

A BRIEF ANALYSIS
OF
THE RECOMMENDATIONS OF
EMPOWERED COMMITTEE AND TASK FORCE
ON THE
PROPOSED GST MODEL

BY

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“In the happiness of his subjects lies the king’s happiness; in their welfare his welfare. He shall not consider as good only that which pleases him but treat as beneficial to him whatever pleases his subjects.”

(Kautilya in “Arthshastra”)

1. Introduction:

- 1.1 The Empowered Committee ('EC' for short) of the State Finance Ministers has released its 'First Discussion Paper' on 10th November, 2009. In this Paper, EC has outlined the broad contours of the proposed GST Model though the various issues, mainly of micro nature, have not been dealt with in the Paper which are expected to be taken up in the subsequent Papers.

Immediately a month after the release of the Discussion Paper by EC, the Task Force ('TF' for short) appointed by the 13th Finance Commission headed by Dr. Vijay Kelkar released its own Report on 'Goods and Service Tax' on 15th December, 2009.

The recommendations of TF are significant, in the sense that, the same are at variance with the recommendations of EC on certain key issues.

- 1.2 In this Note, a brief analysis is attempted of certain important recommendations of EC and TF and comments are offered thereon.
- 1.3 For the sake of simplicity and better understanding, the Note is divided into three broad categories viz.
- (a) Structure-related issues;
 - (b) Implementation-related issues; and
 - (c) Impact-related issues.

These are taken up one by one below:

2. Structure-related Issues:

2.1 The following issues are discussed relating to the 'Structure of GST' in the light of the recommendations of EC and TF:

- (a) Model of GST
- (b) Taxes to be subsumed
- (c) Coverage of GST
- (d) Rate of tax
- (e) Threshold limits
- (f) Treatment of Inter-state transactions.

2.2 Model of GST:

Recommendations of EC:

EC has recommended a Dual GST structure with defined functions and responsibilities of the Centre and the States. Thus, GST will have two components – one levied by the Centre i.e. Central GST ('CGST') and the other levied by the States and the Union Territories (UTs) i.e. State GST ('SGST'). Both, CGST and SGST will be imposed concurrently on a common tax base.

Recommendations of TF:

TF has also recommended the same dual GST levy to be imposed concurrently by the Centre and the States, but independently. The levy will have two components, one CGST to be levied by Centre and other, SGST to be levied by the States and UTs. Again, the dual levy will operate over a common tax base and thus, the base will be identical.

Comments:

The recommendation of Dual GST Model is on expected lines and is to ensure the fiscal autonomy of the States. In a federal country like ours where the power to tax the domestic trade has been divided between the Centre and the States by the Constitution, a unified destination based GST cannot be implemented without the States losing their fiscal autonomy. Obviously, this would not have been acceptable to the States. As a solution, both, EC and TF has recommended a Dual GST Model wherein both levels of Government i.e. Centre and State will have concurrent power to tax the domestic trade in Goods and Service Tax.

It may be pointed out here that Kelkar Task Force , in its Report on 'Implementation of FRBM Act' submitted in July, 2004 has also suggested such dual GST Model with both, Centre and States exercising concurrent but independent jurisdiction over common or almost common tax bases comprehensively extending over all goods and services and in both cases, going upto the final consumer.

Nevertheless, a unified GST can certainly be kept in sight as an ideal model which can be to be pursued in the long run. After all, 'Commerce' can be a great leveler and can go a long way in mitigating the differences and disputes arising on account of caste, creed, language or religion.

2.3 Taxes to be subsumed:Recommendations of EC:

EC has recommended the subsuming of following Central Taxes under CGST:

- ✓ Central Excise duty;
- ✓ Additional Excise Duties;
- ✓ The Excise duty levied under the Medicinal and Toiletries Preparation Act;

- ✓ Service Tax;

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- ✓ Additional Customs duty commonly known as Countervailing Duty (CVD);
- ✓ Special Additional Duty of Customs i.e. SAD @ 4%;
- ✓ Surcharges; and
- ✓ Cesses.

On the other hand, the following State Taxes are recommended to be subsumed under SGST:

- ✓ VAT/Sales Tax;
- ✓ Entertainment Tax (unless it is levied by local bodies);
- ✓ Luxury Tax;
- ✓ Taxes on lottery, betting and gambling;
- ✓ State Cesses and Surcharges in so far as they relate to supply of goods and services;
- ✓ Entry tax not in lieu of Octroi.

The issue of subsuming of Purchase Tax is still being deliberated by EC.

Recommendations of TF:

As against the above, TF has recommended the subsuming of almost all Indirect Taxes on Goods and Services in GST as explained below:

(i) **Central Taxes to be subsumed in the CGST:**

1. Central Excise Duty (including Additional Excise Duties);
2. Service Tax;
3. Additional Customs Duty (commonly referred to as 'CVD');
4. Surcharges and all cesses.

(Omission of 'Special Additional Duty of Customs (4%)' from the list of Central Taxes to be subsumed appears to be an oversight).

(ii) State Taxes to be subsumed in the SGST:

1. VAT/ sales tax (including central sales tax and Purchase tax);
2. Entertainment tax (other than levied by local bodies);
3. Entry taxes not in lieu of Octroi;
4. Other Taxes and Duties (includes Luxury tax, Taxes on lottery, betting and gambling, and all cesses and surcharges by States).

(iii) Other Taxes to be subsumed:

1. Stamp duty;
2. Taxes on Vehicles;
3. Taxes on Goods and Passengers; and
4. Taxes and duties on electricity.

(iv) All entry and Octroi duties levied by the third-tier of Government must be abolished.

- (v) However, any amount collected through the taxes on SIN goods is not recommended to be subsumed either in the CGST or the SGST. Similarly, any amount collected as tax/fee/charge/cess which is essentially in the nature of a user charge for supply of goods and services should also not be subsumed under the CGST or SGST, according to TF.

Comments:

As is evident, the recommendations of EC on subsuming of various Indirect Taxes on Goods and Services are restrictive compared to those of TF. The continued existence of certain Central, State or Local taxes, particularly stamp duty, purchase tax and octroi duty/entry tax, even in GST regime, is certainly not an ideal situation nor advisable. This will not only be a retrograde step hampering the introduction and operation of a 'flawless GST' but also obstruct the free flow of Input Tax Credit ('ITC' for short). It is pertinent to note here that both, EC and TF have identified almost the same set of principles that should govern the issue of subsuming of various Central and State taxes. There is, therefore no reason as to why there should be

difference between the recommendations of EC and TF over the types of Central, State and Local taxes to be subsumed in GST?

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TF has recommended the inclusion of 'Land and Real Estate Sector' in GST with subsuming of 'Stamp duty' in GST in a phased manner. On the other hand, EC's Paper is silent on this aspect. Needless to say, the decision of subsuming of Stamp duty will ultimately depend upon as to whether 'Land and Real Estate Sector' is brought within the scope of GST or not.

So far as 'Purchase tax' is concerned, it is presently being levied only by a handful of States, notably Haryana and Punjab, two major food grain producing States who earn substantial revenue from this tax. The recommendation of TF to subsume 'Purchase tax' in GST is apparently linked to its recommendation to cover 'food sector' comprehensively in GST regime. While the recommended coverage of 'food sector' in GST is highly debatable, there is really no justification for continuing with levy of 'Purchase tax' in GST regime. The concerned States can suitably be compensated for any revenue loss on this count.

Levy of Octroi duty or Entry tax on goods by local bodies in certain States has been a bane of Indirect Tax system. This is an obnoxious levy, that not only hampers free flow of goods across the States, but also breeds rampant corruption and wastes colossal amount of time and energy of all concerned. There is a strong case for subsuming Octroi/Entry tax in SGST. The concerned local bodies can be suitably compensated by the respective State Governments.

Another issue that merits serious consideration is subsuming of tax or duty on Electricity in the GST. TF has recommended subsuming of 'Electricity duty' in SGST based on its recommendation of inclusion of 'Power Sector' in GST. (Detailed comments on coverage of 'Power Sector' in GST are given in subsequent paragraphs).

Similarly, other State taxes including taxes on vehicles, taxes on goods and passengers etc. should also be subsumed in SGST.

Needless to say, the decision on subsuming of various Indirect Taxes – Central, State and Local – on goods and services should be guided by a detached logic, unbiased revenue considerations and dynamism of GST. For the introduction of a 'flawless GST', it is imperative that maximum – if not all – number of indirect taxes on goods and services get subsumed in GST.

2.4 Coverage of GST:

The recommendations of EC and TF on sector-specific coverage of GST are discussed below:

2.4.1 Alcoholic Beverages and Tobacco Products:

Recommendations of EC:

Alcoholic Beverages would be kept out of the purview of GST. These products will continue to attract Sales Tax/VAT as per the existing practice. However, there is no objection if any States have made the same Vatable. Also, the Excise duty, which is being levied by the States presently will not be affected.

Tobacco products are proposed to be covered under GST with Input Tax Credit (ITC) benefit. Centre may be allowed to levy Excise duty on tobacco products over and above GST without ITC benefit.

Recommendations of TF:

TF, on the other hand, has recommended a dual levy of GST and Excise on the entire range of these products which are considered to be SIN goods. As a general rule, no ITC benefit will be allowed under GST levied on these goods, but in case of dealer, this Rule can be relaxed as the consumption in the hands of dealer is essentially intermediate in nature. No ITC benefit will be allowed in respect of Excise duty. TF has suggested that both, the Central and State Governments may work out an appropriate Revenue Neutral Rate

(RNR) in case of these products, which shall not be too high so as to encourage tax evasion.

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Comments:

There is really no reason to keep 'Alcoholic Beverages' and 'Tobacco Products' outside the purview of GST. As these are considered to be 'SIN goods' (i.e. the goods whose consumption create negative externalities), the dual levy of GST and Excise on these goods can be prescribed.

2.4.2 Petroleum Products:

Recommendations of EC:

Many petroleum products like Crude Oil, Motor Spirit i.e. Petrol (including ATF) and HSD are proposed to be kept outside the purview of GST as is the present practice. Sales Tax could continue to be levied on such products with prevailing floor rates. Similarly, Centre could also continue its levies. Inclusion of Natural Gas in GST is under discussion.

Recommendations of TF:

TF has categorized the Petroleum Products into three categories: (i) Industrial Inputs or Fuels such as Crude Oil; (ii) Transportation Fuels comprising of HSD, MS and ATF; and (iii) Household Fuels comprising of Kerosene and Liquefied Petroleum Gas (LPG).

TF has recommended a dual levy of GST and Excise (without ITC benefit) on the entire range of Emission Fuels (i.e. transportation fuels and kerosene). The Rule of Non-entitlement of ITC benefit can be relaxed in the case of consumption of transportation fuels by the Ministry of Railways, State Road Transport Corporations, Airlines, Truckers, Taxi Operators and dealers. In case of Truckers and Taxi Operators, the benefit of ITC shall be allowed through the abatement mechanism only.

The Central and State Governments may also determine an appropriate RNR of Excise in case of Emission Fuels.

As for Industrial Fuels, TF has recommended that the same be subjected only to GST (both CGST and SGST) with the benefit of ITC like any other intermediate goods.

In case of Natural Gas, TF has recommended that the same be subjected to GST (both, CGST and SGST) with the benefit of ITC like any other normal goods.

Comments:

As can be seen, there is a vast difference between the recommendations of EC and TF so far as the GST on Petroleum Products is concerned. Since Petroleum Products and particularly, Emission Fuels are considered to be 'SIN goods', it is felt that the consumption thereof needs to be checked to restrict the negative externalities. With this objective in mind, Petroleum Products have always been subjected to a very special Excise duty regime and the States also enjoy considerable powers in the matter of levying of Local taxes on these products. For both, the Centre and the States, tax revenue from the Petroleum Products has been substantial, almost 20% to 25% of their respective total tax revenue and therefore, the decision to bring these products under the GST purview / regime is not going to be an easier one.

Interestingly, the Kelkar Task Force, in its Report of July, 2004, has recommended the continuation of existing Excise duty regime in respect of Petroleum Products. It has suggested conversion of ad-valorem rates of Excise duties into specific rates and also the continuation of other levies like Special Excise duty, Additional Excise duty and Special Additional Excise duty, wherever applicable.

2.4.3 Power Sector:

Recommendations of EC:

The 'First Discussion Paper' of EC is silent on the inclusion of Power Sector in GST.

Recommendations of TF:

TF has recommended that the Power Sector must form an integral part of the comprehensive GST base. It has recommended that Electricity duty levied by the States should be subsumed in the SGST.

Comments:

It cannot be denied that Power is one of the most important inputs for production of goods and services and is also one of the major components of cost for certain industries like Aluminum, Cement, Copper, MMF, to name a few. The Power Sector is presently subjected to multiple taxation and suffers from significant cascading effect of taxes.

There is a strong case for subsuming of Electricity Duty in GST which would negate/eliminate the cascading effect of tax, make the sector competitive and reduce the cost of generation and distribution of power. This would also greatly benefit the end-users, whether industrial or individual consumers.

2.4.4 Immovable Properties (Land and Real Estate Sector):

Recommendations of EC:

The First Discussion Paper of EC is silent on the inclusion of the 'Immovable Properties Sector' in GST.

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Recommendations of TF:

TF has recommended comprehensive integration of Real Estate Sector into the GST framework and recommended the following strategy for the same:

- Stamp duty on immovable properties levied by the States should be subsumed in GST in a phased manner;
- Under the new GST regime for immovable property transactions and Real Estate Services, GST should apply to all newly constructed properties (both, residential and commercial). In case of self-use, GST should apply on the cost of construction. If it is sold or transferred, GST should be levied on the consideration received at first transfer or sale with ITC benefit being allowed on raw material used in the construction in both the cases of sale or transfer;
- Rental charges received (excluding imputed rental values) in respect of leasing of immovable property used for both, residential and commercial purposes should be charged to GST. ITC benefit would be allowed only in respect of goods and services used for maintenance;
- All secondary market transactions in immovable properties (whether constructed before or after the introduction of GST) should be liable to GST. The admissibility of ITC benefit will however differ based on whether the property has been constructed after introduction of GST or has been acquired before the introduction of GST;
- The proposed threshold exemption of Rs.10.00 lakhs shall be allowed;

- The land transactions will also be subjected to GST and where land is used for construction of a property, it will be treated as an input and ITC benefit of GST paid in respect of land shall be admissible;

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- The State Governments would continue to perform essential asset registry functions and may continue to levy a registration fee at a specific rate not exceeding Rs.1,000/- per transaction as a user charge.

Comments:

Needless to say, the recommendation of TF to cover the 'Land and Real Estate Sector' in GST is quite significant and has far-reaching implications. The Sector is suffering from multiple taxation, irrational tax policies, distortionary tax regime and cumulative cascading effect of tax. Obviously, the sector is one of the most tax evasion-prone sectors and under-reporting of value of transactions is the order of the day. Also, the sector is always seen as susceptible to underworld domination or connections.

Therefore, there is a strong reason to cover this sector in GST framework which would ensure substantial reduction – if not complete elimination – of the cascading effect of tax, impart greater transparency through market mechanism, create an efficient secondary market in the sector and may have significant downward impact on the prices.

However, the Real Estate Sector shall not be looked upon merely as one of the major component of GDP and the decision to bring this sector within the GST framework shall not be guided only by economic or revenue considerations. There are social considerations which are attached to this sector which also need to be kept in mind. A 'roof over the head' is one of the basic necessities of life and, in India, a substantial part of the population is deprived of the same. Therefore, the coverage of this sector into GST fold shall be carefully deliberated upon and it shall be ensured that the same should not result into the spiralling housing prices and make the housing unaffordable to the large masses of the country.

Here, it is interesting to note that the discussion and recommendations of TFin relation to 'treatment of immovable properties' are almost the same as contained in the Report of July, 2004 of Kelkar Task Force (see para 5.3.9 of the Report of KTF).

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2.4.5 Food Sector:

Recommendations of EC:

The 'First Discussion Paper' is silent on the coverage of 'food items' (both unprocessed and processed) into the GST framework.

Recommendations of TF:

TF has recommended the coverage of food items including agricultural commodities and services into the GST framework. The unprocessed food articles covered under the Public Distribution System (PDS) i.e. wheat, rice and sugar have been recommended to be excluded from GST regardless of the outlet through which they are sold.

Comments:

Of all the recommendations – some pragmatic, a few debatable – of TF, the recommendation to cover food items into GST framework is probably the most controversial one, to say the least!

TF has justified the inclusion of food items into GST by observing that if the exemption is extended to all categories of food items, the revenue base will shrink significantly and the standard rate (recommended at 12% by TF) would need to be substantially higher. Such increase in standard rate would adversely affect the poor who consume other goods also, argues TF. It has further been observed by TF that the distribution channel for unprocessed food in the rural sector is either a direct sale by the farmer to the final consumer in village Haats or Bazars or through small retail stores which would remain exempt because of the threshold exemption.

The arguments advanced by TF are illogical, vague, and self-serving in nature and are based on complete ignorance of ground realities as explained below:

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Firstly, TF has conveniently ignored the distinction between the unprocessed or raw food items (like grain, cereals, pulses, oil seeds etc.), raw vegetables/ fruits and processed food articles or processed vegetables or fruits though the distinction is well recognized in the Central Excise and State VAT laws. The observation of TF that 'contrary to popular perception, food items are indeed subject to tax at the State level though at lower rates' is not only incorrect but beautifully vague. TF has failed to take note of the fact that the raw food items or raw vegetables/fruits are not subjected to the levy of either Central Excise or State VAT. It is only the processed food items or processed vegetable/fruits which are subjected to such levy of Excise or VAT. To say therefore that food items are indeed subjected to tax at lower rates is vague and misleading.

Secondly, TF also appears to be unaware of the peculiar marketing chain or value chain prevalent in agricultural commodities. The assertion of TF that the distribution channel for unprocessed food in the rural sector is either a direct sale by farmer to the consumer in village Haats (Bazars) or through small retail stores is not only unfounded but also too simplistic. TF ought to have noted that raw agricultural products are sold through auction only at APMC Markets situated throughout the length and breadth of the country. The trade in agricultural commodities is dominated by intermediaries like commission agents, wholesalers and retailers. The farmers hardly have any say or dominance in the marketing of the products. Only a small fraction of agricultural produce is sold by the farmers through the village haats (Bazar) or small retail stores.

Thirdly, TF also appears to be in dark about who should be considered as 'poor' nor has cared to explain the same. TF states that the possible increase in standard rate due to exclusion of food items from GST would

adversely affect the poor consuming items other than food items. But then who is a 'poor'? As per Planning Commission & NSSO data for 61st (2004-05) Rounds, 27.5 percent of the total population of the country was living 'Below Poverty Line' (BPL). This figure is based on the 'Calorie' criteria

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being applied to determine the number of BPL people in both, rural and urban areas. However, a recent report submitted in November, 2009 by Dr. Suresh Tendulkar Committee puts the percentage of BPL people in 2004-05 at 37.5 percent. The total population of the country in July, 2004 was approximately 106 Crores. In other words, there were about 29 Crores (as per Planning Commission Data) or 40 Crores (as per the Tendulkar Committee Report) people who were living 'Below Poverty Line' in 2004-05. The situation has not improved in any significant manner in last 4 years. The question here is whether such vast majority of the population living Below Poverty Line is to be regarded as 'poor' or not? These people barely manage to secure one meal in a day and therefore, where is the question of them consuming items other than food items? Will these people be really interested in what is the standard rate of GST on such other items? Incidentally, the World Bank recently recommended that the threshold for extreme poverty should be raised to \$1.25 per day which transforms the picture in India. The revised benchmark captures 42 percent of the population, i.e. over 450 million people, one third of the total world figure. Whatever be the merits of these alternative calculations, it is clear that vast numbers of households survive close to the poverty line.

Fourthly, the argument of TF that the increase in prices of agricultural commodities (between 0.61 and 1.18 percent on account of GST) and services would benefit millions of farmers is incomprehensible and absurd. If the rise in agricultural commodities' prices was to really benefit the farmers, then we would not have witnessed a spate of suicides by the farmers in last few years throughout the country nor the Government would have been forced to waive nearly Rs.71,000 Crores of farmers' debt. The increase in prices of food grains, cereals, pulses, oil seeds, edible oils, vegetables, fruits etc. has been substantial in last few years and it is nobody's case that the farmers have benefited from such unprecedented rise in prices. In fact, the food price inflation poses a serious threat to India's poverty reduction

program. Further, in agricultural trade dominated by profiteering and hoarding, any imposition of tax on agricultural commodities or related services will certainly be passed on by the intermediaries to the ultimate consumers and the farmers would never be benefitted by the same.

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Here, let us also not forget the dismal condition of Agriculture sector as a whole. Given below are the latest figures of 'Distribution of operational Holdings – All India' published by the Ministry of Agriculture :

Category of Holdings	No of Operational Holdings		Area Operated		Average Size of Operational Holdings	
	1995-96	2000-01*	1995-96	2000-01*	1995-96	2000-01*
	2	3	4	5	6	7
Marginal (Less than 1 hectare)	71179 (61.6)	75408 (62.3)	28121 (17.2)	29814 (18.7)	0.40	0.40
Small (1.0 to 2.0 hectares)	21643 (18.7)	22695 (19.0)	30722 (18.8)	32139 (20.2)	1.42	1.42
Semi-Medium (2.0 to 4.0 hectares)	14261 (12.3)	14021 (11.8)	38953 (23.8)	38193 (24.0)	2.73	2.72
Medium (4.0 to 10.0 hectares)	7092 (6.1)	6577 (5.5)	41398 (25.3)	38217 (24.0)	5.84	5.81
Large (10.0 hectares and above)	1404 (1.2)	1230 (1.0)	24163 (14.8)	21072 (13.2)	17.21	17.12
All Holdings	115580 (100.0)	119231 (100.0)	163357 (100.0)	159436 (100.0)	1.41	1.33

Note : Figures in parentheses indicate the percentage of respective column total.

* Excluding Jharkhand

Source : Agricultural Census Division, Ministry of Agriculture, New Delhi.

There were about 10.27 Crores of 'farmers' families' engaged in Agriculture in 2000-01. However, out of this, 6.13 Crores constituted 'Marginal category' i.e having hardly 1 Acre or less of average operational holding. Further, 2.09 Crores of farmers families comprised of 'small category' having average operational holding between 2.50 Acres to 5 Acres and 1.30 Crores constituted 'semi-medium' category with average operational holdings between 5 Acres 10 Acres. In other words, nearly 60 percent of farmers families were surviving barely on 1 Acre or less in 2000-01 and another 20 percent on 2 to 5 Acres . Is TF aware of this disturbing state of Agriculture sector?

Fifthly, the recommendation to keep the food items sold through PDS i.e. wheat, rice and sugar outside GST is neither a relief nor a consolation. The vast difference in the figures of the Planning Commission Data and Tendulkar Committee's Report in respect of BPL people would mean that nearly 10 Crores (roughly 10 percent of the population) were already outside the scope of PDS in 2004-05. Besides, for a common man barely surviving against the onslaught of food inflation, the increased burden of taxes on other food items would simply be killing.

Lastly, the comprehensive coverage of food items (with exception of wheat, rice and sugar) in GST would translate into a whopping additional tax burden of nearly Rs.70,000 Crores ! Is the 'common man' of this country ready for this type of back- breaking burden? Incidentally, TF's Report is completely silent on the expected rise in revenue due to coverage of the Agricultural goods and services in GST framework.

Much more can be said on this recommendation of TF. However, suffice to say that the recommendation is fraught with disastrous consequences, is impractical and shows complete ignorance of the ground realities. It is indeed strange that such bold recommendation could even be made by TF!

Whatever may be the case, any attempt to bring the food sector comprehensively into the GST framework should be 'nipped in bud'.

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2.4.6 Financial Services:

Recommendations of EC:

The First Discussion Paper is silent on the inclusion of financial services into GST framework.

Recommendations of TF:

TF has recommended that the consumption of financial services should be comprehensively taxed under the GST framework. The choice of the method i.e. addition method, subtraction method or cash flow method may be based on administrative and compliance consideration.

Comments:

The inclusion or otherwise of financial services in GST is a vexed and complicated issue. Financial services are exempted from VAT in almost all countries. The main reason behind this is that the charge for the services provided by various financial intermediaries is generally not an explicit fee but taken as a margin that is hidden in interest, dividends, annuity payments etc. The issue of measuring the consideration would therefore arise which would lead to complexities.

In India, service tax is already being levied virtually on all financial services where the consideration is in the form of an explicit fee. Not only this, the levy has gone beyond this and selected margin services are also brought within the service tax net.

However, while deciding the scope and design of GST for financial services, the characteristics of the economy and the financial sector will need to be taken into consideration. The compliance and administrative issues also need to be considered. Though, the progressive revenue objective dictates wide

application of GST and bringing financial services within its fold, it is important to consider the extent to which taxation versus exemption will create competitive distortions and significant behavioral changes.

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2.4.7 Transport Services:

Recommendations of EC:

The 'First Discussion Paper' is silent on this aspect.

Recommendations of TF:

TF has suggested the rationalization of the taxation regime for transport services and made the following recommendations:

- (i) The tax on vehicles and the tax on goods and passengers levied by the State Governments should be subsumed in the GST.
- (ii) All transport equipments and all forms of services for transportation of goods and services by railways, air, road and sea must form an integral part of GST.
- (iii) The tax regime for transport equipments and transport services should be the same as in the case of any other normal good.
- (iv) The present practice of levying higher rates of taxes on vehicles should be discontinued.

Comments:

Undoubtedly, the taxation of 'transport equipments and transport services' has always been a thorny issue. Logic and pragmatism dictate that this sector should be comprehensively covered under the GST.

In his address at '3^d National Conference on GST for Accelerated Economic Growth and Competitiveness', Dr. Vijay Kelkar has commented as under:

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"Another possible step to expand the GST tax base will be the inclusion of rail sector. This will be necessary if a level playing field to be provided to the road and air transportation sectors which will be subject to this tax. This inclusion will also ensure that all inter state transportation of goods can be tracked through the proposed IT network. The railways themselves will benefit from this by availing input tax credit on the significant purchase made by them".

A step in this direction was taken in Budget, 2009 presented on 6th July, 2009 when the transportation of goods by Indian Railways and Inland Waterways was brought under the service tax net. However, as apprehended, the firebrand 'Didi' swung into action and finally, prevailed upon the Finance Ministry to exempt the Indian Railways from the levy!

Similar was the case for Road transportation sector. The history of attempts to bring this sector under service tax net has been a chequered one and not much inspiring. The powerful transport lobby, on imposition of service tax, had taken the country to ransom for quite a few days and finally, the Government had to succumb to its pressure and scrap the levy initially. The levy of service tax was introduced only later and that was also under 'reverse-charge-mechanism', whereby any specified person paying the freight has been made responsible to pay service tax, albeit, after abatement of the prescribed percentage.

The Road Transportation Sector is still largely unorganized and bringing it within GST fold is not going to be easy by any means. At the same time, it is also imperative that for effective tracking of all intra-state and inter-state transportations in goods, the road transport sector is comprehensively brought under the GST. This can certainly check – if not completely eliminate – the underground or unreported transactions in goods. It shall be noted that

the resistance of Road Transport Sector to levy of service tax was not only due to administrative complexities or financial burden but also because of its apprehension that all transactions would be susceptible to scrutiny by the tax officials as the same would be reflected in records.

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Be that as it may, there is a strong case for the comprehensive coverage of 'Transportation Sector' into GST framework.

2.5 Rate of Tax:

Recommendations of EC:

EC has recommended a multiple rate structure for goods as under:

- lower or reduced rate for necessary items and goods of basic importance
- standard rate for goods in general
- special rate for precious metals
- exempted items.

As for services, EC has observed that there may be a single rate for both CGST and SGST.

However, the exact value of CGST and SGST rates, including the rate for services has not been specified by EC.

Recommendations of TF:

TF, on the other hand, has strongly pitched for one positive rate, each for CGST and SGST on all goods and services with minimum exemptions. The exports of all goods and services are to be zero rated.

The recommendations of TF are summarized below:

- i) The rate of CGST and SGST of all non-SIN goods should be fixed at single rate of 5 percent and 7 percent, respectively.

- ii) A formula-based devolution of 2 percent of collection of SGST by the State Governments to the third-tier of Government (due to abolition of entry tax/octroi duty etc.) after an appropriate Constitutional amendment.

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- iii) Pending Constitutional amendment, the devolution to third-tier of Government should continue to be made on the basis of the recommendation of the State Finance Commission.
- iv) Both, the Central and State Governments may continue to levy taxes, in addition to the CGST and SGST, on various non-SIN goods as at present.

Comments:

As is evident, the recommendations of EC and TF on the "Rate of GST" are diametrically opposite. Whereas EC has suggested a multiple rate structure within overall GST framework, TF has strongly recommended a single positive rate each of CGST and SGST (with bare minimum exemptions) on all goods and services.

No doubt, as observed by TF, the choice of a single rate or multiple VAT rates is highly controversial. A single rate is hugely favoured by Economists, Trade, Industry and of course, the tax administrators. The multiplicity of tax rates leads to classification disputes, economic distortions, increased cost of compliance and administrative nightmares. It is also not a very effective and elegant way of helping the low income people.

However, without undermining the efficacy of a single GST rate, let us also keep in mind the fact that TF, like EC, has also recommended a dual GST Model comprising of CGST and SGST to be levied concurrently by the Centre and States on a common tax base. It has recommended CGST at 5 percent and SGST at 7 percent, the combined tax rate or RNR thus being 12 percent. It means that the recommendation of TF to have one positive rate each for CGST and SGST on all goods and services would result into the combined tax burden at the rate of 12 percent on all goods and services. The question here is whether such high incidence of tax – irrespective of its

perceived simplicity and efficacy – can be considered as reasonable ? Is it desirable and acceptable? It is inconceivable that items of mass consumption, industrial inputs, consumer durables, luxury items etc. are all subjected to the same tax burden of 12 percent (CGST at 5 percent and SGST at 7 percent)!.

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It is pertinent to note here that once certain goods and services are identified as 'necessities of life', its consumption is inevitable, irrespective of the financial status of the person. That being so, the issue of rich also getting the benefit of lower rate of tax on such necessities becomes irrelevant. The prime consideration here is what tax a person with a limited income can bear. It is not the benefit unjustifiably being enjoyed by rich people. It is also a common experience that with the increased tax burden, a person with low income is forced to curtail the consumption of even basic necessities of life, mostly at his own peril. Further, in our country where a substantial part of population either lives below poverty line or barely manages to make two ends meet, it is not at all desirable to have a single positive rate, each of CGST and SGST on all goods and services.

The debate over the desirability of single GST rate and inevitability of multiple rates is endless. However, in the context of Indian Economy and considering its present state, the recommendation of EC to have multiple rate structure appears to be quite justifiable and reasonable. A single VAT rate can be kept as an ideal in sight and multiple rate structure can be considered as a transitory step towards it. At the same time, it shall be ensured that the list of items (i.e. goods and services) eligible for the lower rate is well defined and there is a complete harmony amongst the Centre and the States/UTs over the list. While fiscal autonomy of the States ought to be recognized and the States shall have flexibility to levy SGST at different rates for compelling and justifiable reasons, it should not result into 'Rate-war' amongst the States as has happened in VAT regime at present. Preferably, a ceiling on number of rates that can be levied by the States in exigencies can be prescribed and no discrimination should be allowed in the matter of coverage of all goods in a particular category. Also, there should be a consensus amongst the States not to go below specified floor rates even while prescribing a different rate on a given category of goods.

2.6 Threshold Limits:

EC has recommended a threshold of gross annual turnover of Rs. 10 lakhs both for goods and services for all the States and UTs. EC has also stated that the States considered that the threshold for CGST for goods may be kept at Rs. 1.5 Crore as reasonable and that the threshold for services should also be appropriately high.

As per Compounding/Composition scheme, EC has recommended gross annual turnover of Rs. 50 lakhs with floor rate of 0.5% across the States.

Recommendations of TF:

TF has, however, recommended that small dealers (including service providers) and manufacturers should be exempted from the purview of both, CGST and SGST if their annual aggregate turnover (excluding both CGST and SGST) of all goods and services does not exceed Rs. 10 lakhs.

TF has further recommended that small dealers with annual aggregate turnover of goods and services between Rs. 10 lakhs and Rs. 40 lakhs may be allowed to opt for a compounding levy of one percent each of CGST and SGST.

TF has also recommended that dealers in high value goods i.e. precious metals and articles thereof or precious stones, subject to the threshold exemption but without the ceiling of Rs. 40 lakhs, may also be allowed to opt for the compounded levy of one percent each towards CGST and SGST.

Comments:

The issue of threshold exemption is yet another vexatious and debatable one and not as simple as it seems.

Whereas a higher threshold for SGST may result into the substantial erosion of tax base in certain States, the varying thresholds will be inequitable, result into tax induced migration and is not desirable.

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Yet another crucial issue that arises here is the level of threshold - should it be high or low ? Too high a threshold will compromise the basic objective of raising revenue. On the other hand, too low a threshold will be an administrative nightmare and substantially increase the compliance cost. A delicate balance is therefore required between these two extremes.

It is imperative that small firms are exempted from the levy on certain basis. Whereas gross turnover is not a very ideal solution, it is found to be the most practical, simple and feasible approach and adopted in most of the VAT-compliant countries.

Another issue that needs to be addressed relates to the uniformity of threshold both, for CGST and SGST and for all goods and services.

Prescribing varying threshold for CGST and SGST and for goods and services may result into confusion, chaos and complications. Under the proposed GST Model, cross-utilisation of CGST and SGST credit will not be permissible. Therefore, if a lower threshold is prescribed for SGST compared to the threshold for CGST, a Dealer will be forced to forgo the ITC benefit of CGST till he exhausts the CGST threshold though he will be eligible for ITC benefit of SGST once he cross Rs.10 akhs threshold for SGST. Obviously, this is not a very ideal and healthy scenario.

Complications and distortions would also arise when we take into consideration the levy of IGST and ITC benefit thereon. Since IGST is recommended to be a combined rate of CGST and SGST and is freely vatable, the ITC benefit of IGST available to a Dealer would be much higher than SGST payable by him when he crosses the threshold of Rs. 10 lakhs but remains exempted from CGST on account of higher CGST threshold. This will either result into unintended accumulation of ITC or call for some

artificial restrictions on availment of IGST Credit in case of a Dealer whose turnover is below the CGST threshold but exceeds the SGST threshold. Obviously, this is not desirable at all.

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Varying thresholds will also lead to other administrative complexities including the difficulties in maintenance of records for the purpose of availment and utilization of ITC by a Dealer on various input purchases.

These are only a few examples of the issues which may arise on account of the varying thresholds for the purpose of SGST and CGST and for goods and services.

The issue of threshold will, therefore, be required to be deliberated upon very carefully. Both, the Centre and the States/UTs will have to take into account various conflicting factors, besides revenue considerations and administrative issues while determining the threshold.

2.7 Treatment of Inter-state transactions:

Recommendations of EC:

EC has suggested the adoption of **Integrated GST(IGST) Model** for taxation of Inter-State transactions of goods and services. The IGST Model will operate in the following manner:

- IGST would be combination of CGST and SGST applicable to all Inter-State transactions of taxable goods and services;
- There will be appropriate provision for consignment or stock transfer of goods and services;
- The Inter-State seller will pay IGST on value addition after adjusting available credit of IGST, CGST and SGST on his purchases;

- The Exporting State will transfer to the Centre the credit of SGST used in payment of IGST;
- The Importing Dealer will claim credit of IGST while discharging his output tax liability in his own State;

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- The Centre will transfer to the Importing State the credit of IGST used in payment of SGST;
- A Central Agency will be set up which will function as a clearing house mechanism who, on the basis of relevant information submitted to it, verify the claims and inform the respective Governments to transfer the funds.

Recommendations of TF:

TF has recommended a 'Modified Bank Model' for the purpose of tax treatment of Inter-state transactions of goods and services under GST framework.

The manner in which 'Modified Bank Model' will operate is not being detailed here. However, after explaining the working method of 'Modified Bank Model', the TF has finally recommended as under:

- (i) all inter-state transactions in goods and services should be effectively zero rated by adopting the Modified Bank Model along the lines discussed in the aforesaid paragraphs,
- (ii) the consignment sales and branch transfers across states should be subject to treatment in the same manner as if it was a inter- state transaction in the nature of sale between two independent dealers,
- (iii) the function of all state border check posts should be reduced to checking contrabands by setting up large scanners for trucks to pass through without any need for physical verification,
- (iv) the cost of the scanners should be entirely borne by the Central Government,

- (v) all check -posts should be jointly named by both states so as to reduced the number of check –posts and enhance efficiency in the road movement of goods.

Comments:

At the outset, it may be said that it is indeed unfortunate that inspite of the 'Bank Model' apparently having been rejected by EC and an IGST model prescribed instead, TF has struck to its ground and proceeded to recommend a 'Modified Bank Model'. Incidentally, the details of 'Original Bank Model' are not within the public domain. Such varying recommendations on an important issue of the tax treatment of the 'inter-state transactions of goods and services' only tend to create confusion and chaos everywhere.

Having said so, the IGST Model suggested by EC is probably the most unique and innovative feature of the entire GST Model as recommended by EC. At present, Inter-State transactions of goods are taxable under the Central Sales Tax Act, 1956 and CST @ 2% is levied thereon. CST however is being collected and retained by the originating State only and no Input Tax Credit is available thereof. Presently, Inter-State supply of services are out of the purview of CST since only service tax is levied on the taxable services in terms of the provisions of the Finance Act, 1994.

The proposed IGST Model which would replace the existing levy of CST is quite interesting and advantageous in many ways. IGST has the following advantages:

- ⇒ *It will maintain an uninterrupted ITC chain on Inter-State transactions and thereby avoiding the break in credit chain, cost inflation and pricing distortions;*
- ⇒ *IGST would ensure that the Inter-State seller or buyer is not required to make any upfront payment of tax and so his funds would not get blocked;*
- ⇒ *There will not be any necessity to claim refund in Exporting State as ITC is used up while paying the tax;*
- ⇒ *The Model is 'self-monitoring' in nature;*

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- ⇒ *As the transfer of funds are between the Centre and State/s, the Exporting/Importing Dealers do not come into the picture nor is there any transfer of funds between the States;*
- ⇒ *Model is capable to take 'Business to Business' (B-2-B) as well as 'Business to Consumer' (B-2-C) transactions into account;*
- ⇒ *All Inter-State Dealers will be E-registered and correspondence with them will be by E-mail which is expected to improve the compliance level substantially.*

The claimed simplicity and advantages of the 'Modified Bank Model' recommended by TF pale in comparison to the IGST Model suggested by EC. The arguments advanced by TF in support of 'Modified Bank Model' do not appear to be convincing and the adoption of IGST Model recommended by EC is certainly advisable and preferable.

3. Comments on Implementation-related Issues:

The following issues are dealt with here:

- (i) Harmonization;
- (ii) Infrastructure;
- (iii) Timeframe of implementation.

3.1 Harmonization:

3.1.1 The harmonization of various dimensions of GST laws is inevitable for the purpose of smooth implementation of a 'flawless GST framework' in the country. Thus, the various aspects like tax-base and rates, tax legislation, procedural aspects of the legislation and tax administration need to be harmonized between the Centre and the States.

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3.1.2 Ideally, there should be a common GST legislation providing for both, CGST as well as SGST to be levied by the Central and the State Governments. EC, in its Paper has already hinted that there will be a separate legislation for CGST and separate legislation for SGST and Rules and procedures for CGST and SGST. However, since both the components of GST i.e. CGST and SGST would be concurrently levied by the Centre and the States on a common tax-base, there is no reason why there cannot be a single legislation governing both?

However, if it is inevitable to have separate legislations, one for CGST and other State Legislations for SGST, it is imperative that the fundamental concepts such as chargeability, definition of taxable event and taxable person, measure of levy, valuation, basis of classification, Rules relating to 'place of supply of goods or services' are fully harmonized and are uniformed across these legislations.

3.1.3 The Rules and procedures governing the operation of GST system through its two components should also be suitably harmonized which would go a long way in reducing the cost of implementing of GST at States' level and also the compliance cost.

It is also highly desirable that both the laws are administered by a common authority which would imply a common registration, common payment of taxes, common format of invoice and return, common filing of returns, common assessment and audit and so on.

3.1.4 Even while adopting a multiple rate structure under GST, the endeavor should be made to have a mechanism in place whereby the agreed rate structures for various items (whether under lower rate or standard rate or exempted category) is not tinkered with by the Centre or States/UTs unilaterally. There should also be a consensus amongst the Centre and the States/UTs so far as the list of exempted goods and services is concerned. Sincere efforts are also required to have a uniform threshold or at least, a varying threshold of minimum degree, for SGST and CGST as well as for goods and services to avoid economic distortions, administrative complexities and litigation.

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3.1.5 Last, but not the least, without undermining the fiscal autonomy of the States, there shall be a mechanism in place which ensures that the basic features of GST are maintained and any changes therein are made only with the concurrence of all the States/UTs and the Centre.

3.2 Infrastructure:

3.2.1 It is undisputed that for the effective implementation of GST, a robust and comprehensive IT infrastructure is a must. Particularly, to ensure tax compliance, check tax avoidance or tax frauds in the matter of Inter-state transactions in goods or services, the States shall be incentivized to put in place a system which has to be IT based. The Centre can play a role of catalyst in this regard.

3.2.2 An effective IT system to capture transaction level data was recognized by European Commission as sine qua non for effective implementation of seamless GST system. In the absence of such IT System with wide area network and appropriate server backup, the introduction of GST will not only create chaos but will also be an open invitation to the scamsters and fraudsters.

3.3 Timeframe of implementation:

3.3.1 The implementation of GST is scheduled for 1st April, 2010. However, it is now almost certain that this deadline cannot be met due to political, administrative and legislative constraints.

3.3.2 While EC has not set any timeframe for the implementation of GST, TF has recommended a new deadline of 1st October, 2010 for rolling out GST. Without going into the propriety of TF to push forward the deadline by going beyond its mandate, it is essential that no artificial deadlines are set for the introduction of GST.

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Considering the abysmal level of awareness and preparedness amongst the trade, industry and the revenue officials of the Centre and the States, the hasty implementation of GST shall be avoided at all cost.

3.3.3 Here, it would not be out of place to state that before issue of the First Draft of Legislation in respect of GST in July, 2000 in Australia, the trade and industry there had a breather of 21 months. Needless to say, in our country, and taking into accounts its existing peculiarities and complexities in the indirect tax regime at Central and the States level and also the level of education amongst the people, a sufficient time would be require to be given to all the stakeholders to enable them to understand the various nuances of the GST framework and prepare for the same.

4. Comments on Impact-related issues:

The following issues are briefly discussed here:

- (i) GST and its impact on prices;
- (ii) GST and exports;
- (iii) GST and check on cash economy.

4.1 GST and its impact on prices:

4.1.1 It is being claimed by all that GST will have a positive impact on the prices and will benefit the common man and the poor people the most.

4.1.2 However, it is too early to make any such claims. No doubt, the GST will reduce the cascading effect of 'tax on tax' but that does not mean that the prices of the goods (including essentials) or services will come down. The prices of goods or services are determined, particularly in our country, by the market forces like demand and supply and such other factors. The imposition of or withdrawal of tax does not really determine the prices of a given product. It may happen that the imposition of a levy may result in increase in the prices with the supplier conveniently passing on the burden to the consumer.

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However the prices need not - and rarely - come down when the tax is withdrawn or rebated in any manner, say by granting input tax credit as under GST. It is a matter of common experience that such benefit of credit or other rebate in any form is generally retained by the suppliers, whether manufacturers or traders or service providers, and is rarely passed on to the consumers unless there are compelling circumstances to do so.

4.1.3 While introducing VAT at States level in and after April, 2005, it was claimed that the same will result into bringing the prices of various commodities to reasonable levels. However, the actual picture that has emerged in last four years is entirely different.

4.1.4 Therefore, one should not have that illusion that the GST will automatically bring down the prices of goods or services. One should adopt a 'wait and watch' attitude so as to avoid any disappointment at a later date.

4.2 GST and Exports:

4.2.1 One of the positive features of GST is that the exports are 'zero rated' under GST meaning thereby that all the input-stage taxes are refunded to the exporter of goods or services under GST. Obviously, this will have a positive

impact on exports which will get the fillip on account of the removal of burden of domestic taxes and making the exports internationally competitive.

- 4.2.2 However, to make the exports really 'zero rated', it is imperative that all – or the maximum - indirect taxes on goods or services presently being levied by the Centre and the States are subsumed under GST. Unless this happens, it cannot be said nor claimed that the exports are 'zero rated'.

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- 4.2.3 At present, there are numerous non-vatable (unrebated) Central/State Indirect taxes/levies like CST, electricity duty, sales tax on petroleum products, entry tax/octroi, turnover tax, mandi tax etc., the cumulative impact of which on exports is substantial. According to the estimates of the Ministry of Commerce, the cumulative effect of such unrebated taxes/levies range from 3% to 12% of the FOB value based on the product and its state of origin. The financial implications on rebate of State cumulative non-vatable Indirect taxes will vary with the coverage of the scheme. As per the rough estimate of the Ministry of Commerce, average rate for such rebate on exports would be 3.01% i.e. 2.74% (for the components of electricity duty, sales tax on petroleum products and CST @ 2%) plus 0.27% (approx. for the component of octroi, mandi tax, turnover tax, entry tax etc.). With the abolition of CST under GST regime, the surrogate average rate will be 1.89% according to the estimate. India's Merchandise export turnover is estimated to be US\$ 234 Billion (Rs.9828 Billion approx.) by 2010 and US\$ 660 Billion (Rs.27,720 Billion approx.) at the terminal year of the Thirteenth Finance Commission Award. Hence, as per the estimates of the Ministry of Commerce, the financial implication on rebating of these unrebated States Indirect taxes will be around Rs.18,500 crores for exports of US\$ 234 Billion and Rs.52,390 crores for exports of US\$ 660 Billion.

4.2.4 It is obvious that the cumulative financial burden of the non-vatable Indirect taxes levied by the States is substantial, to say the least. Unless this burden is removed by effectively subsuming all such taxes in GST, the exports cannot be really considered 'zero rated' under GST. Not only this, as most of the State Governments have their own constraints to refund such taxes to the exporters, a suitable mechanism will have to be evolved with the active role being played by the Centre for the refund of such taxes to the exporters under the GST regime.

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4.3 GST and cash economy:

4.3.1 Finally, the eternally debated question – whether GST will wipe out or control the cash economy?

4.3.2 The optimists claim that as the transactions in goods or services will leave an audit trail under GST regime, it would be easier for the tax officers to unearth any malpractices and tax frauds. This would substantially control the growth of cash economy and in the long run, may even wipe it out.

4.3.3 However, there is no empirical evidence anywhere in the world that the introduction of GST or VAT has achieved any such outcome. On the contrary, what is being witnessed, even in developed countries, is an entirely different scenario. In Australia, for instance, a Study was conducted on the extent of black economy in the country in 2002-03 (GST was introduced in Australia in July, 2000). According to the Study, the black economy was estimated to be upto 15% of GDP of \$ 740 Billion. That means that the extent of the black economy was as high as \$ 110 Billion.

In New Zealand, the cash economy is estimated to have doubled in the initial years of the introduction of GST.

On a modest estimate, UK loses annually over 10 billion sterling pounds of VAT through Missing Trader and Carousel Frauds while other EU countries collectively lose about 100 billion Euros annually on same account.

In Canada, since the inception of GST in 1991 till March, 2003, about 600 individuals and businesses have been convicted of GST related frauds.

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4.3.4 Some of the common malpractices or frauds associated with GST or VAT are:

- Availment of input credit on fictitious or bogus invoices;
- Exaggerated refund claims;
- Underreporting of sales (with a view to avoid tax or remain within the threshold);
- Non-registration;
- Collection of tax, but non-deposit with the Government;
- Claim of credit on taxable supplies used for exempt activities;
- Carrousel fraud (as in EU);
- Cloning fraud etc.

4.3.5 It may be therefore too early to claim that the GST will stop the growth of cash economy or completely wipe it out. Though, it may be possible to detect and control some of the malpractices/fraudulent activities listed above mainly with the help of an effective IT system, it may be too much of an optimism that GST will put an end to such malpractices etc. for good. Let us not forget that most taxpayers are prepared to pay their fair share of taxes if they believe that

others are also paying their fair share. However, that does not always happen and that is precisely why the underground economy may continue to grow in future, with or without GST.

5. **Conclusion:**

India is at the threshold of a unique era which would witness fundamental reforms in the field of taxation, both direct and indirect. A Direct Tax Code (presently under Intense debate), the proposed IFRS, the Companies Bill, 2009 (already tabled in the Parliament) and not the least, the proposed GST regime are capable of changing the face of the Indian Economy. Such opportunities of fundamental reforms or paradigm shifts do not present themselves frequently and the same have to be seized with vigour and enthusiasm. The changes which are being debated in the Direct and Indirect Taxes and even in Corporate Legislation will have long term and far-reaching implications. The implementation of these reforms will therefore require not only long term perspective, but also delicate balancing act between the Centre and the States and also amongst all the stakeholders which in turn, would call for pragmatic and dynamic approach.

“Where the mind is without fear and the head is held high;
Where knowledge is free;

Where the world has not been broken up into fragments
By narrow domestic walls; ...

Where the clear stream of reason has not lost its way
into the dreary desert sand of dead habit;...

'Into that heaven of freedom, my Father, let my country awake.'

(Rabindranath Tagore)