, impact of input taxation was measured in relation to the actual ex-factory price as well as cost of the final product as it would have been if no levy had been made at any but the final stage. The latter study was confined to excise duties and the impact was measured in relation to the ex-factory price. Both the studies, however, took into account the taxes on inputs as well as on inputs of inputs. The studies which we have undertaken, and the details of which are set out in the Table appended to this Chapter include only the taxes on first-stage inputs and measure incidence as a percentage of ex-factory price of the final product. The actual impact on account of all taxes on inputs and inputs of inputs would be more than what has been shown in our study. Further, if the impact is measured with reference to the tax-exclusive price of the product, the cumulative levy would be higher than the figures shown in our study.

5.6 As would be seen from the Table appended to this Chapter, the levies on even the first-stage inputs bring about a considerable divergence between the cumulative levies and the nominal rates of duty on the finished products, not only in respect of consumer products but also of machinery and inputs which are finished products themselves. Thus, on insulin, an important anti-diabetic drug, and chloroquin phosphate, an important anti-malarial drug, while the nominal rates of excise and sales tax consciously imposed by the Central and State Governments are low (at 2 per cent and 4 per cent), the cumulative levy adds upto 27 per cent and nearly 44 per cent of their ex-factory prices. Likewise, a commonly used analgesic tablet bears a cumulative levy of 31.6 per cent as against the nominal rates of 12.5 per cent and 3 per cent. In respect of another widely used item, namely, washing while the nominal rates of excise sales tax are 5 per cent in each case, the cumulative levy is 16 per cent. Similar is the case of a low priced toilet soap where the divergence resulting from input taxation is around 5.3 per cent. Another item of consumer interest where taxation of inputs has a significant cascading effect is the ceiling fan where input taxation alone amounts to 11.5 per cent of the ex-factory price. Similarly, in the case of a 60 watts bulb, whereas the nominal rates are 15 per cent and 4 per cent, the cumulative levy is as high as 38.7 per cent. Yet another item of consumer interest which bears an effective indirect tax burden far in excess of the nominal rates prescribed for it is the dry cell battery; the input duties in this instance amount to 22 per cent of the ex-factory price.

5.7 In the textile family too, we notice a significant divergence between the nominal rates and the cumulative levy. Thus, we find that on a dyed nylon saree, the duties on inputs alone account for about 23 per cent of the ex-factory price. In the case of a popular blend (67/33) of polyester/ cotton shirting the taxes on fibre and yarn alone constitute 34.7 per cent as against the fabric duty of 5.5 per cent. Similarly, hand knitting woollen yarn, which is fully exempt from excise levy bears a cumulative levy of 40 per cent.

5.8 Another class of goods where the impact of input taxation is substantial is capital goods and machinery. We find that a 30HP electric motor, while having nominal rates of 15 per cent and 10 per cent bears a cumulative levy of 34.3 per cent. Again, a power driven pump (of the mono-blocktype) carries a cumulative levy of 21.3 per cent, the element of input taxation alone being 5.8 per cent as against the nominal rate of excise of 5 per cent on it. Similarly, in the case of commercial vehicles, which are capital goods for the road transport industry, the duties and taxes on inputs amount to 13.2 per cent of the ex-factory price. This is slightly more than even the individual nominal rates of excise and sales tax. Another item belonging to this category, is the water cooler which is widely used in industrial and commercial establishments. Here we find that the taxes on inputs are of the order of 26 per cent as against nominal rates of 20 per cent and 15 per cent under excise and sales taxes.

5.9 Turning to inputs, on an item like printed aluminium foils for packing contraceptives, while the nominal rate of excise is a little over 30 per cent, one finds that the cumulative levy is as high as 63 per cent. In respect of an item like storage battery, which goes as original equipment as well as a replacement, the element of tax on inputs is 14. 9 per cent in a total cumulative levy of 51.7 per cent. Truck tyres (nylon) are subject to a cumulative levy of 92 per cent as against the nominal rates of 55 per cent and 10 per cent of excise and sales taxes. Wires and cables which are used widely as inputs as well as for replacement purposes are also among the items which are affected by excessive input taxation. Thus, in the case of PVC armoured aluminium conductor, as against the nominal rates of 5 per cent and 4 per cent, the cumulative levy is 39 per cent. Similarly, enamelled copper winding wires, while being subjected to nominal rates of 10 per cent and 4 per cent bear an effective cumulative levy of 56 per cent.

5.10 One of the facts brought out by our study is that where imported material forms
a major component of the inputs, then the effect of import duties tends to be significant. The cascading on account of excise taxation of inputs which are purely indigenous is moderate except in the case of inputs like non-ferrous metals (e. g., aluminium and copper) and textile fibres and yarn (e. g., Polyester and nylon). The combined impact of excise and sales tax on inputs even in the case of indigenous inputs also plays a significant role in bringing about the divergence between nominal rates and cumulative levy.

5.11 The NCAER studies referred to earlier also reveal the extent of input taxation and the effective tax burden borne by various commodities. The first study indicates that tyres, trucks, tractors and yarn (both cotton and rayon), bear a cumulative levy far higher than the nominal rates of excise and sales tax applicable to them. The second study, which measured the impact of excise duties alone shows that cascading of excise on inputs and inputs of

inputs is particularly significant (i.e , more than 5 per cent of the ex-factory price of the final product) in the case of aluminium, refrigerators, air-conditioners, tyres and commercial vehicles.

5.12 Further due to widespread taxation of both inputs and final products and that too by different authorities, it is not possible to control tax incidence on final products. It is only after a great deal of research and sometimes not even then, that the total increases in the cost and price of the final product due to levies on various inputs (raw materials, intermediates, etc.) can be determined. The total effective incidence on any given product especially a product at the end of the chain of production, becomes almost fortuitous and largely unknown. This is one of the major consequences of the interaction of the different taxes to which we draw attention at the beginning of this Chapter. It thus happens that the total tax burden on the consumers does not have determinate degree of progression to which both the Centre and the States individually attach importance in fixing nominal rates on final products. In fact, the heavy tax on an input, for which no relief is given at later stages, generally tends to be intrinsically regressive. It places a greater burden on the varieties of products consumed by the poor than on those consumed by the rich. The way this happens is, that for the range of products in the manufacture of which a particular input is used, the cost of the input would be a higher proportion of the value of the cheaper products than of the more expensive ones in respect of which the value added in the manufacturing stage would be much greater. As a result, the tax levied on the input will constitute a higher proportion of the price of the cheaper product than of the more costly one. Thus, in the case of a textile fabric, while the cost of the fibre or the yarn could be 50 per cent or more of the price of a cheaper variety, in the case of fabrics of fancy designs and colours, specially processed to prevent shrinkage and resist creases, the cost of the fibre or the yarn may well be only 25 per cent of the price of the fabric. This would mean that the percentage incidence of the levy made at the fibre or yarn stage might be twice as much on the cheaper qualities of textiles than on the more expensive ones. Similarly, a tax on aluminium may mean a greater percentage incidence in the case of simple aluminium utensils than in respect of garden furniture made of aluminium.

5.13 Another distortion which taxation of inputs creates is that it generally tends to encourage what is known as vertical integration, that is, bringing under one firm several stages of production. In a vertically integrated firm, the manufacturer himself tries to produce more and more of the inputs needed by him, rather than purchase them from ancillary industries. By doing so, he clearly saves on sales tax because when he produces rather than buys the necessary inputs for his final product he has no liability to sales tax, since no sales take place in such cases. Thus in the engineering industry, manufacturers of products like bicycles, refrigerators or automobiles would be at an advantage if they manufacture all the components themselves instead of buying out a number of them. Government's policy of developing small scale industries as ancillaries to

larger units, supplying them with components, thus gets hindered. Excise duties too can have a similar effect, but here steps have been taken to mitigate this generally either by levying excise duties on inputs manufactured within the factory even if used for captive consumption or relief from excise in respect of bought out components. This device has been used in a large number of cases but the practice is not universal.

5.14 Yet another way in which the taxation of inputs by different authorities can create distortions is by their impact on the allocation of resources. The differential incidence of indirect taxation on different intermediates and inputs has the effect of influencing the producers' choice between factors of production in unintended ways. If the levies are carefully determined to encourage or discourage the use of particular raw materials or intermediates, indirect taxation can be used as a positive instrument of planning. However, when the incidence is purely fortuitous, changes in relative prices of factors of production can give wrong signals to the producers and may in fact encourage them to make greater use of resources which are more scarce. Further, it leads to the misdirection of investments contrary to national priorities.

**ADVERSE EFFECTS ON RAW MATERIALS**

5.15 It has been an accepted principle in India, as in other countries, to free exports of all internal commodity taxes so that our industries are not handicapped in competing in international markets. Towards this end, a system of drawbacks is operated. But the effectiveness of the drawback system depends on an accurate computation of all taxes paid from the raw material to the manufacturing stage. With the kind of interaction of taxes levied by different authorities at different points, that has been referred to above, it becomes virtually impossible to calculate exactly the total quantum of indirect levies on a product which is to be exported. Although an elaborate system for the grant of drawback of duties has been evolved, the amount of drawback granted seldom equals the actual customs and excise duties paid at successive stages of the manufacture of a given product. Further, sales taxes and octroi duties paid are not taken into account in the drawback calculations. Even if a duty drawback is given for all the levies, the competitiveness of the Indian product would still be adversely affected because, owing to cascading effects, the rise in cost and prices will be higher than the amount of levy and further because, if factor prices have got disturbed, production is not that economical as it would otherwise have been. There arises, therefore, a recurring need for giving various forms of cash assistance and other incentives to Indian exporters which may attract the imposition of anti-dumping duties and other restrictions by importing countries.

5.16 We have referred above to the difficulty in making exports completely free of indirect taxes. In relation to inter-State trade also, there is a tendency

for taxes levied in one State being ultimately paid by consumers in other States. Even though there is concessional treatment to inputs in a number of the States' sales tax systems they are often not extended to sales outside the State. This leads to an unplanned distribution of the burden of sales taxation among the citizens of different States with each State trying to export its taxation through the imposition of taxes on inputs and Inter-State sales tax. The more developed states which have attained higher levels of agricultural or industrial production or have raw materials needed for industry, get greater benefit and are in effect in a position to export their taxation other States.

5.17 Some other undesired or undesirable effects of the present system of indirect taxes may also be noted. In order to avoid payment of sales tax at more than one point, manufacturers, instead of operating through wholesalers, prefer set up their retail depots. Likewise, to avoid the CST on the inter-State sales manufacturers set up their depots in other States sending the goods on consignment to their own agents thus cutting out the wholesalers. Another type of distortion to which the present system of octroi leads is in the matter of location of industries because octroi duties can be avoided if all the components and inputs can be manufactured within the limits of the municipality or the local authority concerned. There is a tendency of concentration of industries in larger cities instead of being dispersed over a wider area.

**PROVISIONS TO RELIEVE CUMULATIVE IMPACT**

5.18 The possibility of the cumulative impact of excise taxation levied at different stages leading to an unduly heavy burden on a particular product has been recognised by Government and a number of provisions, detailed in Chapter 2, have been introduced to mitigate the rigours of input taxation. The scope of these procedures as pointed out is limited in various ways and does not extend to custom duties at all. The sales tax laws of most States also grant limited exemptions and/or concessional treatment for the sale of intermediate products to manufacturers that go to reduce the cumulative effect of sales taxation in such cases. However, concessions rather than exemptions are the general rule and the concessions are applied in a way that they benefit mostly the producers within the state.

5. 19 Our review of the interaction of indirect taxes imposed by the Centre and States brings out that -

(a) as a result of different levied by different authorities both on finished products and on their inputs,

(i) the total burden on the consumer is much higher than the rates of tax imposed on the final product on considerations of desired progression;

(ii) the total increase in the prices of finished products is in excess of the sum total of revenues accruing to the Centre and the States;

(iii) there are distortions in the relative prices of raw materials and other factors of production;

(iv) there are other economic side effects of an undesirable nature such as discouragement of small scale and ancillary industries;

(b) both the Central and the State Governments have evolved procedures to mitigate the undesirable effects referred to above but the scope of these procedures is limited in many ways and their application has on the whole been restrictive.

## *An extract from the interim report of the tax reforms committee*[30]

### SUMMARY OF RECOMMENDATIONS

**Guiding Principles of Tax Reform**

12.1 The guiding principles underlying the tax reforms proposed by the Committee are as follows:

a. The tax system and its burden must be acceptable to the citizens i.e., the potential taxpayers.

b. Given our past experience and the present totality of circumstances affecting the tax system and its operation, it is better to have moderate rates with broader bases.

c. While the tax structure should be progressive, it should not be such as to induce the generation of unaccounted income and wealth.

d. The tax system must be rational from the economic point of view. For this purpose, the structure once established must remain stable unless and until the economic conditions undergo a radical transformation. Ad-hoc changes from year to year will undermine rationality and reintroduce complications.

e. The tax system and law should be as simple as possible: it should have the strictly limited objectives of raising revenues for the government in a fair and efficient manner, achieving redistribution and discouraging some industries and the use or consumption of some products as well as granting a reasonable degree of protection to domestic industries. A simple system will have only a limited number of rates and exemptions or deductions and give the least possible discretionary power to the tax officials for interpreting the law.

f. Methods of tax administration should be modernised and tax enforcement should be visibly improved.

g. The tax reforms suggested should be fully, or at least nearly, revenue neutral in their totality; however, the system should become more income elastic.

**Income Tax**

12.2. Ideally, a single rate income tax would be the simplest both for compliance and administrative reasons. However, for the present, the following tax rate schedule for different taxable entities is recommended:

a. in the case of individuals, the exemption limit should be fixed at Rs.28,000. The marginal rates of tax (inclusive of surcharge, if any) should be:

i.20 per cent for total income in the range of Rs.28,000 to Rs.50,000;

ii. 27.5 per cent for total income in the range of Rs.50,000 to Rs.2,00,000; and

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[30] CHAPTER 12 of Interim Report of Tax Reforms Committee chaired by Prof. Raja J. Chelliah, 1991, pg. 134, Department of revenue, Ministry of Finance, Govt. of India

iii. 40 per cent for total income exceeding Rs.2,00,OOO.

b. in the case of a Hindu undivided family, the existing distinction between a "specified HUF" and a "non-specified HUF" should continue. The rate schedule for non-specified HUFs should be the same as recommended in the case of individuals. For specified HUFs, the exemption limit should continue at Rs.12,000. The marginal rates of tax (including surcharge, if any) should be 27.5 per cent for total income in the range of Rs.12,OOO to Rs.1,OO,000 and 40 per cent for total income exceeding RS.1 ,00,000.

c. in the case of local authorities, tax should be levied at a flat rate of 30 per cent.

d. in the case of domestic companies, the tax rate (inclusive of surcharge) should, in the course of the next three years (i.e.,by assessment year 1995-96), be reduced to the same level as the maximum marginal rate of tax (inclusive of surcharge) in the case of individuals *i.e AO* per cent. Further, the existing distinction between companies in which the public are substantially interested and companies in which the public are not substantially interested for the purposes of tax rate, should also be abolished within the next three years. When the new scheme of taxation of partnership firms, AOP and BOI recommended in this report comes into operation, there will be no need for prescribing a separate tax schedule for registered firms. [Paragraph 6.18 & 6.19]

12.3 Complete integration of the incomes of both the spouses or, for that matter, all adult members in the family is not feasible or necessary. However, the existing safeguards in the income tax law for aggregation of incomes in the case of splitting of assets should continue, with the modifications that all incomes of a minor, other than wage income, should be aggregated with the total income of

i. the parent having the higher income, where the total income of one parent or of both the parents happens to fall below the exemption limit for individuals;

ii. anyone of the parents at the option of the parents where the income of both the parents exceeds the exemption limit; and

iii. if over time the income of the parent, with whom the income of the minor was aggregated earlier, goes below the exemption limit, the parent having the higher income.

iv. the income of the minor arising from assets transferred to him or her by anyone including his grandparents should be aggregated with the income of the parent as recommended above. [Paragraph 6.38]

*1204* The following tax concessions now available under the Income-tax Act should be abolished:

a. exemption under Section 10(15)(iic) in respect of interest on notified Relief Bonds:

b. exemption under Section 10(15)(iv)(h) in respect of interest received from any sector company in respect of notified bonds or debentures;

c. exemption under Section 10(15)(iv)(i) in respect of interest received from Government on deposits in notified scheme out of moneys due on account of retirement;

d. deduction under Section 80-L in respect of income from specified sources. [Paragraph 6.44}

12.5 The tax rebate allowed under section 88 for investment in provident fund, NSCs, etc. should continue to be allowed at the entry point rate of tax but only for investment upto a reduced maximum level of Rs. 10,000/-. Further, the tax concession should be restricted to contributions to provident fund, life insurance policies and repayment of loans taken for purchase or construction of a residential house property.
[Paragraph 6.46]

12.6 The tax concession under Section aO-CCA for any investment in the Jeevan Dhara or Jeevan Akshay annuity plans of the Life Insurance Corporation of India should be withdrawn. The tax concession under Section 80-CCB for investment in equity linked saving scheme should be abolished.
[Paragraph 6.47]

12.7 The existing ceiling of Rs.40,OOO for deposits in the National Savings Scheme under Section 80-CCA should be increased to As.50,000.
[Paragraph 6.48}

12.8 The provisions of Sections 35-AC, 35-CCA, 35-CCB and 8O-GGA should be amalgamated with Section 80-G. The 100 per cent deduction at present allowable under Sections 35-AC, 35-CCA, 35-CCB and 80-GGA should be restricted to 50 per cent as in the case of deduction for other donations under Section SO-G. Further, deductions should be allowed only in respect of donations to an approved association/institution and not for expenditure incurred on an in-house programme.
[Paragraph 6.52]

12.9 The tax incentives under Sections 8O-HH, 8O-HHA, 80-1, BO-IA, 8O-JJ, 80-00 and 8O-00A should be abolished with immediate effect, with the result, the taxpayers would not henceforth be eligible for the tax benefits they have been enjoying under the above-mentioned provisions. [Paragraph 6.54]

12.10 The provisions such as Sections 8O-HHC, 8O-HHE, etc., need to be kept under review. [Paragraph 6.55]

12.11 The rules for perquisite valuation of concessional rent accommodation or rent-free accommodation should be modified so as to remove the present distinction in perquisite valuation between employees of the Government, companies in the private sector and public sector and other autonomous bodies. The perquisite value of both the rent-free accommodation and concessional rent accommodation should be taken to be equal to twenty per cent of the salary or the expenditure incurred by the employer in providing housing, whichever is lower. This rule should be made applicable to all employees irrespective of whether the employee is in the private sector or in the public sector or in the Government. However, where the expenditure incurred by the employer in providing housing is fully recovered from the employee, the perquisite value should be taken to be nil. Further, the perquisite value should be taken to be nil in all cases where the annual

income under the head 'Salary' (excluding non-monetary benefits or amenities) does not exceed Rs.36,OOO.
[Paragraph 6.71]

12.12 The provision of clause (13A) of Section 10ofthe I.T.Act providing for exemption of house rent-allowance as per rule 2A should be abolished. [Paragraph 6.71]

12.13 All taxpayers, whether enjoying a rent-free accommodation or concessional rent accommodation or in receipt of house rent allowance or receiving no such benefit on account of being self-employed should be entitled to relief under Section BOGG of the Income-tax Act for rent paid. For the purposes of computing relief under Section 8OGG, 'rent paid' should mean the rent actually paid as increased by the amount of HRA that would otherwise have been admissible to the taxpayer. The existing provisions of Section 80GG of the I.T. Act should be modified to provide for deduction in respect of rent paid in excess of ten per cent of salary upto a maximum of twenty per cent. The limit of Rs.1,OOO under Section 80GG of the I.T.Act should be removed. Further, since the income from a let-out property is taxable ana the Income from a self-occupied property is deemed to be nil, the benefit under this provision should not be available in any case where the taxpayer or his spouse or minor child or the Hindu undivided family of which he is the Karta has a self-occupied property anywhere in India.
[Paragraph 6.71]

12.14 Where the expenditure incurred by the employer in providing housing to its employee is in excess of twenty per cent of the salary of the employee, such excess which remains uncaptured in the tax assessment of the employees, should subjected to a separate fringe benefit tax in the hands of the employer at the flat rate of 30 per cent. The tax so paid by the employer, however, should not be allowed as a deduction in the computation of profits of the employer. The expenditure incurred by the employer in providing housing to its employees should be subjected to the rent which a similar accommodation would realise in the same locality or actual rent paid if accommodation is hired by the employer or the municipal valuation in respect of the accommodation, whichever is higher. [Paragraph 6.71]

12.15 At least, 80 per cent of the leave travel allowance, home travel allowance, travel allowance on retirement, passage money and such other payments should be subjected to tax. [Paragraph 6.73}

12.16 The allowances paid to legislators should be fully subjected to tax. [Paragraph 6.74]

12.17 The exemption in respect of allowances covered under sub-clause (ii) of clause (14) of Section 10 of the Income-tax Act should not exceed 10 per cent of salary. [Paragraph 6.75]

12.18 All loans given to employees should be deemed to have been given at the rate of 12 per cent and any concession implicit in the interest actually charged should be treated as a fringe benefit and taxed accordingly. However, where the concess!onal interest loan is utilized for construction of a house property or any other income generating asset, the perquisite value

of the concessional interest loan should also be allowed as a deduction in the computation of income from such house property or any other income generating asset. [Paragraph 6.77]

12.19 The value of all other perquisites as contained in Rule 3 of the Income-tax Rules should be revised upward to take account of inflation since the values were last fixed or revised. [Paragraph 6.78]

12.20 For purposes of computation of capital gains arising on the transfer of a capital asset

i. A long-term capital asset be defined to mean a capital asset transferred after one year from the end of the financial year in which the asset is acquired. To compute long-term capital gains, all long-term capital assets should be deemed to have been acquired on the last day of the financial year in question and transferred on the first day of the financial year in which the transfer takes place.

ii. The cost of all assets acquired prior to a cut-off date be converted into the value of the asset on the cut-off date. For the present, the existing cut-off date of 1.4.1974 should continue.

iii. The value of the asset should be indexed for inflation for the Subsequent period of holding in a manner described below.

iv. The cost of acquisition of an asset or the value of the asset, as the case may be, should be increased by a cost-inflation index (CII), which should be equal to 75 per cent of the consumer price index for urban non-manual employees (CPI), for the entire period of holding or for the period reckoned from the specified cut-off date, respectively. Similarly, the cost of any improvement undertaken to the asset should also be inflation indexed using the CII.

v. In the case of non-corporate taxpayers, long-term capital gains duly indexed will be subject to tax at the marginal rate applicable to the assessee in the concerned year subject to a maximum of 27.5 per cent. If income other than capital gains is below the general exemption limit the tax on long term capital gains will be applied to the excess of the sum of other income and long term capital gains over the exemption level. In the case of corporate assessees the indexed long term capital gains will be subject to a flat rate of 40 per cent. When the rate of tax on corporate profits is reduced to 40 per cent, as per our recommendations, the rate of tax on long term capital gains for the corporate assessees should be fixed at 30 per cent.

vi. In the case of firms, the income from capital gains should be apportioned among the partners in the ratio of their share in the partnership. This income should be treated as capital gains in the hands of the partner.

vii. The roll-over provisions should be retained but the special exemptions granted under Sections 53 and 54E of the Income-tax Act should be withdrawn. Rollover relief should, however, be granted uniformly in each roll-over section of the Income-tax Act in the following manner:

a. The gain should be computed after adjusting the cost of acquisition and improvement by the cost inflation index as recommended earlier.

b. The fraction of the capital gain that is allowed "roll-over" relief should be equal to the proportion formed by the cost of the newly purchased asset

(new asset) to the net sale consideration from the sale of existing asset (old asset). In the case of a new asset, capital gain should be reckoned as the sale price less the inflation adjusted cost of the old asset. The inflation adjusted cost of the old asset should, however, be calculated for the entire period of holding of the new asset and the old asset. Where the old asset is acquired prior to the cut-off date, the cost of acquisition and the period of holding of the old asset should be reckoned to be respectively, the value of the old asset on the cut-off date and the period from the cut-off date.

viii. The existing Capital Gains Accounts Scheme should be *replaced* by a simple scheme along the lines of a money-multiplier scheme promoted by some banks in the country.

ix. The existing method for computing the period for re-investment, with reference to the date of transfer should be replaced by a method whereby the period is computed with reference to the financial year in which the asset is transferred. Accordingly, the period specified for re-investment should be either within the financial year immediately preceding or within two succeeding financial years immediately after the financial year in which the original asset is transferred.

x. There is no necessity to make any further change in the existing scheme of allowing set-off of capital losses only against capital gains.

xi. Capital loss should be computed after adjustment of the cost of the asset by the cost inflation index. Provisions relating to scaling down of long-term capital losses may, consequently, be deleted.

xii. The existing provisions relating to tax treatment of capital gains from depreciable assets used for business or profession does not merit any change. [Paragraphs 6.87 to 6.99]

12.21. The existing provisions seeking to restrict the deductibility of certain expenses in Business be reviewed and limits prescribed be revised. The restriction on the deductibility of certain expenses have been rationalised. [Paragraph 6.100)

12.22. The deductions of Rs.3,600 in respect of each residential unit forming part of a building for a period of five years from the date of completion of such a building at present allowable under second proviso to sub-section (1) of Section 23 of the Income-tax Act should be withdrawn. Further, since the proposed lower rates of personal income tax will benefit also tax payers having income from house property, the deduction for construction of new residential units should be withdrawn from the AssessmentYear1993-94for all taxpayers even in respect of residential units in a building completed prior to the implementation of this recommendation. [Paragraph 6.103]

12.23. An amount equal to 1/5th of the "annual value" of the property should be allowed as a statutory standard deduction for the aggregate expense on repair of the house property and collection of rent. [Paragraph 6.105)

12.24. The number of years in which the interest on borrowed capital relating to pre-completion period that is allowed as a deduction in the

computation of "income from house property" should be reduced from five to three. ' [Paragraph 6.106]

12.25. In the case of partnership firms,

a. The scheme of registration of firms for income tax purposes should be abolished,' All firms should be treated alike for income tax.

b. The sxlstlnq separate tax on the income of the firm should be abolished. The firm should be required to calculate capital gains and its income other than capital gains separately. The income other than capital gains should be apportioned amongst the partners in the ratio of their share in the profits of the firm, for taxation in their hands at the appropriate income tax rates. In computing the income of the firm, it should be allowed, as against the present practice, to claim as a deduction any payment of interest, salary, bonus, commission or remuneration to any of its partners.

c. Where new partners are admitted to the benefits of a partnership at any time during the accounting year after the end of the first three months. the share of the new partners in the profits of the firm should be ignored and profits should be apportioned amongst the old partners in the revised ratio of their shares in the manner indicated in Chapter 6. However, this should only be in respect of the financial year in which the new partners have been admitted. This however will not apply when a firm is reconstituted on the death of a partner.

d. Where a firm has any income from capital gains, it will be eligible to *claim*"roll-over" relief wherever permissible. Any capital gain (after allowing for the "roll-over" relief) or loss incurred by the firm should be apportioned amongst the partners in the ratio of their share in the profits of the firm. However, the partners should not be allowed any "roll-over" relief in respect of such share in the capital gains. The relief for "bunching" of gains should be allowed to be claimed by the partners in *their* personal assessments.

e. All association of persons and bodies of individuals should be taxed *in* the same manner as firms.

f. Where the shares of partners in a firm or of members in the AOP or BOI are not specified, they should be presumed to be equal amongst them and no partner or member should be allowed to claim differently at anytime in the future in respect of profits of the year for which such presumption is made.

g. The firm or AOP or BOI should not be allowed any credit for the tax deducted at source from payments received by it. However, it should be allowed to apportion the same amongst its partners in the ratio of their share in its profits.

h. The firm should be required to pay advance tax on behalf of partners in respect of the income of the partner from the firm and income from all other sources along the same lines as the facility available under sub-sections (2), (2B) and (3) of Section 192 to both the employer and the employee. in respect of deduction of tax at source. The advance-tax paid by the firm on behalf of the partners should be deposited with the Central Government through a single challan. The firm should after the end of the previous year

be required to submit separate annual statements regarding advance-tax paid on behalf of the partners.

i. Every firm should be required to issue a certificate to every partner indicating the amount of interest, salary, bonus commission or remuneration paid by it. the share of the partner in the profits of the firm the share of the partners in the tax deducted at source on payments received by the firm and the advance-tax paid by the firm in respect of income of the partners.

j. Notwithstanding the fact that there would be no tax liability on the part of the firms. AOPs and BO is they should be required to file their returns of income irrespective of their level of income. Where the firm files the return of income voluntarily but after the due date they should be required to pay one-half per cent of the computed income of the firm subject to a minimum of Rs.20D. as a late fee for every month of default. If the return is filed in response to a notice issued after the end of the assessment year and the firm has not deposited the deducted tax at source, in the appropriate manner, from payments made to the partners, the firm should be assessed to tax at the maximum marginal rate of tax for individuals and also be required to pay late fee as indicated above. In such a case, distribution of income in the partners' hands would not arise.

k. In a case where the returned income of the firm is increased as a result of additions or disallowances the difference between the assessed income and the income declared should be taxed at the maximum marginal rate in the hands of the firm but exempt from any additional tax liability in the hands of the partners. However, in a case where loss is returned and where the additions made result in a reduction in the loss or in the computation of a positive income. the income or loss computed should be apportioned amongst the partners and consequential rectifications should be carried out in their tax assessments.

l. The problem of "benamidar" partners should be tackled only by sustained investigation under the Benami (Prohibition) Act, 1988 without causing undue distortion in the tax structure. Where it is established that a partner in a firm is the benamidar of any other partner of the firm or is an undisclosed benamidar of an outsider and anyone or more of the other partners new or had reasons to believe that it was so, the whole of the income of the firm (including any payment income to the partners) should be taxed at the maximum marginal rate. [Paragraphs 6.113 to 6.115]

12.26. In the case of co-operative societies,

a. The deduction, presently available to cooperative societies under Section 80-P, in respect of whole of their profits from business, should be restricted only to 20 per cent of their profits. However, all other deductions under Section 80-P should be abolished.

b. The income exemption limit for cooperative societies should be fixed at Rs.25,000.

c. The total income of the cooperative society, in excess of the exemption limit, should be subjected to tax at the flat rate of 30 per cent. [Paragraph 6.118]

12.27. For inducing traders and manufacturers operating on a small scale but enjoying taxable income to make some contribution to income tax, two simple schemes based on the presumptive approach are recommended. The first variant which we call the scheme of presumptive taxation envisages a very simple system under which one is required only to pay a lump-sum tax in lieu of income tax. This scheme will apply only to traders and manufacturers havlnq a total business turnover of between Rs.3 lakh and 51akh. Under the other scheme the net income of the taxpayer will be estimated as a specified percentage of the gross turnover in business (the percentages depending on the type of business activity). This, we call, the estimated income scheme (EIS). The specifications of' the two schemes are outlined below:

**i. Presumptive tax scheme**

Under this scheme, traders and manufacturers deriving income from business should be allowed an option to pay tax in a lump-sum of RS.1 ,000/- without filing any return if their total turnover in business happens to fall between Rs.3lakhs and Rs.5lakhs as estimated by themselves.

It is possible that even such small traders/producers have income from other sources like brokerage from commission agency, interest, dividend, property, etc. The facility of this scheme should not be denied to them so long as income from these sources remains modest. For brokerage income, this limit may be fixed at Rs.25,OOO. But tax at the rate of 20 per cent may be realised from such income without going through the process of aggregating such income with income from other heads. When the trader/producer has income from other sources, again the scheme would still be open to the trader or producer if the receipts from such other sources do not exceed Rs.10,000. Here 'receipts from other sources' would include interest, dividend, property, salary, etc. However, in such cases the taxpayer should not be permitted to claim any refund of tax deducted at source on such receipts.

Taxpayers opting for this scheme should not, however, be allowed any deduction on account of savings incentives or any other provision of the Income-tax Act. As mentioned earlier, no return need be filed by persons opting for this scheme. Nor should they be required to make any advance payment of tax in instalments. It should suffice, if they pay the tax in one lump-sum any time before the 15th of March during the accounting year.

**ii. Estimated income scheme (EIS)**

Persons having business turnover of more than Rs.5 lakhs or brokerage or commission receipts exceeding Rs.25,000 or receipts from other sources above Rs.10,000 should come under the alternative scheme, namely, the Estimated Income Scheme (EIS). Under this scheme, net income from business will be presumed to be equal to

a. eight per cent of the turnover from trading or manufacturing operations;
b. fifty per cent of the receipts from brokerage or commission;
c. ten per cent of receipts from contracts relating to construction of roads, bridges, buildings, other public works and transporting. This is in line with the scheme of estimating income taxation for contractors as outlined in Sub-section 'c' below.
d. eighty per cent of receipts from other sources, being in the nature of 'interest, dividend, rent, export incentive schemes or any other receipt of similar nature. 'Receipts from other sources' for this purpose will not include any receipt falling under the head 'salaries' or 'income from house property' or 'profits and gains from business or profession'. The income estimated in the aforesaid manner will be aggregated with income from profession and income under the heads like 'salaries' and 'house property', if any, to determine the gross total income. Taxpayers opting for the scheme will be eligible for deductions allowed for savings and specified activities as may be available under the Income-tax Act from time to time. The total income so computed should be subjected to tax at the appropriate rates. Unlike in the case of PTS, tax due under the EIS should be paid in advance in three instalments and the provisions in the Income tax Act relating to the payment of advance tax should apply. The EIS should, however, be restricted to persons whose turnover and/or receipts do not exceed Rs.25 lakh.
Further, a simple statement should be furnished by taxpayers coming under these schemes to the nearest income tax office. The challan and statement forms should be made availab1e freely in all bank offices or branches, market committees, office of trade associations, etc.
For the first three years, the statements of turnover may be accepted without any question,' unless there is strong evidence to the contrary. Every attempt should be made to estimate the ratios separately for each separate activity and for different locations as has been done in Israel for the 'takshivs", *Once* these ratios are set up they should be given wide publicity (Subject to periodic revisions), so that they can be used for self-assessment by taxpayers having income from business on their own and also by tax officers as a check against gross understatement. In other words, these ratios can be used as benchmarks or guidelines for estimating business Incomes where verifiable accounts are not maintained. Incomes computed on the basis of the ratios should be accepted without any question. Any variation above or below the norms so set up beyond say 10 per cent should be subjected to scrutiny and approval by the next higher official. In order that the presumptive income approach suggested above for small enterprises does not come under any legal attack, it would be necessary to make the presumptions rebuttable.
[Paragraph 6.130 to 6.138]
12.28. In the case of contractors, 10 per cent of contract receipts from all contracts relating to construction of roads, bridges, buildings, other public works and transporting, should be presumed to be the income in such cases and the same should be formalised in law. [Paragraph 6.139]

12.29. Efforts should be made to introduce the estimated income system on the basis of physical indices. A beginning may be made by prescribing that each truck with an inter-State permit could be presumed to yield an income of Rs 4:000 per month. Similarly each truck with a State permit could be presumed to yield an income of Rs 3,000 per month. [Paragraph 6.140J

**Taxation of Wealth**

12.30. The tax on wealth should be abolished in respect of all items of wealth other than those which can be regarded as unproductive forms of wealth or other items whose possession and use could legitimately be discouraged in the soctal interest.
(Paragraph 7.4]

12.31. The new scheme of net wealth tax should be as follows:

a. An annual tax on the aggregate capital value, in excess of the specified exemption level, of the following items of wealth will be levied in the hands of individuals, Hindu undivided families, and all companies.

b. The items on which wealth tax would be levied are: residential houses, motor cars (other than those used in the business of running them on hire), bullions and jewellery, (other. than those used as stock-intrade) yachts and boats and planes (other than those used for commercial purposes) and urban land.

c. Residential houses should include all farm houses within 25 kilometers from the local limits of any municipality or cantonment board.

d. For the purpose, the valuation of the above items for wealth tax purposes would be according to the procedures now being adopted under the Wealth Tax Act. However, the rules regarding valuation of residential property would be required to be re-examined as there is a general feeling that these rules are a little too liberal. Simultaneously, efforts should be made to suitably adjust the rates of stamp duty on transfers of property and the level of municipal property tax. The objective should be that the total burden of all these taxes on property income should be reasonable.

e. Any liability specifically incurred for acquiring the assets which are liable to wealth tax and charged against them will be deductible from the computed value of the assets before the tax is applied.

f. The first Rs 15 lakh of the net value of the taxable items of wealth will bear nil tax. Any excess of net value over that level will bear tax at one per cent of value.

g. The existing provisions in the Wealth Tax Act will apply to taxable items' of wealth transferred to members of one's family without adequate consideration. However in line with our recommendation in respect of income of minor children, we recommend that the net value of the taxable items of wealth in the hands of any minor child should be aggregated with the net value of such assets in the hands of the parent whose taxable assets have a higher value if one or both of them are not liable to pay wealth tax and with the net value of the taxable assets of either parent if both of them are liable to pay the wealth tax.

h. Although only items of wealth mentioned in (b) above will be subjected to wealth tax, all income tax payers whose gross total income exceeds Rs.1 lakh should be required to file a net wealth statement in the form indicated in Annexure to this Chapter. For this purpose, all assets should be valued at cost. The statement should form an integral part of the return of income. The statement should not give details of individual items of wealth, but only values of specified categories of wealth, e.g.. equity shares and debentures, bank deposits and money invested in partnerships or in own business. [Paragraph 7,5]

12.32. Net wealth tax should also be levied on the specified assets owned by all public and private sector companies. The wealth tax paid should not be allowed to be claimed as expense for income tax purposes. [Paragraph 7.7]

**Restructuring Import Tariff**

12.33 The main elements of the programme of reform of import tariff should be:

a. Reduction of the general level of tariffs;

b. Reduction of the spread or dispersion of tariff rates;

c. simplification of the tariff system;

d. Rationalisation of tariff rates, along with the abolition of numerous exemptions and concessions; and

e. Abolition of the practice of making changes in effective rates through notifications.

12.34 In the next four years, the general level of import tariff should be reduced by about 50 per cent, so that the import-weighted average rate of protective import duty comes down to about 45 percent. In subsequent years, further reduction in duty rate should be attempted so that the average is brought down to about 25 per cent by 1998-99 of the 50 per cent reduction in the average rate of nominal tariff to be achieved in the first phase of tariff reduction 10 to 15 per cent reduction should be made in the next Budget for 1992-93 and the remaining part of tariff reduction should be carried out in the years 1993-94 to 1995-96. [Paragraph 8.13]

12.35 There is need to greatly simplify the tariff system. One step in this direction would be to combine the basic and auxiliary rates of customs duty into one protective rate. [Paragraph 8.16]

12.36 Another step towards simplification of the tariff system is to reduce the multiplicity of rates. It should not be difficult to achieve in the coming years a rate structure of protective customs duties with only a small number of rates. [Paragraph 8.18]

12.37 Where the rates are expressed on specific duty basis, or as specific cum ad valorem basis the combined ad valorem incidence should be reviewed taking into account changes in the international prices. [Paragraph 8.19]

12.38 There is also a case for reducing, and eventually removing end-use exemptions which cause tariff rates for the same product to differ among uses, with a few possible exceptions. [Paragraph 8.20]

12.39 The practice of making changes in effective duty rates of customs through notifications should be done away with. If any change in the statutory customs is to be made because of special circumstances such as a drastic change in the international price of imported goods the change should be made only on the recommendation of the Tariff Commission, into which the BICP is proposed to be converted. [Paragraph 8.23]

12.40 If the loss of customs revenue has to be kept under Rs.2,OOO crors, the maximum duty rate may be confined to 120 or 110 per cent. Choosing 12C per cent as the peak rate in the Budget for 1992-93 has the advantage tha: the net loss of customs revenue on account of lowering of the peak will be only about Rs.l.00a error, so that there would be scope for making other changes in the structure of the tariff rates. [Paragraph 8.28]

12.41 A tariff reduction by ten percentage points be made for those items of basic metals basic industrial chemicals and machinery, which are at present subject to a rate of duty in the range of 80 to 120 per cent. [Paragraph 8.31]

12.42 Even after these changes are made many commodities (nearly 50 per cent of the items) will be subject to a rate of protective customs duty of 100 per cent or more which is quite high in relation to the levels of tariff rates prevailing in most other developing countries. It should be noted further that a large part of capital goods imports and a number of important raw materials and intermediate goods are at present SUbject to a rate of duty in the range of 40 to 70 per cent. The tariff changes proposed for the next year will leave the duty rates of such items unchanged. Appropriate changes in the duty rates of those items will have to be made in the years 1993-94 to 1995-96. Substantial reduction in duty rates would be necessary also for items for which the rate of duty is at present 80 per cent or higher. [Paragraph 8.35)

12.43 The average duty rate for capital goods should be reduced to 55 per cent by 1995-96. (As has been indicated in paragraph 8.55, this could be achieved even earlier). [Paragraph 8.43]

12.44 The import-weighted average tariff rate for intermediate goods should be brought down to 45 per cent by 1995-96. [Paragraph 8.44]

12.45 By 1995-96, the average tariff rate should be brought down to about 50 per cent and the peak rate to about 80 per cent. In the years 1996-97 to 1998-99 tariff rates should be reduced further to bring down the average rate to around 25 per cent and the maximum rate to 50 per cent by 1998-99. [Paragraph 8.47}

12.46 By 1998-99, all end-use exemptions should be removed with a few exceptions.

[Paragraph 8.49J

12.47 There are several anomalies in the duty structure and all such cases should be looked into and necessary corrections in duty rates made. In making the corrections, the broad structure of duty rate ssuggested for1995-96should be kept in view. [Paragraph 8.52]

12.48 By 1998-99, a minimum rate of import tariff, say 10 per cent, should become generally applicable. A beginning should be made in this direction in the next year. [Paragraph 8.53]

**Taxation of Domestically Produced Goods and Services**

12.49 The indirect tax at the Central level should be broadly neutral in relation to production and consumption and should, in course of time, cover commodities and services. This means we should move towards VAT covering services and commodities. To make the VAT scheme simple and easily administrable, it should be levied at two or three rates, say, at 10, 15 or 20 per cent. The selective excise duty on non-essential consumption could be levied at 30, 40 or 50 per cent (This means that the maximum rate on a commodity will not exceed 50 per cent with a few exceptions like cigarettes) . [Paragraph 9.2J

12.50 There is a need to widen the tax base and extend the coverage of excise duties. The Committee has identified a number of commodities which could be brought under the excise net. Except Black & White T.V. sets which should bear dury at the rate of 20 per cent ad valorem, other commodities should be Subjected to be minimum duty rate of 10 per cent ad valorem. [Paragraphs 9.6 & 9.29J

12.51 In respect of Ayurvedic and other indigenous systems of medicine, articles of plastics and ready-made garments which are recommended to be brought under excise net, the Simplified Assessment Procedure (SAP) scheme should be made applicable. [Paragraph 9.7J

12.52 All end use based exemptions for inputs should be withdrawn and the minimum duty rate of 10 per cent ad valorem should be levied on such inputs. If it is not possible to withdraw all such exemptions immediately, this should be done gradually over a period of time when inputs and finished products will bear,duty with the benefit of Modvat credit for inputs. [Paragraph 9.7J

12.53 A new scheme, Simplified Assessment Procedure (SAP), should be introduced for goods covered under the general scheme of excise duty concession in respect of those small scale units whose turnover in the preceding year did not exceed RS.3D lakh.

**12.54 The proposed duty structure for small scale sector is as follows:**

| Slab Rs.lakh | Proposed Duty |
|---|---|
| 0-15 | NIL |
| 15-25 | Two per cent of the turnover for units operating under SAP; for others. duty at normal rates minus 10 per cent ad valorem subject to minimum duty of 5 per cent ad valorem. |
| 25-75 | Duty at normal rate minus 10 per cent ad valorem Subject to a minimum duty rate of 5 per cent ad valorem. |
| 75-200 | Duty at normal rate. |

12.55 The following procedural relaxations should be allowed for units operating under SAP:

i. No excise licence would be required for such assessees.

ii. Duty shall be paid quarterly.

iii. The requirements of the filing of price lists and classification lists and of clearance of goods on gate passes will be waived. Records maintained for sales tax/income tax purposes shall be accepted for the purpose of verification of production figures and turnover in lieu of statutory Central excise records. The returns filed by the assessees shall be accepted without question with a provision for random audit.

iv. Investigation, enquiry or audit in these units shall be only with the approval of the Assistant

**Collector of Central Excise.**

12.56 Since no duty paying documents will be issued for goods cleared under SAP, Modvat credit shall not available.

12.57 The desirability of extending this scheme to other small scale units should be examined in the light of the experience gained while administering this procedure in respect of goods covered under the general scheme. [Paragraph 9.17J

12.58 The subsidy in the form of notional higher credit available to industries using inputs covered under the general scheme should be withdrawn. [Paragraph 9.19]

12.59 The present distinction in regard to the availability of concession, between brand name of trader or organised sector and that of the smallscale sector should be removed. All goods manufactured under the brand name of any person other than the manufacturer should be charged to normal duty. Corresponding amendments regarding branded goods may be made in the special schemes of exemption for the small-scale sector producing cosmetics and toilet preparations, air conditioners and refrigerators. [Paragraph 9.20J

12.60 All exemption notifications should be subfected to a close scrutiny with a view to ascertaining whether these can be withdrawn. Where notifications prescribe effective rates of duty without any condition, such rates can, be incorporated in the tariff after adjusting them in line with the rate structure proposed in Paragraph 9.2. [Paragraph 9.21]

12.61 The power-of granting exemptions from excise duty should be withdrawn. However, Government may retain the power of adjusting the rates of duty under very exceptional circumstances.[Paragraph 9.22]

12.62 in a system of commodity taxation ad valorem duties are preferable to specific duties, particularly under Modvat regime. Switching over to ad valorem rates in respect of a number of commodities is, therefore, recommended. Slrnultaneously, rationalisation of the existing rates has also been suggested with a view to reducing multiplicity of rates. The ad valorem rates suggested for various items broadly conform to the duty slots in which

the tariff is required to be structured in the long run. For administrative considerations, however, some commodities like petroleum products, tobacco products and textiles; coffee, tea, marble, etc., may continue to have specific rates.[Paragraph 9.29]

12.63 Where specific rates are retained, there should be a system of revising the rates every year to take into account price increases as represented by the relevant sectoral wholesale price index. While fixing ad valorem rates, goods falling within the same class should as far as possible be made to bear the same rate. [Paragraph 9.31]

12.64 In certain cases like coffee, tea and marble, the specific rates should be revised immediately since these rates have remained practically unchanged for a number of years while prices have gone up considerably. [Paragraph 9.32]

12.65 As the Modvat or the value added tax system gets extended and becomes the main plank for raising revenue from domestically produced goods and services. it would be necessary to move over to a system of assessment on the basis of invoice value. However, for this to be possible and easily administrable it would be desirable to fulfil two conditions. First, there should be extension of value added tax from the manufacturing to the wholesale stage; this would considerably reduce attempts at under-valuation of products. Second, it would be necessary to give up the traditional method of administering excises on the basis of clearance of goods from the factory and move over to a system of assessment on the basis of periodic returns to be submitted by consultation with the manufacturers' associations.[Paragraph 9.44]

12.67 A Directorate of Valuation should be created which will be responsible for closely monitoring the movement of prices of goods produced by individual manufacturers especially in those cases where the revenue implications are large. The responsibility of having consultations with the manufacturers' associations in regard to fixation of the quantum of abatement from the retail price. The work of fixation of tariff value, etc., should also be entrusted to this Directorate. On the basis of studies of this Directorate, Government could take a decision in regard to addition to or deletion from the fist of commodities which are assessed to duty on the basis of tariff value or retail price.[Paragraph 9.45]

12.68 The valuation method should be simple and fair so that by and large manufacturers are not provoked to take up the issues to the Courts and atthe same time the unscrupulous elements do not make this as a gateway for evasion. Ultimately, the department will have to adopt invoice value for assessment and carry out the needed changes in procedures.[Paragraph 9.46]

12.69 The Committee envisages that as the Union excise on commodities gets gradually transformed into a value added tax at the manufacturing level the services tax will get woven into that system and, therefore tax could be levied also on services that enter into the productive processes.[Paragraph 9.49]

12.70 The Committee recommends that a tax be levied for the present on the following services:

a. Advertising services,

b. Services of stock brokers,

c. Services of automobile insurance,

d. Services of insurance of residential property personal effects and jewellery and

e. Residential telephone services.

12.71 In all the cases above except for telephone services, the tax should be levied at 10 per cent of the value of the transaction. In the case of manufacturers. These are Important changes and their feasibility would have to be studied in greater detail. The Committee does not, therefore, recommend a changeover to the system of assessment on the basis of invoice value at present. However, it is recommended that a beginning may be made, by way of experiment with the use of invoice value for assessment of excise in respect of selected commodities which are largely eligible for Modvat in the sense that they are mostly sold to taxable manufacturers. Meanwhile the question of extending the collection of Modvat to the wholesale stage must be taken up for active consideration. [Paragraph 9.40]

12.72 The centre should work out a package of measures with the States that would represent a just compromise of the interests of the individual States and those of the Union as a whole. The enactment of the law imposing the consignment tax should be one of the measures. [Paragraph 9.57]

12.73 The harmful effects of the inter-State sales tax-cum-consignment tax can be avoided or minimised in two different ways. The first and the more satisfactory arrangement would be as follows:

(a) The inter-State or Central sales tax or the consignment tax imposed by the exporting State will be given credit by the importing State against the sales tax payable to it by the "importer".

(b) The exporting State will credit the inter-State sales tax and consignment tax collections to a Central pool.

(c) Thus all collections of these two taxes will be deposited in the Central pool and will be then shared among the States on the basis of an agreed formula. The formula should be so devised as to give even treatment to the producing and consuming States.

(d) The rate of inter-State sales and consignment. taxes would be two per cent. The second best arrangement could be that the consignment tax would be imposed at one per cent after the ceiling rate of the Central sales tax has been reduced to one per cent. [Paragraphs 9.58 & 9.59]

**Issues Relating Tax Administration and Procedure**

12.74 Appeals should be provided against any adjustment made under Section 143(1)(a) of the Income-tax Act, 1961. [Paragraph 10.9]

12.75 A Tariff Guide should be issued giving the classification of all commodities currently manufactured in the country and the classification given therein which would be in line with the established practice should be followed by all the assessing officers in the field. The additions to the Tariff

Guide should be made on the basis of the decisions of the Board. This arrangement should be brought about simultaneously with the setting up of the computer network among all the Collectorates. [Paragraph 10.14]

12.76 The Committee would urge that the pace of implementation of the computerisation project in the Customs and Excise Department should be accelerated. [Paragraph 10.17]

## *An extract from the Final report of Tax reform committee*

SUMMARY OF CONCLUSIONS AND RECOMMENDATIONS[31]

### Introduction (Chapter 1)

10.1 In this Report, the Committee has dealt with and made recommendations on issues in the following five broad areas:

a. Corporate profits including the taxation of foreign entities, problems relating to business taxation, the interest tax, taxation of agricultural income, the gift tax and charitable organisations;

b. Further reform of the system of domestic indirect taxes, particularly at the Central level;

c. Improvements in tax administration, procedures, removal of harsh and complicated provisions and appellate procedures;

d. Major problems relating to tax administration;

e. Revenue Audit.

### Recommendations in the Interim Report (Chapter 2)

10.2 We would first like to reiterate some of our earlier recommendations. in the Interim Report which have not been so far implemented.

a. Direct Taxes: For broadening the base and improving the fairness of the income tax system:

i. the perquisite value of rent-free or concessional rent residential accommodation provided should be taken to be equal to 20 per cent of the salary or the actual expenditure by the employer, if lower, for those employees whose annual incomeunder the head 'Salary' exceeds Rs.36,OOO. The taxable perquisite value could be the above perquisite value as reduced by the sum of rent paid and house rent allowance foregone;

ii. 15 per cent of leave travel allowance, sitting allowances received by members of Parliament and State Legislatures and the fringe benefits implicit in the concessional interest rate charged on loans granted to employees for the acquisition of durable goods and houses should be included in taxable income;

iii. the allowances exempted from tax under sub-clause (ii) of clause (14) of Section 10 of the Income-tax Act should be limited to 10 per cent of the salary. In order to induce greater voluntary compliance and to subject the majority of taxpayers to the same marginal rate, the middle rate of 27.5 per cent should be applied to income in the range of Rs.50,000 to Rs.2 lakhs. However, since the Government has fixed the rate 30 per cent last year, it may be retained at that level for the time being.

To remove many of the problems in tax assessment and the scope for harassment of small assessees in respect of the assessment of income from business of smaller assesses 'whose total turnover is less than Rs 20 or Rs 25

[31] CHAPTER 12 of Final Report of Tax Reforms Committee chaired by Prof. Raja J. Chelliah, 1992, pg. 166, Department of revenue, Ministry of Finance, Govt. of India

lakh, the estimated income scheme which is an important component of our recommendations relating to hard-to-tax groups should be implemented.

b. Indirect Taxes: We reiterate the recommendations for adopting a simple broad-based domestic indirect tax system with a few rates of duties covering almost all commodities other than raw produce of agriculture and many, if not most, services. For moving towards such a system:

i. The multiplicity of rates of excise duty should be reduced to 2 or 3 rates at 10, 15 or 20 per cent, barring the selective excise duty on non-essential commodities or commodities injurious to health which could be levied at higher rates say 30, 40 or 50 per cent (excluding cigarettes and petroleum products);

ii. The tax base should be enlarged by including services within the tax net and by withdrawing exemption notifications. The selected services identified by the Committee and about 30 commodities hitherto enjoying full exemption should be brought under the extended excise system; and

iii. The law and procedure relating to valuation should be simplified and specific duties should be replaced by ad-valorem duties in respect of most goods.

For preventing the fragmentation of the common market, the imposition of the consignment tax should follow an agreement between the Centre and the States to the effect that the Central sales tax and the consignment tax imposed by the exporting State will be given credit by the importing State against the sales tax payable to it by the "importer", that the exporting State will credit the inter-State sales and consignment tax collections to a Central pool and that this pool will be shared among the States on the basis of an agreed formula. If such an agreement proves impossible to arrive at, then the level of the Central sales tax should be gradually brought down to 1 per cent and after that is done, the consignment tax could be levied at the same rate.

## Further Reform of Direct Taxes (Chapter 3)

### Taxation of Corporate Profits – Domestic Companies

10.3 It is difficult to devise a system of corporate profit tax that would be satisfactory from all the relevant points of view. In India, we follow the classical system which treats corporations as a distinct taxable entity, and thus leads to the double taxation of dividends. Briefly speaking, the following are the deficiencies of the classical system:

(a) It discourages distribution of corporate profits and thus affects free flow of funds into new companies;

(b) It tends to encourage mergers to the disadvantage of new enterprises;

(c) It puts a premium on debt as opposed to equity financing; and

(d) The dividend retained earnings differential tends to distort the choice between corporate and non-corporate forms of doing business. Hence, the need for integration of corporate tax with personal taxes.

10.4 Full integration system wherein the corporation tax is fully transformed into income tax on the respective shareholders is, however, fraught with insurmountable practical difficulties. Partial integration systems have been adopted in various countries with a view to reducing the dividends/retained earnings differential. In India, the earlier system of partial integration (in vogue till 1960-61) led to considerable administrative and compliance problems. We think that the simplest and fairest method of giving relief from the double taxation of dividends would be to exempt a proportion of the distributed profits from the corporation tax. For the present, we do not recommend even this for three reasons viz., (i) the total burden of tax on dividend income in any case would be considerably reduced if the corporate and personal income tax rates as recommended by us are adopted; (ii) the whole issue could be re-examined after the findings of the Rudding Committee appointed by the EEC are available; (iii) given the revenue constraint, it is preferable to bring down the corporate profit tax rates to reduce dividend/retained earnings differential.

10.5 The Committee would, therefore, recommend the retention of the existing "classical system" of taxation for the present with the lowering of the corporate tax for all domestic companies to 45 per cent in 1993-94 from the present level of 51.75 per cent by the abolition of surcharge and to 40 per cent in 1994-95. This rate of 40 per cent would not be unreasonable for foreign investors given the spread of the present tax rates in different countries.

10.6 At the same time, the Committee would reiterate its recommendations made in the Interim Report for withdrawal of the concessions under Sections 35CCA, 35CCB, 35AC for making donations to associations and institutions carrying out rural development or any scheme or project for promoting social and economic welfare. This would simplify and improve the equity of the tax system, give less room for tax avoidance and reduce disputes.

**Depreciation Allowance**

10.7 As in many other countries, depreciation under the Indian Income-tax Act. s allowed as a percentage of the historic capital cost of the assets. The replacement cost method of allowing depreciation has not found favour in many countries including India for the reasons that it is not easy to measure or estimate asset-wise replacement costs because of divergent price trends and the cost of replacement is known only at the time of replacement while the depreciation allowance has to be availed of, during the period of use of the asset. Thus, only broad adjustment could be provided for taking care of the rise in the price of the assets. Following the recommendations of the Economic Administration Reforms Commission (EARC), the system of granting depreciation was simplified and the general rate of depreciation of plant and machinery was fixed at 33.33 per cent in 1988-89, merging the various types of depreciation available and to provide sufficient funds to replace capital assets in the context of rising capital goods prices. EARC's recommendations were against the background of a rate of tax of 55 per cent on corporate profits and the top marginal rate of 66 per cent on

personal income. The general rate of depreciation was reduced to 25 per cent in the 1991-92 Budget when the corporate tax rate was fixed at 45 per cent.

10.8 We have assessed the funds that will flow to a business if depreciation on plant and machinery (along with interest net of tax) is granted at alternative rates of 33.33 per cent, 25 per cent, 22.5 per cent and 20 per cent. It was seen that with the adoption of the depreciation rate at 25 per cent, the business enterprise would be able to recoup the total cost of the asset within a period of about 5-1/2 years. This is considered quite reasonable by the Committee when it is seen along with its recommendation for lowering the corporate tax rate to 40 per cent. In view of this, the Committee would like to recommend the retention of the general rate of depreciation on plant and machinery at 25 per cent.

**Deduction under Section 43B**

10.9 Section 43B makes a departure from the well accepted principle of allowing deduction for business expenses on an accrual basis. We are of the view that the use of tax law for collateral purposes, quite apart from complicating the law, is unfair and unjust as it militates against the principle of taxation of 'real' income. However, considering the need for prompt collection of revenue, we recommend that Section 43B should be restricted to taxes, duties, etc. Other items of expenditure like contributions to provident fund or gratuity fund or any other fund for the welfare of the employees, sums referred to in clause(ii) of sub-section (1) of Section 36 and interest on any loan or borrowing from any public financial institution should be taken out of the purview of Section 43B.

**Reconstruction and Other Arrangements of Companies**

10.10 Under the present provisions of the Income-tax Act and the Gift Tax Act, capital gains or gift, if any, is exempt from tax in a Scheme of Amalgamation of companies. However, such exemptions are not allowed in the case of Compromise; Arrangement and Reconstruction of companies. The provisions of company law in these cases are similar to the provisions in the case of Amalgamation. The Committee is of the view that there is no likelihood of the abuse of the scheme of Compromise, etc. to defraud revenue, shareholders or the creditors of the company. in view of the procedures laid down in chapter 5 of the Companies Act, which empower the High Court to take into account the views and objections of the Central Government, shareholders and the creditors of the company before any scheme is approved. We, therefore, recommend that no capital gains tax or gift tax may be levied in the case of Compromise, Arrangement and Reconstruction. We would also suggest that for removing doubts on the taxability .of shares or assets received by a shareholder in a scheme of Amalgamation, Compromise, Arrangement and Reconstruction, necessary clarification may be issued that the provisions of Section 2(22)(a) of the Income-tax Act would not apply in such cases.

**Taxation of Non-residents including Indian Branches of Foreign Companies**

10.11 Taxation has a significant impact on international investment and financing decisions. Simplicity, transparency and perceived fairness are essential to attract the much needed foreign investment. The Committee is, therefore, of the view that the determination of the proportion of income taxable in India and the deductions in computations should be done within a reasonable time and be fair and just where no specific percentages have been laid down in the law itself. The estimated income approach contained in Sections 44B to 44BBB could be extended to further areas of business activity as that would considerably reduce areas of uncertainty and resultant disputes.

10.12 The Committee would also recommend the amendment to provision under sub-section (2) of Section 195 for enabling the recipient of income also to make an application to the assessing officer for determining the appropriate proportion income on which tax is deductible.

10.13 The Committee notes that although the intention to introduce the system of advance ruling has been announced in the 1992-93 Budget Speech of the Finance Minister, no further follow-up measures have been taken to implement the intention. The Committee would recommend expeditious action in this regard.

10.14 The Committee considers that the difference between the tax rate on domestic companies (at present 51.75 per cent including surcharge) and the tax rate on foreign companies (at present 65 per cent) is quite large even at the withholding tax rate of 25 per cent on dividends paid to foreign companies. With the reduction in the rate of tax on domestic companies to 40 per cent there will be scope for reduction in the tax rate on foreign companies. The effective average withholding tax rate would not often exceed 15 per cent given the network of tax treaties with almost all developed countries. However, taking the withholding tax rate of 25 per cent the differential between the rates on domestic and foreign companies should be around 7.5 percentage points assuming that half of the after tax profit is distributed as dividend. In any case, this differential should not exceed 10 percentile points.

10.15 The Committee would consider that, as a further measure for attracting foreign investment and foreign technical know-how, double taxation of the foreign company in respect of both the fees obtained for the technical services and the salaries paid to its personnel staffed in India beyond a certain number of days needs to be avoided. The law should be amended for exempting the salaries paid to such personnel from Indian tax irrespective of the length of their period of stay.

10.16 Under Section 10(15)(iv) of the Income-tax Act, interest payable by the Government, financial institutions and industrial undertakings on borrowings abroad is exempt from tax. In the absence of any provision for tax sparing by the home country, the beneficiary of the tax concession is not the investor but the home country. In effect, there is transfer of resources from the host

country treasury to the home country treasury. We, therefore, recommend the discontinuance of the provisions in Section 10(15)(iv).

10.17 The Committee noted that there is hardship to non-resident taxpayers in respect of tax liability on account of the interpretation given to Rule 115 of the Income-tax Rules, 1962 for conversion of foreign exchange payments made for royalty, fees, etc., into rupees for purposes of assessing tax. The Committee would, therefore, suggest that where the income has already been remitted, the conversion rate should be the rate at which the foreign currency was actually purchased. Where the non-resident is paid directly in foreign exchange abroad with no remittance from India, the conversion rate should be that applicable on the day the non-resident receives payment. The Committee would recommend the adoption of this amendment with retrospective effect to cover the income for the accounting year 1991-92 on account of the magnitude of the rupee devaluation which took place during that year.

**Treatment of losses**

10.18 The Committee is of the view that the inequities in the existing scheme of set off and carry forward of losses need to be corrected. We, therefore, recommend as follows:

a. the newly introduced Section 71A in the Income-tax Act extending scheduler treatment to loss from house property should be revoked;

b. the losses carried forward for set off in the subsequent years separately under each head of income like, 'income from house property' or 'profits and gains from business or profession' (other than losses from speculation business or from the activity of owning and maintaining race horses) and 'other sources' should all be allowed inter set off.

c. the condition that the business to which the loss relates should be carried on in the subsequent year in order that the business loss carried forward from the earlier year is allowed to be set off should be removed.

Further, in the larger interest of the economy, the provisions of Section 79 of the Income-tax Act should either be deleted or should be restored to its form as it existed prior to its amendment by the Finance Act, 1988.

**Treatment of charities and charitable organisations**

10.19 For rationalising the provisions of the Income-tax Act in regard to charities and charitable organisations, the Committee recommends the following:

a. Application under Section 12-A and sub-section (5) of Section 80G should be processed together and with utmost expedition, that is, within a period of three months from the date of receipt of the applications;

b. Approvals granted and renewals approvals should be valid for 5 years; of

c. Where the income from any business accruing to a trust/institution is not more than Rs.5 lakh, the trust/ institution may continue to be given the exemption irrespective of whether the business is incidental to the attainment of the objectives of the trust/institution or not;

d. The restrictive provisions contained in Section 13 of the Income-tax Act for the withdrawal of exemptions available under Section 11 or 12 need to be reviewed, for avoiding hardship in genuine cases. The monetary limit of Rs.25,000 prescribed in respect of substantial contributions may be raised to Rs.50,000;

e. The last date for filing returns in the case of charitable organisations claiming exemptions under Section 11 and 12 of the Income-tax Act may be fixed at 31st December instead of 31st August as at present;

f. The income limit for Audit laid down in clause (b) of Section 12A may be enhanced from Rs.25,000 to Rs.50,OOO;

g. There is need to make the law uniform for all charitable organisations irrespective of the dates on which they were set up.

**Interest Tax**

10.20 The Committee recommends the abolition of the interest tax as it acts as a wedge between the reward to the savers and return on investments.

Gift Tax

10.21 The Committee recommends the continuance of the levy of gift tax, since it discourages transfer of assets for reducing the total tax liability of a family. The exemption limit may, however, be raised to Rs.30,OOO from the present level of Rs.20,OOO.

**Taxation of Agricultural Income**

10.22 The Committee is of the view that while agriculturists whose income consists of only agricultural income or agricultural income, say, below Rs.25,000 per annum and non-agricultural income below the income-tax exemption limit may not be brought within the income tax net. The agricultural income in excess of, say, Rs.25,000 accruing to the non-agriculturists should be brought under the tax net to promote equity and reduce scope for tax evasion. We recommend that in the case of individuals or any other entities having income from non-agricultural sources above the exemption level and also income from agricultural sources above Rs.25,000, agricultural income in excess of Rs.25,000 accruing to the concerned entity should be aggregated with non-agricultural income and the tax should be levied on the total of such aggregated income. Agricultural income for this

purpose will not include income from plantations subject to taxation by the States. The Central Government should obtain the cooperation and consent of the State governments for enacting a provision which would enable it (the Central Government) to bring under the purview of the Central income tax, agricultural incomes in excess of Rs.25,000 of those non-agricultural assessees whose non-agricultural incomes are above the exemption level. The entire tax yield attributable to the agricultural component of income could be distributed among the States on the basis of origin.

## Structural Reform of the Excise Tax System (Chapter 4)

### The Case for VAT

10.23 The Committee is of the view that the present excise tax system has to be gradually transformed into a genuine VAT at the manufacturing level particularly because the Government of India has no alternative at least in the near future but to resort to an extended form of excise taxation. Manufacturing under such a VAT should include also 'manufacturing' of services although some services may be exempted for practical considerations.

10.24 An extended excise tax system of the cascading type can be shown to lead to four major types of undesirable consequences. First, the total effective incidence on any given final product at the end of the chain of production would be almost fortuitous and largely unknown to policy makers. Second, it interferes with the producers' choice of inputs, thereby leading to severe economic distortions. Third, it leads to avoidable increases in costs and prices of inputs as well as of final products through the phenomenon of cascading. Fourth, such a cascading type of extended excise tax system combined with a similar type of sales tax superimposed on it acts as a great hindrance to our export effort.

10.25 If exports are to be completely freed of excises, then the tax burden on the final export product arising from the taxation of all inputs and from that of machinery must be removed through set-off. The tax on machinery, if not remitted, will also like the tax on current inputs lead to uncontrolled and regressive incidence, distortions of producers' choices and cascading. It is, therefore, necessary to grant VAT credi t also to the tax on machinery.

### Transition to VAT at the Central Level

10.26 We urge that the following steps should be taken simultaneously, over the next three to four years, in a phased manner, to reform indirect taxes:

a. Extension of excises to cover most manufactured goods at present exempt and some select services mentioned in the Interim Report; b.

Reduction in the level of rates on some commodities which are unduly high;

c.

Gradual reduction in the number of rates moving them towards three rates between 10 and 20 per cent, for all goods that would be covered by the VAT system;

d.

Extension of Modvat credit to all inputs that are used in the production of, or incorporated in, taxable commodities except for office equipment, accessories and furniture, building material and a few others;

e.

Extension of Modvat credit to machinery not fully at the time of purchase but in instalments during a subsequent period of years which could be laid down in the law; and

f. Extension of VAT to the more important services used by productive enterprises.

**Textile Industry**

10.27 The textile industry is an example par excellence of concentrating most of the tax at the input stage. This system has several disadvantages. To mention the most important, value added at later stage is not covered by the VAT and hence the tax rates at the earlier stage have to be higher and there is unnecessary discrimination among products with different proportions of value added at later stages. The cost of production is unduly raised by the interest on the duty paid at the earlier stages. What is worse the input tax may form a larger percentage of the prices of the cheaper fabrics.

10.28 There are two other important reasons why steps must be taken to rationalise the excise duty regime for textiles. First, if the existing excise duty regime is not reformed simultaneously with the proposed reforms in customs tariff and import policies, domestic producers of fabrics would be hard hit. The second reason is that as the States have argued, they have been subjected to a substantial loss of revenue though the exemption of grey fabric and shifting of the tax burden to the yam stage.

10.29 Therefore, the existing excise duty regime for the textile sector must be reformed in the direction of a VAT system. However, this can be done only in stages because of the peculiar nature of the industry with the predominance of small producers and because of the high level of duties on synthetic yarn, especially filament yarn.

10.30 The first stage of reform should consist of (a) introducing the Modvat scheme till the yarn stage in all sectors and (b) applying the Modvat principle in cotton textiles without subjecting grey fabrics to tax at the present time. The cotton sector is chosen first because India has comparative advantage in this important sector and because the rate of duty on yarn is not unreasonably high.

10.31 We believe that it is possible to introduce the principle of Modvat in respect of cotton textile industry immediately without much difficulty except that the grey fabric stage will continue to be exempt for the time being.

10.32 With the condition that the grey fabric stage will remain exempt from duty for the present, the introduction of Modvat in cotton textiles will cause

no problems as far as the composite mills are concerned. As per normal Modvat rules, they are not required to pay duty on the yarn captively produced and consumed while on other inputs brought from outside, set off will be granted against the tax payable at the processing stage. For maintaining revenue neutrality and unchanged final incidence, the duty at the processing stage will have to be raised.

10.33 Since the grey fabrics will remain exempt from duty fa; the present, the duties paid on inputs would have to be estimated and the system of deemed credit would have to be introduced against the enhanced duty payable on the processed fabric's.

10.34 Once deemed credit is introduced on the basis of a formula based on assumptions, reasonable though they may be, the assessees might, and probably will, start questioning them and ask for changes. We, therefore, suggest alternative solution to the problem. The proposal is that Modvat credit for tax on all inputs used for the manufacture of cotton textile fabrics be provided to the composite mills and they will be asked to pay Union excise duty on the processed fabrics (in addition to the Additional Excise Duty in lieu of sales tax which they are now paying). The excise duty rate will be so fixed as to roughly neutralise the Modvat credit given in terms of incidence. Since the independent processors will not be within the ambit of the Modvat Scheme, the processed fabrics emanating from them will bear the duty on inputs. The total burden on such duties should be estimated using the same methodology as is done in arriving at the amount of deemed credit. The Union Excise Duty to be levied on the independent processors must be kept lower than that leviable on the composite mills by the amount of burden of duty on inputs. In such a case the independent processors cannot complain of discrimination in terms of higher duty. The Additional Excise Duty in lieu of sales tax is a tax falling only at the final stage and it should be treated separately from the Union excise duty and will not be part of the Modvat scheme..

10.35 We are suggesting extension of Modvat for the cotton textile sector immediately to give boost to export of cotton fabrics and garments. Soon thereafter, the same system should be applied to synthetic and blended fabrics other than those for fabrics made of filament yarn. The entire textile sector industry may be brought under the proposed VAT regime with suitable modifications as indicated above for the decentralized sector only after a period of, say, five years by which time it would be possible to bring down excise duty on filament yarn at similar level to others. Extension' of VAT to the Wholesale Stage

10.36 We would have more rational indirect tax system if the VAT, that is, the reformed Central excise, could be extended to the wholesale stage. By wholesale stage we mean traders who buy from manufacturers and sell to other manufacturers or traders. For purposes of this tax, we may define wholesalers to mean those whose total turnover exceeds certain level, that is, Rs. 50 lakh or Rs 1 crore. They should be subject to VAT in addition to excises payable by the manufacturer. This means only the value added at their hands would be subjected to tax. Manufacturers who buy from these

wholesales will also be able to obtain credit for tax paid earlier. Apart from capturing the value added at the hands of the wholesalers, this would provide adequate safeguard against the attempts at under-valuation by the manufacturer to reduce excise liability which is the cause of many disputes in excise. Administratively, it will be convenient if VAT at the wholesale stage is collected by the Sales Tax Department of the States concerned in close cooperation with the officers of the Central Excise Department. The amount of VAT collected could be allowed to be retained by the State where it is collected. The Central VAT can be levied with the cooperation of the States who can be persuaded to accept this levy because their own right to levy the sales tax on goods will in no way be circumscribed and at the same time they wil get the entire revenue from VAT at the wholesale stage.

**Sales Tax**

10.37 As regards sales tax, the Committee is of the view that this tax could be converted into a form of State VAT within the manufacturing sector. There may be no need for levying sales tax at more than two rates since the distributional and other non-revenue objectives could be left to be performed by the Central taxes which apply uniformly throughout the country.

**Problems Relating to Tax Administration (Chapter 5)**

10.38 The administration of the major Central taxes leaves much to be desired. The root causes for the present unsatisfactory state of affairs in the field of tax administration are: (a) high rates of taxes; (b) multiplicity of duty rates; (c) changes in the law brought about in secrecy and enacted without adequate public consultation and debate; (d) multifarious exemptions, concessions and deductions introduced in the tax laws for achieving many and growing non-revenue objectives and constant changes in the provisions incorporating them; (e) amending rates and granting exemptions throughout the year; (f) the practice of fixing somewhat unrealistic targets of tax revenue collection;
(g) fear of Audit; (h) lack of accountability of the assessing officers; (i) tendency to go in for appeals without proper. application of mind; (j)relentless pursuit cases of small short-term revenue gains through prolonged litigation; (k) inappropriateness of the present reward system; (l) inadequacy of the information system; (m) ineffective functioning of the administration and interference in administration by political authorities; and (n) lack of proper and adequate training of officers.
10.39 Apart from what we have already recommended in the Interim Report regarding the changes in the tax structure, some of which have been reiterated in earlier paragraphs, the following are the other measures

needed to bring about a significant improvement in tax administration and enforcement:

a. Stability -The Government should announce that the practice of introducing changes and concessions in each year's budget is being given up and only the structural reform will be carried out as per a given agenda. The Tax Research Bureau (TRB) whose establishment we are recommending later in the Report should receive all suggestions and study them. On the basis of such study and its own research, the Bureau can formulate proposals for change which should be circulated to the public for debate and discussion. After full debate these minimum changes could be introduced, if found absolutely necessary, once in five years.

b. Target fixing We cannot overemphasise the harassment caused to the assessees as a direct result of the fixation of unrealistically high targets. It is important that the target should be fixed realistically keeping in view the expected rate of growth of the economy and the likely rise in prices.

c. Accountability The assessing officers should be made accountable for their actions. If the percentage of demands not upheld by the Tribunals is higher than a reasonable figure, say, 50 per cent, the officer should be given a black mark and reprimanded. On the other hand an assessing officer should be protected and defended if he has obeyed instructions of the Board and followed case laws even though Audit might raise objections about his actions.

d. Changing the perception of the officers regarding their work -(i) Training: The assessing officers should be advised and trained to keep in mind the broader, social and economic aspects and consequences of taxation. It is essential that officers selected for appointment to senior posts are given a thorough grounding in the economic aspects of taxation and made aware of changing international practices; (ii) Rewards and Punishment: The attitude and performance of the officer depends much on the system of rewards and punishments. We recommend that instead of giving rewards to individual officers, the bulk of the rewards should be credited to the fund already created in Central Excise and Customs Department for welfare activities for the officers or for distribution on an annual basis among all officers performing well in several areas. We suggest that a welfare fund, similar to what exists in the Excise and Customs Department, may be created for the benefit of the officers of the Income Tax Department too. Rewards in the form of commendations and accelerated promotions should be given to honest and competent officers. Similarly, adverse remarks should be given to officers who fail to complete assessments in time or widen the base or habitually make over-assessments or under-assessments.

e. Grievance redressal machinery -The existing grievance machinery and the advisory councils should be activated as these agencies provide a forum for the taxpayers to get their grievances ventilated.

f. Taxpayer education and publicity There is also a need for boosting the publicity campaign of the two Departments, so that there is a greater awareness in the minds of the tax paying public regarding the activities of the

Department collecting taxes from them. If considered necessary, expert agencies could be consulted in preparing and publishing tax education pamphlets.

The Role and Impact of Receipt Audit by C&AG

10.40 The following seem to be the major complaints:

a. Too many objections are raised and only a few of these objections finally stand. As a result, the assessees are put to unnecessary trouble and harassment.

b. Audit often interprets the law and sticks to their interpretation, even when the Board clearly opines that the intention of law is contrary to the Audit's view.

c. It tends to place excessive emphasis on the revenue aspect in individual cases.

d. It pays unduly little attention to cases of over-pitched assessment causing long drawn-out disputes and harassment to the assessee.

e. Visits of Audit parties to the factories add to the hardship caused by the visits
of lower level tax personnel.

10.41 Questioning by Audit of assessment decisions of a quasi-judicial nature by the Departmental officers has given rise to a wide-spread sense of fear and has resulted in a distinct tendency on the part of the officers to make high-pitched assessments. These do not yield any fruitful result, since, finally most of these assessments are set aside by the appellate authority.

10.42 The Committee is of the view that the action taken by the properly authorised officer should be final as far as the assessee is concerned and it should not be subjected to any change with retrospective date except to the extent there is an error in the assessment as perceived by the officer. The difference in opinion between the Department and the Audit should not result in an audit phobia developing in the tax collection machinery with the consequences that assessments tend to be always high-pitched and in favour of revenue. The Committee would therefore, recommend the following:

**a. Direct taxes**

i. in cases where audit objections are accepted by the assessing officer, the demand notices may be issued within one month from the date of receipt of the objection.

ii. where the audit observations are not accepted by the assessing officer and -referred by him to higher authorities, the demand notice may be issued only

for those cases which would get time barred within three months of the date of reference.

iii. in other cases, no show-cause notices should be issued until clear decisions are obtained by the assessing officers from the higher authorities.

**b. Indirect taxes**

Where the Range/Divisional officer accepts the audit objection, similar action as for direct taxes should be taken. If, on the other hand, the objection is not accepted no demand or show-cause notice should be issued. Where the Range/Divisional officer is not in agreement with the audit observation, a reference should be made by him within two weeks to the Collector who would in turn either communicate his agreement with the audit observation to the Range/Divisional officer for issuing the show-cause notice or refer the matter to the Board within two weeks. If the objection is still found unacceptable, the correct position should be explained to the C&AG's officers. If the Audit's point is conceded, the Board should immediately modify its instructions with prospective effect. This action at the Board's level should be completed within one month. Where, based on the audit objection, change in procedure or instruction is considered necessary, such a change should be brought into effect with prospective effect.

**Penalties and Prosecutions**

10.43 It is seen that the prosecution cases initiated under the Income-tax Act and Central excise Act take unduly long time for ultimate disposal. The effectiveness of prosecution as a deterrent punishment is therefore considerably diluted. For improving matters in this regard, we recommend the following:

**a. Direct Taxes**

i. the Department should concentrate on large cases and be selective in rosecutions;

ii. Prosecution cases, when they are launched, should be taken up seriously by engaging competent Counsel for expeditious disposal. Serious efforts should be made to bring down the existing pendency of prosecution cases;

iii. the general power for launching prosecution for failure to pay in time the TDS under Section 276B and 276BB should be withdrawn and replaced by a specific power for launching prosecution in those cases only where the tax with interest and additional interest remains unpaid after a specified period of time;

iv. the Department should impose late fee or penal interest for technical violations such as those contained in Sections 276B and 276BB of the Income-tax Act instead of launching prosecution proceedings. The levy of such penal interest should be statutorily laid down and automatic;

v. the discretionary penalties under Sections 221(1), 271(1)(b), 271(B) and *272A(2)* of the Income-tax Act may be replaced by the imposition of additional interest/late fee;

vi. automatic penalty in the form of a late fee may be imposed in place of penal interest under Sections *234A* and 139(3);

vii. the Department should launch prosecutions under Section 276C(2), only if the assessee fails to make the payment for over one year and where prosecutions are launched for technical offences, should compound the prosecutions;

viii. there should be substantial delegation of powers to the Chief Commissioners/Directors General for compounding the penalties, where necessary; and

ix. the levy of penal/additional interest/fine should be as per the scales indicated by us earlier in this Report.

**b. Central excise**

i. prosecutions should be limited only to cases of suppression of production, surreptitious removal of excisable goods, under-valuation where fraudulent intention of evasion of duty is established and repeated offences;

ii. the existing duty limit of Rs.1 lakh for launching prosecution should be increased to Rs.5 lakh;

iii. complaints should be filed in the Court within a period of 4 months from the date of the order of adjudication; and

iv. the prosecution cell should be strengthened by placing a Deputy Collector as the officer in charge and manning it with officers having adequate experience in legal matters.

**Settlement Commission**

10.44 Unlike in some advanced countries like UK, the power to settle cases has not been granted to the senior officers of the Indian Income Tax Department. Given the fact that Courts ordinarily take long time to decide tax matters, it is useful to have an institution like the Settlement Commission for quick and final settlement of complicated tax cases.

10.45 However, it is necessary to provide adequate safeguards in the law to ensure that the Settlement Commission does not become an easy escape route for tax evaders. We, therefore, recommend the following:

a. Only complicated disputed facts and should be settled; cases involving questions of law

b. The Committee is of the view that the present limit of Rs.50,000 as income tax payable, the cases above which are referred to the Settlement Commission, is too low and it should be increased to at least Rs.1lakh;

c. The power to object to an application to the Settlement Commission should be given to an officer not below the rank of Chief Commissioner. This will ensure judicious application of this power; and

d. The Settlement Commission should not be given the power to over-rule the objection made by the Chief

**Computerisation**

10.46 In regard to the proposed Settlement Commission for settling disputes involving indirect taxes, we recommend that the provisions defining its scope and functioning should be the same as those mentioned above.

Computerisation

10.47 No worthwhile improvement in the enforcement of taxes and reduction in the hardship and trouble caused to the assessees can be achieved without full-fledged computerisation. We recommend that technical assistance from the multilateral financial institutions' could be availed of, as regards the design of the computer system or if no such assistance is available, an internationally renowned consultancy agency could be hired. A team of officers from the Department should be associated with this exercise.

10.48 In the indirect taxes side, we understand, that the existing facility in the Customs Houses is not being fully utilised. This is partly because of lack of involvement of senior officers in this matter and also hesitation on the part of the Department to replace the manual system by the computerised system. The Committee recommend that professional assistance from a leading consultancy agency should be availed of, to gain maximum benefits from the facility already installed and proposed to be installed.

**Office and Residential Accommodation**

10.49 Another matter concerning attention for improving the tax administration machinery is the provision for suitable office and residential accommodation for the officers and staff. Office accommodation must be designed in a functionally efficient manner keeping in view the reassignment of assessment functions that may be necessary in view of our recommendations and the planned computerisation programme in both the Departments. The degree of satisfaction in regard to residential accommodation particularly for the junior officers should be increased.

10.50 The existing direct tax administration is characterised by several major problems: overlapping of functions, lack of real control in the execution of tasks, inefficient manual processes, scattered and deficient guidelines, inadequate arrangements for Departmental representation in legal disputes, lack of a sound information system and deficient facilities which damage the tax administration's image. A global solution to these problems is necessary with the three fundamental objectives of: (a) modernising the administrative system in order to achieve better taxpayer control; (b) correcting structural failures that result in an overlap of functions, scattered or deficient guidelines and lack of continuity and effectiveness of the processes; and (c) promoting deconcentration.

**Taxpayer Identification and Control**

10.51 The identification and registration of taxpayers is absolutely essential for developing an efficient tax compliance control system. Taxpayers, both potential and effective, can be identified through information from sources both internal and external. Once these are identified, they must be carefully registered by using indexes and an adequate identification system so that names and addresses of the taxpayers can be cross-verified. Since names and addresses can be changed, it is necessary to use unique identification numbers for taxpayers as a substitute for their names and addresses.

10.52 The identification system should coverall persons (individuals, firms, companies, etc.) engaged in substantial economic activities or in possession of economic wealth which has the potential of yielding income so that all potential and effective taxpayers in the country would be allotted an identification number which could be required to be quoted compulsorily at the time of undertaking a wide variety of transactions. The existing identification system in the form of Permanent Account Number (PAN) is deficient in so far as its coverage of potential taxpayers is too narrow, multiple numbers have been issued to a single person and the system is not available in an on-line PAN directory on an all-India computer network. To remove these shortcomings, the Committee recommends the restructuring of the existing identification system, the existing PAN may be replaced by a new Taxpayer Identification Number (TIN) which should be allotted to, and obtained by, all persons and institutions (individuals, HUFs, AOPs, companies, firms, etc.), *inter alia,* who have shop establishment licences in all cities and towns with population in excess of one million, who are registered as industrial units, who have Central sales tax or
-local sales tax numbers, who are members of any professional association, who are owners of trucks/buses/taxis/cars, who have credit cards, who are share brokers or small saving agents, who are applying for fixed deposits above Rs.50,OOO in a bank or applying to a bank for drafts or telegraphic transfers for amounts above Rs.50,OOO, and who are selling goods exceeding Rs.1 lakh to the government or a public sector company or a public limited company, and any other persons desirous of obtaining TIN.

These persons should be issued a photo-pass containing all relevant information relating to the identification of the entity concerned. The work relating to the allotment of TIN should be through an all-India computer network with an on-line TIN directory so to eliminate possibilities of fraud through *benami* or multiple numbers. Further, since a large number persons are required to obtain TIN, it is necessary to build up a system of allotment on demand. Until an all-India computer network within the Income Tax Department is developed, the Department should explore the possibilities of either using the National Informatics Computer Network (NICNET) of the Planning Commission or any other all-India computer network for this purpose.

10.53 In order to ensure that a large number of persons obtain the identification number, it is necessary to make the permission for certain transactions, services or investments or carrying on certain trades or professions contingent on the person having a tax identification number. For this purpose, the Committee recommends *inter alia,* non-renewal of industrial license, non-issuance of 'C' Forms and 'D' Forms to dealers, non-renewal of membership of professional associations, non-renewal of registration of vehicles, rejection of applications for 2000 shares or 500 debentures or more, if the statutory requirement to quote TIN is not fulfilled.

10.54 Once a broad-based identification system is developed within the country, a statutory obligation should be cast on all TIN allottees to quote their TIN in all specified economic transactions. Then, all the information pieces relating to a TIN could be bunched to identify potential taxpayers. All potential and effective taxpayers should be registered in the Taxpayer Master File (TMF) which is the basic and essential control instrument of tax administration. The TMF should include only the taxpayers' basic identification and addresses, and the taxes they are obliged to pay. It is of utmost importance that once the TMF is established, continuous and permanent procedure be implemented to keep the file up-to-date on the basis of information from both internal and external sources. Towards developing an effective TMF, the Committee recommends the revival of the General Index Register (GIR) in the form of TMF, which should contain the basic items of information, number, name, address, TIN, liability to file various returns of the persons' income, wealth, gifts made, expenditure and tax deductions at source. It should also contain the names of persons who are non-filers of returns but have discharged their tax liabilities through tax deducted at source by the employer. Overtime, the TMF should be extended to include all new taxpayers voluntarily filing returns and non-filers who are subsequently established to be taxpayers. A person should be removed from the TMF on the fulfilment of the cumulative conditions that his income is below the taxable limit continuously for a period of three years and he is not liable to file any information return.

**Verification System**

10.55 The verification system should be designed to allocate the available resources in a manner which will maximise the yield from the system in

relation to its operating cost. However, this must not conflict with the basic responsibilities of the tax administration for eliminating or at least minimising the more glaring forms and acts of tax evasion. Hence, the need for dealing with most returns in a summary manner without interacting with the taxpayer, by making adjustments for normative and mathematical errors. However, in order to induce compliance through letting each taxpayer know that he or she could be subjected to strict scrutiny and to increase the general effectiveness of the tax administration, a small proportion of returns needs to be selectively subjected to intense scrutiny.

10.56 Currently, the assessment procedure comprises a scheme of summary assessment of all returns after correcting for arithmetical mistakes and *prima facie* errors, and levying of additional tax, if there is an addition to income by the assessing officer and that of scrutiny assessment of a sample of returns selected non-randomly in accordance with the instructions issued by the CBDT.

**Summary assessment**

10.57 The new summary assessment scheme was the most intensely debated subject during all evidence before the Committee, whether by officers of the Department or by the representatives of trade and industry. While some advocated the acceptance of returned income without any *prima facie* adjustment or additional tax, others advocated only corrections in the anomalies of the scheme. After consideration of the divergent views, the Committee recommends the continuation of the existing scheme of summary assessment after correcting for arithmetical errors and genuine *prima facie* inadmissible claims and levying additional tax. However, the Committee recommends the removal of the anomalies in the scheme arising on account of thy lack of a clear definition of the scope of *prima facie* adjustments and delay in the disposal of applications for rectification of *prima facie* disputes. After consideration of the various issues relating to these anomalies, the Committee recommends the following:

a. The existing scheme of summary assessment after correcting for arithmetical errors and *prima facie* inadmissible claims should be continued.

b. The first proviso to sub-section 1 of Section 143 defining the scope and meaning of the term *'prima facie'*
should be amended. It should be defined to mean:

i. an incorrect claim, if such an incorrect IS apparent from the existence of other information on the return;

ii. an entry on a return of an item which is inconsistent with another entry of the same or another item on such a return;

iii. an omission of information which is required to be supplied on the return to substantiate an entry on the return; and

iv. an entry on a return of a deduction or credit in an amount which exceeds a statutory limit imposed, if such limit is expressed

(a) as a specified monetary amount; or

(b) as a percentage, ratio, or fraction.

(c) and if the items entering into the application of such limit appear on such return.
The return of income must clearly indicate, against the relevant item of claim or in the worksheet relevant to the claim, the need for furnishing evidence in support of the claim. The nature of the evidence necessary in support of the claim must also be specified in the return. This evidence should, however, be only for the purposes of processing under summary assessment and should be without prejudice to the degree of proof that may be required to be furnished by the taxpayer under scrutiny assessment. Once the necessary evidence is filed along with the return, the sufficiency of the evidence should be considered or questioned only under scrutiny assessment.

(d) In stipulating the evidence required to be filed along with the return of income, caution must be exercised to prevent undue burden of compliance on the taxpayer. Attempt should be to secure only minimal necessary evidence.

(e) Audit reports required under various provisions of the Income-tax Act should be merged into a single Audit report which should be comprehensive. For example, Form No. 3CD (relating to the statement of particulars in the case of a person carrying on a business, which is required to be given along with the Audit report in Form No. 3CA) could be amended to seek information on whether payments covered under Section 43B of the Income-tax Act have been made by the due date of filing the return. In that case, the need for separate certificates from accountants as evidence in support of a claim would not be necessary.

(f) The return form should be re-designed along the lines of a check sheet to seek specific information and also to provide for logical sequencing of the arithmetical steps for the computation of income. This will help demarcate the scope of *prima facie* adjustments.

(g) In the case of depreciation, the incorrect block classification of assets should not be corrected through *prima facie* adjustments. Further, a separate standardised format should be prescribed for depreciation claims, to be appended to the return by only those taxpayers who make such a claim.

(h) A claim made on the basis of an Audit report given by an accountant should be corrected if *prima facie* inadmissible, but no additional tax should be levied in such cases. Where the Auditor makes more than a specified number of mistakes, he should be debarred from practice for a certain minimum period.

i. The Department should release annually a booklet codifying the instructions/guidelines on the scope of *prima facie* adjustments as is being currently done in respect of guidelines issued to Drawing and Disbursing Officers (ODDs) for tax deduction at source from salary payments. The booklet must contain examples of *prima facie* adjustments drawn from instances reported by the assessing officers. These examples should cover instances to highlight both what can be and cannot be treated as being *prima facie* inadmissible.

j. The existing scheme of set off and carry forward of losses should be rationalised along the lines indicated in the Section on Taxation of Corporate Profits in Chapter 3.

k. No *prima facie* adjustment should be allowed to be made after six months from the end of the month in which the Return is received.

1. The assessing officer should not be allowed to make any *suo motto* rectifications of summary assessment after three months from the end of the six month period for *prima facie* adjustment under summary assessment.

m. The taxpayer should not be allowed to make an application for rectification of *prima facie* adjustment after two years from the end of the assessment year in which the return is filed.

n. The application for rectification of *prima facie* adjustment should be required to be disposed of by the assessing officer within three months from the end of the month in which the application is received. Failure to dispose of the application within the stipulated time should tantamount to acceptance of the contentions of the taxpayer. The Committee is aware that through an amendment by the Finance Act, 1992, 'direct' appeal against *prima* adjustment has been provided for, only if the rectification application is not disposed of by the assessing officer within three months. However, we are of the view that this indirect remedy is totally inadequate. There should either be a provision for appeal against *prima* adjustment, as was recommended by us in our Interim Report, or as suggested above, the applications for rectification which are not disposed of within, say, three months, should be considered as accepted and effect should be given to them accordingly, within a further period of one month.

10.58 During the course of evidence before the Committee, a large section of the taxpayers questioned the validity of the additional income tax on grounds of arbitrariness, etc., and the instructions of the CBOT to its field formations to the effect that in respect of all returns, first, *prima facie* adjustments, if any, should be carried out, additional tax, if any, should be levied and intimation to this effect should be sent to the taxpayer, and only after that any proceedings for scrutiny of selected cases should be initiated.

10.59 With a View to encouraging voluntary compliance, reducing the discretionary power of the tax administration so as to minimise opportunities for bribery, and reducing the costs of checking the expected excuses that would be submitted for almost every case of arithmetical error and *prima facie* inadmissible claims, it is necessary to build in a system of automatic sanction in the nature of additional tax. The Committee, therefore,

recommends the continuation of the existing scheme of levying additional income tax under Section 143(IA) of the Income-tax Act. Further, in the interests of an equitable tax system, it is necessary that taxpayers committing the same fault should be subjected to the same penal consequences. Therefore, the existing policy of first completing every case under the summary assessment scheme and only, thereafter, initiating proceedings for scrutiny assessment should be continued.

**Scrutiny Assessment**

10.60 Given the objective of scrutiny assessment, in selecting cases for scrutiny assessment, there must be a combination of the criteria of randomness and probability of evasion. The device of assigning differing scores to various taxpayers for the purpose of chosing the sample, as is done in the USA, for example, is an attempt to combine these criteria. Since the element of randomness is present in such a system, evasion will not be there to be deducted in all cases. Further, in the absence of computerisation of the tax administration, the selection of the sample by a central computer will not be possible. Hence, clear-cut tests or criteria should be laid down for selection and the selection should never be done at the level of the officer who is going to carry out scrutiny assessment.

10.61 Under the rules in force, there has to be a hundred per cent scrutiny of all company and non-company cases where the income or loss is Rs.S lakh or above; there has to be sample scrutiny in other cases on the basis of the guidelines laid down by the CBDT. The scheme of selection of cases for scrutiny as devised by the CBDT is said to be primarily geared to the objective of reducing the discretionary power of the assessing officer in selecting cases so that the possibility for showing, favouritism and getting illegal gratification would be minimised. However, one of the criteria "glaring cases of tax evasion/avoidance" allows for free' play of discretion and judgement. Several complaints were made to us by trade and industry representatives that the lower level staff were still (in several cases) trying to extort money through promises to take the taxpayer's name off the scrutiny list. This pernicious practice must be eliminated. The two basic reasons which open up the scope for such a practice are that the selection is made at the level of the assessing officer himself and the criteria laid down leave room for discretion. Further, the element of randomness is also missing in the existing method of selection. Also, no regular procedure has been devised to incorporate any information learned from the statistical analysis of evasion trends. Keeping in view the pitfalls in the existing scheme of selection of cases for scrutiny, the Committee recommends the following procedure for selection of scrutiny cases:

a. The percentage of assessees to be selected for scrutiny should be as follows:

i. roughly 3 per cent of non-company assessees with income/loss below Rs.2lakh;

ii. 4 per cent of non-company assessees with income/loss from Rs.2 Jakh upto Rs.9,99,999;

iii. 33 per cent of non-company assessees with income/loss of Rs.10 lakh and above;
iv. 20 per cent of company assessees with income/loss below Rs.1lakh;
v. 100 per cent of all company cases with income/loss of Rs.l lakhand above; anc

vi. 100 per cent of all search and seizure cases.
N.B. The incomelloss should be the gross total income as reduced by the amount of unabsorbed losses carried forward from earlier years for set-off against the current year's income.
b. Where 100 per cent or 33 per cent of cases are taken up for scrutiny, for obvious reasons, no special procedures for selection are needed. In the first category each case will be _taken up each year and in the second category each case will be taken up every 3rd year. But for the other categories, the procedure for selection becomes important. The selection should be strictly impersonal, should leave little room for discretion and must be based on weighted random sampling. In the sample selection, certain characteristics of particular trades or professions and items of information received will be used to give weights or scores to various cases in a non-discretionary way to increase the chances of those cases being selected according to their respective scores. Finally, the selection should be made centrally or at a few centres which are not associated with the assessment work.

While in the long run, the Income Tax Department ought to aim for a system based on a scoring rule as advocated by expert Committees earlier and as used in advanced countries, such as USA, in the short run a scoring system based on a Taxpayer Compliance Measurement Programme (TCMP) design does not appear to be feasible in the context of a very poor level of computerisation of the Department. However, immediate steps should be initiated to undertake a TCMP study on a pilot basis. Till a proper score system can be developed, one has to be satisfied with some improvement in the existing system. Given the percentages of cases to be selected as recommended by us, it is the selection of cases from among non-company assessees with income/loss of less than Rs.10 lakh that needs to be given the greatest care these assessees constitute the majority of the taxpayers and percentage of cases to be selected is so small that the manner of selection becomes all important. Among these assessees, those who have opted for the Estimated Income Scheme or the Presumptive Tax Scheme can be kept aside. For the rest of the filers in this category, the following procedure may be adopted. A set of presumptive factors which can be taken as indicators of tax evasion should be identified. The Chief Commissioner/Commissioner of a Charge should prescribe the system of assigning scores to these factors. The assessees should be required to supply certain specific information (not exceeding 10 in number and not involving any additional work or computation on their part) in a form to be attached to the return. This form should be required to be filed by all taxpayers who derive income from business or profession and do not opt for the estimated income scheme

recommended .by us. The salaried assessees and those with other sources of income should be asked to fill in a different form with less details. The form should be typewritten so as to facilitate automatic reading of the data through *optical character recognition,* thus eliminating the need for costly and delayed manual transcription and verification processes. These forms should be passed on to the Deputy Commissioner of the Range. He would add information obtained from Central Information Branch (CIB) sources. After taking all items of information into account, the Deputy Commissioner will work out the total number of scores to be given to each return. The selection for scrutiny assessment will be done at the level of Deputy Commissioner. Where a total of 3 per cent of cases is to be chosen for scrutiny, 2 per cent should be based on the descending order of scores and one per cent on pure random sampling. If the total sample is to comprise 4 per cent, then 3 per cent should be on the basis of descending scores and one per cent on the basis of random sampling. In the case of company assessees with income loss less than Rs.l lakh, 5 per cent of the 20 per cent sample should be chosen on the basis of random sampling.

h. The entire sample should not be chosen at one stroke at the beginning of the assessment year. The selection process could be carried out in two (or perhaps even three) stages so that the late filers could also be included in the list for selection with their respective scores. All cases of non-filers should be scrutinised by an officer not below the. rank of an Assistant Commissioner. If after scrutiny the total income of the taxpayer continues to be non-taxable, this finding must be taken note of, along with other information on him, in identifying non-filers in the subsequent year. As regards assessees with income from business who have opted for the Estimated Income Scheme, there should be no scrutiny assessment for the first three years in each case. After that period there should be scrutiny of one per cent sample chosen randomly merely to check the accuracy of the gross turnover. For the purpose of scrutiny assessment, a set of clear questions must be framed and the assessee must be asked to provide the answers to these questions. Only if the answers are found unsatisfactory, should the assessee be asked to come to the office of the assessing officer with his books of account.

**Taxpayer Information System**

10.62 Adequate information concerning taxpayers is essential for scoring additional revenue. The sources of information used by the tax administration to build up an information system may be classified into three main categories: taxpayer declarations, information returns, and information and evidence collected by the Tax Department during the course of investigation.

10.63 Under the system of self-assessment, the taxpayer forms the basic source of information. The taxpayer provides information to the tax administration through returns and accompanying documents. These

returns contain valuable information on the taxpayer and his activities. All this information can potentially be used to help gauge taxes due from the taxpayer. In this regard, it is necessary to address the problems of the design of the return form, filing requirements, making returns available and sanctions against non-filing of taxpayer declaration. The Committee, after examining these issues, recommends the following:

a. As against the existing four different return forms applicable to different categories of taxpayers, the return of income should be in seven different forms details of which are contained in para 6.84;

b. The Department should take steps to ensure that forms are easily available to the taxpayers. Forms 1, 2 and 3 should be made available in the major Post Offices in the cities/towns, banks accepting payment of taxes, and all tax offices. Further, Form 7 should be sent to all Drawing and Disbursing Officers for circulation amongst taxpayers. Forms 1 and 2 should be printed, at least every fortnight during the Return filing season, in the local dailies so that taxpayers could use the paper cutting as the Return forms.

**c. Return of income should be required to be filed by:**

i. all persons whose total income during the previous year exceeds the maximum amount not chargeable to tax except salaried employees whose income from other sources is totally exempt under the law (e.g., under Section 80-L) or does not exceed Rs.15,000 on which tax has been deducted by the employer at the proper rate. These salaried taxpayers will be required only to submit a simple statement in a special Form (Form 7 referred to earlier), if their taxable income exceeds Rs.50,000;

ii. all companies irrespective of the level of income;

iii. all persons (other than companies) carrying on business whose total turnover exceeds Rs.5 lakh irrespective of the level of income;

iv. all persons (other than companies) carrying on a profession whose gross receipts exceed Rs.1 lakh irrespective of the level of income; and

v. all Trusts under Section 11 to 13.

In the subsequent year, even if the taxpayer does not fall in anyone of the categories in (i) to (v) above, he must continue to file the return of income for three consecutive assessment years. If after such three years, the taxpayer continues to remain outside the purview of (i) to (v), has no outstanding recovery of tax dues, and has no appeals pending at any level, he should, in the fourth year, apply in a prescribed form for the removal of his name from the TMF.

d. against the existing provisions,

if a loss return is filed after the due date, the benefit of carry-forward of loss should be allowed to the taxpayer. Further, on consideration of the various issues and problems relating to collection, collation, dissemination and verification of numerous pieces of information relating to both potential and effective taxpayers, the Committee recommends a new taxpayer information system along the lines indicated in para 6.105.

**Tax Account Information System**

10.64 The existing information system for collection and recovery of direct taxes is inefficient and unproductive in so far as it depends on manual and repetitive processes and an outdated system of storing information relating to collection and recovery. After consideration of the various issues and problems associated with the information system for collection and recovery, the
Committee recommends a new information system known as the tax account information system. This new system will consist of manual and computerised procedures and databases which would enable the Department to keep up-to-date tax information for each taxpayer with respect to debits, credits, analysis, interests, readjustments, payment arrangement and other taxpayer transactions with the administration. This would be used to detect and report delinquent accounts and to provide timely information to other Wings in the Department on the taxpayers' overall tax situation. The method of building this system is described in detail in para 6.119.

**Re-assignment of Responsibilities**

10.65 The assessing offi cer is the pivot around which the Income Tax Department revolves. The assessing off cers combine in themselves the multifarious functions of assessment, collection, redressal of taxpayer grievances, taxpayer ..ssistance, and furnishing of information for managerial decision-making. The consequence is that much of the time of officers and staff-even in assessing charges is spent 01 duties other than assessment. It is, therefore, not surprising that the quality of scrutiny assessment leaves much to be desired.
10.66 The allocation of duties and responsibilities in respect of collection and recovery of taxes again casts a heavy burden on the assessing officer. The practice of assigning budget targets to assessing officers without reference to the potential, to say the least, is arbitrary in approach, since he has no control over current collections. At best, he could be assigned a target only for arrear collections. The responsibility for arrear collection, however, lies not only with the assessing officer but also with the Tax Recovery Officer (TRO).
10.67 Yet another instance of holding the assessing officer responsible for a task in respect of which a separate specialised authority has been created is collection of TDS. The Income Tax Officer (TDS), in any case, is required to maintain a register of all persons liable to deduct tax at source. Hence, there is no rationale in assigning the assessing officer and the Income Tax Officer (TDS) the joint responsibility for monitoring collection of TDS. Similarly, the casting of responsibility on the assessing officer for collecting advance tax to meet budget targets is unreasonable. Further, the joint responsibility of the assessing officer and the TRO/Income Tax Officer (TDS) for collection and recovery leads to mis-utilisation of scarce trained personnel through

duplication of work, particularly, maintenance of multiple registers and initiation of recovery proceedings against the same taxpayer by both the authorities. In fact, very often, while the TRO and his staff remain under-utilised, the assessing officer and his staff are over-burdened. It is an annual routine for the assessing officer and his staff to spend the first two months of any financial year constructing the arrear demand and collection register. As a consequence, the quality and the quantity of output at the assessing officer level suffers.

10.68 Sample studies of time allocation of the assessing officers and staff in assessment charges as well as discussions with tax administrators and professionals confirm the fact that there is considerable degree of congestion of workload at the assessing officer level, and therefore, a significantly large proportion of the time available to the assessing officer is spent in the discharge of non-assessment functions. Hence, the need for the distribution of work amongst the officers and staff along functional lines.

10.69 The Committee is aware that the functional scheme, whereby, the collection and recovery function were separated from the assessment function was given an experimental trial by the Department in the late 1960's, but was given up soon after primarily on the consideration that all the assessment records had to be shifted to and fro between the assessment wards and the Collection and Recovery Wing, throwing the entire system of record management into disarray. However, since then, the procedure for summary assessment and the volume of scrutiny assessment have substantially changed.

Further, it is not difficult to seek a solution to the problem of record management. On completion of assessment, the information relating to assessed tax, amount paid and balance payable/refundable could more appropriately be transmitted from the Assessment Wing to the Collection and Recovery Wing through the medium of assessment scrolls and not through the physical movement of the assessment records as in the experiment in the late 1960's.

10.10 Based on the above considerations, the Committee recommends that the existing system of combining in an assessment officer all the functions of collection and recovery, summary assessment, scrutiny assessment and miscellaneous functions (like rectifications, appeal effects, imposition of penalties, dealing with audit objections, reporting, etc.) should be replaced by a ,new system based on functional classification of jobs. Under the new system, the collection, recovery and refund functions performed by the assessing officers, the collection functions performed by the Central Treasury Units (CTUs), the TDS functions by the Income Tax Officer (TDS) and the recovery functions by the TRO should be assigned wholly to the Directorate of Income Tax (Collection and Recovery). For this purpose, this Directorate headed by a single Director General (DG), should have its office in each city/town where an income tax office is located. The span of control of the DG should extend over five Directorates of Income Tax (DITs) (Collection and

Recovery) with the jurisdiction of each extending over a well-identified geographical area. The span of control of the DIT (Collection and Recovery) should extend over the Collection Wing, Recovery Wing, and the Refund Wing within such a geographical area.

10.71 While in metropolitan cities and other big towns, both officers and staff should be separately assigned to this Directorate, in smaller towns the Officers performing the assessment function could be assigned the additional responsibility of the office of the Directorate, but the staff could be separately assigned.

10.72 The. co-ordination between the Assessment Wing and the office of the DIT (Collection and Recovery) will be done by the Chief Commissioner/Commissioner/ Deputy Commissioner (Range), as the case may be, but the line of command for the officers in this Directorate will be within the Directorate. On completion of assessment, the information regarding assessed tax, amount paid and balance payable/refundable should be transmitted from the assessing officer to the DIT (Collection and Recovery) through the medium of assessment scrolls (and not through physical movement of assessment records). Similarly, information relating to any change in the tax liability subsequently arising from rectification and appeal effect could all flow through the scroll system.

10.73 A change is called for in regard to the allocation of the work of scrutiny assessment. With a view to pooling of experience, improving the effectiveness of assessment, increasing the level of supervision and thereby ensuring greater accountability, it is necessary to change over from the present system of single officer based assessment by Deputy Commissioner (Assessment), Assistant Commissioners and Income Tax Officers to a system of group assessment in which the work of the assessing officers could be more effectively supervised by senior officers. Each group should consist of one Deputy Commissioner (Assessment) and a designated smaller number ofAssistant Commissioners and Income Tax Officers, along with complementary staff. The Deputy Commissioner would decide the allocation of files for scrutiny among the officers working under him. He would also be responsible for supervising closely the scrutiny assessment work of those officers, although the officers themselves will be finally responsible for the assessment. We understand this system is in a sense already in vogue in the Central Circles where large cases are assessed. It must be ensured that a uniform degree of supervision, to the desired extent, is given in all those circles. It would be highly desirable that, in course of time, the same system is extended to cover the smaller cases also. However, if all scrutiny assessment cases are brought under the system of group assessment, there would be a need to increase substantially the number of posts of Deputy Commissioners in the Department. As the number of searches and seizures are reduced, some posts of Deputy Director of Income Tax (Investigation) engaged in work connected with search and seizure could be converted and the posts of Assistant Directors/Assistant Commissioners now engaged in the same work can' be released and their posts upgraded. In addition some new posts might have to be created. The Committee believes that the creation of

the extra posts would be worthwhile in terms of improvement in the quality of assessment, reduced harassment to the smaller taxpayers and increased public confidence in the system of scrutiny assessment.

**Search and Seizure**

10.74 Searches and seizures are used by the Income Tax Department as a method of gathering direct evidence of income and wealth tax evasion. Section 132 of the Income-tax Act gives powers to certain categories of empowered officers to authorise any Deputy Director/Commissioner, Assistant Director, etc., to enter and search any premises or persons in those premises if the empowered officer has reason to suspect that books of account or money or other valuables are kept in those places. A search can be authorised only if the authorising officer has reason to believe that the person concerned has not produced the documents when asked to do so or would not produce the documents or the person is in possession of money or other assets which represent assets or property which has not been or would not be disclosed.

10.75 From the provisions of Section 132 it is clear that a search can be authorised only if on the basis of sufficient evidence the officer concerned has reason to believe that the money or assets have been secreted in the premises or that documents that would not be produced are kept there. Second, the main object of the search is to unearth the documents and/or assets.

10.76 The Income Tax Department has been resorting to this method of tackling evasion on a fairly substantial scale (in recent years 3500 to 5500 searches per year). The search and seizure operations would have a deterrent effect if they are conducted after gathering reliable information and if they are followed quickly by successful prosecution of the offender. In practice, the search and seizure operations do not seem to be producing the deterrent effect to the desired extent.

10.77 In the circumstances prevailing in our country it may be necessary - however unfortunate that may be -to continue to empower the Income Tax Department to conduct searches and seizures where there is clear evidence that a tax evader has concealed in certain premises, documents and assets which cannot be reached except through a search. However, since the right to privacy is a fundamental right without which the gift of personal freedom will lose its meaning, it is extremely important to provide safeguards against possible excesses by the executive branch of the Government so that unreasonable invasion of privacy and the violation of other fundamental rights could be prevented.

10.78 While searches and seizures would be required to some extent, they cannot be a substitute to the building up of a comprehensive information system which alone would make possible the effective enforcement of taxes. As the information system is built up, the number of searches and seizures should be gradually cut down. As things stand, nearly 27,000 assessments

relating to searches and seizures cases are pending and too many Assistant Commissioner level officers are tied up in this work (that is, seizure and assessment of seizure cases), considering the extra revenue produced.

10.79 The Committee wishes to make the following recommendations to make search and seizure operations effective, to prevent excesses and to prevent the restrictions being placed on the rights of individuals beyond a reasonable degree:

a. Section 132(1) should be amended to say that only an officer of the level of Chief Commissioner or where in a charge there is no officer of the level of Chief Commissioner the senior most Commissioner, can authorise a search under that Section. That section should also be further amended to say that only an officer of the level of Deputy Commissioner or Assistant Commissioner can be authorised to conduct a search and that he could be assisted by Income Tax Officers..

b. The major focus of the search must be to unearth documents, revealing concealed income as well as assets such as money, jewellery and other valuable articles. Section 132 authorises the search officer 'to record a statement by any person found in the premises which may be used in evidence before any Court proceedings. Since interrogation is not a part of the object of the search, it must be ensured that the assessee is not interrogated under intimidation and *is* not coerced into making a confessional statement. For this purpose it is necessary to permit the assessee to call a lawyer to be present when he makes the statement. The lawyer can be one of the members of a panel approved by the Ministry of Law. Besides, the provision for paying part of the additional tax collected on the basis of the search and confession as a reward to the members of the search party must be removed.

c. Since the Income Tax Department does not .have the power to arrest and the ground rules announced on the floor of the Parliament in 1987 specifically lay down that the income tax authorities shall have no power to arrest, the general practice of the search party preventing an assessee whose premises are searched from leaving the building to attend to his work must be discontinued. After the person has made the statement required he should be allowed to leave. There is no justification for amending Section 132 as was proposed in the Finance Bill, 1992. After the search is over the search party should hand over to the persons concerned copies of statements made on oath by them.

e. In the course of a search, the property belonging to the owner of the premises is often damaged by the search party. In order to minimise damage every search party should be asked to use metal detectors first to find out if articles are concealed in walls, within mattresses, etc. If damage is done but no concealed articles are found, then the Income Tax Department should be required by law to repair, the damage done and to restore the articles to their previous state.

f. If search and seizure are to become an important instrument of deterrence, there must be speedy prosecution of cases of large scale evasion unearthed by the search party. It would be desirable to set up a Special Court whenever within a region there are large cases of suspected tax evasion together amounting to not less than Rs.s crore.

**Advance Tax**

10.80 With the amendment introduced by the Finance Act, 1992, which has increased
the proportion of the first instalment from 20 to 30 per cent, there would be greater probability of having to pay interest on shortfall in the first two instalments owing to unforeseen income arising particularly in the last quarter. To the extent that the new provision requires a high proportion of tax on the total income, which cannot be estimated precisely, to be paid within the first six months it makes compliance difficult. In order to mitigate the hardship caused by this amendment, the Committee recommends that interest under Section *234C* should not be levied in cases where the first and the second instalments of payment of tax by the assessee are each equal to 30 per cent of the tax liability on the basis of the returned income of the immediately preceding assessment year. Interest should continue to be chargeable if payments by 31st March fall short of 90 per cent of tax on the basis of current year's income.

**Direct Taxes Code**

10.81 The objective sought to be achieved by a single direct taxes code is uniformity and simplicity with regard to the legislation concerning direct taxes, which is desirable. However, the Committee is of the view that before enacting the direct taxes code the Government should first consider the Committee's recommendations and take a final view in that regard so that the code is not required to be amended after its
enactment.

10.82 In view of the above, the Committee recommends that the entire matter regarding the introduction of a direct taxes

code should be postponed till such time as the law, after implementation of this Committee's recommendations, has stabilised. Further, before undertaking codification, the arrangement of the Sections in the code and the language used therein should be referred to a Committee of Experts to ensure that unintended changes in the provisions do not occur.

10.83 The draft code should be given wide publicity so that public debate and informed comments or opinions arising the refrom could be taken into account before finalising the code.

10.84 The problem areas which the Committee has identified are:
a. a complicated code of procedures in the Central and Rules; rules and Excise Act
b. procedures not getting updated with the changes in the administrative structure;
c. inadequate inspection system;
d. outmoded system; reporting and monitoring
e. Lack of training of officers particularly in specialised functions and improper placement of officers;
f. frequent changes in the procedures without preparation at the field level; rates and adequate
g. classification assessment of duty; of goods for
h. valuation in Central excise;
i. short recovery and refund;
j. huge pendencies in respect of provisional assessments;
k. lack of customs expertise in Central Excise Collectorates;
l. poor testing facilities in the customs and excise laboratories;
m. a tendency to over assess for fear of Audit;
n, inordinate delay in the disposal of appeals at the level of the Tribunal; and
o. inability of the manual system to cope with the increase in the number of documents to be processed and lack of commitment on the part of the system as a whole to computerisation.

**Updating and simplification of procedure**

10.85 When the Department undertakes newer duties and responsibilities, it is necessary that the system is geared up as a whole by making necessary changes in training curricula, audit procedure, anti-evasion measures, computer software, inspection methodology, etc. We would recommend that such updating may be attempted every year. One way of making this exercise would be through a workshop to be organised by the Training Academy, with participation by policy makers and middle level officers in the field.

10.86 We hope that the exercise to prepare a common customs and excise code already started by the Committee of Experts, would result in a review of the existing procedures and help in updating them with reference to the existing administrative set up and changes likely to be brought about after considering the recommendations contained in this Report.

**Inspection and monitoring**

10.87 It is important that the inspection system is reactivated to ensure accountability of the various levels of revenue administrators. The Board, with the assistance of Principal Collectors, should ensure that the schedule of inspection is strictly adhered to and that there is proper follow-up action.

10.88 It is necessary that Departmental manuals are updated taking into account modifications in the procedures likely to be brought about in the near future.
10.89 The Committee would also urge the government that a new management information system may be worked out using the modern communication facilities already available with the Department. With the establishment of the computer network, the present system of submission of periodic returns could be dispensed with.

**Training**

10.90 The Committee is of the view that the time has come to assess the training needs of the officers of the Customs and Excise Department afresh and to draft an appropriate training policy and work out details of training modules.

**Publication of Draft Notification regarding Changes in Procedures**

10.91 We would suggest that every proposed change in the procedure of duty collection may be first published as draft notification inviting comments of the assessees and other concerned and finalised after taking into account their views. The Committee would urge that it should be ensured that the notifications are published on the same date on which they are issued so that there is no legal ambiguity regarding the date on which they come into operation.

**Classification**

10.92 The problem of classification will be reduced considerably with the simplified rate structure and the issue of a Tariff Guide containing directions of the Board in respect of all excisable and imported goods which will be binding on assessing officers.

**Valuation in Central Excise**

10.93 In regard to valuation of excisable goods the precise scope of the various provisions in Section 4 and the valuation rules with regard to admissibility or otherwise of the deduction of various expenses for the purpose of arriving at assessable value are still not clear. In fact, the Supreme Court had to recall its judgment in Assistant Collector of Central excise *vs* MRF Ltd. [1987 (10) ECR 625 (S.C.)] because of the inconsistency in the impugned judgment with the law laid down by the Court in the Supreme Court's earlier decision in the case of Union of India *vs* Bombay Tyres International Ltd.[1983 ECR 1627D (S.C.)];
10.94 Having regard to this background, the Committee had made certain recommendations in the Interim Report. One of them related to the fixation of tariff value. The Supreme Court has recently decided the Century

Manufacturing Company's case in favour of the Government. We suggest that the Government can take recourse to fixation of tariff value for suitable commodities such as sugar, acids, gases, caustic soda and aerated water. We had also suggested assessment of certain selected goods notified under Standards of Weights and Measures Act, 1976 on the basis of maximum retail price fixed thereunder.

10.95 The Committee had observed that as the Modvat or the VAT system gets extended and becomes the main plank for raising revenue from domestically produced goods and services, it would be necessary to move over to a system of assessment on the basis of invoice value. To start with, invoice value can be adopted for industrial inputs. However, ultimately the Department has to adopt the invoice value as the measure of assessment in all cases covered by Modvat (and later VAT) except the goods which can be assessed to duty on the basis of tariff value and on the basis of maximum retail price. As regards allowing various discounts from the invoice price to arrive at assessable value, we suggest that the international practice may be adopted in this regard. It would also be necessary to move away from one to one correspondence between individual units of goods cleared and the invoices raised at the depots, in the case of depot sales. If invoice is accepted as the basis for assessment of Central excise duty, there will be no need for filing of price lists and, therefore, the time and effort spent in processing price lists could be more effectively used for market inquires and investigation of cases of under-valuation.

**Short Recovery and Refunds**

10.96 We recommend that the time limit for demand of duty short-paid or short-levied should be brought down from six months to three months. Similarly, the period of refund may also be reduced to three months which will also ensure that the number of cases of unjust enrichment is limited to the minimum. The Government may take a view in this matter after the Court decides the legality of the provision enacting the doctrine of unjust enrichment.

10.97 Considering the revenue bias often discernible in the case of many officers at the lower level, Section IIA of Central Excises and Salt Act and Section 28 of the Customs Act were amended in 1985 giving the power of demanding duty for the the extended period of five years to Collectors to ensure its more judicious application. This power has however, been given back to the 'proper officer'. The Committee would suggest that the position in the law, prevailing before the amendment in this year's Budget, should be restored.

**Pendency of Provisional Assessments**

10.98 The Committee would recommend that a time limit of six months may be fixed for finalisation of provisional assessments except in exceptional

cases like those relating to variation clauses in contracts. There could be similar time limits for finalisation of classification lists and price lists in the case of Central excise duties.

**Customs Expertise in Central Excise Collectorates**

**10.99** We recommend that the existing vacancies in the cadre of appraisers should be filled up and regional cadres of customs appraisers, transferable within Central excise collectorates of the region, should be created. This is necessary for handling increasing quantum of customs work in Central excise collectorates.

**10.100 Other Points**

a. Procedure of collection of excise duty on matches and cigarettes: The Committee feels that considering the relative insignificance of the revenue from matches, the feasibility of doing away with bandrolling of matches should be examined. Cigarettes on the other hand account for a substantial portion of the Central excise revenue and this commodity lends itself easily to the system of collection of duty through bandrolling. The feasibility of such a system should be examined.

b. Excise documentation: The statutory form of gate pass for removal of excisable goods should be suitably amended to indicate the total duty paid in words. This is essential as this may minimise the chance of the figures getting fraudulently changed with a view to getting a higher amount of Modvat.

The Committee is of the view that while control should be exercised at the time of removal from the factories, there is no reason why assessment procedure and documentation should be different for commodities subjected to physical control such as tyres, PSF etc., from what is applicable to other commodities 'under Self Removal Procedure.

c. Reversal of Modvat credit on inputs: In regard to clearance of inputs in respect of which the credit is already taken under Modvat, it should suffice if the credit taken initially is merely reversed.

d. Clearances of imported goods: Learning from the beneficial results obtained from the limited Gold Import Scheme, we would recommend that the Government should introduce a special scheme in respect of baggage of those returning to India after a stay abroad of at least six months. The rate of duty on the dutiable goods contained in the baggage of these passengers in excess of Rs.3,OOO, should -be 100 per cent if paid in foreign currency, upto a limit of Rs.1 lakh (value of goods). Such a scheme will enable the Government to earn foreign exchange, while giving adequate protection to domestic industry. The value limit of import of parcels by post free of duty was fixed quite sometime back. The Committee, therefore, feels that there should be an upward revision of this limit.

Having regard to the need of the consuming industry and the high level of financing cost, we recommend that the period of warehousing should be increased to a minimum period of three months from the existing period of one month.

In regard to the incorporation of tariff and exemption notifications in the computer data bank, the Committee would recommend that the Harmonised System of nomenclature which is available in the form of floppies with the Customs Cooperation Council can be fed into the computer. In addition an alphabetical index of all goods imported, indicating the customs classification and current rates can also be evolved, which should be available on tap in all of the terminals throughout the country. This will greatly facilitate classification of goods for purposes of customs duty.

e. Dissemination of information regarding international customs experience: We recommend that an international division may be set up in the Board under a senior officer not below the rank of a Director for collection and dissemination of information relating to international experience in customs administration and to deal with international conventions relating to customs matters. This division could also collect and transmit publications of the Customs Cooperation Council and foreign customs administrations among the Custom Houses. Computerised manifest clearance: The Committee is of the view that the delay in manifest clearance could be reduced if the shipping agents supply the manifest in diskettes or floppies which could be processed in the computer. Field security at the airports: The security at the airports and docks would have to be tightened considerably in order to safeguard revenue. This would require provision of adequate manpower and modern gadgets like closed-circuit televisions.

h. Drawback: We suggest that the Board may consider to what extent the computer facility can be made use of, for expediting the drawback rate fixation.

i. Augmenting staff for additional work: The Committee feels that there should be automatic sanction of staff on the basis of norms to be evolved wherever a new unit like Inland Container Depot (ICD), air cargo complexes and Container Freight Station (CFS) are established.

## Appeals and Appellate Procedure (Chapter 8)

10.101 The Committee has identified the following problems, in regard to the system of appeals:
a. huge pendencies at all appellate levels of the appeals under direct tax laws; large number of pendencies in CEGAT of appeals under customs and excise laws;

b. absence of clear-cut guidelines to guard against frivolous appeals;
c. inadequate infrastructural facilities and support to appellate authorities and members of the Tribunals as well as to the Departmental Representatives; and
d. selection of unsuitable personnel as Departmental Representatives and the absence of requisite training programmes for them.

10.102 The Committee is of the view that the average time for disposal of appeals at first appellate stage should not exceed a period of six months. In the case of direct taxes, the pendency of appeals before the first appellate authority has increased to more than 1.5 lakh. We, therefore, suggest that a suitable number of temporary posts of Commissioner (Appeals) may be created for a period of two to three years to reduce the average time for disposal to not more than six months.

10.103 The pendency position in the two Tribunals is worsening with the net addition of about 25,000 cases per year in ITAT and about 6,500 cases per year in CEGAT to the already staggering level of pendencies.

10.104 The huge pendencies in the Tribunals can be attributed to the following:
(i) too many appeals without application of mind; (ii) repetitive appeals: (iii) under-staffed Benches; (iv) seeking of frequent adjournments by both the Department and the taxpayer; and (v) lack of co-ordination between the Chief Departmental Representative (CDR) and the Collectors/Commissioners.
10.105 The Committee is however of the view that the problem of huge pendencies and denial of quick justice cannot be effectively tackled unless we strike at the root of the problem, namely, generation of too many appeals. With the implementation of our recommendations on changes in the tax structure which would have the effect of reducing the institution of appeals at the first appellate stage, the institution of appeals to the ITAT/CEGAT would be reduced consequently.
10.106 If the first appellate order goes against the Department, it shouid take a decision whether a second appeal needs to be filed well before the finalisation of assessment for the subsequent year. In case the first appellate order is accepted, the assessing officer would not repeat the additions in the subsequent year and thus repetitive appeals to the Tribunal would be avoided.
10.107 The Committee strongly feels that appeals should not be preferred by the Department in a routine manner. The Collector/Commissioner should be held accountable for the wastage of time and resources of the Department and the Tribunals by making frivolous appeals.
10.108 The CBDT has prescribed a monetary limit of Rs.lO,OOO as the tax liability for fing Departmental appeals to ITAT. We suggest that this limit should be increased to Rs.25,000. The CBEC should also prescribe the same monetary limit. These limits shall apply only to disputes which relate to procedural matters where no substantial question of law is involved.

10.109 The Boards should ordinarily accept the decision of the Tribunal.and once it does so, a corresponding amendment of law should be made or a suitable instruction should be given to the field formations to ensure that such disputes do not occur future.

10.110 We feel that there has to be a substantial improvement in the quality of Departmental Representatives for safeguarding the interests of revenue. The Government can get much more by giving a little, by way of incentives, to the Departmental Representatives. We, therefore, recommend that a special pay should be given to the Departmental Representatives at the same rate as given to the faculty members in the training establishments. This willmake the Departmental Representatives more motivated and help in presenting the Department's case more effectively before the Tribunals. Government revenue will be in safer hands as special pay will surely attract better talents in the Department, who by virtue of their merit, experience and professional qualifications will be more equipped to meet this challenging task.

10.111 The work facilities for the Departmental Representatives also need to be improved. The Departments should codify all case laws on different points of law with the help of computer experts. The computer cell in the office of CDR should provide the necessary details of relevant case laws to Departmental Representatives for arguing their cases. The Collector/Commissioner should send the concerned files and a brief note surveying relevant judicial decisions on the same matter or similar matter well in time. In order to ensure more effective cooperation from Collector/Commissioner, we suggest that a very senior Collector/ Commissioner should be posted as Chief Departmental Representative in CEGAT/ ITAT. The CDR in the apex Tribunal should be of Principal Collector/Chief Commissioner's grade.

10.112 The vacancies in the post of Members of the Tribunals and their secretarial staff should be filled up immediately.

10.113 We urge that the decision of the Government to set up a National Court of Direct Taxes and to revive the Central Revenue Tribunal for excise and customs should be implemented without any further delay.

10.114 The Committee, however, suggests that these two Tribunals should be integrated into one apex body, called the National Revenue Tribunal (NRT) with two separate wings for direct taxes and for Central excise and customs. Such an arrangement will have some inherent advantages like having common infrastructural facilities. The judicial members for this Court could be appointed for both the direct and indirect taxes. Since the choice will be wider, a larger number of candidates will be available for these posts.

10.115 The Committee is of the view that the Department of Revenue should not have any administrative control over the CEGAT and the proposed new Tribunal, and the Ministry of Law should be charged with the administration of these two institutions, just as that Ministry is administering the ITAT now.

Simultaneously, the terms and conditions of service of the Members of CEGAT and ITAT should be equated.

10.116 The Committee is of the view that there should not be any difference in regard to the channel of appeal against the orders of the two Tribunals, i.e., CEGAT and ITAT, once NRT comes into being. Appeals against the orders of Collectors in respect of classification and valuation matters should continue to be filed before the Special Benches of CEGAT but the appeal against the decision of the Special Benches in such matters should lie with NRT.

10.117 Each bench of the new appellate body should comprise at least one Member (Judicial) and one Member (Accounts)/Member (Technical).

10.118 Since the new Tribunals' would be performing the same functions of a High Court in so far as they relate to tax matters (except writs), the terms and conditions of service of the members of these Tribunals should be at par with those of the judges of the High Court. Similarly, the Chairman of the new appellate body should enjoy the status of the Chief Justice of High Court.

10 119 In order to guard against institution of frivolous and unnecessary appeals, we recommend that there should be an admission procedure as provided under Section 100 of Civil Procedure Code before any appeal is instituted in ITAT/CEGAT and the National Revenue Tribunal.

10.120 We also suggest the creation of additional Benches in CEGAT and ITAT for a specified period to clear the backlog of pending appeals.

10.121 In a recent case, the Supreme Court has observed that in the case of a dispute between the Government and public sector undertakings (PSUs), a clearance for litigation from an Inter-Ministerial Committee has to be obtained but for which no Court or Tribunal would admit such dispute for hearing. While we appreciate that prolonged litigation between Government Departments and PSUs means only wasteful expenditure, we are of the view that the solution has to be found otherwise than by a clearance procedure. While the Appellate Tribunal may continue to deal with appeals relating to issues even without the clearance from this Committee, machinery may be set up within two Boards to go into the question of maintainability of the stand taken at lower levels regarding the tax liability of the PSUs and to issue proper directions.

## Personnel Policies and Administrative Structure (Chapter 9)

### Recruitment, Promotion and Evaluation of Performance

10.122 In Central Excise and Customs as well as Income Tax Departments, the promotions, by and large, are by selection according to the merit-cum-seniority principle and merit is judged solely on the basis of Confidential Reports (CRs). We are of the view that the CRs by themselves cannot be considered to be the test of merit unless they become more reflective of the actual proficiencies and deficiencies. than they are now. We think that it is possible to pick out honest, diligent and intelligent officers through the proper wording of CRs and indicate in a "negative" way which officers and

staff do not possess these qualifications. We recommend that in considering the suitability of candidates for promotion to an important position like Income Tax Officers a combination of criteria should be used -seniority, the results of a Departmental written examination and an interview and CRs.

10.123 The Departmental examination for promotion from a lower post to higher post should be of a much higher standard and conducted in greater secrecy, than now, either by an external agency or by one of the Directorates under the Boards.

10.124 Honest, hard-working and intelligent officers constitute the basic foundation for good tax administration and in a Department which collects thousands of crores of rupees, it is extremely important that honest and diligent officers are not only supported but also sufficiently rewarded, We would strongly recommend that, if the CRs are used as *we'* have suggested as a tool for distinguishing and picking out officers of outstanding merit, a higher proportion of promotions to ranks above the level of Assistant Commissioner/Collector should go to officers of outstanding merit, subject to their satisfying other conditions.

**Tackling Corruption**

10.125 We recommend a three pronged approach on this matter. First, the Vigilance machinery should be used more purposely. The Chief Commissioner/Principal Collector should informally get to know the names of the really corrupt officers within his jurisdiction. He could have informal discussions with those Commissioners! Collectors who are themselves persons of integrity. Then every year, he should send to the Vigilance the names of a few officers who have the worst record in terms of corruption through a secret memo. When a strong case has been built up, the CBI should be asked to take over the case.

10.126 The second important way of getting rid of really corrupt officers is to invoke the provision FR 56J.

10.127 Thirdly, appointment to sensitive posts and where scope for corruption is large must be made with great care and only the most honest and able officers should be given those posts. Transfers and appointments to the so-called "lucrative posts" through political patronage must be completely stopped. Proper guidelines could be laid down by the political authority, but the power to transfer must be with the Boards and the designated authorities at different levels.

10.128 In order that the scheme outlined above may operate successfully, it is essential that the entire task of transfers and postings must be within the jurisdiction of the Boards. The political authority may be kept informed of what is being done, but a self-denying ordinance on the part of Ministers is called for.

Recruitment to Group *'A'* Revenue Service, Training of Officers and Promotion Prospects

10.129 We feel that the age limit for the Revenue Service examination should be lower than in the case of other Services. The chances of bringing

about the correct attitudinal changes in the recruits is far greater if the age of entry is lower.

10.130 At the level of Deputy Commissioner/Deputy Collector the officers should be subjected to rigorous training for at least a minimum period of three months. In the training course the officer should be made to understand through proper study the broader social aspects and the economic consequences of taxation. Obviously the trainers should be selected with care. The services of an institution like the National Institute of Public Finance & Policy (NIPFP) could be utilised for conducting some of the courses mentioned above. Promising officers of the two revenue services should also be given adequate opportunities of studying at first hand the taxation system in other countries, particularly those that have carried out tax reforms and modernised their tax administration.

10.131 It is important that the morale of the honest and competent officers in the two Departments is kept high by providing enhanced opportunities for deputations to Central Ministries particularly at the middle and higher levels on par with what is available to the best among the organized civil services.

**Constitution of the Boards and their Autonomy**

10.132 As regards filling the vacancies in the Board, a rule should be adopted that amongst the four senior most people, the most meritorious will be chosen to fill a vacancy that arises in the Board subject to the condition that the candidate should have at least 12 months of service left. However, once appointed, the officer concerned should be allowed to have a minimum tenure of two years as member of the Board. Among the Board members, normally, the chairmanship should go to the senior most officers who should have at least one year of service left. This condition should be relaxed in the case of members who have put in at least three years of service in the Board, and therefore, will be in a position to settle into the new job without much preparation and study. Once appointed the Chairman should be allowed to continue for a minimum period of one year or till the end of his service, whichever is longer.

We recommend that (a) the two Boards should be given financial autonomy with separate financial advisers working under the supervision and control of the respective Chairmen; (b) the Chairmen of the two Boards should be given the status of Secretary to the Government and the members the rank of Special Secretary; and

(c) the post of Revenue Secretary should be abolished.

10.134 Though the two Chairmen will be accountable to the Finance Minister in so far as matters relating to tax administration are concerned, the Finance Secretary should exercise overall supervision and coordination particularly in relation to the formulation of tax policy and changes in the tax law. We recommend that a Tax Council be constituted with the Finance Secretary as the Chairman and with the Chairmen of the two Boards, Member (Budget, CBEC), Member (Legislation, CBDT), Secretary (Economic

Affairs) and Chief Economic Adviser as Members of the Board. All matters relating to tax policy and changes in law should come to the Tax Council and proposals in this regard would be submitted by the Finance Secretary to the Ministers. This Council would be serviced by a Tax Research Bureau consisting of experts. The Bureau should consist of two economists, two Revenue Service officers, two chartered accountants and a tax lawyer, besides a few research assistants. It will conduct research in problems of tax policy under the general direction of the Tax Council and will report to the Finance Secretary or one Member of the Council designated by him.

## *An extract from the Report of the commission on centre state relation chaired by Justice M.M.Punchhi*[32]

### 9.1 Background

**9.1.01** The ToR requires the Commission to examine the need and relevance of separate taxes on the production and on sales of goods and services subsequent to the introduction of value added tax regime. Union excise duties and sales tax are the two important indirect taxes on goods levied by the Union and the States, respectively. The tax system was characterized by cascading effects leading to distorted structure of production, consumption and exports and evasion. The first step towards the reforms of taxation on goods was the introduction of Modified Value Added Tax (Modvat) in March 1986. In the late nineties, Modvat was renamed as Central Value Added Tax (CENVAT). The main feature of the CENVAT is allowing credit on the duty paid on inputs and input services. With the distinction between goods and services getting blurred and with the service sector accounting for a predominant share of the GDP, service tax was introduced initially on three services in 1994 and was extended to cover more and more services in a phased manner. Reforms in the sales taxation commenced with the introduction of VAT in 2005-06. The State VAT provides full set-off for the tax paid on inputs as well as tax on previous purchases. Under State VAT, tax liability is self-assessed by the dealers after setting-off tax credit. There are fewer rates of tax and exemptions under VAT as compared with the earlier system of sales taxation.

### 9.2 Need for Reform

**9.2.01** Despite reforms, the system of taxation of goods and services in the country continues to fall short of international norms and practices. The main problems relate to definition of manufacturing, fragmentation of taxation of value addition, inter-State trade and the overarching nature of many services that cut across State borders from the stage of production to final consumption. Currently, CENVAT is levied on the manufacture and production of excisable goods. Excise duty can be levied only if the goods are manufactured and are marketable. Besides definitional problems as to what constitutes manufacturing, there are problems of valuation. There are also problems with regard to the classification of goods and application of duty rate relevant for a group or sub-group of goods. What makes the whole system more complex is the multiplicity of rates, exemptions and irrational structure of the rates.

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[32] Chapter 9, Goods and services tax, Centre state financial relations and planning, The report of the commission on centre and state relations, Vol. III, March 2010, Pg 83 The government of India

**9.2.02** There are also problems with regard to the system of service taxation in the country. The key problem is the levy of tax on specified services, each of which generates an extensive amount of augmentation. Ideally, the Tax should be levied on all services with a short negative list. The other problem is with regard to the distinction between goods and services, which is getting blurred with the advancement of information technology. Under the Indian law, goods have been defined to include intangibles like copy right and software. But intangibles are often supplied as part of a service contract. Software upgrades are considered as goods but these can be supplied as part of a service contract. A number of value added services are provided to mobile phone users. An online subscription to a magazine can be treated as a service, but online purchase of a book could constitute purchase of goods. Leasing of equipment without transfer of possession and control to the lessee may be interpreted as a service but may also be deemed as sale of goods. In the modern economy, goods and services are often bundled and sold together.

**9.2.03** The system of State level VAT also suffers from a number of infirmities. These relate to classification of goods, lack of clarity as to whether a transaction constitutes a sale of good or service. Non-integration of local taxes like entry tax, work contracts, entertainment tax and luxury tax goes against the basic premise of VAT, which is to have uniformity in tax structure.

**9.2.04** The taxation system at the Centre and State levels is still characterised by cascading and resultant distortions. The significant contributory factor for cascading is the partial coverage of tax base. Oil and gas production, mining, agriculture, wholesale and retail trade, construction and a range of services remain outside the purview of Central taxation. The exempt sectors are not allowed to claim any credit for the CENVAT or the service tax paid on inputs. Similarly, under the State VAT, no credit is allowed for the inputs used in the exempt sectors, which include the entire service sector, real estate, agriculture, oil and gas production and mining. Another major factor contributing to the cascading is the levy of Central Sales Tax (CST) on inter-State sales which is collected by the State of origin for which no credit is allowed. Besides, CST creates unnecessary tax barriers affecting the free flow of goods and creates hurdles in ensuring an integrated market for the entire country.

### 9.3 Rationale for Goods and Services Tax

**9.3. 01** In order to deal with the above problems, it is considered necessary to bring about two changes in the taxation of goods and services in the country. The first one is bringing services under the purview of State VAT and the second one is the extension of value addition up to the retail level under the purview of CENVAT. These changes basically amount to integration of goods and services for the purpose of taxation under the value added system. There is a strong rationale for bringing services under State VAT. Service sector is the fastest growing sector in the economy presently

contributing over 60 per cent to the GDP. The extension of service taxation will enable States to share the revenue buoyancy. It improves horizontal equity as taxation of goods and services will be at par. Taxation of services at the rates applicable to goods is likely to improve allocation of resources. Lastly, treating services and goods at par is likely to minimize classification disputes and compliance costs.

**9.3.02** There are similar advantages in extending the taxation of goods up to the retail stage in respect of the Centre. Firstly, it will do away with the need to define manufacturing and eliminate valuation problems. Secondly, there will be symmetrical treatment of goods and services. Thirdly, there will be no revenue loss for the Centre for sharing the taxation of services with the States. Fourthly, taxation of goods all the way up to the retail stage will create a proper record of all goods leaving State boundaries making settlement of inter-State disputes far easier and will enable the realization of a destination based system of taxation.

## 9.4 Progress towards Introduction of GST

**9.4.01** Realising the need for reforms in the taxation of goods and services, the Government of India announced in February 2007 that a roadmap for the introduction of destination - based GST from April 1, 2010 would be prepared in consultation with the Empowered Committee (EC) of State Finance Ministers. As a step towards the introduction of GST, CST was reduced from 4 per cent to 3 per cent in 2007 and further to 2 per cent in 2008. In consultation with the GoI, the EC prepared 'A Model and Roadmap for Goods and Services Tax in India' in April 2008. This paper by the EC suggested adoption of a dual GST, identified operational problems and the legal and administrative arrangements necessary for the introduction of GST. Following further discussions, the EC brought out the 'First Discussion Paper on Goods and Services Tax in India' (FDP) in November 2009.

**9.4.02** The FDP proposed dual GST, one levied by the Centre and the other levied by States. It also listed out the taxes to be subsumed under Central GST (CGST) and the State GST (SGST). The taxes proposed to be subsumed under CGST are Central excise duty, additional excise duties, excise duty under medicinal and toilet preparations, ser-vice tax, additional customs duty known as countervailing duty and special additional duty. Cesses and surcharges are also proposed to be subsumed under CGST. The taxes proposed for subsumation under SGST are VAT/Sales Tax, entertainment tax, if not levied by local bodies, luxury tax, tax on lotteries, betting and gambling, cesses and surcharges in so far as they relate to goods and services, entry tax not in lieu of octroi and purchase tax. Taxes on alcohol, tobacco and petroleum products are proposed to be kept out of the purview of GST. The FDP has not suggested any revenue-neutral rates for the CGST and SGST.

**9.4.03** FC-XIII appointed a Task Force to examine, inter alia, the GST model best suited to the country and the modalities of implementation of GST. The

Task Force submitted its report in December 2009[33]. Following are the main features of the model GST suggested by the Task Force:

i) It should be dual levy on a common and identical base imposed concurrently by the Centre and the States but independently to promote cooperative federalism. It should cover all the goods and services. There should be no distinction between raw materials and capital goods in allowing input tax credit. GST should be structured as a destination based tax.

ii) Exemptions should be minimum and common to the Centre and the States. Exemptions may be limited to services rendered by the Government and the local bodies, unprocessed food Articles and educational and health services rendered by non-governmental organizations. Area based exemptions should be removed. In case there is a felt need for such exemptions, investment linked cash subsidy may be provided.

iii) Keeping in view the compliance costs, small dealers and manufacturers should be exempted from the purview of CGST and SGST, if their annual turnover (excluding both CGST and SGST) of all goods and services does not exceed Rs.10 lakh.

iv) Central excise duty, service tax, additional customs duty, surcharges and all cesses may be subsumed under CGST. State taxes proposed for subsumation under SGST are VAT/sales tax, entertainment tax other than that levied by local bodies, entry taxes not in lieu of octroi, luxury tax, taxes on lotteries, gambling and bettings, stamp duties, taxes on motor vehicles, goods and passengers and taxes and duties on electricity.

v) Tobacco and alcohol should be taxed through GST as well as an additional duty with no input credit.

vi) Consumption of financial services should be taxed under GST and the real estate sector should be integrated into GST framework by subsuming the stamp duty on immovable properties levied by the States to facilitate input credit and to eliminate cascading.

vii) Inter-State transactions should be handled through a mechanism of permitting sellers in one State to charge SGST from buyers in another State. This SGST should be credited to the consuming State.

viii) All goods and services should be taxed at the CGST rate of 5 per cent and SGST rate of 7 per cent. There should be zero rating of all goods and services exported out of the country.

**9.4.04** Based on the Report of the Task Force, FC-XIII recommended a model GST to be adopted by the Centre and the States and an Incentive Fund. We are in broad agreement with the dual GST recommended by FC-XIII. The adoption of the model will pave the way for realizing the full benefits of a modern and distortion free system of taxation of goods and services. We recommend the adoption of the dual GST to be levied by the Centre and the States concurrently on a common base with fewer exemptions. Exemptions may be limited to unprocessed food services rendered by the governmental organizations and local bodies. All area based exemptions should be replaced by cash subsidy linked to investment. The aggregate GST base should be

[33] Report of the Task Force on Goods and Services Tax, Thirteenth Finance Commission, December 2009.

large enough to permit lower rates. The EC may work towards building up consensus in this direction.

### 9.5 Concerns of Stakeholders

**9.5.01** A few States responding to our questionnaire have expressed concerns regarding the possible accentuation of vertical imbalances with the Centre gaining access to the taxation of consumption. To address this concern, we recommend that the revenue neutral rates should be worked out with care. The rates for the Central and State components should be determined taking into account not only the present activities but likely revenue growth of taxes to be subsumed under GST. In the initial years, it should be ensured that the share of the States in the combined revenue receipts should not be lower than what would have accrued to them in the pre-GST regime. The second concern is while the SGST rate may be revenue neutral at the aggregate level, States with high tax effort may suffer a revenue loss. In a paper, D.K. Srivastava has hinted at the possibility of differential revenue impact of GST on States[34] As the resource base of the States is limited, it would be difficult for them to absorb any revenue loss. We, therefore, recommend that the Centre should compensate the States suffering revenue loss, if any, in the initial years of the introduction of GST.

**9.5.02** In view of the dire need to arrest environmental degradation it is necessary to integrate environmental considerations within the framework of GST. Environmental taxes act as an indirect mechanism to control pollution and are likely to induce appropriate environmental decisions. We therefore recommend that polluting inputs and outputs may be subjected to a special non-rebatable levy by both the Centre and the States. In addition petroleum products alcoholic beverages and tobacco products may also be subjected to a non-rebatable levy.

**9.5.03** There is a need to maintain stability and integrity in the structure of GST to ensure that no distortions creep into the tax system. Therefore, the existing machinery for arriving at collective decisions which has served the purpose well should be institutionalized on a permanent basis. Details with regard to the proposed institutional mechanism may be worked out by consensus.

**9.5.04** The success of GST would largely depend on the IT infrastructure available with the States. IT infrastructure will enable States to build a database and better implement the system. We recommend a one-time grant to States for putting in place adequate IT infrastructure.

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[34] Srivastava, D. K. 'Finance Commission and the Southern States: Overview of Issues'. Paper presented at the seminar on 'Finance Commission: Issues before the Southern States'. Madras School of Economics, December 8-9, 2008.

## *An extract from the 13th Finance commission report*[35]

**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

[35] Chapter 5 , Goods and Services tax, Thirteenth finance commission report 2010-2015, vol 1, 2009, Pg 63, Govt. of India

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.[36] 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.

[36] 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.

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 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 availment 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**

| 1. Subtraction Method | (Rs. crore)<br>**30,73,037** |
|---|---|
| 2. Consumption Method | 37,43,077 |
| a. Task Force Method | 30,77,952 |
| b. NCAER Method | 37,43,077 |
| 3. Shome Index Method | 27,82,809 |
| 4. Revenue Method | 29,49,748 |
| | **Average**<br>**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 predetermined 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 interstate 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 incentives 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 noncomplying states would thus require to be treated differently in the wake of selective implementation of GST. If CST were to continue to apply in noncomplying states, inter-state sales would become further complex. Goods passing through a noncomplying 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 percent 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-opertive 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) internalsecurity.

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 retionale 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 Center 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 proposedagreement 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.
(v) the procedure for claiming compensation is at Para 5.60 (Para 5.48).

5.56 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).

5.57 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).

5.58 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).

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

**Bill No. 22 of 2011**

# THE CONSTITUTION (ONE HUNDRED AND FIFTEENTH AMENDMENT) BILL, 2011

A

BILL

*further to amend the Constitution of India.*

BE it enacted by Parliament in the Sixty-second Year of the Republic of India as follows:—

**1.** (*1*) This Act may be called the Constitution (One Hundred and Fifteenth Amendment) Act, 2011. Short title and commencement.

(*2*) It shall come into force on such date as the Central Government may, by notification in the Official Gazette, appoint, and different dates may be appointed for different provisions of this Act and any reference in any such provision to the commencement of this Act shall be construed as a reference to the commencement of that provision.

**2.** After article 246 of the Constitution, the following article shall be inserted, namely:— Insertion of new article 246A.

'246A. Notwithstanding anything contained in articles 246 and 254, Parliament and the Legislature of every State, have power to make laws with respect to goods and services tax imposed by the Union or by that State respectively: Special provision with respect to goods and services tax.

Provided that Parliament has exclusive power to make laws with respect to goods and services tax where the supply of goods, or of services, or both takes place in the course of inter-State trade or commerce.

*Explanation.*— For the purpose of this article, "State" includes a Union territory with Legislature.'.

Amendment of article 248.

**3.** In article 248 of the Constitution, in clause (1), for the word "Parliament", the words, figures and letter "Subject to article 246A, Parliament" shall be substituted.

Amendment of article 249.

**4.** In article 249 of the Constitution, in clause (1), after the words "with respect to", the words "goods and services tax or" shall be inserted.

Amendment of article 250.

**5.** In article 250 of the Constitution, in clause (1), after the words "with respect to", the words "goods and services tax or" shall be inserted.

Amendment of article 268.

**6.** In article 268 of the Constitution, in clause (1), the words "and such duties of excise on medicinal and toilet preparations" shall be omitted.

Omission of article 268A.

**7.** Article 268A of the Constitution [as inserted by section 2 of the Constitution (Eighty-eighth Amendment) Act, 2003] shall be omitted.

Amendment of article 269.

**8.** In article 269 of the Constitution, in clause (1), after the words "consignment of goods", the words, figures and letter "except as provided in article 269A" shall be inserted.

Insertion of new article 269A.

**9.** After article 269 of the Constitution, the following article shall be inserted, namely:—

Levy and collection of goods and services tax in course of inter-State trade or commerce.

'269A. (1) Goods and services tax on supplies in the course of inter-State trade or commerce shall be levied and collected by the Government of India and such tax shall be apportioned between the Union and the States in the manner as may be prescribed by Parliament by law.

*Explanation* I. — For the purposes of this clause, supply of goods or of services or both in the course of import into the territory of India shall be deemed to be supply of goods, or of services, or both in the course of inter-State trade or commerce.

*Explanation* II. — For the purpose of this article, "State" includes a Union territory with Legislature.

(2) Parliament may, by law, formulate the principles for determining when a supply of goods, or of services, or both takes place in the course of inter-State trade or commerce.'.

Amendment of article 270.

**10.** In article 270 of the Constitution,—

(*i*) in clause (1), for the words, figures and letter "articles 268, 268A and 269", the words, figures and letter "articles 268, 269 and 269A" shall be substituted;

(*ii*) after clause (1), the following clause shall be inserted, namely:—

"(1A) Goods and services tax levied and collected by the Government of India shall also be distributed between the Union and the States in the manner provided in clause (2).".

Amendment of article 271.

**11.** In article 271 of the Constitution, after the words "in those articles", the words "except the goods and services tax" shall be inserted.

Insertion of new articles 279A and 279B.

**12.** After article 279 of the Constitution, the following articles shall be inserted, namely:—

Goods and Services Tax Council.

'279A. (1) **The President shall, within sixty days from the date of commencement of the Constitution (One Hundred and Fifteenth Amendment) Act, 2011, by order, constitute a Council to be called the Goods and Services Tax Council.**

(2) **The Goods and Services Tax Council shall consist of the following members, namely:—**

(*a*) **the Union Finance Minister ..... Chairperson;**

(*b*) **the Union Minister of State in charge of Revenue .... Member;**

(*c*) **the Minister in charge of Finance or Taxation or any other Minister nominated by each State Government ..... Members.**

(3) **The Members of the Goods and Services Tax Council referred to in sub-clause (*c*) of clause (2) shall, as soon as may be, choose one amongst themselves to be the Vice-Chairperson of the Council for such period as they may decide.**

(4) **The Goods and Services Tax Council shall make recommendations to the Union and the States on—**

(*a*) **the taxes, cesses and surcharges levied by the Centre, the States and the local bodies which may be subsumed in the goods and services tax;**

(*b*) **the goods and services that may be subjected to or exempted from the goods and services tax;**

(*c*) **the threshold limit of turnover below which goods and services tax may be exempted;**

(*d*) **the rates of goods and services tax; and**

(*e*) **any other matter relating to the goods and services tax, as the Council may decide.**

(5) **While discharging the functions conferred by this article, the Goods and Services Tax Council shall be guided by the need for a harmonised structure of goods and services tax and for the development of a harmonised national market for goods and services.**

(6) **One-third of the total number of members of the Goods and Services Tax Council shall constitute the quorum at its meetings.**

(7) **The Goods and Services Tax Council shall determine the procedure in the performance of its functions.**

(8) **Every decision of the Goods and Services Tax Council taken at a meeting shall be with the consensus of all the members present at the meeting.**

(9) **No act or proceedings of the Goods and Services Tax Council shall be invalid merely by reason of—**

(*a*) **any vacancy in, or any defect in, the constitution of the Council; or**

(*b*) **any defect in the appointment of a person as a Member of the Council; or**

(*c*) **any irregularity in the procedure of the Council not affecting the merits of the case.**

*Explanation.*—For the purposes of this article, "State" includes a Union territory with Legislature.

Goods and Services Tax Dispute Settlement Authority.

279B. (1) **Parliament may, by law, provide for the establishment of a Goods and Services Tax Dispute Settlement Authority to adjudicate any dispute or complaint referred to it by a State Government or the Government of India arising out of a deviation from any of the recommendations of the Goods and Services Tax Council constituted under article 279A that results in a loss of revenue to a State Government or the Government of India or affects the harmonised structure of the goods and services tax.**

(2) **The Goods and Services Tax Dispute Settlement Authority shall consist of a Chairperson and two other members.**

(3) **The Chairperson of the Goods and Services Tax Dispute Settlement Authority shall be a person who has been a Judge of the Supreme Court or Chief Justice of a High Court to be appointed by the President on the recommendation of the Chief Justice of India.**

(4) **The two other members of the Goods and Services Tax Dispute Settlement Authority shall be persons of proven capacity and expertise in the field of law, economics or public affairs to be appointed by the President on the recommendation of the Goods and Services Tax Council.**

(5) **The Goods and Services Tax Dispute Settlement Authority shall pass suitable orders including interim orders.**

(6) **A law made under clause (1) may specify the powers which may be exercised by the Goods and Services Tax Dispute Settlement Authority and provide for the procedure to be followed by it.**

(7) **Notwithstanding anything in this Constitution, Parliament may by law provide that no Court other than the Supreme Court shall exercise jurisdiction in respect of any such adjudication or dispute or complaint as is referred to in clause (1).**

*Explanation.*— For the purpose of this article, "State" includes a Union territory with Legislature.'.

Amendment of article 286.

**13.** In article 286 of the Constitution,—

(*i*) in clause (1),—

(*A*) for the words "the sale or purchase of goods where such sale or purchase takes place", the words "the supply of goods or of services or both, where such supply takes place" shall be substituted;

(*B*) in sub-clause (*b*), for the word "goods", at both the places where it occurs, the words "goods or services or both" shall be substituted;

(*ii*) in clause (2), for the words "sale or purchase of goods takes place", the words "supply of goods or of services or both" shall be substituted;

(*iii*) for clause (3), the following clauses shall be substituted, namely:—

"(3) Any law of a State shall, in so far as it imposes, or authorises the imposition of a tax on the sale or purchase of goods declared by Parliament by law to be of special importance in inter-State trade or commerce be subject to such restrictions and conditions in regard to the system of levy, rates and other incidents of tax as Parliament may by law specify.

(4) Nothing in clause (3) shall apply to a law of a State insofar as it imposes or authorises the imposition of goods and services tax.".

Amendment of article 366.

**14.** In article 366 of the Constitution,—

(*i*) after clause (12), the following clause shall be inserted, namely:—

'(12A) "goods and services tax" means any tax on supply of goods or services or both except taxes on the supply of the following goods, namely:—

(*i*) petroleum crude;

(*ii*) high speed diesel;

(*iii*) motor spirit (commonly known as petrol);

(*iv*) natural gas;

(*v*) aviation turbine fuel; and

(*vi*) alcoholic liquor for human consumption.';

(*ii*) clause (29A) shall be omitted.

Amendment of article 368.

**15.** In article 368 of the Constitution, in clause (2), in the proviso, in clause (*a*), for the words and figures "article 162 or article 241", the words, figures and letters "article 162, article 241, article 279A or article 279B" shall be substituted.

Amendment of Sixth Schedule.

**16.** In the Sixth Schedule to the Constitution, in paragraph 8, in sub-paragraph (*3*),—

(*i*) in clause (*c*), the word "and" occurring at the end shall be omitted;

(*ii*) in clause (*d*) , the word "and" shall be inserted at the end;

(*iii*) after clause (*d*), the following clause shall be inserted, namely:—

"(*e*) taxes on entertainment and amusements.".

**17.** In the Seventh Schedule to the Constitution,— Amendment of Seventh Schedule.

(*a*) in List I — Union List,—

(*i*) for entry 84, the following entry shall be substituted, namely:—

"84. Duties of excise on the following goods manufactured or produced in India, namely:—

(*a*) petroleum crude;

(*b*) high speed diesel;

(*c*) motor spirit (commonly known as petrol);

(*d*) natural gas;

(*e*) aviation turbine fuel; and

(*f*) tobacco and tobacco products.";

(*ii*) entries 92 and 92C shall be omitted;

(*b*) in List II — State List,—

(*i*) for entry 52, the following entry shall be substituted, namely:—

"52. Taxes on the entry of goods into a local area for consumption, use or sale therein to the extent levied and collected by a Panchayat or a Municipality.";

(*ii*) for entry 54, the following entry shall be substituted, namely:—

"54. Taxes on the sale, other than sale in the course of inter-State trade or commerce or sale in the course of international trade and commerce of, petroleum crude, high speed diesel, natural gas, motor spirit (commonly known as petrol), aviation turbine fuel and alcoholic liquor for human consumption.";

(*iii*) entry 55 shall be omitted;

(*iv*) for entry 62, the following entry shall be substituted, namely:—

"62. Taxes on entertainments and amusements to the extent levied and collected by a Panchayat or a Municipality or a Regional Council or a District Council.".

**18.** Notwithstanding anything in this Act, any provision of any law relating to tax on goods or services or on both in force in any State immediately before the commencement of this Act, which is inconsistent with the provisions of the Constitution as amended by this Act shall continue to be in force until amended or repealed by a competent Legislature or other competent authority or until expiration of one year from such commencement, whichever is earlier. Transitional provision.

**19.** (*1*) If any difficulty arises in giving effect to the provisions of the Constitution as amended by this Act (including any difficulty in relation to the transition from the provisions of the Constitution as they stood immediately before the date of assent of the President to this Act to the provisions of the Constitution as amended by this Act), the President may, by order, make such provisions, including any adaptation or modification of any provision of the Constitution or law, as appear to the President to be necessary or expedient for the purpose of removing the difficulty: Power of the President to remove difficulties.

Provided that no such order shall be made after the expiry of three years from the date of such assent.

(*2*) Every order made under sub-section (*1*) shall, as soon as may be after it is made, be laid before each House of Parliament.

## STATEMENT OF OBJECTS AND REASONS

The scheme of the Constitution does not provide for any concurrent taxing powers to the Union as well as the States. It is proposed to introduce the goods and services tax and for this purpose to amend the Constitution conferring simultaneous power on Parliament as well as the State Legislatures including every Union territory with Legislature to make laws for levying goods and services tax on every transaction of supply of goods or services or both. The goods and services tax would replace a number of indirect taxes presently being levied by the Central Government and the State Governments and is intended to remove cascading of taxes and provide a common national market for goods and services. The proposed Central and State goods and services tax would be levied on all transactions involving supply of goods and services except those that are exempt or kept out of the purview of the goods and services tax.

2. The proposed Bill which seeks further to amend the Constitution, *inter alia,* provides for—

(a) subsuming of various Central and State indirect taxes and levies like Central Excise Duty, Additional Excise Duties, Excise Duty levied under the Medicinal and Toilet Preparations (Excise Duties) Act, 1955, Service Tax, Additional Customs Duty commonly known as Countervailing Duty (CVD), Special Additional Duty of Customs (SAD), Central Surcharges and Cesses (excluding those applicable to income-tax, customs duties and to excise duties so far as they relate to goods outside the purview of the goods and services tax;

(b) subsuming of State VAT/Sales Tax, entertainment tax (unless it is levied by the local bodies), Luxury Tax, Taxes on lottery, betting and gambling, tax on advertisements, State Cesses and Surcharges insofar as they relate to supply of goods and services and Entry Tax, not levied by local bodies;

(c) levy of Integrated GST (IGST) on inter-State transactions of goods and services;

(d) conferring simultaneous power upon Parliament and the State Legislatures to make laws governing goods and services tax;

(e) coverage of goods other than crude petroleum, diesel, pertol, aviation turbine fuel, natural gas and alcohol for human consumption under the goods and services tax for the levy of goods and services tax;

(f) creation of a Goods and Services Tax Council to examine issues relating to goods and services tax and make recommendations to the Union and the States on parameters like rates, exemption list and threshold limits;

(g) enabling the setting up of a Goods and Services Tax Dispute Settlement Authority, which may be approached by the affected Government (whether the Centre or a State) seeking redressal for any loss caused by any action due to a deviation from the recommendations made by the Goods and Services Tax Council or for adversely affecting the harmonious structure and implementation of the goods and services tax;

(h) empowering District Councils and Regional Councils also to levy tax on entertainment and amusement;

(i) enabling the levy of goods and services tax on sale or purchase of newspapers and advertisements published therein;

(j) permitting only Municipalities and Panchayats to levy and collect tax on entry of goods in a local area for consumption, use or sale therein;

(k) allowing States to levy tax on intra-State sale of goods kept outside the purview of the goods and services tax, namely, Petroleum crude, High Speed Diesel, Natural Gas, Motor Spirit (Petrol), Aviation Turbine Fuel and Alcoholic Liquor for human consumption.

3. The Bill seeks to achieve the above objects.

NEW DELHI; PRANAB MUKHERJEE

*The 16th March,* 2011.

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## PRESIDENT'S RECOMMENDATION UNDER ARTICLE 117 OF THE CONSTITUTION OF INDIA

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**[Copy of letter No. 31011/04/2009, dated 16.3.2011 from Shri Pranab Mukherjee, Minister of Finance to the Secretary-General, Lok Sabha]**

The President, having been informed of the subject matter of the proposed Bill, recommends, under clauses (1) and (3) of article 117, read with clause (1) of article 274, of the Constitution of India, the introduction of the Constitution (One Hundred and Fifteenth Amendment) Bill, 2011 in Lok Sabha and also the consideration of the Bill.

## FINANCIAL MEMORANDUM

Clause 12 of the Bill seeks to insert new articles 279A relating to constitution of Goods and Services Tax Council and 279B relating to establishment of Goods and Services Tax Dispute Settlement Authority in the Constitution. The proposed new article 279A seeks to empower the President to constitute a Council to be called the Goods and Services Tax Council consisting of the Union Finance Minister as its Chairperson and Union Minister of State in-charge of Revenue and the State Minister in-charge of Finance or Taxation or any other Minister nominated by each State Government as their Members.

The proposed new article 279B seeks to provide for the establishment of a Goods and Services Tax Dispute Settlement Authority to adjudicate dispute or complaint referred to it by a State Government or the Government of India arising out of a deviation from any of the recommendations of the Goods and Services Tax Council constituted under the proposed article 279A that results in a loss of revenue to a State Government or the Government of India or affects the harmonised structure of the goods and services tax.

There are no direct financial implications on account of the proposal. However, the creation of the Goods and Services Tax Council and the Goods and Services Tax Dispute Settlement Authority will involve creation of some posts. Given that the introduction of goods and services tax will make the Indian trade and industry much more competitive, domestically as well as internationally and contribute significantly to the growth of the economy, such additional expenditure on these bodies would be miniscule.

It is not practicable to make an estimate of the expenditure, both recurring and non-recurring on account of the above. However, such expenditure would be considerably marginal.

## MEMORANDUM REGARDING DELEGATED LEGISLATION

Clause 12 of the Bill seeks to insert a new article 279A relating to the constitution of a Council to be called the Goods and Services Tax Council and another article 279B establishing the Goods and Services Tax Disputes Settlement Authority. Clause (1) of the proposed new article 279A provides that the President shall, within sixty days from the date of the commencement of the Constitution (One Hundred and Fifteenth Amendment) Act, 2011, by order, constitute a Council to be called the Goods and Services Tax Council. Clause (7) of the said article provides that the Council shall determine the procedure in the performance of its functions.

2. The procedure, as may be laid down by the Goods and Services Tax Council in the performance of its functions, are matters of procedure and details. The delegation of legislative power is, therefore, of a normal character.

## ANNEXURE

### EXTRACTS FROM THE CONSTITUTION OF INDIA

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Residuary powers of legislation.

**248.** (1) Parliament has exclusive power to make any law with respect to any matter not enumerated in the Concurrent List or State List.

* * * * *

Power of Parliament to legislate with respect to a matter in the State List in the national interest.

**249.** (1) Notwithstanding anything in the foregoing provisions of this Chapter, if the Council of States has declared by resolution supported by not less than two-thirds of the members present and voting that it is necessary or expedient in the national interest that Parliament should make laws with respect to any matter enumerated in the State List specified in the resolution, it shall be lawful for Parliament to make laws for the whole or any part of the territory of India with respect to that matter while the resolution remains in force.

* * * * *

Power of Parliament to legislate with respect to any matter in the State List if a Proclamation of Emergency is in operation.

**250.** (1) Notwithstanding anything in this Chapter, Parliament shall, while a Proclamation of Emergency is in operation, have power to make laws for the whole or any part of the territory of India with respect to any of the matters enumerated in the State List.

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*Distribution of Revenues between the Union and the States*

Duties levied by the Union but collected and appropriated by the States.

**268.** (1) Such stamp duties and such duties of excise on medicinal and toilet preparations as are mentioned in the Union List shall be levied by the Government of India but shall be collected—

(*a*) in the case where such duties are leviable within any Union territory, by the Government of India, and

(*b*) in other cases, by the States within which such duties are respectively leviable.

* * * * *

Service tax levied by Union and collected and appropriated by the Union and the States.

**268A.** (1) Taxes on services shall be levied by the Government of India and such tax shall be collected and appropriated by the Government of India and the States in the manner provided in clause (2).

(2) The proceeds in any financial year of any such tax levied in accordance with the provisions of clause (1) shall be—

(*a*) collected by the Government of India and the States;

(*b*) appropriated by the Government of India and the States,

in accordance with such principles of collection and appropriation as may be formulated by Parliament by law.

Taxes levied and collected by the Union but assigned to the States.

**269.** (1) Taxes on the sale or purchase of goods and taxes on the consignment of goods shall be levied and collected by the Government of India but shall be assigned and shall be deemed to have been assigned to the States on or after the 1st day of April, 1996 in the manner provided in clause (2).

*Explanation.*—For the purposes of this clause,—

(*a*) the expression "taxes on the sale or purchase of goods" shall mean taxes on sale or purchase of goods other than newspapers, where such sale or purchase takes place in the course of inter-State trade or commerce;

(*b*) the expression "taxes on the consignment of goods" shall mean taxes on the consignment of goods (whether the consignment is to the person making it or to any other person), where such consignment takes place in the course of inter-State trade or commerce.

* * * * *

Taxes levied and distributed between the Union and the States.

**270.** (1) All taxes and duties referred to in the Union List, except the duties and taxes referred to in articles 268, 268A and 269, respectively, surcharge on taxes and duties referred to in article 271 and any cess levied for specific purposes under any law made by Parliament shall be levied and collected by the Government of India and shall be distributed between the Union and the States in the manner provided in clause (2).

* * * * *

Surcharge on certain duties and taxes for purposes of the Union.

**271.** Notwithstanding anything in articles 269 and 270, Parliament may at any time increase any of the duties or taxes referred to in those articles by a surcharge for purposes of the Union and the whole proceeds of any such surcharge shall form part of the Consolidated Fund of India.

* * * * *

Restrictions as to imposition of tax on the sale or purchase of goods.

**286.** (1) No law of a State shall impose, or authorise the imposition of, a tax on the sale or purchase of goods where such sale or purchase takes place—

(*a*) outside the State; or

(*b*) in the course of the import of the goods into, or export of the goods out of, the territory of India.

(2) Parliament may by law formulate principles for determining when a sale or purchase of goods takes place in any of the ways mentioned in clause (1).

(3) Any law of a State shall, in so far as it imposes, or authorises the imposition of,—

(*a*) a tax on the sale or purchase of goods declared by Parliament by law to be of special importance in inter-State trade or commerce; or

(*b*) a tax on the sale or purchase of goods, being a tax of the nature referred to in sub-clause (*b*), sub-clause (*c*) or sub-clause (*d*) of clause (29A) of article 366,

be subject to such restrictions and conditions in regard to the system of levy, rates and other incidents of the tax as Parliament may by law specify.

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Definitions.

**366.** In this Constitution, unless the context otherwise requires, the following expressions have the meanings hereby respectively assigned to them, that is to say—

* * * * *

(29A) "tax on the sale or purchase of goods" includes—

(*a*) a tax on the transfer, otherwise than in pursuance of a contract, of property in any goods for cash, deferred payment or other valuable consideration;

(*b*) a tax on the transfer of property in goods (whether as goods or in some other form) involved in the execution of a works contract;

(*c*) a tax on the delivery of goods on hire-purchase or any system of payment by instalments;

(*d*) a tax on the transfer of the right to use any goods for any purpose (whether or not for a specified period) for cash, deferred payment or other valuable consideration;

(*e*) a tax on the supply of goods by any unincorporated association or body of persons to a member thereof for cash, deferred payment or other valuable consideration;

(*f*) a tax on the supply, by way of or as part of any service or in any other manner whatsoever, of goods, being food or any other article for human consumption or any drink (whether or not intoxicating), where such supply or service, is for cash, deferred payment or other valuable consideration,

and such transfer, delivery or supply of any goods shall be deemed to be a sale of those goods by the person making the transfer, delivery or supply and a purchase of those goods by the person to whom such transfer, delivery or supply is made;

* * * * *

## PART XX

AMENDMENT OF THE CONSTITUTION

Power of Parliament to amend the Constitution and procedure therefor.

**368.** (1)* * * * *

(2) An amendment of this Constitution may be initiated only by the introduction of a Bill for the purpose in either House of Parliament, and when the Bill is passed in each House by a majority of the total membership of that House and by a majority of not less than two-thirds of the members of that House present and voting, it shall be presented to the President who shall give his assent to the Bill and thereupon the Constitution shall stand amended in accordance with the terms of the Bill:

Provided that if such amendment seeks to make any change in—

(*a*) article 54, article 55, article 73, article 162 or article 241, or

(*b*) Chapter IV of Part V, Chapter V of Part VI, or Chapter I of Part XI, or

(*c*) any of the Lists in the Seventh Schedule, or

(*d*) the representation of States in Parliament, or

(*e*) the provisions of this article,

the amendment shall also require to be ratified by the Legislatures of not less than one-half of the States by resolutions to that effect passed by those Legislatures before the Bill making provision for such amendment is presented to the President for assent.

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## SIXTH SCHEDULE

[*Articles* 244 (2) and 275 (1)]

### Provisions as the Administration of Tribal Areas in the States of Assam, Meghalaya, Tripura and Mizoram

**8. Powers to assess and collect land revenue and to impose taxes.**—(1)* * * *

(3) The District Council for an autonomous district shall have the power to levy and collect all or any of the following taxes within such district, that is to say—

* * * * *

(*c*) taxes on the entry of goods into a market for sale therein, and tolls on passengers and goods carried in ferries; and

(*d*) taxes for the maintenance of schools, dispensaries or roads.

* * * * *

## SEVENTH SCHEDULE

(*Article* 246)

### List I—Union List

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**84.** Duties of excise on tobacco and other goods manufactured or produced in India except—

(*a*) alcoholic liquors for human consumption;

(*b*) opium, Indian hemp and other narcotic drugs and narcotics,

but including medicinal and toilet preparations containing alcohol or any substance included in sub-paragraph *(b)* of this entry.

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**92.** Taxes on the sale or purchase of newspapers and on advertisements published therein.

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**92C.** Taxes on services.

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### List II—State List

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

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**54.** Taxes on the sale or purchase of goods other than newspapers, subject to the provisions of entry 92A of List I.

**55.** Taxes on advertisements other than advertisments published in the newspapers and advertisements broadcast by radio or television.

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**62.** Taxes on luxuries, including taxes on entertainments, amusements, betting and gambling.

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LOK SABHA

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BILL

further to amend the Constitution of India.

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(*Shri Pranab Mukherjee, Minister of Finance*)

GMGIPMRND—7321LS(S3)—17-03-2011.