Price: Rs.250/-
US $ 30
ISBN 81-900518-0-6

Published by N. Natarajan for National Institute of Public Finance and Policy, 18/2 Satsang Vihar Marg, Special Institutional Area, New Delhi - 110 067
Printed by Rachit Printer, New Delhi-68

Reform of Domestic Trade Taxes in India: Issues and Options

Report of a Study Team

1994

National Institute of Public Finance and Policy
New Delhi - 110 067

Study Team

Team Leader : A. Bagchi, NIPFP

Members : Mahesh C. Purohit, NIPFP
S. Venkatarama Iyer, NIPFP
O.P. Gahrotra, IAS, Government of Maharashtra
Pawan K. Aggarwal, NIPFP
A.V.L. Narayana, NIPFP

Consultants

Satya N. Poddar, Ernst & Young, Toronto, Canada
Sijbren Cnossen, Erasmus University, Rotterdam, Netherlands

Research Assistance

Hasheem N. Saleem
Vishwa N. Alok
H.K. Nath
R.R. Barman
Soumya Kanti Ghosh

FOREWORD

The study on the Reform of Domestic Trade Taxes in India was undertaken by the NIPFP at the instance of the Ministry of Finance, Government of India. The objective of the study is to design a possible system of Value Added Tax (VAT) for India on which there could be a broad agreement among the Centre and the States.

The urgency of reforming the chaotic and complex system of domestic trade taxes that is operating in the country at present and the need for moving towards a system of VAT are generally acknowledged. In a country with a federal structure where, as in India, the powers of indirect taxation are fragmented between different levels of government, devising a scheme of VAT that would be acceptable to both the Centre and the States is no mean task. The study addresses this task by first reviewing the existing system to identify its glaring deficiencies and problems. Keeping in view the objectives and the parameters, the study avers that a destination based consumption type VAT would provide effective remedy for most of the ills of the present system. After a brief narration of the characteristics and mode of computation of a VAT, it spells out the options for VAT in the Indian context and proceeds to outline a design that could find a consensus. An attempt is also made to provide an idea of the revenue implications and economic impact of the proposed reform. The legal, administrative and institutional requirements are also gone into briefly.

After considering the various options, the study concludes that, given the constraints, solutions which might look ideal in principle may not work and, therefore, it is advisable to move towards a system that can be devised within the existing constitutional framework and implemented in the near future. Reform even on these lines would call for a major endeavour on the part of the governments concerned, the people and the political leaders. The authors would feel rewarded if the study helps to initiate an awareness of how urgent the task is and a debate on the issues and options.

The study was carried out by a team set up at the Institute led by A. Bagchi. Besides members drawn from the Institute's academic staff, the team included O.P. Gahrotra and S. Venkatarama Iyer who, as senior administrators, had intimate knowledge of the operation of internal commodity taxes in the country. Contacts were also established with the Commissioners of Commercial/Sales Taxes in the States and meetings were held in several rounds to discuss the issues and options for reform and seek their views at an informal level. Representatives of the Ministry of Finance and most States and Union Territories participated. The study benefited immensely from their interaction. In fact, it would not have been possible to formulate the proposals put forward in the study without their insight, interest and active participation in the deliberations. The team also made presentations on VAT at conferences of Commissioners of Commercial/Sales Taxes at Jaipur and Amritsar and in seminars organised by Chambers of Commerce and Industry.

The Institute also had the benefit of consulting some internationally renowned experts. Satya N. Poddar who had helped to design a VAT in Canada was associated with the study right from the beginning. The Institute gratefully acknowledges the generous support provided by Canadian International Development Agency (CIDA) for securing his services. A visit by Sijbren Cnossen, a well known authority on VAT helped the team in getting the bearings right and avoiding pitfalls. Thanks are due to UNDP for funding his visit.

The team profited from the earlier work of Nicholas Stern and his colleagues at the London School of Economics on the Reform of Indirect Taxes in India.

While the study is the product of collective effort of the team, the report was drafted largely by A. Bagchi in collaboration with Satya Poddar. Background papers on the administrative requirements and on the operation of VAT in the European Union and Brazil were prepared by Mahesh C. Purohit. Proposals for reform of the Union excises were drafted by Venkatarama Iyer. Valuable inputs on the sales taxes were provided by O.P. Gahrotra.

Substantial contributions were also made by Pawan K. Aggarwal and A.V.L. Narayana. Pawan Aggarwal helped in revising the drafts. The analysis of revenue implications was carried out mainly by him and A.V.L. Narayana in consultation with State government officials. The Institute intends to bring out a Technical Note shortly to provide a more detailed description of the methodologies and data relied upon.

The Governing Body of the Institute does not bear any responsibility for the contents or views expressed in the report. That responsibility lies with the authors, in particular, the leader of the team.

The Institute is grateful to the Ministry of Finance for entrusting and supporting this study.

29 April 1994

A. Bagchi
Director

ACKNOWLEDGEMENTS

The Study team is deeply indebted to the Sales tax administration of the States for their help and cooperation.

Of the State officials with whom the team had close interaction throughout, special mention should be made of S.A. Subramani and T.V. Somanathan (Tamil Nadu), S.R. Govinda Rajan (Andhra Pradesh), K. M. Sahni (Delhi), Anil Vaish (Rajasthan), C.K. Thanu Pillai (Kerala), and V.S. Gopalakrishnan (Maharashtra). The Institute is deeply indebted to them for giving of their time generously and coming over to Delhi for consultation whenever requested. Thanks are due to Justice Radhakrishna Menon, Chairman, Commission for Taxation Laws, Kerala for attending some of the meetings organised by the Institute for discussion. M.K. Kaw of the Ministry of Finance took keen interest in the study and lent his good offices in securing support for the team whenever needed.

The team is indebted to several scholars and experts for ideas, suggestions and comments on drafts. Thanks are due particularly to Raja J. Chelliah, Nicholas Stern, Stephen Howes, I.S. Gulati, M.G. Rao, Arindam Dasgupta and M.R. Narayana.

Valuable contributions were made by members of the research staff, viz., Hasheem Saleem, V.N. Alok, H.K. Nath, R.R. Barman and Soumya Kanti Ghosh.

R. Parameswaran bore most of the burden of word processing successive drafts of the report. Anil Sharma also shared the task especially in the final stages. Their devotion to work deserves special commendation. The Production Unit led by N. Natarajan performed the task of bringing out the preliminary drafts and the final report efficiently and cheerfully. The team wishes to place on record its deep appreciation of their labours and the care taken by them to see the work through expeditiously.

The team alone is responsible for the errors and omissions.

CONTENTS

LIST OF BOXES IN THE TEXT

LIST OF CHARTS IN THE TEXT

LIST OF STATEMENTS IN THE TEXT

LIST OF ANNEXURES IN THE TEXT

Page #

LIST OF TABLES IN THE TEXT

Page #

Page #

LIST OF TABLES IN THE APPENDICES

Page #

SUMMARY

1. Introduction

Domestic trade taxes in India are in urgent need of reform. The system that is operating at present is archaic, irrational and complex - according to knowledgeable experts, the most complex in the world. It interferes with the free play of market forces and competition, causes economic distortions, and entails high costs of compliance and administration. The rapid economic growth that is occurring in many Asian countries will bypass India, if, among others, its antiquated system of domestic trade taxes is not reformed.

2. Costs of the Present System

The manner in which the taxes on domestic production and trade are currently levied and administered causes:

- Loss of output growth and welfare;
- Inefficiency and high cost in industry and trade;
- Impediments to the free flow of trade within the country and growth of the common market that the Indian Union offers;
- Inter-jurisdictional conflicts;
- Handicap for exports; and
- High costs of compliance and enforcement.

2.1 Basic problems

The costs enumerated above stem essentially from the following features of the present system:

- Levy of taxes at the manufacturer level/first sale point;
- Exclusion of services from the tax base;
- Taxation of inputs and capital goods;
- High level and multiplicity of rates;
- Taxation of inter-State sale and lack of harmony in States' sales tax systems; and
- Complex laws and archaic administration.

2.1.1 Taxation at manufacturer level/ first sale point

Under the Constitution, the bases of excise duties and sales taxes, the two principal components of the domestic trade taxes, are distinctly defined - production of goods in the case of excise, and sale or purchase for the sales taxes. In practice, the two bases have come to overlap. Because of problems in administering taxes at the retail level, most States have moved the point of levy of their sales taxes to the first point of sale, that is, on manufacturers and importers of goods in their respective jurisdictions.

Taxation at the manufacturer level or at the first point of sale encounters intractable problems as the term "manufacturing" is not easy to define. Goods may undergo a change of form due to a variety of processing activities performed after their initial production or manufacturing (e.g., grinding, packaging, blending). There are many processes which constitute only "marginal manufacturing". Attempts to bring them all under "manufacturing" for excise taxation have given rise to disputes and uncertainty. Clarifications have been provided in the law in the form of section/chapter notes to contain the areas of dispute but the uncertainty persists.

Determination of manufacturing value also is equally troublesome. Manufacturers often sell their products through their own distributors or through wholesalers and sometimes directly to the consumers. In determining the assessable value at the manufacturer level adjustments have to be made for legitimate trade margins at different trade levels. Sales between related entities also need careful examination. These problems are aggravated by the exclusion of services from the base.

Taxation of sales at the first point, besides encountering all these problems, increases the risk to revenue in that the entire tax burden is concentrated at one stage. The rates of tax also have to be higher to raise a given amount of revenue than if the base was wider. Higher rates induce evasion and thus call for stringent anti-evasion measures which are not very easy to enforce.

2.1.2 Exclusion of services

The definition of the powers of excise taxation as well as sales tax refers only to "goods" without any mention of services. As a result, neither Central excise nor sales tax can be applied to services. The distinction implicitly drawn in the Constitution between goods and services is not in accord with the realities of modern economies. Services are often an integral part of manufacturing and trade, and the line between goods and services is getting increasingly blurred (e.g., in the manufacture of computer software, desk-top publishing, developing and printing of photographs, photocopying, etc.). Manufacturers may provide a wide variety of services for the goods manufactured by them such as training, advertising, installation and maintenance. Taking advantage of the definitional ambiguities and the exclusion of services, manufacturers have tried to minimise the assessable value of their products by making sales at artificially low values to a related distributor/wholesaler and by claiming discounts for the so-called "post-manufacturing services" (e.g., transportation, installation and warranty services).

Similar problems are encountered in first-point levy of sales taxes too. Apart from technical problems, taxation of goods only at manufacturer/first-point level, that is, on a base that does not include distribution margins and associated services, tends to distort producer and consumer choices. Items which carry large trade margins (as is usually the case with luxury products) are favoured over essential consumer goods. It also provides an incentive for producers to push as many trading functions forward as possible to keep down the assessable value of their products. Exclusion of services from the base also creates a bias against goods and in favour of services (which are usually consumed more by the rich).

2.1.3 Taxation of inputs and capital goods

Left with a base constrained by exclusion of trade margins and services and faced with mounting pressures for revenue, both the Centre and the States have gone on to extend the coverage of their excises and sales taxes to include inputs and capital goods. This leads to cascading and constitutes another major source of economic distortion. Cascading inhibits specialisation and thus efficiency in industrial production. While attempts have been made to alleviate the ill-effects of input taxation through MODVAT in Central excise and concessional treatment or exemption in sales taxation, the distortions persist as the reliefs are inadequate or ineffective. Moreover, no relief is available for taxes paid on plant and equipment. In many States there is now a turnover tax which falls on all commodities including inputs at more than one point of sale but does not get relieved. This causes cascading and induces vertical integration with all its attendant evils.

2.1.4 High and multiple rates

With a narrow base the rates have to be high to raise the same amount of revenue. Where the trade margins are high (in the case of certain consumer durables, the margins can be more than 100 per cent of the ex-factory price) the rate of tax at first point has to be higher than if the margins were taxed. Finding it difficult to raise the level of sales taxes at the first point any further, the States are now resorting to additional levies like turnover tax, additional sales tax, surcharges and so on, making the system totally non-transparent and the tax incidence arbitrary and unpredictable.

All this further aggravates the distortions inherent in a manufacturer's tax. It also provides incentives for evasion and avoidance and generates pressures for exemptions and concessions. One thus witnesses multiplicity of rates based on classification (sometimes hair-splitting) of commodities and sectors with bizarre results. Not surprisingly, the system has proved to be a breeding ground for disputes. Over 30,000 excise cases are pending before the Appellate Tribunal alone (over 12,000 before the High Courts). In some States (e.g., West Bengal) the number of sales tax cases awaiting decision before the appellate authorities is more than 50,000.

2.1.5 Taxation of inter-State sales

Another major source of distortion is the system of taxing inter-State sales under the Central Sales Tax (CST) Act. Though legislated by Parliament, it is administered by the States who also retain the revenue. Operation of the inter-State sales tax implies taxation according to "origin", that is, where the goods are produced, no matter where they are consumed ("destination"). This constitutes a serious impediment to the free flow of trade within the country and is inimical to competition and efficiency. It also conflicts with principles of inter-jurisdictional equity because the producing States can export their taxes to others, constraining the domestic tax base of the poorer consuming States (like U.P., Bihar and M.P.). Four "high income" States with less than 20 per cent of the country's population account for 45 per cent of the total revenue from CST, while the low income States with 44 per cent of the population get 18 per cent of the CST revenue.

The States have been trying to "export" taxes via the CST and at the same time undercutting each other in sales tax rates to attract trade and industry. This has created a situation in which all States are finding it difficult to rationalise their tax structures, and in some States, products like automobiles are currently being taxed at the same low rate as cereals.

Taxation of inter-State sale combined with the tax on inputs encumbers exports since under such a system the incidence of tax on export production cannot be reliably quantified, much less relieved.

Since transfers between the branches of a firm do not constitute "sale", one way of avoiding the CST is to transport goods across State borders as transfer on consignment. With a large part of the inter-State trade now flourishing in several States in the form of consignment transfers, the States have been clamouring for a tax on consignments too. If introduced, this will exacerbate the hindrance caused by inter-State sales tax to the flow of trade within the country and the growth of the common market, and accentuate the disparities in the revenue levels among the States. While the trend all over the world is towards unification of markets to promote competition and efficiency, India is almost the only country going in the opposite direction.

2.1.6 Complex laws and administration

The distortions are compounded by the complexity of the laws and administration. In order to counter avoidance and evasion, the laws have been tightened to help enforcement and elaborate procedures and forms have been laid down. These have, however, not been very effective in the absence of a modern system of information and administration. On the contrary, they have added to the complexities.

The damage caused by the distortions discussed above remains to be quantified. There can be little doubt, however, that the resulting losses to the economy are enormous. It cannot be gainsaid that if trade and industry is to grow, the tax system must be neutral, that is, it should not interfere arbitrarily with producer and consumer decisions. If competition and efficiency are to be promoted, there has to be a level playing field. Neutrality in the domestic market is also a prerequisite for external neutrality, especially in an increasingly competitive world.

3. Directions of Reform

If the ills of the present system are to be remedied, the problems have to be attacked at their roots and not by symptoms. The guiding principles should be neutrality, simplicity and equity. Due note must also be taken of the compulsions of a federal polity and the revenue needs of different levels of government.

It can be demonstrated that the value added tax could provide a solution to most of the ills of the present system. If levied on a comprehensive base including goods and services at a uniform rate, a VAT would help restore neutrality, simplify the laws, reduce litigation and provide an elastic and stable source of revenue.

3.1 Design features of VAT

Introduction of VAT calls for several choices in regard to its design features. Some of the basic questions that arise are: How to compute the tax - by subtraction method or by the tax credit method? Should it follow the principle of origin or of destination? What should be the threshold for a dealer to be liable to pay tax? How to treat farmers and small producers/dealers? What should be the treatment of foreign trade? What about exemptions? Should the base be tax inclusive or should it exclude the tax?

The commonly adopted form of VAT is the destination-based, consumption type, operated through the tax-credit or invoice method. While a single uniform rate enhances simplicity and transparency, VAT is levied in some countries at two rates (one standard rate and another for essential consumption goods) and rarely at more than three. Essentials are also exempted in many countries instead of being taxed at a lower rate. For administrative simplicity, small businesses (that is, those having sales below a specified limit) are left out of the liability to pay VAT.

If VAT is to be introduced in India, the choice should be the invoice operated consumption type with a uniform or at the most two or three rates and a cut off point that would leave out small businesses without undue risk to revenue. Also, if common market is to grow, *the tax should adhere strictly to the principle of destination.*

In implementing the VAT based on the destination principle in a federal country like India two additional important choices centre around the questions: (i) which level of government should levy the tax (the Centre or the States, or both) and (ii) what should be the mechanism for operating the destination rule?

3.2 The options

The options for introducing a VAT in the Indian context are:

i. *A National VAT* - VAT as a National levy implemented through a Parliamentary legislation and administered by the Centre (or the States on behalf of the Centre) replacing both Central excise and sales tax, covering all goods and services, with arrangement for revenue sharing.
ii. *State VAT* - Centre withdrawing from domestic trade taxation and leaving it to the States to levy the tax on domestic trade in the form of VAT, replacing both Central excises and sales taxes (allowing a few special excises on sumptuary and luxury items to be levied by the Centre).
iii. *Dual or Joint System* - Both the Centre and the States levying VAT either concurrently or independently, converting their excise and sales taxes into VAT.

The pros and cons of the various options are briefly discussed below.

3.2.1 A National VAT

A unified system of taxing domestic trade in the form of a national VAT imposed and administered by the Centre would appear to be most attractive from many angles. It would, at one stroke, bring about harmonization and help remove the tax on inter-State trade.

Rough computations show that if applied on a comprehensive base (that is, removing the exemptions but excluding services, with a threshold of Rs 30 lakh and two-thirds of the agricultural output outside the base) a uniform rate of about 18 per cent could be revenue neutral (that is, would yield the same revenue as currently derived from Union excises and sales taxes combined). If services are included in the base, the revenue neutral rate works out to a little over 16 per cent.

Though attractive from many angles, a scheme of tax reform that takes away the most important tax powers of the States and increases their dependence on the Centre would not be acceptable to the States. The

States then would have to depend on the Centre for over 70 per cent of their tax revenue as compared to 32 per cent at present. Nor would that be desirable in principle. It would go against the tenets of fiscal decentralisation which is widely believed to be crucial for the effective functioning of a multi-level system of governance, allocation of resources for public spending according to the preferences of the people and promoting fiscal responsibility at all levels. It would call for a major amendment to the Constitution, which, given the present political configuration in the country, will not be easy to carry out. Moreover, in a vast country like India, the Centre would inevitably have to depend on the States in administering such a tax. (The Central excise department now handles only about 1,50,000 assessees. A nationwide VAT would involve dealing with at least a million taxpayers. For all these reasons this option does not seem to be either desirable or feasible.

3.2.2 State VATs

From the angle of linking spending decisions with revenue raising powers and thereby promoting fiscal responsibility, widening the sales tax base of the States by getting the Centre to vacate the domestic tax field has much to commend itself. In the public finance literature, there is a strong body of opinion that favours assignment of income and capital taxes to the federal government and taxes on consumption to the sub-national levels (although the contrary view is also held by some). The diminution in the Centre's revenues such a scheme would entail could be taken care of by (a) permitting the Centre to levy special (non-rebatable, non-sharable) excises on a few sumptuary items, and (b) bringing down the level of flow of federal funds to the States (devolution of taxes, or grants or both).

However commendable in principle, replacing both Central excises and sales taxes by a regime of State VATs does not seem to be feasible at present. First of all, it would call for a drastic reallocation of tax powers between the Centre and the States, the implications of which need to be gone into in depth. Secondly, it would entail a sharp drop in Centre's revenue since collections from excises contribute about one-third of its total tax revenues at present (Rs 18,000 crore out of about Rs 58,000 crore)[1] and, even with special excises on selected items, the Centre's revenue would drop by at least Rs 12,000 crore. With the revenue from customs dwindling in the wake of liberalisation of foreign trade, the Centre may not be able to balance its budget under such a regime, or be in a position to play a significant role in bringing about some equalization in the level of public services in the country through transfers to poorer States unless: (i) its revenue from income taxes improves dramatically, and/or (ii) the share of the States in the Central revenues comes down sharply, or (iii) the Centre sheds some of its functions or responsibilities. None of these seems likely to come about in the foreseeable future. Moreover, given the uneven quality of sales tax administration in the States, for the Centre to withdraw from the indirect tax field immediately might also be a little too risky for revenue. One also wonders whether it would be possible to set up a destination-based system of domestic trade taxation without Centre's active involvement. In any case, reform along these lines would involve a radical shift in the powers and functions of the Centre and the States which cannot be brought about without a national consensus.

3.2.3 A dual VAT system

For reasons mentioned above, in exploring the possibilities of introducing VAT in India, one has to think of a dual system in which both the Centre and the States share the consumption tax base in a mutually acceptable arrangement.

3.2.3.1 Concurrent VAT

A theoretically appealing variant of the dual system is one in which the Centre as well as the States have concurrent jurisdiction in taxing goods as well as services going up to the retail or final-point sale. Under such a system, there would be a common base for both Central and State VATs. The States

1. As of 1992-93 (R.E).

would have the powers to fix the rates but within a harmonized system of narrow rate bands. Inter-State sales will carry a rebatable Central VAT while State VATs would be zero-rated and taxed by the importing State. A concurrent VAT extended upto the retail stage would get over many of the problems in administering the taxes at the manufacturing level encountered under the present excise system and first-point sales taxes. The evils of tax exporting and hindrance to inter-State movement of goods would also go.

However, effective administration of a concurrent system would call for a degree of coordination between the Centre and the States that is lacking at present and would be difficult to achieve even with the best of intentions. There could also be conflicts between the tax authorities at the two levels over assessment of the base that would not be easy to resolve. Moreover, the administration of a VAT by the Centre beyond the manufacturing level would require the help of the States since the Central Excise Department is simply not equipped to handle the number of dealers who would come within the tax net under a VAT regime even if the threshold is fixed at a relatively high level.

Considering the problems that the Centre would face in implementing a VAT beyond the manufacturing level the Tax Reforms Committee (TRC) of which Prof Raja Chelliah was the Chairman, while recommending that the Central VAT be extended to the wholesale stage, had suggested that the tax on the wholesalers be administered by the States who could also retain the revenue so collected. This, the TRC had felt, would not call for any constitutional change. In essence, however, the TRC proposal would only be a variant of the concurrent VAT and encounter similar problems.

Apart from the conflicts which it might generate, a concurrent VAT would be seen by the States as an invasion into their tax powers. The arrangement favoured by the TRC, viz., the States be called upon to collect the Central VAT at the wholesale stage also does not seem to be very satisfactory as it could also lead to conflicts between the Centre and the States since the VAT paid at the Central level would be rebatable against the VAT leviable by them on wholesalers. Also, if a manufacturer buys inputs from a wholesaler, the Centre would have to give rebate for the tax collected by the States at the wholesale stage.

While designing a model of dual VAT, it is thus advisable to explore ways in which both the Centre and the States can move their respective excises and sales tax systems towards a system of VAT within the framework of the Constitution and improve their implementation through better legal and administrative structures.

3.2.3.2 Independent dual system

Given this background, the only feasible option seems to be a dual system in which the VAT is levied by the two levels of government independently within the existing constitutional framework. This would be possible if the MODVAT now operating through the excise tax system is made into a full-fledged manufacturers' VAT and the States also adopt a destination-based harmonized system of VAT in place of the chaotic sales taxes operating now. Although it would not be the perfect or first best solution to the problems of the present system, reform on these lines would go a long way to remove many of its ill effects and perhaps lay the foundation for an even more rational regime in the future. The main elements of reforms envisaged under this scheme are outlined below.

3.3 A feasible scheme of reform towards VAT

3.3.1 A Central VAT on manufacturers[2]

MODVAT can be reformed and made into a fullfledged manufacturer level VAT with the following measures:

a. Widening of the base to include all goods produced, manufactured or imported and a few selected services;

2. These proposals were drawn up before the Central Budget for 1994-95 was unveiled.

b. Provision for full and immediate credit of input duty to registered manufacturers and producers for
   - all raw materials and parts used in manufacturing;
   - production machinery and equipment for use exclusively in taxable manufacturing; and
c. Rationalisation of the rates to introduce a structure of not more than three rates at the most and eventually a uniform rate. However, excises would also be levied on selected luxury items and commodities with negative externalities.

Measures outlined above might help avoid many of the problems and worries which a concurrent VAT or extension of MODVAT to wholesale traders would give rise to.

Exercises carried out with available data show that with excises converted to VAT and the rates reduced to three (10, 15 and 20 per cent) along with (non-rebatable, non-sharable) excises on a few commodities and tax on selected services, it should be possible to carry out these reforms without large loss of revenue. There could, in fact, be a gain of about Rs 1,000 crore to provide a cushion for the change.

Eventually, in order to keep the burden of taxation by both levels of government within reasonable limits and allow more room to the States, the rate of Central VAT should be brought down to a uniform rate of 10 per cent.

Under a tax rental agreement, the Centre now levies an additional excise duty in lieu of sales tax on three commodities, viz., textiles, tobacco and sugar but the States are unhappy with the arrangement. In a reformed regime of commodity taxes, the States should ultimately get back the powers to tax these commodities even though the Centre would also be free to levy Central VAT on them at appropriate rates.

3.3.2 Reforming State sales taxes into State VATs

Measures which could go a long way to remove the non-neutralities and harmful effects of sales tax systems operating at present and achieve a measure of simplicity would be to:

a. Convert sales taxes into VAT by moving over to a multistage system of sales taxation with rebate for tax on all purchases with only minimal exceptions.
b. Extend the tax base to include all goods sold or leased with minimal exceptions, and services which are integral to the sale of goods. The base should also include services which are predominantly of a consumption nature and can be taxed conveniently by the States.
c. Allow input tax credits for all raw materials and parts, consumables, goods for resale, and production machinery and equipments. (No rebate will be allowed in respect of overhead expenses like repairs, etc., office equipment, construction materials and fixtures and purchases in use for transportation and distribution of goods).
d. Replace the existing structure of tax rates with two or three rates within specified bands, applicable in all States and Union Territories.
e. Remove the exemptions except for a basic threshold limit and items like unprocessed food and also withdraw other concessions like tax holiday, etc.
f. Zero-rate exports out of the country and also inter-State sales and consignment transfers to registered traders with suitable safeguards against misuse.
g. Tax inter-State sales to non-registered persons as local sales.
h. Modernize tax administration, computerise operations and the information system and simplify forms and procedures.

The measures for harmonization of the rates will call for agreement among States and also the Centre (the latter for the Union

Territories). If the States signal their agreement on such a package, the Centre should permit the States to tax three additional excise duty items, viz., textiles, tobacco and sugar under State VATs.

Further, under the CST at present, there is a ceiling on sales taxes that can be levied by the States on certain commodities considered vital for inter-State trade and commerce (called declared goods) even when sold within their own territories. The ceiling is equal to the tax on inter-State sale (i.e., 4 per cent). With the reforms outlined above these restrictions should go. However, the Central legislation to fix the ceiling rate for declared goods may be retained to ensure that the States accept and adhere to a harmonized rate structure.

The most convenient method of operating a destination-based system of State VATs is to zero-rate inter-State sales between registered dealers. As a safeguard against misuse, a system of advance payment of tax by the importing dealer can be devised. Under this system inter-State movement of goods through consignment transfers should be treated on the same footing as inter-State sale between registered dealers. As an interim system, exporting States may levy a tax on inter-State sales at a low rate for which importing States would grant rebate and the revenue will be shared through a pooling arrangement.

Informal discussions with State government officials suggest that such a scheme of reform as outlined above might receive favourable consideration in general. The rate bands proposed are: 4 to 5 per cent for essential goods and 12-14 per cent for all other goods. Basic, unprocessed food items may be exempt while tobacco, alcohol, petroleum, aviation fuel and narcotics may be subjected to a non-rebatable VAT at a floor rate of 20 per cent (see Statement 1). The tax on the high rated items will not be rebatable although the tax paid on their inputs will be credited against the VAT payable on them. Resellers would however be entitled to deduct the tax paid on their purchases from the VAT payable on their sale.

Eventually the States should be given the power to tax services in general. A beginning can be made by bringing under the State VATs, services which are ancillary or incidental to the production or supply of goods and also those which form a significant part of final consumption like photo processing. VAT on such items of consumption need not be rebatable. The Parliament can pass a legislation empowering the States to levy the tax on services so selected. Pending a general extension of the tax base to services, the taxes on entertainments, electricity duty and taxes on passengers and goods carried on road may continue to be levied by the States.

Statement 1

Proposed Commodity Grouping for State VAT Rates

Exemptions

1. Unprocessed cereals including rice, rice flour, wheat, atta, maida, and suji.
2. Pulses.
3. Fresh vegetables and fruits.
4. Fresh meat, fish, and livestock excluding race horses.
5. Unprocessed salt.
6. Fresh milk
7. All types of eggs
8. Plain water not including mineral water, aerated water, tonic water, distilled water, scented water or water sold in sealed containers/sockets, etc.

Rate of Tax (4 TO 5%)

1. Oilseeds, edible oils and oil cake
2. Processed salt
3. Dried fish, vegetables and meat
4. Pasturised milk
5. Chillies, turmeric, tamarind, cumin seed, dried ginger, etc.
6. Kerosene
7. Sugar

High Rate of Tax (Minimum 20%)

1. Diesel, petrol and aviation fuel.
2. Opium, ganja, bhang, narcotics, etc.
3. Liquor
4. Tobacco and tobacco products.

All Other Commodities

Standard Rate (12 TO 14%)

The potential benefits of the proposed reform scheme include mitigation of economic distortions, greater fairness and uniformity in taxation, better tax compliance, transparency in tax incidence and simpler tax design. However, there may be some initial problems such as opposition from tax practitioners, large initial investment in administration, and rise in costs of both compliance and administration.

Exercises based on available data show that such a regime can be revenue neutral even with zero-rating of inter-State sales, provided the reform scheme is implemented as a whole. However, some States where the level of taxation is high may have to pitch their rates high (e.g., in Gujarat, a rate structure of 5, 14 and 32 per cent would be called for to make the reform revenue neutral). The average rate of tax in high tax States might be in the region of 12 or 13 per cent. This, however, takes no account of the likely gains from better enforcement that VAT should facilitate. With even a 10 per cent increase in revenue with better administration the revenue neutral rates would come down appreciably (e.g., for Gujarat, the rates could be 5, 13, 26 vide Table 1).

Table 1

Revenue Neutral VAT Rates for Selected States : 1992-93

State	With no administrative improvement		With administrative improvement*	
	Tax rate regime	Average rate	Tax rate regime	Average rate
Andhra Pradesh	(4,9,20)	10.3	(4,8,20)	9.5
Gujarat	(5,14,32)	13.0	(5,13,26)	12.0
Maharashtra	(4,11,23)	11.7	(4,10,22)	10.7
Rajasthan	(4,8,20)	10.7	(4,7,20)	10.0
Tamil Nadu	(4,14,20)	13.1	(4,12,22)	12.1

Notes:
1. Figures in brackets give VAT rates for low rated, standard rated and high rated goods, respectively.
2. Figures for Gujarat relate to 1991-92.
3. These computations are based on tax turnover data furnished by the State Sales Tax Administrations.
4. * Assuming a resulting increase of 10 per cent in the tax yield.

Combined with the Central VAT, which, under the proposed scheme, would contain rates going up to 20 per cent (even though the average would come to 15 per cent), standard rates of this order might appear to be a little too high. However, this is in reality the level prevailing now. Only the incidence of excise duties remains invisible. The position will not worsen with the proposed reform rather the rates can be brought down if the base is truly widened and substantial improvement takes place in administration.

Abolition of tax on inter-State sales may adversely affect the States deriving large amounts of revenue from this source. In the case of States like Maharashtra, the loss will probably be made up with the extension of the base to include consumption items like textiles and the capture of trade margins beyond the first point under the multi-stage system that VAT implies. For States like Bihar and Madhya Pradesh, where CST on minerals yield substantial revenue, appropriate pricing of their natural resources and a wider base for their VAT should take care of the revenue loss, if any. Estimates show that with the widening of the base and withdrawal of exemptions and some improvement in administration, it should be possible to protect the revenues of even the exporting States with tax rates within the suggested bands. In most countries where VAT has been introduced on a comprehensive base, the additional revenue accrual has outstripped the estimates.

As for price effect, international experience suggests that a revenue-neutral replacement of sales taxes by VAT is not inflationary.

3.4 Legal, administrative and institutional requirements

Reforms proposed in the preceding paragraphs will require appropriate legislation for implementation and overhaul of administrative organisation and methods. Suitable institutional arrangements also would have to be evolved to formulate action plans and oversee their implementation. In particular, attention will be required on the following aspects of law and administration and institutional set up:

1. Drafting of the law and regulations
2. Formulation of procedures and design of the forms
3. Reform of administrative systems and organisation
4. Computerization and modernization of administrative methods
5. Training and reorientation of staff
6. Taxpayer education
7. Creation of institutional infrastructure.

3.4.1 Legislation

Once a decision has been taken in principle to introduce VAT and broad agreement reached about its basic design features, steps would be needed to prepare the necessary legislation along with supporting regulations.

Considering that uniformity of basic structure and procedures would be necessary for the harmonization and smooth operation of the system all over the country, a model law should be devised which the States can adopt with suitable changes but retaining the basic structure.

Drafting, being a specialised job, has to be undertaken by a team of experts. The States should jointly set up a team consisting of experts drawn from the law departments/legal cell of sales tax departments and officers with background of sales tax administration to undertake the task of drafting the law. Since VAT would be an unfamiliar concept and its rationale may not be apparent to legal experts, it would be necessary to include a fiscal economist in the team. The tasks of the team should include, besides drafting the basic law, formulating regulations and resolving operational issues. It may be useful to hire consultants from abroad to help the team in some of these tasks.

The scheme of State VATs proposed in this study will call for some far reaching amendments in the Central Sales Tax Act of 1956 (e.g., to bring down the rate of CST to nil when the sale is between registered dealers, remove the ceiling on State sales taxes on declared goods and so on).

3.4.2 Procedures and forms

Implementation of any tax calls for prescribing operational procedures for

- Registration of taxpayers
- Filing of returns
- Payment of tax
- Assessment and reassessment
- Appeals against assessment.

3.4.3 Registration

Under a system of destination-based VAT, inter-State movement of goods would need to be monitored and transactions between registered dealers across States cross-checked from time to time, even though on a sample basis. Hence, it would be necessary to evolve an all-India coding system and allot tax identification numbers to all registered dealers accordingly.

3.4.4 Tax return and other forms

Unlike under a sales tax with multiple levies and rates of tax, the VAT return form can be very simple, especially if the rate of tax is uniform. With more than one rate, space has to be provided in the return form for reporting sales and purchases under the different rate bands. Even so, the form should be simpler than those in vogue for sales taxes at present.

The periodicity of return filing and payment of tax would have to be determined in the light of the experience and requirement of each State. Some uniformity in this regard among all States would be desirable.

3.4.5 Invoices and accounts

Requirement of documents and forms to support a tax return should be kept to a minimum. The most important document for the operation of tax credit-based VAT is the invoice. The tax invoices which only VAT registered dealers should be authorised to issue, should provide all relevant information regarding the seller, the buyer and also date of issue, serial number, particulars of goods sold and amount of VAT charged.

Dealers registered for VAT (other than those coming within the "small dealers" category) must maintain record of all tax invoices issued and received by them indicating their serial number, date, price charged and the VAT.

3.4.6 Filing of returns and tax payment

It would simplify life if banks were authorised to receive returns along with taxes with the responsibility to pass on the returns to the tax authorities.

3.4.6.1 Assessment and appeals

Procedures for both assessment and appeal should also be standardised. Tax administration all over the world is now moving towards a system in which returns filed by the assessees are accepted and thorough scrutiny or audit of only a few cases is taken up on a sample basis. The basis of selection and the proportion of cases to be taken up for audit have to be decided keeping in view the costs and the likely results.

3.4.7 Administrative system and organisation

Success in the implementation of VAT hinges critically on financial or accounts-based controls supplemented by field visits by authorised officers. Hence, with the introduction of VAT, tax officers will have to orient their approaches towards examination of accounts instead of relying heavily on physical controls. This would call for reassessment of staff needs, staffing pattern, and retraining and redeployment of the existing staff. It would also require a reorganisation of the tax departments.

There should be no fear of any retrenchment of staff with VAT. Only some reallocation of functions and redeployment with emphasis on examination of accounts might be needed.

To meet the need for qualified and competent staff at senior levels, consideration may be given to the creation of a unified independent Value Added Tax Administration or authority with All India and State Services.

3.4.8 Computerisation and modernisation of administrative methods

Modernization of administration with extensive use of computers is a crucial element of reform. Computers provide an extremely powerful and at the same time affordable instrument for administration of taxes and are particularly useful in the operation of a tax like the VAT which calls for monitoring of tax payments and credits availed of continuously and also cross-verification of tax-credit claims even if selectively.

It is absolutely necessary to draw up plans for computerising tax administration in all States in a time bound programme. Administration of Central excise department also needs to be modernized for the MODVAT to be expanded and operated efficiently.

3.4.9 Institutional set-up : Need for a VAT Council of States

Implementation of the reforms will require consultation and discussion among the State governments on a continuing basis. Consultation and involvement of the States would be needed for steering the implementation of VAT in the initial stages and also later for overseeing its operation. The process should be initiated as soon as the Central and State governments agree on the whole package.

To facilitate consultation and chalk out lines of action it would be advisable to set up an All-India VAT Council of the States. This Council will provide the mechanism for bringing all States together and ensuring their active participation. It will concentrate expertise, prepare the draft of a common tax base (like the Sixth Directive of the European Union) and common procedures, play a major role in educating and guiding State VAT officials, provide for review and continuity of the VAT adoption process, integrate policy/analysis with legal drafting, etc.

The permanent statutory institution for consultation among States and overseeing the introduction and the operation of VAT should be in two tiers: one, the apex body (VAT Council) and another, a functional one below it.

The apex body should be constituted with finance ministers of all the States. At the second tier, there should be a Standing Committee of officials (Commissioners of Commercial Taxes) who would meet regularly to identify issues and propose solutions.

3.4.10 Taxpayer education and publicity

Dissemination of information regarding VAT and the case for reform is crucial for the success of any scheme for replacing the present system with a scheme of VAT. Before embarking on the reform, it would be necessary to launch a programme of public discussion about the ills of the present system, how VAT could remedy them and the benefits likely to be derived.

3.4.11 Lead time

Introduction of VAT without adequate preparation or institutional backing can be disastrous. A lead time of 2 to 3 years, would be needed for moving towards a system of VAT at the Centre and in the States.

4. Concluding Observations

Because many parties would be involved, a package reform with inter-dependent gains and losses would be preferable to incremental change which is favoured by some on practical grounds. Incremental reform may soon get bogged down and lead to nowhere.

Reform of this magnitude cannot be carried through without strong political will, real interest on the part of the Central and State governments, and support from the people. Obviously the task will be arduous but, as stressed at the outset, needs to be addressed boldly if the Indian economy is to get free of the shackles of its irrational and injurious tax system and move forward fast.

Chapter 1

INTRODUCTION

1.1 Prelude : The Urgency of Reform

Domestic trade taxes in India are in urgent need of reform. The reason simply is that the system that is operating at present is antiquated, complex - according to knowledgeable experts, the most complex in the world - and injurious to the economy in many ways. It follows no rational pattern, having evolved over the years mostly through changes made *ad hoc* from time to time in response to exigencies and violates all time-honoured canons of taxation - certainty, neutrality and equity.

Apart from inherent flaws in the structure, the laws and procedures are so complex and there are so many grey areas that assessments are often taken to the courts and they remain locked up for adjudication for years creating uncertainty for revenue as well as taxpayers. Such a system causes incalculable damage to the economy by arbitrarily interfering with the decisions of economic agents and thereby distorting the pattern of trade and industry, adding to their costs, undermining their competitive strength, and misallocating scarce resources. In the absence of transparency, it cannot serve the goal of equity either. Unless radically reformed, the tax system will impede the growth of the economy and realisation of the full potential of the huge common market that the Union of India offers, and the phenomenal economic development that is occurring elsewhere in Asia will bypass India.

The decade of the 1980s witnessed sweeping reform of tax systems across the world reflecting a growing awareness of the significance of the role that taxes play in the performance of the economy and public perceptions about the fairness of the social and economic system. Fairness, efficiency and simplicity have been the guiding aims of the reform. An additional motivation, particularly in the developing countries, was the need for augmenting government revenues to contain the deficits in the budgets that had tended to widen alarmingly in the wake of the oil shocks in the seventies and the economic crisis that many countries had to cope with in the early eighties. In the structural adjustment programmes adopted by the countries that sought to stabilise their economies and find a solution to their chronic problems, tax reform invariably formed a key component. In fact, all countries which are doing well economically have reformed their trade taxes, both domestic and external, and gone in for a system that promotes neutrality and reduces interference with the functioning of the economy.

The crisis that overtook the Indian economy in 1991 also brought into sharp focus the need to carry out some radical reforms of the tax system which were even otherwise long overdue. Reforms in the trade and industrial policies and the move towards a liberalised outward-oriented economy called for complementary reforms in the tax system to make sure that it did not act as a drag on the growth of domestic industries or their competitiveness in the world markets. The need to recompense the government for the diminution of revenues from customs duties from the lowering of customs tariffs, which is concomitant to liberalization and opening up of the economy to external competition, lent further urgency to domestic tax reform.

The Tax Reforms Committee (TRC) which was set up in 1991 under the chairmanship of Prof Raja J Chelliah has come out with wide ranging measures to improve the system of both direct and indirect taxes. Many of the recommendations particularly for direct taxes and taxes on foreign trade have since been implemented. The focus of the TRC was, however, on the taxes levied by the Centre. Comprehensive reform of domestic trade taxes including the taxes levied by the States as well remains to be undertaken. Reflecting the anxiety of the government to initiate reforms. of the domestic trade taxes, the Union Finance Minister in his Budget Speech for 1993-94 had observed:

".....our long term aim should be to move to a Value Added Tax System. However, a nationwide value added tax system cannot be introduced overnight. There has to be a broad agreement among the Centre and the States on the design of such a system. In order to promote informed discussion and debate, I am requesting the National Institute of Public Finance and Policy to prepare the design of a possible value added tax system."

The report presented below is the outcome of the study undertaken by the NIPFP in this context.

1.2 Plan of the Report

The study seeks to provide a blueprint for the reform of the two principal taxes on domestic production and trade currently in operation, viz., the Central excises and the State sales taxes. The need for a thorough-going reform of the domestic indirect taxes is sometimes questioned on the ground that the system that has evolved over the years and attained a measure of stability should not be cast aside or tinkered with especially in a federal country like India where Centre-State relations are not too easy. Before proceeding to consider the possible options for reform it is, therefore, necessary to take a look at the problems with the present system and their consequences. Correct diagnosis of the ills is a prerequisite for the prescription to be efficacious.

Chapter 2 of the report is, accordingly, devoted to an appraisal of the system that is in operation at present in order to identify the basic problems, their roots and the costs they impose on the economy. Although they constitute a major component of the trade taxes in the country, sales taxes have not received the attention they deserve in discussions on tax reform. Chapter 3 focuses on the main features of the sales tax systems of the States and their injurious effects. The goals of reform in the current context and the parameters to be kept in view are put forth in Chapter 4. Briefly, it is argued that the existing structures of domestic taxes on commodities are fundamentally flawed and only a move towards a system of value added tax holds out the promise of a satisfactory and lasting solution - a prescription that is put forward forcefully by the TRC too. The principal forms and basic features of the value added tax are explained briefly in Chapter 5. Options for reforming the present system towards a system of VAT, especially in India's federal context, are examined in Chapter 6. Since, given the compulsions of a federal polity of India's dimension and diversity, it may not be feasible to go in for reforms that might appear to be ideal in the abstract, the scheme which could remove many of the ills of the present system and is also likely to be acceptable is put forward as the best alternative for the foreseeable future. Chapter 7 elaborates the scheme of reforms on the States side. The revenue and economic impact of the proposed reforms is considered in Chapter 8. The administrative and institutional changes required for implementing the VAT at the two levels are discussed in Chapter 9.

Chapter 2

THE CURRENT SYSTEMS AND THEIR PROBLEMS

2.1 India's Tax Structure and Its Shortcomings

In terms of tax ratio - the proportion of tax revenue to GDP - India with a ratio of 16.8 per cent ranks above the average among countries with similar per capita income. At the beginning of the 1950s, the ratio was only about 7 per cent (vide Table 2.1). The tax structure that has emerged in the process of reaching the present level, however, differs significantly from that of developing countries in general.

Over 84 per cent of the revenues of the government (Centre and the States combined) come from indirect taxes, of which nearly 27 per cent is derived from excise duties levied by the Union government, 22 per cent from customs and 21 per cent from the States' sales taxes. In the case of the States, the dependence on indirect taxes is even greater. Nearly 90 per cent of their own-source tax revenues come from indirect taxes, among which the dominant source is the sales tax [vide Appendix Tables A3.1, A3.2(a) and A3.2(b)]. While dependence on indirect taxes is a common characteristic of the tax structure of developing countries, the degree of dependence on taxes on domestic production and trade in India is way above that of even the poorest among less developed countries. The proportion of domestic indirect taxes in the total tax revenue of LDCs, on an average, is only about 28 per cent (in the case of poorest LDCs, 33 per cent), whereas in India it is over 60 per cent.

Such dependence on indirect taxes would not be of much concern if the taxes were imposed in a fair and neutral manner and collected efficiently. This is clearly not the case in India. Operation of both Union excises and sales taxes, the two principal components of the domestic trade taxes, has given rise to problems and inefficiencies that cost the economy dearly in many ways. Briefly, the manner in which the taxes on domestic production and trade are currently structured and administered causes:

- Loss of output growth and welfare;
- Inefficiency and high cost in industry and trade;
- Encumbrance for exports;
- Impediments to the free flow of trade within the country and growth of the common market that the Indian Union offers;
- Inter-jurisdictional conflicts; and
- High costs of compliance and enforcement.

2.2 Basic Problems

The costs enumerated above stem essentially from certain features of the present system. Principally, these are:

- Heavy reliance on taxes at the manufacturer/first seller level;
- Exclusion of services from the tax base;
- Taxation of inputs and capital goods;
- High level and multiplicity of rates with too many exemptions and concessions;
- Taxation of inter-State sale and lack of harmony in States' sales tax systems; and
- Complex laws and archaic administration.

Some of these are common to both excises and sales taxes while some are peculiar to either one or the other.

2.2.1 Taxation at manufacturer level

Under the Constitution, the bases of excise duties and sales taxes, the two principal components of the domestic trade taxes, are distinctly defined - *goods* manufactured or produced in India in the case of excise, and sale or purchase of goods for the sales taxes.[1] In practice, the two bases

1. Entry 84 of the Union List in the Seventh Schedule to the Constitution empowers the Centre to levy excise taxes on tobacco and other goods manufactured or produced in India (except alcoholic liquors and narcotics) while Entry 54 of the State List empowers the States to levy "taxes on the sale or purchase of goods other than newspapers".

Table 2.1

Revenue Receipts of Centre, States & Union Territories as Proportion of Gross Domestic Product
(at Current Market Prices)

(per cent)

	Taxes/Years	1950-51	1955-56	1960-65	1965-70	1970-75	1975-80	1980-85	1985-90	1991-92(RE)
	Direct Taxes of which	**2.46**	**2.53**	**2.91**	**2.44**	**2.51**	**2.87**	**2.42**	**2.39**	**2.66**
1.1	Corporation Tax	0.42	0.36	1.10	0.95	0.98	1.19	1.15	1.07	1.20
1.2	Taxes on Income	1.43	1.29	1.07	1.04	1.18	1.24	0.90	1.03	1.11
1.3	Land Revenue	0.55	0.77	0.59	0.34	0.23	0.20	0.13	0.14	0.09
1.4	Others	0.06	0.11	0.15	0.11	0.12	0.23	0.25	0.15	0.26
	Indirect Taxes of which	**4.23**	**4.96**	**6.99**	**8.07**	**9.60**	**11.76**	**12.76**	**14.54**	**14.15**
2.1	Customs	1.68	1.63	1.39	1.50	1.60	2.12	2.79	3.94	3.76
2.2	Union Excise Duties	0.72	1.42	3.10	3.54	4.34	5.00	4.75	4.89	4.54
2.3	State Excise Duties	0.53	0.44	0.35	0.42	0.55	0.62	0.78	0.87	0.92
2.4	Stamp & Registration Fees	0.30	0.30	0.31	0.32	0.30	0.32	0.32	0.38	0.42
2.5	Sales Taxes	0.62	0.80	1.20	1.59	1.96	2.70	3.13	3.43	3.58
2.6	Others	0.38	0.38	0.63	0.71	0.85	1.00	0.98	1.02	0.93
	Total Tax Revenue	**6.69**	**7.48**	**9.89**	**10.51**	**12.11**	**14.63**	**15.18**	**16.93**	**16.81**

Source: *Indian Public Finance Statistics* (various issues), Government of India, Ministry of Finance.

have come to overlap. Because of problems in administering taxes at the retail level, most States have moved the point of levy of their sales taxes primarily to the first point of sale, that is, on manufacturers and importers of goods in their respective jurisdictions.

2.2.1.1 Definitional ambiguities

Taxation at the manufacturer level which excise taxation predicates encounters intractable problems as the term "manufacturing" is not as easy to define as might be supposed. Goods may undergo a change of form due to a variety of processing activities performed after their initial production or manufacturing (e.g., grinding, twisting, texturing, blending). There are many processes which constitute only "marginal manufacturing". Attempts to bring them all under "manufacturing" for taxation have given rise to disputes and uncertainty. Clarifications have been provided in the law in the form of section/chapter notes to contain the areas of dispute but the uncertainty persists. Some examples of judicial rulings bearing on the definition of "manufacturing" are given in Box 2.1. Box 2.2 illustrates how the law gets complicated when attempts are made to delimit the grey areas through "notes" in the statute rather than addressing the problems at their roots.

Box 2.1

Definition of Manufacturing
(Some Judicial Rulings)

- Adding of water, perfume, colour to liquid soap does not amount to manufacture as no new substance of a distinct name, character or use is produced.

- Making of aluminium cans out of aluminium slugs does not amount to "manufacture"

- Application of rubber compound to cotton fabrics does not amount to manufacture of "cotton fabrics rubberised".

- Assembling of cycle from its parts in CKD condition is not "manufacture", but assembling of fishing rods out of imported components amounts to manufacture.

- Body building on duty paid chassis is not manufacture.

- Conversion and sawing of timber logs into different sizes, planks, beams, etc. is not manufacture.

- Process of mercerising does not amount to manufacture.

- Evaporator plant built on cement concrete foundation permanently laid and embedded in the ground is immovable property and not `goods'. Assembly, erection and commissioning thereof does not, therefore, amount to manufacture.

- Process of coating of steel pipes with cement does not amount to manufacture; coated steel pipes being only steel pipes and not a different product.

- Process of punching or drilling and galvanising duty paid MS angle and flats of specified sizes not being high intricate, specialised or technical nature does not amount to manufacture.

Source: R.K. Jain's Excise and Customs Case Referencer, 1993 and Excise Law Times.

Box 2.2

Extracts from Chapter/Section Notes in Central Excise Tariff Act, 1985

Note 4 to Chapter 33: "in relation to products under heading Nos. 33.03 (Perfumes and toiletwater), 33.04 (Beauty and make-up preparations and preparations for the care of skin), and 33.05 (Preparations for use in the hair), conversion of powder into tablets, labelling or relabelling of containers intended for consumers or repacking from bulk packs to retail packs or the adoption of any other treatment to render the products marketable to the consumer, shall be construed as manufacture'".

In respect of machinery covered by Section XVI, Note 6 of this Section says: "conversion of an article which is incomplete or unfinished but having the essential character of the complete or finished article (including `blank', that is an article, not ready for direct use, having the approximate shape or outline of the finished article or part, and which can only be used other than in exceptional cases, for completion into the finished article or part), into complete or finished article shall amount to `manufacture'."

Taxation of sales at first point only has to contend with similar problems. To avoid taxation when the tax is payable by the first seller only, addition of value through, say, processing or packaging of a product is often claimed to be not manufacturing and so not liable to first point sales tax.

2.2.1.2 Malleability of manufacturing value

In taxation at the manufacturer level, determination of manufacturing value also is equally troublesome. Manufacturers often sell their products through their own distributors or through wholesalers and sometimes directly to the consumers. In determining the assessable value at the manufacturer level adjustments have to be made for legitimate trade margins at different trade levels. Sales between related entities also have to be looked through carefully. Not surprisingly, the basis of valuation for Central excise levy has been a contentious issue throughout. The matter has gone up to the Supreme Court on numerous occasions. To facilitate compliance and administration, the law was amended in 1973 providing further guidance on the basis for valuation, but the issues are not all settled yet.

Dealing with the question whether costs of after-sale service, advertisement and selling, organisation expenses come under manufacturing cost, the Supreme Court ruled in a leading case that it is not the bare manufacturing cost and manufacturing profit which constitute the basis for taxable value (Union of India vs. Bombay Tyre International). Even after such rulings, determination of excisable value has continued to present acute problems. In a subsequent judgement, the Supreme Court directed that deductions be allowed for items like "prompt payment discount", interest on finished goods and stocks from the date the stocks are cleared till date of sale, interest on deferred realisation, but not for warranty discount, year-end bonus, campaign bonus, discounts to government or defence supplies and so on (Assistant Collector of Central Excise vs. MRF Ltd). It seems the judgement in the subsequent case has been recalled and is awaiting review by the Supreme Court.

To circumvent the problem of valuation, the excise system has come to rely heavily on "specific" rather than ad valorem rates. Nearly 60 per cent of excise revenue is realized through specific rates. It is not usually appreciated that specific duties cause economic distortions. For they only tax that characteristic of the product which is mentioned in the law, distorting producer choices in favour of those that go untaxed. Specific duties can be justified on economic grounds only when one wants to internalize externalities (e.g., in the case of tobacco and alcohol or even non-renewable energy products like petroleum). But that does not seem to be the rationale for such heavy reliance on specific rates in Indian excises.

2.2.2 Exclusion of services

Both in excise and sales taxes, the problems in taxation at manufacturer level have been compounded by the exclusion of "services" from the base.

The definition of the powers of excise taxation as well as sales tax refers only to "goods" without any mention of services. As a result, neither Central excise nor sales tax can be applied to services. The distinction implicitly drawn in the Constitution between goods and services is, however, not in accord with the realities of modern economies. Services are often an integral part of manufacturing and trade and the line between goods and services is getting increasingly blurred (e.g., in the manufacture of computer software, desk-top publishing, developing and printing of photographs, photocopying, etc.). Manufacturers may provide a wide variety of services for the goods manufactured by them such as training, advertising, installation and maintenance. Taking advantage of the definitional ambiguities and the exclusion of services, manufacturers have tried to minimise the assessable value of their products by making sales at artificially low values to a related distributor/wholesaler and by claiming discounts for the so-called "post-manufacturing services" (e.g., transportation, installation and warranty services). Essentially it is exclusion of services from the base coupled with the inability of the Centre to extend taxation of goods beyond the manufacturing stage that underlies the problem of determination of manufacturing value for excise that came up before the Supreme Court in the MRF case referred to above.

Another problem is that the powers of indirect taxation are defined in the Constitution in terms of "goods" that is, things which are tangible and movable. So the processes of erection or fabrication or any such activity that helps in the creation of something immovable, even when integral to a transaction involving production, are claimed as falling outside the definition of "manufacturing" and so not liable to excise taxation. How problems arise in the application of excise taxes because of these ambiguities can be seen from cases commented upon in the recent audit reports of the Comptroller and Auditor General (C&AG).

In one such case, the assessee manufactured ash handling system under contract on turn-key basis. This item falls under one of the headings of the Schedule to the CE Tariff Act. Some of the parts and components used for the "system" were manufactured by the assessee while some were procured from the market. Duty was paid duly by the assessee on the parts manufactured by him. The bought out items were taken directly to the site and used along with the parts manufactured in the assessee's factory to set up the "system" on site. No duty was charged by the Excise Department on the "system" as a whole on the reasoning that the "system" is an *immovable* product made up of manufactured as well as bought out items. This was objected to by C&AG's audit.

It is not difficult to see that the controversy in these cases arose not so much from the "immovable" nature of the goods in question as from the exclusion of services from the base and the failure to recognise that the essence of manufacturing in the economic sense lies in the addition of value and that the final product consists of both material and service components in various forms.

Similar problems arise in the implementation of first-point sales taxation too. Even where the movability of the product is not in doubt, when services are not included in the base, whether activities such as the following come under "manufacturing" and so liable to sales tax at first-point are not all that obvious and have had to go to courts for a decision:

- dispensing of medicines
- grinding of spices
- chopping of firewood
- assembling of prescription eye glasses
- breaking and dismantling of ships.

When the tax is levied only on the first point of sale, sellers of goods providing services such as those noted above do not have to pay tax, if they do not come within the category of "manufacturer" as they can then claim to be resellers only.

Apart from technical problems, taxation of goods only at manufacturer/first-point level, that is, on a base that does not include distribution margins and associated services, tends to distort producer and consumer choices. Items which carry large trade margins (as is usually the case with luxury products) are favoured over essential consumer goods. It also provides an incentive for producers to push as many trading functions forward as possible to keep down the assessable value of their products. Exclusion of services from the base also creates a bias against goods and in favour of services (which are usually consumed more by the rich). With taxation of sales at the first point, sole distributors especially of imported goods get an advantage over other distributors who usually provide more marketing services, costs of which go into the manufacturer's price.

2.2.3 Taxation of inputs and capital goods

Left with a base constrained by exclusion of trade margins and services and faced with mounting pressures for revenue, both Centre and the States have gone on to extend the coverage of their excises and sales taxes to include inputs and capital goods. This leads to cascading and constitutes another major source of economic distortion. While attempts have been made to alleviate the ill-effects of input taxation through MODVAT in Central excise and concessional treatment or exemption in sales taxation, the distortions persist as the scope of the provision in the law sanctioning the reliefs is restrictive and the procedures cumbersome. As a result, the alleviation is inadequate or ineffective. Purchases which from the economic angle clearly pertain to the manufacture of the commodities are often denied MODVAT credit on technical grounds (see Box 2.3). In any case, no relief is usually available for taxes paid on plant and equipment.[2] In many States there is now a turnover tax at different stages of trade. This leads to cascading with all its attendant evils (increase in costs by more than the tax, vertical integration and disincentive for specialisation in production). How cascading (that is, increase in selling price by more than the tax element) occurs with taxation of inputs and levy of tax at different trade levels is shown in Table 2.2.

With taxes levied on producer goods and at different stages of production and trade, the system lacks transparency. Effective rates diverge significantly from the prescribed rates (vide Table 2.3). For several commodities (e.g., fertilisers) the gap between effective incidence of sales tax and excise duties combined and the implicit nominal rate (that is, statutory rate) is as high as 12 percentage points.

2. The MODVAT credit has since been extended to capital goods (vide proposals of the Union Finance Minister in the Budget for 1994-95).

Box 2.3

Audit Objection to Granting MODVAT Credit for Inputs Used in Manufacture of Iron and Steel Products

"The .... MODVAT declaration (in question) was not specific in relation to the inputs for the reasons that the input, ferro molybdenum was not specified. Also steel shredded scrap was not included in the declaration. In respect of aluminium, the declaration was only indicating aluminium and articles thereof under sub- heading 7601.00, whereas credit availed on inputs like aluminium wires and wire rods were covered under different heading 76.12 and sub-heading 7604.10. Mere mention of the chapter sub-heading and availment of MODVAT credit on all the articles of a specific chapter was in contravention of the provision of rule 57A". (Report of the Comptroller and Auditor General on Receipts of the Union Government : Indirect Taxes, No.4 of 1993, p.400.)

2.2.4 High and multiple rates

With a narrow base the rates have to be high to raise the same amount of revenue. Finding it difficult to raise the level of sales taxes at the first point any further, the States are now resorting to additional levies like turnover tax already referred to, additional sales tax, surcharges and so on, making the system totally non-transparent and the tax incidence arbitrary and unpredictable. The multiplicity of tax rates prevailing in different States and their consequences are dealt with further in Chapter 3.

High tax rates aggravate the distortions inherent in a manufacturer's tax. They also provide incentives for evasion and avoidance, and generate pressures for exemptions and concessions. One, thus, witnesses in the excise system multiplicity of rates based on classification of commodities and sectors often relying on hair-splitting distinctions. As could be expected, the system has proved to be a breeding ground for disputes. Over 30,000 excise cases are pending before the Appellate Tribunal alone (over 12,000 before the High Courts).

While, as briefly noted, most of the problems mentioned above occur in the Union excise systems, some are peculiar to and more acute in the State sales taxes. Chapter 3 highlights the main features of the present systems of sales taxation and draws attention to their problems and consequences. Problems with the excise system are no less intractable but these have been discussed in detail in the report of the TRC[3] and are not gone into further here.

3. See Chapter 9 of the Interim Report and Chapter 4 of the Final Report - Part I of the TRC. (Ministry of Finance, Government of India.)

Table 2.2

Cascading and Uncontrolled Incidence under Taxation of Inputs: An Illustration

Manufacturer/ Dealer	Cost of inputs/ purchases	Price before tax (mark up 50%)	Tax @ 10%	Sale price with tax	Value added (pure cost)
A	0	100	10	110	100
B	110	165	16.5	181.5	50
C	181.5	272.25	27.2	299.5	75
			53.7		225

Difference between final selling price and cost:	299.5 - 225	=	74.5
Tax on value added only:	10% of 225	=	22.5
Cascading because of tax on inputs:	53.7 - 22.5	=	31.2 (or 13.9% of value added)
Additional cascading caused by price mark-up on tax:	74.5 - 53.7	=	20.8 (or 9.2% of value added)

Note: This takes no account of possible cost increase on account of advance financing of cost.

Table 2.3

Nominal and Effective Rates of Excise duty and Sales Tax for Selected Commodities

(per cent)

	Commodity	Sales tax		Excise duty		Sales tax & excise duty	
		Nominal rate	Effective rate	Implicit nominal rate	Effective rate	Implicit nominal rate	Effective rate
	1	2	3	4	5	6	7
1.	Paddy	2.26	3.51	0.00	1.01	2.26	4.53
2.	Wheat	2.60	4.12	0.00	1.24	2.60	5.36
4.	Pulses	2.74	3.75	0.00	0.58	2.74	4.34
5.	Cotton	5.10	7.28	0.00	1.74	5.10	9.02
6.	Coal & Lignite	4.32	6.82	0.07	3.73	4.40	10.55
7.	Crude Petroleum, Natural Gas	5.57	6.29	1.46	3.01	7.03	9.30
8.	Iron Ore	0.00	1.37	0.00	2.14	0.00	3.50
9.	Khandsari, Boora	1.15	2.39	1.92	3.56	3.07	5.96
10.	Hydrogenated Oil	8.12	11.60	4.08	8.39	12.20	19.99
11.	Oth.Food & Beverages etc.	8.66	10.74	11.15	12.92	19.81	23.66
12.	Cotton Textiles	2.36	4.94	1.14	3.60	3.51	8.54
13.	Woollen Textile	5.66	7.77	0.50	3.00	6.16	10.77
14.	Art Silk,Synthetic Fibre	0.00	1.92	8.90	14.91	8.90	16.84
15.	Jute,Hemp,Mesta Textiles	0.00	1.98	1.27	3.49	1.27	5.47
16.	Paper & Paper Products	3.98	7.41	3.66	5.34	7.64	12.75
17.	Leather & Leather Products	11.14	14.39	1.14	2.44	12.28	16.83
18.	Petroleum Products	9.82	13.20	8.40	11.85	18.22	25.05
19.	Coal Tar Products	4.25	9.26	0.42	4.60	4.67	13.86
20.	Fertilisers	2.94	7.90	0.11	7.83	3.05	15.73
21.	Iron & Steel	4.39	7.46	5.11	6.67	9.50	14.13
22.	Tractors and Other Agric.	10.20	14.38	2.02	3.36	12.22	17.74
23.	Electrical Machinery	11.30	13.98	7.46	8.54	18.76	22.52
24.	Communication Equipment	11.75	14.77	3.96	4.74	15.72	19.51
25.	Electronic Equipment Inc.	13.10	16.23	21.97	22.56	35.07	38.79
26.	Rail Equipment	10.20	13.15	2.49	4.02	12.69	17.17
27.	Motor Vehicles	9.89	13.45	14.71	15.95	24.60	29.40

Source: Aggarwal (1994): a forthcoming study of the National Institute of Public Finance and Policy.

Notes :
1. Nominal rates of sales tax are obtained as simple averages of the nominal rates of 16 States, and relate to the year 1992-93.
2. Implicit nominal rate of excise duty of a commodity is obtained as the ratio of tax yield to its gross output, and relates to the year 1989-90.
3. Effective rate of tax includes taxes paid on inputs. The estimates are based on input-output Tables 1989-90, Sales tax rates in various States, Central Excise Tariff Working Schedule (1989), etc.
4. Nominal rates of sales tax and excise duty are not additive. Hence, the figures in column 6 need to be interpreted with caution. However, sales taxes are assumed to fall on price including excise.

STATE SALES TAXES

3.1 Main Features of the Current Systems

Sales taxes are levied by the States in diverse forms, each under its own legislation enacted in exercise of the powers conferred by the Constitution. They vary in structure - viz., the points of levy and the rates - as well as administrative procedures, although some common features are discernible. Neither the structures nor the procedures are, however, simple in any State. Also, as briefly noted already, with the shift in the point of levy to the first point, the problems in excise taxation associated with definition of manufacturing, undervaluation and commodity classification are revisited when one looks at the sales tax systems. In sheer complexity and irrationality, the sales tax systems, as they are structured and implemented at present, surpass the excises even at their worst. In this chapter, we first outline the main features of the present sales tax systems, and then proceed to discuss the problems they have generated and the consequences.

3.1.1 Point of levy

Initially, the systems of sales taxation in India took two main forms - the Madras (or multipoint) system and the Bengal (retail taxation) system. Over the years, to avoid the problems of administering a tax at the retail level and dealing with too many dealers which multipoint taxation entailed, all States have now turned to taxation mainly at the first point to raise the bulk of the revenue. Vestiges of the original system, however, remain. Thus, in the States which started with the retail point tax, the general rate is still applied at the last point falling on commodities not specifically mentioned elsewhere, although the main revenue yielding commodities have been brought under the first point. Similarly, the residuary items in the States which had adopted the Madras model are still, by and large, subject to the multipoint levy. Ironically, Tamil Nadu has switched to the first point system. Some States (e.g., Gujarat) divide taxable goods into three categories with the first category taxed at the first point of sale, the second at the last point and the third at both first and last points.Points of levy and the rates of tax prevailing in different States are given in Appendix Table A3.3.

Driven by pressures to raise more and more revenue, most States have resorted to levies in the form of surcharges (SC), on the one hand and additional sales tax/turnover tax (TOT), etc., on the other. The surcharges are currently in operation in a majority of the bigger States, the base in some being the amount of general sales tax (GST) and in some, the total of both GST and TOT payable. The TOT in most cases is a multipoint tax. It is levied on gross turnover of dealers with sales in excess of the exemption threshold, and this applies to intermediate dealers even in States where the general sales tax is largely leviable at only one point.

To minimise the problem of collecting tax from sale of farm produce like paddy, sugarcane and fruits, a commonly followed practice is to levy the tax on purchase at the last point (e.g, on the rice miller for the purchase of paddy).

The changes in the systems described above have come about either through amendments in the basic law governing the levy of sales tax, or through enactment of supplementary laws. In several States, the laws relating to saies tax are embodied in more than one legislation. A classic example is that of West Bengal. The tax on sale and purchase of goods is governed in that State by as many as four legislations, viz.:

- The Bengal Finance (Sales Tax) Act, 1941;
- The West Bengal Sales Tax Act, 1954;
- The West Bengal Motor Spirit Sales Tax Act, 1974; and
- The Bengal Raw Jute Taxation Act, 1941.

Then there is the Central Sales Tax Act of 1956, the legislation authorizing the levy of tax on inter-State sales, enacted by

Parliament with the powers delegated to the States to administer it and retain the revenue.

Recommendations for reform of the systems by consolidating the laws into one do not seem to have been taken seriously by policymakers except possibly in one or two instances. A consolidated law was reported to be ready for placing in the Assembly in West Bengal since long but its enactment is still to come. Taxpayers dealing with commodities subjected to tax under the five legislations are still required to file as many returns every year and assessments have to be made for each of them individually (unless the case in question comes under the Self Assessment Scheme). As a result, assessments in arrears keep piling up and the government of the State is obliged to clear the backlog by declaring, periodically, the pending assessments as deemed to have been completed.

3.1.2 Rates

The complexities of multiple levies and legislations are compounded by the multiplicity of rates.

Invoking considerations ranging from social justice and equity to promotion of trade and industry within the State, the rates of sales tax are differentiated across commodities. As may be seen from Table A3.3, the number of rates in most States is at least six or seven and in some (West Bengal and Maharashtra) as many as twelve or more, varying from 0 and 1 per cent to 150 per cent. In general, non-luxury foods and certain other basic necessities are taxed at approximately 4 per cent, while other items attract tax at rates in the range of 8 to 15 per cent.

The TOT is levied mostly at graduated rates. For instance, in Andhra Pradesh, the rates of the TOT which was introduced recently (August 1993) for dealers having (gross) turnover of Rs 10 lakh or more, are as follows:

Turnover (Rs.)	Rate of TOT
Below 10 lakh	Nil
10 to 50 lakh	0.5%
50 lakh to 1 crore	1.0%
More than 1 crore	2.0%

The rates of surcharge vary from 5 to 25 per cent. In some States, the rates of surcharge are graduated according to the size of turnover (Table 3.1). In Tamil Nadu, a uniform surcharge is levied all over the State to supplement the income of local governments; an additional surcharge is levied in the greater Madras area for water supply schemes.

3.1.3 Exemptions

Most States provide a variety of exemptions, either to lessen the regressivity of the tax, or as incentive to industry.

Exemptions to lessen the regressivity are provided for items like basic food products sold in unprocessed form, books and maps (including students exercise books), and bicycles. There are, however, significant inter-State variations in the list of exempt food items. For example, Haryana, Punjab, Rajasthan, Uttar Pradesh, and Orissa apply tax to cereals and pulses, while many States exempt them. Tamil Nadu, exempts cereals, but not pulses. Andhra Pradesh exempts pulses but not wheat or rice (vide Table A3.3).

Industrial incentives take various forms such as deferment of sales tax, sales tax holidays, repayment of term loans from sales tax collected, etc. (Table 3.2). Such incentives are generally limited to new industrial enterprises or units locating in specific areas, small scale enterprises, and the amount of sales tax foregone or deferred under the incentive provisions is usually tied to the amount of fixed capital investment by the enterprises. The exemption for khadi cloth and cottage industry products granted in many States, also constitutes a form of industrial incentive to promote production and employment.

Another category of exemptions is related to end-use. These are exemptions for specific organizations and institutions, such as military canteens, public hospitals and so on.

3.1.4 Treatment of inputs

Except for commodities specifically

Table 3.1

Structure of Additional Sales/Turnover Tax and Surcharge in States Sales Taxes (as of January 1994)

State	Additional Sales Tax		Turnover Tax		Surcharge on Sales Tax	
	Turnover Limit (lakh)	Rate	Turnover Limit (lakh)	Rate	Turnover Limit (lakh)	Rate
1 Andhra Pradesh			10 - 50	0.5%	-	10%
			50 - 100	1%		
			100 & above	2%		
2 Bihar	On the sale of specified goods	1%	-	-	05 - 10	5%
					10 & above	10%
3 Chandigarh	-	-	-	-	-	2%
4 Delhi	-	-	-	-	-	-
5 Goa	20 - 40	10%	-	-	-	-
	40 & above	15%				
6 Gujarat	-	-	50 & above	1.00%	-	-
			200-400	1.5 lakh+1.25%		
			400-800	4.0 lakh+1.50%		
			800 & above	10 lakh+2.00%		
7 Haryana	-	-	-	-	-	10%
8 Himachal Pradesh	-	-	-	-	-	10%
9 Karnataka	-	-	10 -200	1.25%	-	-
			200 -500	1.75%		
			500 & above	2.50%		
10 Kerala	01 - 10	5%	-	-	-	-
	10 & above	8%				
11 Madhya Pradesh	-	-	-	-	-	-
12 Maharashtra	-	-	12 -100	1.25%	10 & above	12%
			100 & above	1.50%		
13 Manipur	-	-	-	-	-	-
14 Orissa	-	-	-	-	10 & above	10%
15 Punjab	-	-	-	-	-	10%
16 Rajasthan	-	-	-	-	-	-
17 Tamil Nadu	10-40	1.25%	-	-	-*	15%
	40 - 100	1.50%				
	100 - 500	2.00%				
	500 - 1000	2.25%				
	1000& above	2.50%				
18 Tripura	10 & above	.0825%	-	-	-	-
19 Uttar Pradesh	-	-	-	-	-	25%
20 West Bengal	-	-	-	-	-	15%

Source: Commissioners of Sales/Commercial Taxes of various States.

Notes : 1. In Andhra Pradesh and Bihar the surcharge is also levied on additional sales tax.

2. * Additional surcharge @ 5% on tax in Madras urban area only

3. - denotes 'not applicable'

Table 3.2

Incentives for Industries under States Sales Taxes*

	States	Years for which available		Tax holiday applicable to Sales/RM
		Deferment**	Tax holiday	
1.	Andhra Pradesh	10	5	Sale
2.	Assam	-	7	Sale and RM
3.	Bihar	5	5	RM
4.	Gujarat#	6 to 9	6 to 9	Sale and RM
5.	Goa	12 to 15	12 to 15	Sale
6.	Haryana#	5 to 9	5 to 9	Sale
7.	Himachal Pradesh#	6 to 12	4 to 12	Sale
8.	Jammu & Kashmir	10	10	Sale and RM
9.	Karnataka#	6 to 8	4 to 7	Sale
10.	Kerala#	10	7	Sale
11.	Madhya Pradesh	2 to 11	2 to 11	Sale and RM
12.	Maharashtra#	3 to 10	3 to 10	Sale and RM
13.	Meghalaya	5	5	Sale and RM
14.	Orissa	5	7	Sale and RM
15.	Punjab	-	7 to 10	Sale
16.	Rajasthan	7 to 11	7 to 11	Sale
17.	Tamil Nadu	10 to 14	5 to 7	Sale
18.	Tripura	-	5	Sale
19.	Uttar Pradesh	8 to 10	8 to 10	Sale
20.	West Bengal	5 to 9	4 to 9	RM

Source: Central & State Governments Incentives for Industrial Development, *PHD Chamber of Commerce and Industry*, September 1993.

Notes :
* The incentives are usually subject to certain conditions such as the size of the unit, location and so on.
** In some States this benefit is called interest free loan.
\# An industrial unit may opt for either exemption or deferment.
\- Denotes not applicable.

Abbreviations: RM = Raw material

exempted, sales tax is generally levied on the sale or purchase of all commodities including raw materials, inputs and capital goods. To alleviate the cascading effect of taxes on inputs, various remedies are applied such as total exemption or taxation at a concessional rate (vide Table 3.3).

However, no State allows a full rebate of tax on all business inputs. The only rebate that is allowed is in respect of raw materials, parts and consumables for use in manufacturing. Even for such items, the rebate is in some States often only partial and is designed to reduce the tax to approximately 4 per cent. Some States deny or reduce the input tax rebate in respect of goods that do not subsequently attract the State sales tax. For example, in Maharashtra, manufacturing inputs are subject to a tax of 4 per cent, where the manufactured goods attract the CST or the local sales tax. (In addition, turnover tax and additional sales tax are charged depending on the turnover of the selling dealer.) Where the manufactured goods leave the State under a consignment arrangement, without bearing any sales tax in the State, the net tax on inputs used in the manufacture of those goods is increased to 6 per cent through a complex claw-back formula.

No rebate is allowed in respect of production machinery and equipment, or for inputs used in the distribution of goods.

Table 3.3

Sales Tax Rates on Goods used as Raw Materials by Manufacturers

	States	Basic rate (per cent)
1.	Andhra Pradesh	4
2.	Bihar	3
3.	Delhi	0
4.	Goa	0
5.	Gujarat	Set off on purchase
6.	Haryana	0
7.	Himachal Pradesh	1
8.	Karnataka	4
9.	Kerala	2.5
10.	Madhya Pradesh	4
11.	Maharashtra	4
12.	Manipur	0
13.	Orissa	4
14.	Punjab	0
15.	Rajasthan	0 to 3
16.	Tamil Nadu	3
17.	Uttar Pradesh	0 to 4
18.	West Bengal	2

Source: Office of Commissioners of Sales/ Commercial Taxes of the States.

3.1.5 Taxation of inter-State sales

Although the powers of the States to levy the tax on sale and purchase of goods are meant to be exercised only in respect of transactions within their respective jurisdictions, in practice sales tax is levied by them on inter-State sales also. To regulate the taxation of inter-State sales taking place between dealers or between dealers and consumers, a law was enacted by Parliament in 1956 designated as the Central Sales Tax (CST) Act. While powers to tax inter-State sales under the Constitution belong to the Centre, the States have been authorised to levy the CST on such sales originating in their territories and retain the proceeds. There is a ceiling on the rate of tax which can be levied. Initially fixed at 1 per cent, the rate currently stands at 4 per cent. This rate applies to sales to a registered dealer. Sales to an unregistered dealer (such as a consumer of a final product) attracts tax at 10 per cent or the rate applicable on local sales including additional sales tax and surcharge, whichever is higher.

Since the CST is applicable to *sales*, inter-State movement of goods as consignment has not been liable to any CST in the exporting State. Finding that this was being used on a large scale to defeat inter-State sales taxation, the States pressed for legal remedy and the Constitution was amended in 1982 (46th Amendment) to authorise the levy of sales tax on consignments. The legislation to implement the levy on consignments is still awaited. As explained below, taxation of inter-State sales has been a major source of inefficiency and inequity in the system.

3.2 Problems and Consequences

3.2.1 Complex structure

Even a bare description of the sales tax laws presented above would provide an idea of the complexity of the prevailing structure. It would not be an exaggeration to say that the States sales tax systems in India are one of the most complex around the world. The rules and procedures laid down for compliance and enforcement make the systems even more complex than might appear from the primary legislations alone.

In fact, judging by the complexity of the system and frequency with which changes are made, one wonders whether the tax officials themselves can keep abreast of them or fully comprehend them. The complexity of the systems is vividly illustrated by the design of some of the prescribed tax return forms which typically run into several pages. By contrast the VAT returns in most industrialised countries contain no more than a single page. Then there are the variations in laws and procedures from State to State. An enterprise having business transactions spread over more than one State has to keep track of the sales tax laws and procedures in each in order to comply with them - the structure of the various levies, the threshold for each, the rates, the forms required for claiming reliefs and exemptions/concessions, the periodicity of return filing and so on. In several States (e.g., Maharashtra), the number of forms prescribed for compliance with the sales taxes run to 40 or more. The hassle and cost involved in complying with all the regulations can be easily imagined. The costs of administration are also not small.

Complexity makes the tax system unfair by imposing a disproportionate compliance cost burden on small businesses. Also, the complexities create inequities by providing unequal opportunities for evasion and avoidance depending on the nature of the commodity and the operation of the trade channels.

3.2.2 Pitfalls of first-point sales taxation

Primarily for reasons of administrative convenience, the States have tended to apply the tax more and more at the first point of sale, falling either on manufacturers or on importers from other States or from abroad. Apart from the definitional conundrums associated with taxation at manufacturer level, in sales tax first point taxation has its own set of problems. It is susceptible to evasion and avoidance and can also cause serious economic distortions and inequity in the incidence of tax among competing firms. These are:

The base being narrow, when the tax is levied at the first point of sale, the rates of tax have obviously to be high to yield a given target amount of revenue. The high rates, in turn, induce business firms and consumers to find ways of avoiding the tax and generate pressures for relief through concessions and exemptions. Differentiation in the rates reflect the outcome of these and the anxiety of the governments to make the systems acceptable.

Under a first point tax, the tax falls either on manufacturers or on importers. As in the case of excises, what constitutes "manufacturing" gives rise to disputes over questions such as, does cutting of marble slabs from rocks or twisting of yarn constitute manufacturing? Then there are problems of valuation especially when services fall outside the ambit of the tax.

Like in Union excises, first point sales taxation creates opportunities for tax avoidance through making of sales to a sister concern at artificially low prices, and shifting of certain services related to the sale of goods beyond the first point. To counter tax avoidance, Kerala Sales Tax (KST) Rules contain a specific rule debarring deduction of post-sale expenses from sale value except where it is shown separately in the bill (Rule 9 of KST Rules). Similar rules prevail in other States too. Even with all this the margin between the first sale and the sale to the final consumer is found to be as high as 100 per cent or more in many instances. Information gathered from one State shows that for several consumer goods, the gap between first point price and the price at the second point of sale varies from 4 per cent to over 300 per cent of the first sale price (vide Table 3.4). The value added on the subsequent sales, after the first point - whether genuine or artificial - goes totally untaxed under the first point sales tax.

Again, as under excise taxation, exemption which is extended to the small scale producers in some States, facilitates tax avoidance by farming out production to SSI units with the large units acting as distributors effecting second sales only under their own brand names, but acting as sole sellers. There are instances of a hotel business being split up with the kitchen shown as a separate unit owned by the spouse of the hotel owner. Similarly, exemption granted to charitable institutions also has opened up opportunities for tax avoidance through this device. In the case of exemptions granted to new manufacturing units, the exempt units set up in one State move to

Table 3.4

Difference in Unit Price of Products Between First Sale and Second Sale

Items	Unit	First sale Price (Rs.per unit)	Second sale Price (Rs.per unit)	Difference (Rs.) (Col.3 -Col.2)	Difference (%) (Col.4/Col.2)
1	2	3	4	5	6
1. Suitcases					
a) B.Belt II-2	1	522	850	328	63
b) Calive -21	1	509	915	406	80
c) Valet	1	401	659	258	64
2. Air Coolers	1	3825	5732	1907	50
3. Paints					
a) 2021	50 kg	685	1016	331	48
b) 3011	50 kg	685	1016	331	48
c) 4221	50 kg	685	1016	331	48
4. Dental Cream					
a) 200gms	1 Dzn	168	262	95	57
b) 100gms	1 Dzn	94	148	54	57
c) 50gms	1 Dzn	53	81	28	53
5. Tooth powder					
a) 200 gms	1 Dzn	130	232	103	79
b) 100 gms	1 Dzn	73	133	61	84
c) 50 gms	1 Dzn	49	74	25	51
6. Talcum powder					
a) 100 gms	1000 pieces	7556	18896	11340	150
b) 400 gms	1000 pieces	18790	46750	27960	149
7. Whisky empty bottles					
a) 375 ml	1 Dzn	21	90	69	329
b) 180 ml B.P	1 Dzn	14	45	31	221
c) 750 ml B.P	1 Dzn	15	40	25	167
d) 5 bottles in corrugated boxes	1 Dzn	150	540	390	260

Source: Office of Commissioner of Sales Tax, Andhra Pradesh.

another on the expiry of the tax holiday. As used machinery bought from outside the State is regarded as new investment for purposes of the exemption, they are able to extend the exemption period through relocation to another State.

Looking at the actual operation of the sales tax systems in various States, even the arguments of administrative simplicity of tax at the first point of sale do not seem to be very convincing. The number of registered dealers in the larger States is quite large, and includes many dealers beyond the stage of manufacturing. Even under a single-point taxation at the first stage intermediate dealers are required to register and file returns simply to establish their eligibility for the exemption. Exemption of intermediate dealers operates on the strength of evidence of purchase or invoice from another registered dealer who is supposed to have already collected the tax from the purchaser. The invoices are often faked ("Hawala") and the tax department is often hard put to establishing that the intermediate dealer is a fictitious entity. The standard of evidence insisted upon by the courts is almost impossible to meet in most cases. That there is a thriving market in bill trading goes to show that the claim of administrative advantage in the first point taxation is exaggerated.[4] Another reason why the number of registered dealers is not small even under first point sales tax is that intermediate dealers usually sell goods imported from other States or they are subject to a turnover tax that applies at all points of sale.

Registered dealers selling goods acquired from other States are required to charge tax on their selling price of imports under the first point tax. However, they may also carry in their inventory goods acquired within the State, which can be resold without any further tax. This dual tax regime for imports and intra-State goods which presumably many dealers have to contend with requires complex inventory accounting procedures, increases costs of compliance, and creates opportunities for evasion. To check evasion of tax under the first point system checkposts are established at the State borders and permits are required for imports into one State from another. In Andhra Pradesh, there are checkposts even around the city of Hyderabad.

To reiterate the point briefly mentioned in Chapter 2, a tax at first point alone leads to economic distortions because the first point of sale could represent a sale at different trade levels, such as a manufacturer, a national distributor, a regional wholesaler, a local wholesaler, or a retailer. In each case, the price would be different. Even if the tax were to apply at a uniform statutory rate on the actual selling price at that point, the effective tax rate (defined as the ratio of tax to the final consumer price) would not be uniform because of variations in the extent of value addition at different trade levels. Table 3.5 (and Chart 3.1) provide illustration of how the trade margins beyond manufacturing vary across products. The effective tax rates can vary not only across products, but also across different dealers for a given class of products. This lack of neutrality in the application of tax creates distortions in production and distribution channels, and creates inequities in the application of tax to competing firms. Such distortions and inequities force even otherwise honest dealers to resort to activities that are unethical or in contravention of the law. Also, the first point tax without full set off for the tax on inputs tends to encourage vertical integration.

3.2.3 Ill effects of excluding services

Exclusion of services has tended to narrow the base and created scope for avoidance of sales tax in some peculiar ways.

Because of the exclusion of services from the base in the law as ruled by the Courts, States were debarred from levying sales tax on goods sold in the course of execution of works contracts and by hotels as part of their catering service. The Constitution had to be amended to permit the levy of sales tax on goods sold as part of a

4. In Delhi, the Capital of India, forms evidencing sales by a registered dealer (ST-I form) are reported to be selling for anything between Rs 2000 and Rs 5000 for each form ("Sales Tax Evasion Racket Unearthed", Statesman, New Delhi, 19 November 1993).

Table 3.5

Tax Component and Trade Margins for Selected Commodities

(per cent)

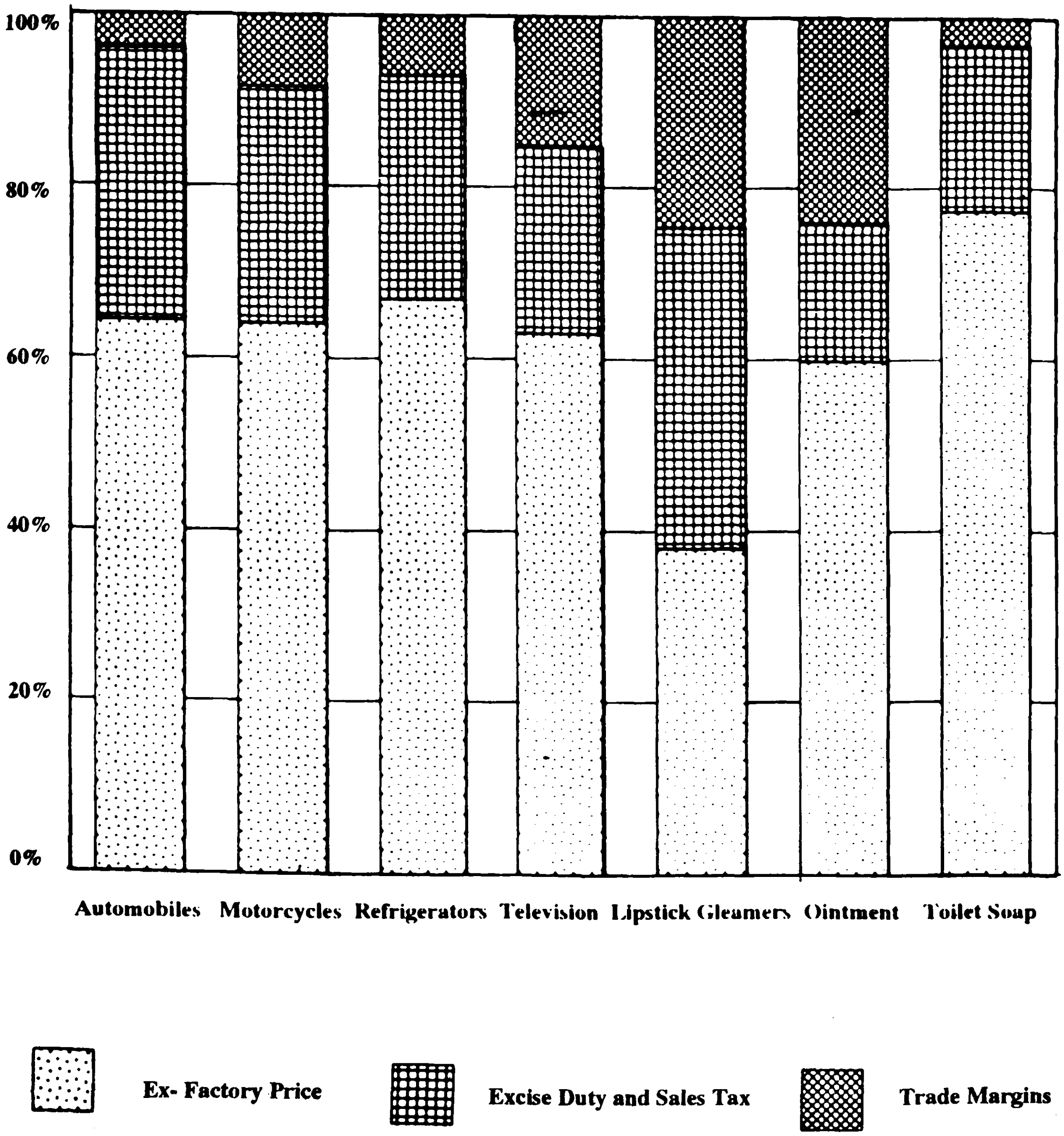
Name of the product	EFP/MRP	EXD+ST/ MRP	TM/MRP	TM/EFP
Compressor				
Type-1	0.43	0.52	0.05	0.13
Type-2	0.63	0.30	0.07	0.11
Cement	0.58	0.31	0.11	0.19
Agricultural tractors				
Model-1	0.83	0.12	0.05	0.06
Model-2	0.84	0.12	0.03	0.04
Automobiles	0.64	0.32	0.04	0.06
Motorcycles	0.64	0.27	0.08	0.13
Refrigerators				
1. 165 litres	0.76	0.21	0.03	0.04
2. 305 litres	0.67	0.26	0.07	0.11
3. 300 litres (Double door)	0.70	0.26	0.04	0.06
Television				
Model-1	0.63	0.22	0.15	0.24
Model-2	0.64	0.21	0.15	0.23
Model-3	0.65	0.21	0.14	0.22
Model-4	0.64	0.22	0.14	0.22
Model-5	0.70	0.21	0.09	0.13
Lipstick gleamers	0.38	0.37	0.25	0.64
Ointment	0.60	0.16	0.24	0.40
Toilet soap	0.77	0.19	0.03	0.04

Source: NIPFP Survey (1993).

Notes : EFP = Ex-Factory Price.
SIP = Sales Invoice Price.
MRP = Maximum Retail Price.
EXD = Excise Duty.
ST = Sales Tax.
TM = Trade Margin.

Chart 3.1

Composition of Price for Selected Consumer Items



composite contract or service (46th amendment). Disputes have arisen over the question of segregating the service part in a works contract when the States proceeded to tax works contracts in exercise of the powers conferred through the 46th amendment. A recent judgement of the Supreme Court in this regard serves to bring out how the fracturing of the base into goods and services can pave the way to avoidance and evasion by loading on services part at the expense of goods in a works contract (vide Box 3.1). Similar difficulties are encountered in the taxation of leasing and hire purchase, and it seems, legislations intended to bring lease rentals under sales taxation are locked up in disputes pending before the courts.

Exclusion of the service component in works contracts or job work also tends to thwart standardisation while it is through standardisation that efficiency is achieved in production in advanced countries. When a plant or a building component is made at the site, it is not possible to adhere to standards to the extent possible in a mass production factory under strict quality control. Failure to tax services obviously makes it cheaper to undertake manufacturing at the work site, to the detriment of efficiency. Exclusion of services from the base thus has consequences going beyond mere complexity.

The States have sought to circumvent the restrictive effect of exclusion of services in several other ways, e.g., by seeking to tax the sale of intangibles like import licence and lottery tickets. The reference to "goods" only in the relevant entry in the State List, however, raises doubts about the legality of extending sales taxation to such items and the matter has been taken to courts.

3.2.4 Multiplicity of rates and levies

With a narrow base, the rates of tax have obviously to be higher than when the base is broader. To mitigate the effects of such high rates, relief is provided for selected commodities - particularly essential items - in the from of exemption or concession in rates. However, search for revenue or considerations which are not always apparent have led to differentiation in the rates between commodities which are difficult to implement. As a result, innumerable cases have been taken to the highest courts for adjudication on whether a given commodity falls in one category or another for purposes of sales taxation (vide Box 3.2).

The levies imposed as supplements to sales tax are also often structured to serve the objective of progressivity while raising additional revenue. Thus the "turnover" taxes are in most cases graduated with reference to the size of the turnover. The result again is bizarre.

For instance, if the total number of rates in a State are ten and three rates are presented for the TOT depending on the turnover, the number of rates actually charged for different commodities goes up to thirty. If, in addition, there are surcharges, the rates can multiply further. In Andhra Pradesh sales tax is charged on a base that includes sales tax and the appendages like surcharge and TOT. Consequently, the rates at which tax is payable by dealers are not what they apply on their sales. A ready reckoner for the effective rates for dealers in different ranges of turnover sets out as many as 100 and odd rates (vide Table 3.6).

In some States, the law prohibits the dealers from passing on the TOT. This, however, is only a wishful act on the part of the policy makers since traders cannot possibly be prevented from passing on as much of the tax as they can to their buyers. Since there is a ceiling on CST, TOT or its equivalent cannot, however, be passed on when the sales are made inter-State. How convoluted the rules can be to ensure this can be seen from a circular issued by the CCT, Tamil Nadu (Box 3.3).

Sometimes, the quest for equity takes curious forms. For instance, in Kerala, a fee is payable annually by dealers for registration. The rates fixed are as follows:

For yearly turnover of Rs 1 crore	Rs 4,250
For yearly turnover above Rs 1 crore	Rs 1,750 *plus* Rs 50 for every lakh above Rs 50 lakh subject to a maximum of Rs 10,000

Box 3.1

Supreme Court in Builders' Association of India

Vs.

State of Karnataka & Others (1993) 88 STC 248

The charges for labour and services which are to be deducted in establishing the value of goods involved in the execution of works contracts are:

a. Labour charges for execution of the works;

b. Amount paid to the sub-contractor for labour and services;

c. Charges for obtaining on hire or otherwise machinery or tools used for the execution of the works contract;

d. Charges for planning, designing and architects' fee;

e. Cost of consumables used in the execution of the works contract which are not transferred in the execution of the contract;

f. Cost of establishment of the contract to the extent it is relatable to supply of labour and services;

g. Other similar expenses relatable to supply of labour and services; and

h. Profit earned by the contractor to the extent it is relatable to supply of labour and services.

Earlier, for dealers having turnover of Rs 30 crore or even more the registration fee was Rs 850 only. One wonders whether the fees in question can legitimately be regarded as part of sales tax or a fee for service (registration) and whether and how the dealers are arranging to recover it from their customers. Also, it is not clear how a dealer can anticipate what his turnover is going to be in a given year. Uncertainty also arises when there is a dispute between the taxpayers and the tax authorities as to where a commodity belongs for purposes of rate. As the disputes take long time to resolve, the correct amount of tax payable remains indeterminate for years. The upshot is acute complexity and total obscurity as to what is the final incidence of the taxes and who bears how much of the burden.

3.2.5 Economic distortions and tax cascading

A complex and irrational commodity tax

Box 3.2

Hair-splitting Under Sales Tax

According to some high courts:

Cosmetics and toilet articles include:

- Kajal
- Hairpins and clips
- Mehendi
- Combs

According to others:

Cosmetics and toilet articles do not include:

- Bhimseni kajal
- Safety razor and shaving brush.
- Sindoor
- Combs

Source: Balasubramanian and Vijay Srinivas (1991)

system can be a source of distortion in resource allocation and thwart growth in ways which may not be obvious to laymen. There is reason to think that the sales tax systems prevailing in India constitute a serious impediment to capital formation and efficient functioning of the economy and is inimical to growth in a variety of ways.

First, the imposition of sales taxes at the first point of sale is itsèlf a source of distortion as it induces manufacturers and dealers to shift value addition beyond the first point in order to minimise tax. Economic distortions result where not all competing firms enjoy the same flexibility to shift value addition. Even where firms do not engage in any tax-motivated shifts in value addition, the application of tax is not neutral because the first point of sale does not represent a uniform trade level.

Second, taxation of inputs results in cascading and encumbers industries more than what is warranted by the tax alone (as demonstrated in Table 2.2). Hence, sales tax systems of all States seek to provide relief for tax on inputs either by suspending the levy or by lowering the rate. However, these concessions do not apply universally and are often nullified through claw-back provisions. Then there are the TOTs. Non-rebatable turnover taxes were prevalent in Europe during the fifties, but were subsequently

Table 3.6

Basic Rates and Effective Rates of Tax in Andhra Pradesh

Basic rate of (%)	Turnover tax at 1/2%	Surcharge at 10% of tax and turnover tax due	Effective rate chargeable by the department for dealers whose total turnover is:		Effective rate chargeable by dealers whose total turnover is:	
			Less than Rs.10 lakh	Rs.10 lakh or more	Less than Rs.10 lakh	Rs.10 lakh or more
1	2	3	4	5	6	7
			FIRST SCHEDULE (Sale point goods)			
0	0.50	0.05	0.00	0.55	0.00	0.58
1	0.50	0.15	1.10	1.65	1.11	1.63
2	0.50	0.25	2.20	2.75	2.25	2.83
3	0.50	0.35	3.30	3.85	3.41	4.00
4	0.50	0.45	4.40	4.95	4.60	5.21
5	0.50	0.55	5.50	6.05	5.82	6.44
6	0.50	0.65	6.60	7.15	7.07	7.70
7	0.50	0.75	7.70	8.25	8.34	8.99
8	0.50	0.85	8.80	9.35	9.65	10.31
9	0.50	0.95	9.90	10.45	10.99	11.67
10	0.50	1.05	11.00	11.55	12.36	13.06
11	0.50	1.15	12.10	12.65	13.77	14.48
12	0.50	1.25	13.20	13.75	15.21	15.94
13	0.50	1.35	14.30	14.85	16.69	17.44
17	0.50	1.75	18.70	19.25	23.00	23.84
25	0.50	2.55	27.50	28.05	37.93	38.99

Source: Krishna Murthy (1994).
Note : Effective rates chargeable under the APGST Act applicable to dealers whose total turnover is Rs.10 lakh or more but less than Rs.50 lakh, (effective from 18.07.1993).

abandoned and replaced by the VAT because of their pernicious influence on the economy. The most objectionable feature of the tax is that its burden cascades every time goods change hands. The larger the number of dealers in the distribution chain, the larger is the burden of tax. It creates incentives for vertical integration of firms to the detriment of specialisation in production. In addition, in the absence of a satisfactory system of rebating of all taxes collected at prior stages, it has a detrimental impact on the competitive position of local firms in export markets (including both inter-State and international trade).

Even with concessional treatment, from estimates based on available information it would appear that, in the aggregate, unrebated tax on business inputs accounts for approximately 30 per cent of sales tax collections of all of the States. From an economic perspective, this magnitude of tax cascading (i.e., taxation of inputs as well as finished output) is perhaps the most harmful aspect of the State sales tax systems. It increases the cost of investment and production and creates pressures for tax incentives for new industries. The incentives themselves become a source of economic distortions, when granted in a selective

Box 3.3

Method of Arriving at Central Sales Tax Rate for Goods Covered by C/D Forms

"Section 8(1) says that the rate to be charged is either at a flat rate of 4% or the local rate, whichever is lower. Therefore, if the local rate (which includes Surcharge, Additional Surcharge and Additional Sales Tax) is lower than 4%, only that lower local rate will be charged. If it exceeds, only 4% will be charged. It may be noted that when a flat 4% is charged, it is the rate specified in the Central Sales Tax Act; therefore, there is no Additional Sales Tax component to it as such and the entire 4% can be billed and passed on to the consumer. However, if only the local rate is charged, only the basic rate, the surcharge and the Additional Surcharge can be explicitly billed and passed on to the consumer, and the Additional Sales Tax component cannot be so passed on to the consumer. (This will be so in the other cases also, i.e., where local rate is made applicable as the equivalent Central Sales Tax rate, Additional Sales Tax component cannot be passed on; but, if any flattened rate like 4% or 10% under the Central Sales Tax Act is made applicable, it has no Additional Sales Tax component explicitly and the entire rate can be passed on)."

(Extracts from Circular No. Acts Cell III/43921/93, dated 29.4.1993 issued by the Special Commissioner & Commissioner of Commercial Taxes, Government of Tamil Nadu, Madras.)

manner. They undermine the competitive position of existing firms not eligible for the incentives, apart from opening up opportunities for abuse.

In the past, under a system of high tariff and regulatory protection of domestic industries, it was relatively easy for businesses to pass on the burden of input taxes to final consumers. As a result, the adverse effects of tax cascading may not have been that serious. This would no longer be the case under the new regime of economic liberalisation. Foreign goods enter the country free of all foreign taxes. If the domestic goods are to compete with foreign goods, they will need to be freed of the burden of input taxes.

Another undesirable feature of cascading is that it makes the effective burden of tax on a given commodity unpredictable. This means that the tax may lead to unintended changes in relative prices and that the governments do not have any control on the final incidence of tax.

Economic distortions are created not only by the flawed structures of the sales taxes, but also by the lack of uniformity in their enforcement. State administrations vary in the degree of computerisation, and the use of other modern technologies and procedures in the enforcement of tax. The other major reason for variation in enforcement is the collusion between the tax officials and the assessees. The lack of uniformity in enforcement could mean a wide and unpredictable divergence between the statutory and the effective tax rates.

Lastly, the current tax treatment of inter-State sales is also a major distorting factor in the operation of the Indian economy. Given the importance of this issue in the overall design of the State sales tax systems, and the strongly-held views on the appropriate treatment of inter-State sales, the issue is gone into separately as follows.

3.2.6 Pernicious effects of inter-State sales taxation and tax competition among States

The CST Act which authorises the levy of tax on inter-State sales (to which a reference has been made already) was designed, on the recommendations of the Taxation Enquiry Commission (TEC) of 1953-54, as an instrument to regulate the taxation of sales occurring between dealers located in more than one State. While it has no doubt helped to restore some order in the tax treatment of inter-State sales , the operation of the CST has impeded growth and diminished welfare by acting as a barrier to free trade and specialisation within the country. It has also given rise to problems which constitute a serious roadblock to the reform of domestic trade taxes. The problems basically are three-fold: (i) cascading; (ii) tax exporting and tax competition; and (iii) evasion/avoidance. The manner in which the States have gone about to export their taxes to consumers in other States on the one hand and, on the other, to undercut each other to attract trade and industries (e.g., by reducing their sales tax rates and/or extending concessions in various forms) has added not a little to the complexity, inequity and damaging effect of the entire system.

3.2.6.1 Cascading and distortions in the location of industry

The tax on inter-State sales falls on all commodities including inputs when sold in an inter-State transaction. No relief is available to users in the importing State even when these are used as industrial input while some relief is commonly extended for taxes paid on locally purchased inputs. As a result, the effective rate of tax on goods produced in another State is higher than when locally produced and consumed.

The difference in the incidence of tax is large in the case of durable goods like motor cars and because of this there is considerable diversion of trade in these commodities. When CST is avoided by opening branches in the other States and consigning goods, the price increase in the State where there is no branch is so great that the consumers of that State go to the other States for these goods. Sometimes even government agencies of a State buy their requirements of vehicles, etc. in a low-tax State.

Since the CST is leviable on each inter-State sale of goods, regardless of the application of the tax at prior stages, when the goods go through a chain of purchase and resale in several States, the tax cascades in a manner similar to a multistage turnover tax. For example, if a Karnataka dealer imports paper from Maharashtra and then resells it to a dealer in Tamil Nadu, the CST would apply twice, for a total burden of 8 per cent. Obviously, this becomes a handicap for the Karnataka dealer, compared with one who can arrange a sale directly from Maharashtra to Tamil Nadu. There are provisions to grant exemption from CST for "transit sales", but the conditions stipulated are so stringent (e.g., the dealer in Karnataka must not take delivery of the goods in question) that dealers engaging in such transactions are often hard put to satisfy the tax authorities that the sales indeed came under the "transit" category.

3.2.6.2 Hidden tax on international exports

Cascading of sales taxes affects international exports too. The States' powers of taxation do not permit levy of sales tax on sale or purchase in the course of international exports or imports. Under a provision of the CST Act, introduced in 1976, the last sale or purchase preceding the export is also "deemed to be in the course of such export" and so outside the purview of sales taxation. However, the exemption is available provided "the last sale or purchase took place after and was for the purpose of complying with the agreement or order for or in relation to such export"

In practice, to qualify for exemption, exporters must purchase the commodities in question against confirmed orders. As a result, exporters cannot make purchases in anticipation to take advantage of favourable market conditions. Moreover, disputes arise now and then as to whether a given sale can be regarded as a penultimate sale. For instance, nearly a hundred cases are understood to be pending before the courts on the question whether purchase of cashew kernel by exporters of cashew nuts can be regarded as a purchase in the course of export. In a recently reported case, the point of dispute was whether purchase of polythene bags by exporters of hosiery products could be regarded as a purchase in the course of exports.[5]

In any case, sales tax is payable on sales at all stages earlier to the penultimate to exports and these do not get rebated. This is true of inter-State sales taxes as well. There is no provision in law for refund of CST paid by export traders to the suppliers in other States. Even if such a provision was there and governments were willing to refund the tax on export products or their inputs, it would not be easy to do so for the simple reason that to design a suitable rebate system for exports under the existing regime is an impossible task because of difficulties in identifying and quantifying the magnitude of taxes borne by exports at all prior stages.

Sales taxes paid on export products or inputs like packing material do not get fully rebated even when the purchases/sales are all within the State for the prevailing understanding seems to be that the exemption from sales tax is available only to export traders and not to manufacturers who export their own products. In Maharashtra, export-producers have to pay sales tax at 4 per cent on almost all materials, purchased and used by them in the manufacture whether the products are exported or sold locally.[6]

5. [(1991) 81 STC 228].

6. See Krishnan (1993).

It is because of the burden it imposes on exports that no country in the world has chosen to apply indirect taxes to international trade on an "origin basis", that is, taxation by the country of origin. VAT and other forms of indirect taxes are levied on the principle of "destination" or the country where the goods are finally consumed. Under the origin principle the exporting country or State levies the tax and the importing country/State then applies its tax on either the full resale value of the goods ("cascade type origin tax") or only on the difference between the selling price and the purchase cost (non-cascading type). Under the destination principle, the exporting country/State does not collect any tax on sale of goods that move out of its boundary, leaving the importing State free to levy tax on the full resale value of the goods so imported.

The principle of destination is followed not only for taxation of international exports but also in the case of inter-State or inter-provincial sales in federal countries. For example, in the United States and Canada, the States and the provinces follow the destination principle in levying their retail sales taxes. The only example of a general sales tax levied on the basis of origin is that of the ICMS (Imposto Sobre Operacoes Relativas A Circulacao De Mercadorias E Sobre), levied by the Brazilian states. Given the difficulties that Brazil has encountered in the design and operation of this tax, it is not an example that Indian States should emulate. It is generally recognised that it is the origin basis of tax that is one of the main causes of the problems.

3.2.6.3 Valuation of inter-State sales

A sales tax based on the origin principle in an unharmonized regime gives rise to the problems of valuation of inter-State sales among sister companies, similar to the problem of transfer pricing under the income-tax system. When the tax on inter-State sales is not rebatable against the tax on the resale of the goods in the importing State, both the exporting and the importing dealers have an incentive to undervalue the inter-State sale.

3.2.6.4 Tax exporting

The system prevailing in India is a form of restricted cascading type origin tax. The exporting State levies the CST, though subject to a ceiling of 4 per cent, and the importing State applies its local rate on the resale value of the goods imported including the CST paid to the exporting State. This system hinders the smooth flow of inter-State trade and growth of a common market with its benefits that a country of India's dimension could offer. It raises issues of inter-jurisdictional equity which need to be resolved in the interests of unity and political stability of the country.

For various reasons, some historical, the levels of development and income in India are marked by sharp disparities among different regions. As Table 3.7 would show, nearly 30 per cent of the State domestic product in India originates from only four States accounting for less than 20 per cent of the population. A good part of the production of these States get exported to the remaining twentyone States. With an origin based tax, the producing States are able to export taxes too to citizens of the consuming States and thereby making inroads into their tax base. As column 5 of the table will show, the four high income States account for nearly 45 per cent of the total revenue from CST. The low-income States are the net importers and so they lose out in the game even though some of them also find this route a convenient device for deriving revenue from export of raw materials like minerals and tobacco leaves (e.g., Bihar and Madhya Pradesh vide Table 3.8).

An argument often put forward on behalf of producing States in support of origin based taxation is that they need to collect at least some tax from inter-State sales in order to recover the cost of infrastructure and public services provided by the State governments to the industries producing the goods which are consumed in other States. This line of reasoning is based on the assumption that in the absence of a tax on inter-State sales, the location of export industries within their jurisdiction would not contribute to the tax revenues of the exporting State. This is clearly fallacious. Any value addition (through production or distribution) in a jurisdiction necessarily means extra income in the hands of residents of that jurisdiction. Spending of this income on consumer goods expands the sales tax base of the producing States and, thereby, contributes to their revenues. In fact, to the extent that consumer expenditures are dependent on the level of income of the residents of a State, it is the producing States that stand to gain the most in additional sales tax revenues (even under the destination basis of consumption taxes) from increased export output. It is for this reason that countries are prepared to let exports leave their boundaries free of any domestic taxes. If zero tax makes sense for exports to other nations, it should make equal sense for exports to other States. It is shortsighted on the part of the exporting States to try to export taxes as that ultimately harms their own economy not to speak of the economy of the country as a whole. As for costs of infrastructure, these should be charged to businesses who benefit and not recovered in a way that goes against the interest of the State's economy.

3.2.6.5 Inter-State tax competition and fillip to avoidance/evasion

While the CST enables the States to extend their sales tax jurisdiction beyond their territories and thereby realise revenue from citizens of other States, the lack of harmony in the tax structures has promoted tax competition that closely resembles a negative-sum game. In the bid to attract trade and industry Union Territories and some States reduced the rates of tax on sales in their territories compared to those prevailing in the neighbouring areas.

Union Territories (e.g., Pondicherry and Dadra and Nagar Haveli), in particular, have reduced sales tax rates to attract shoppers from neighbouring States. Many States have had to lower their sales tax rates on consumer durables (and even automobiles) to stop revenue loss from such inter-State shopping. For example, in its 1993 budget, Orissa reduced the sales tax rates on motor vehicles, earth moving equipment, TVs and other electronic goods from 6 per cent, 16 per cent and 16 per cent respectively to a uniform 4 per cent, largely in response to competition

Table 3.7

Statewise Distribution of Population, SDP and Revenue from Sales Tax

(per cent)

States		Population	SDP@	G.S.T*.	C.S.T*.
1		2	3	4	5
High Income States					
1.	Maharashtra	9.46	15.30	17.37	21.78
2.	Gujarat	4.95	6.81	9.57	11.89
3.	Haryana	1.97	3.12	2.13	6.19
4.	Punjab	2.43	4.72	3.09	5.22
	Sub Total	**18.80**	**29.95**	**32.16**	**45.08**
Middle Income States					
5.	Andhra Pradesh	7.97	8.31	8.82	5.07
6.	Karnataka	5.39	5.89	7.28	7.84
7.	Kerala	3.49	3.17	5.57	2.87
8.	West Bengal	8.15	8.73	6.75	8.82
9.	Tamil Nadu	6.69	6.86	11.47	9.71
	Sub Total	**31.68**	**32.95**	**39.89**	**34.31**
Low Income States					
10.	Bihar	10.35	6.01	4.25	5.22
11.	Madhya Pradesh	7.93	6.36	4.22	6.85
12.	Orissa	3.79	2.74	2.21	0.56
13.	Uttar Pradesh	16.66	13.27	9.88	4.15
14.	Rajasthan	5.27	4.85	4.39	1.32
	Sub Total	**44.00**	**33.23**	**24.95**	**18.10**
Special Category States					
15.	Arunachal Pradesh	0.10	0.12	0.00	0.00
16.	Assam	2.68	2.34	1.57	1.76
17.	Himachal Pradesh	0.62	0.67	0.37	0.25
18.	Jammu & Kashmir	0.92	N.A.	0.38	0.00
19.	Manipur	0.22	0.19	0.06	0.00
20.	Meghalaya	0.21	0.17	0.07	0.30
21.	Nagaland	0.14	0.11	0.08	0.00
22.	Sikkim	0.05	N.A.	0.02	0.03
23.	Tripura	0.33	N.A.	0.09	0.00
24.	Goa	0.14	0.26	0.36	0.17
25.	Mizoram	0.08	N.A.	0.00	0.00
	Sub Total	**5.51**	**3.86**	**3.00**	**2.52**
	Total (25 States)	**100.00**	**100.00**	**100.00**	**100.00**

Sources: [1] RBI Bulletin, (various issues).
[2] Census of India, 1991.
[3] Indian Public Finance Statistics, 1992.

Notes : Classification of the States is as per the Ninth Finance Commission Report.
@ = Quick Estimate of SDP at current prices for the year 1990-91.
* = Average for the years 1988 to 1991.

Abbreviations:
NA = Not Available, GST = General Sales Tax, CST = Central Sales Tax,
SDP = State Domestic Product.

Table 3.8

Share of Central Sales Tax in Total Sales Tax Revenue (For Major States)

(per cent)

State/Year		1980-85@	1985-90@	1990-92@
1		2	3	4
High Income States				
1.	Maharashtra	22.43	20.26	18.92
2.	Gujarat	21.93	20.33	17.81
3.	Haryana	40.69	37.61	35.72
4.	Punjab	21.12	22.01	24.35
Middle Income States				
5.	Andhra Pradesh	16.17	N.A.#	15.85
6.	Karnataka	20.23	16.11	17.10
7.	Kerala	7.93	7.72	9.66
8.	West Bengal	28.94	22.41	21.55
9.	Tamil Nadu	16.72	14.78	13.47
Low Income States				
10.	Bihar*	24.26	27.47	27.31
11.	Madhya Pradesh	23.94	24.18	27.14
12.	Orissa	19.18	10.75	15.75
13.	Uttar Pradesh	9.90	8.50	6.89
14.	Rajasthan	10.04	5.63	7.38
	Total (14 States)	**18.80**	**17.41**	**17.20**

Source: Budget Documents of various States.

Notes : * = Revised Estimates from RBI Bulletin have been used for the years 1978 to 1992 to obtain consistent data.

= Consistent data are not available.

@ = Average for the period.

from neighbouring States. At the same time, the tax on certain basic food items was proposed to be increased from zero per cent to 4 per cent to compensate for the revenue loss from the rate cuts. Punjab has been obliged to reduce its sales tax rate on motor vehicles to 3.5 per cent while taxing cereals like rice and wheat at 4 per cent because of the tax rates prevailing in the Union Territory of Chandigarh.

There are two distinct forms of tax-motivated inter-State transactions and trade diversion. First, a registered manufacturer may buy production machinery and equipment, parts and other inputs from another State and pay only the 4 per cent CST. If the same goods were to be acquired from local dealers, they would attract tax at the full local sales tax rates which could be higher than 4 per cent. Second, consumers and unregistered businesses may buy goods in a lower-tax jurisdiction by paying the applicable local sales tax rates in that jurisdiction.

The first type trade diversion is of differential tax incidence by location of purchase. If the tax on production inputs were fully rebatable, there would be no incentive for manufacturers to go to other States for their inputs or capital goods.

The revenue loss from inter-State shopping by consumers and unregistered persons is of more serious concern and needs to be addressed on a separate footing. Even if the taxes were levied under a rational structure like VAT, this phenomenon would continue unless the tax rates were uniform in all the States, or some other mechanism were found to equalize the tax burden on purchases in different jurisdictions. Some States (e.g., Maharashtra) have indeed devised a method of such equalization (e.g., by levying the octroi or entry tax on motor vehicles brought into the State from outside). But that is not a very satisfactory solution to the problem of tax competition.

Perhaps unwittingly the CST Act seems to have abetted the practice of tax competition among the States by permitting them to reduce the rate of tax on inter-State sales to unregistered dealers (who may be final consumers) below the maximum rate of CST [through notifications issued under Section 8(5) of the CST Act]. For instance, Andhra Pradesh taxes inter-State sale of electronic items even without "C" form (that is, unregistered dealers) at 2 per cent while the local rate is 4 per cent. The diversion of trade in the goods taking place from neighbouring States will no doubt compel them to fall in line soon. Some States even went to the extent of reducing the rate of tax on such inter-State sales below the rate applicable to local sales. This practice, though frowned upon by the Supreme Court as violative of free flow of trade and commerce within the country, still seems to be practised in various ways.

The tendency to discriminate between inputs produced locally and those bought from other States was also held unconstitutional by the courts. The practice of granting concessions like tax holiday to new industries has been considered constitutionally permissible. And so, almost all States have schemes of concessions or deferment of tax for new manufacturing units. The gain again to any one particular State is dubious. Rather these have eroded the tax base and spawned schemes for avoidance by taking advantage of first point taxation as pointed out earlier.

The "rate war" as it has come to be known has had its toll on the buoyancy of revenue from sales tax. During the 1980s, the buoyancy of revenue from sales tax with reference to SDP for all the 14 large States suffered a set back (vide Table 3.9) and this despite all the additional imposts like surcharge, TOT and all.

The operation of inter-State sales tax has led businesses to find ways of avoidance and evasion. A simple and widely practised way is to camouflage inter-State sale of goods as transfer on consignment, or a depot or branch transfer. While there is no firm estimate of how much of the products of one State goes out in the form of consignment, it is widely believed that the volume is sizeable and in some cases (like pharmaceutical products of Maharashtra) the proportion is said to be as high as 80 per cent. According to knowledgeable persons, on an average, not less than 50 per cent of the inter-State movements of goods go as "consignment" transfers some of which, of course, could be genuine intra-firm transfer.

In response to the demand from States, the Constitution was amended to permit the levy of "taxes on the consignment of goods (whether the consignment is to the person making it or to any other persons) where such consignment takes place in the course of inter-State trade or commerce" (entry 92B of the Union List). Necessary legislation to authorise the levy of the tax is, however, yet to be introduced in Parliament, although the Central government had agreed to propose the legislative measure for imposing the tax.

While there seems to be a *prima facie* case for levying the consignment tax as long as inter-State sales are subjected to tax, it

Table 3.9

Buoyancy Coefficients* of Revenue from Sales Tax in 14 Major States for the 1970's and 1980's

States/year	1970-71 to 1979-80	1980-81 to 1989-90
Andhra Pradesh	1.69	1.36
Bihar	1.49	1.07
Gujarat	1.40	1.26
Haryana	1.64	1.19
Karnataka	1.48	1.34
Kerala	1.60	1.38
Madhya Pradesh	1.60	1.09
Maharashtra	1.21	1.12
Orissa	1.60	1.18
Punjab	1.25	1.09
Rajasthan	1.54	1.16
Tamil Nadu	1.62	1.18
Uttar Pradesh	1.86	1.18
West Bengal	1.52	1.09
All States	**1.52**	**1.16**

* With respect to State Domestic Product.

should be recognised that such a measure will only compound the ill effects of origin -based tax on the economy. It will exacerbate inter-jurisdictional inequity in the accrual of revenue. It should not be overlooked that genuine depot or branch transfers have mitigated the harmful effects of the CST and thereby benefitted the economy and the poorer States. Implementation of a tax on consignment will also pose a new set of problems, such as valuation, treatment of depot transfer, verification of movement of consignments, and keeping of record to indicate stocks moving on consignments through more than one State.

As it is, the question when does a sale constitute inter-State sale has not been as simple to answer as might be supposed. There has been a string of decisions from the Supreme Court on the question in specific cases, yet no general principle has emerged. It depends on the facts of each case. In a recent case, purchases were made by a firm in Uttar Pradesh as a commission agent for its principals located in other States. The contention of the firm was that these purchases had taken place in the course of inter-State trade, and so no purchase tax on agricultural commodities purchased by him could be levied. The sales tax department contested the claim and the matter had to go up to the Supreme Court for a final decision. In another case, sales tax authorities in Tamil Nadu sought to charge purchase tax on sugarcane purchased by the Government of Kerala from Tamil Nadu for a cooperative sugar factory under an express understanding with the Government of Tamil Nadu. Again the Supreme Court upheld the contention of the buyer that it was an inter-State purchase. For qualifying as "inter-State". sale the dicta laid down in these cases run as follows:

> "the movement of the goods is *occasioned by sale*, or inextricably connected with the sale/purchase, there is no break between the purchase and the movement of goods and so on".

However, as one commentator notes, what is the difference between a *contract of sale* and *a sale*, what is the incident of a contract of sale and a sale, how inextricable is the connection between movement of goods and sale are matters on which one has to find light from the judgements of the Supreme Court delivered since 1952. "In order to determine the true nature of the transaction, the seller has to enquire of the buyer, the purpose for which the goods are purchased by him and whether he is bound to despatch the goods outside the State any time, and afterwards the goods were actually despatched outside the State.....If due to non-availability of booking, the goods are not despatched even after a period of time, the seller will have to switch over his liability for payment of tax, treating his sale as one governed by the State sales tax law."[7]

What should be the appropriate rate chargeable on inter-State sale to unregistered dealers has also not been free from difficulty. While the CST Act enjoins that for cross-border sales to unregistered dealers, the tax payable on local sales or 10 per cent

7. See Mehta (1993).

whichever is higher will apply, what is the appropriate local rate in this context has generated controversy.

3.2.6.6 Disputes and court challenges

As in the case of Union excise, the complex and irrational structure of the sales tax system has created a huge backlog of unresolved disputes before the appeal authorities and courts. The number of cases pending for decision before the appellate authorities exceeded 57,000 in one State alone (West Bengal). Even in a relatively small State like Kerala, over 20,000 cases were reported to be pending for adjudication before the Appellate Tribunal only.[8] In the Union Territory of Delhi, nearly 40,000 cases were pending before the appellate authorities at the end of 1991-92, whereas the total number of registered dealers was no more than 119,243. It speaks ill of a tax system where assessments are disputed on this scale and remain undecided for long periods. In commodity taxes in particular, such litigation creates uncertainty in incidence for years. When the cases are finally decided, problems arise in the implementation of the judgements. If they go in favour of the assessee, refunds can lead to "undue enrichment", while adverse judgements cause problems to assessees as they cannot recover the tax from their customers.

3.2.7 Vicious circle of sales tax problems

Perhaps enough has been said to show that the systems of domestic trade taxation operating at present are far from simple or conducive to growth. They lack so utterly in transparency that any assertion about their equity or rationality must be regarded as an article of faith.

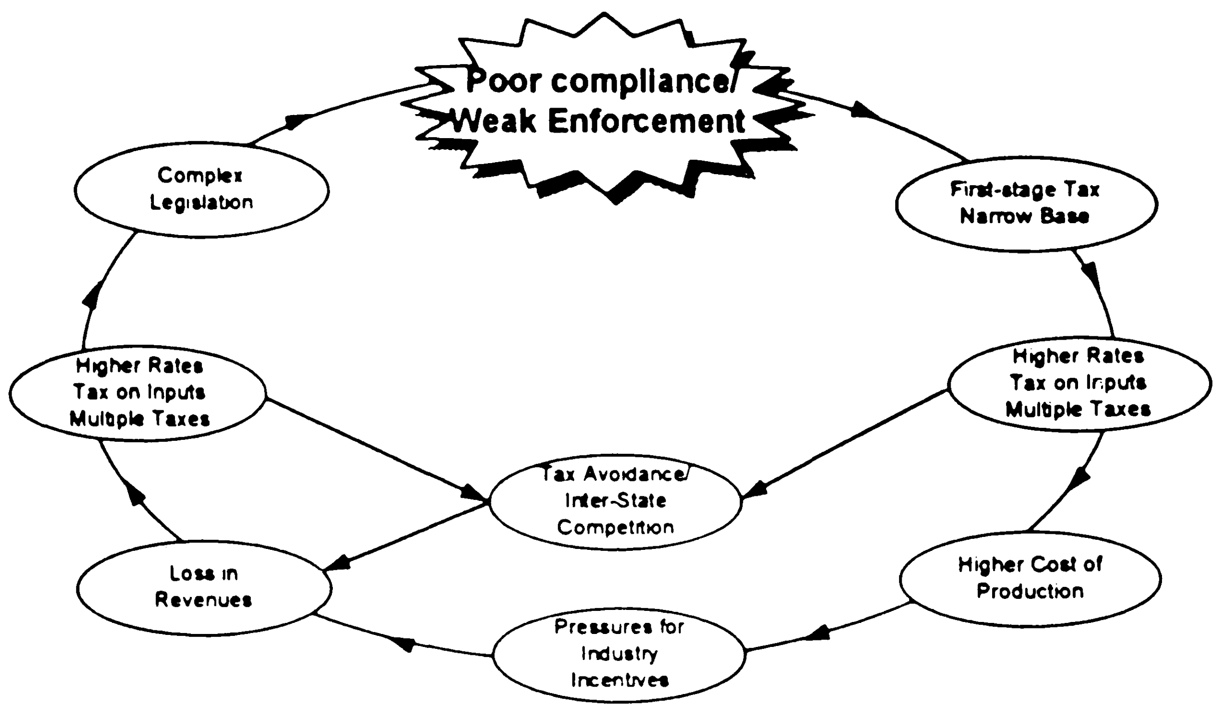
The various problems discussed above are interconnected and form a vicious circle, as illustrated in Chart 3.2. The starting point in this circle is the poor compliance by taxpayers and weak enforcement of tax laws by administrators. The enforcement may be weak because of administrative inefficiencies, and also because of the prevalence of unethical practices. These factors lead authorities to impose tax at the first point of sale. The narrow tax base at this point necessitates higher tax rates, extension of tax to business inputs with nil or only partial rebates, and experimentation with supplementary taxes in the form of surcharges and turnover taxes. The higher rates and tax cascading lead to increased tax avoidance and inter-State tax competition, and create pressures for industrial incentives. These forces further undermine revenue potential of the tax system, and elicit policy response in the form of yet higher rates, supplementary taxes, ad hoc adjustments and even more harmful taxes like the octroi or entry tax.[9] The result is a more and more complex tax structure, which can only worsen compliance and enforcement. The problems with sales tax system have become so acute and intractable that little room is left for any maneuver on the part of any individual State singly. Thorough going reforms are needed if the problems are to be removed.

8. These include cases in agricultural income tax but the bulk related to sales tax.

9. Octroi/entry taxes are outside the scope of this study and are therefore left out of consideration here.

Chart 3.2

State Sales Tax Systems: Caught in a Vicious Circle



THE OBJECTIVES OF CONSUMPTION TAX REFORM

4.1 Deficiencies of the Present System

The discussion in Chapters 2 and 3 about problems of the current system of domestic trade taxes leads to a set of broad conclusions. It is useful to reiterate them briefly, as a background to the identification of various reform options and their assessment.

First, it is apparent that the Union excises and State sales taxes as they are being levied now, viz., at the level of manufacturing or the first point of sale are not sustainable in the long run. Taxation at that level gives rise to intractable problems of defining manufacturing and the assessable value. Finding no other way to address these problems satisfactorily, the common trend is to extend the tax to the retail stage in the form of a retail sale tax or a value-added tax.

Second, the distinction between goods and services underlying the present structure is archaic and a source of complexity. It facilitates tax avoidance and creates unnecessary distortions in consumer choices. It is desirable to bring services under taxation not only to ensure proper taxation of goods but also to expand the consumption tax base which, in turn, would permit a general lowering of the tax rates. Taxation of services would also lessen the regressivity of the sales and excise taxes, since services account for a relatively larger proportion of the consumption basket among the upper income/expenditure groups.

Third, the current definition of domestic trade tax powers of the Centre and the States is a serious obstacle in the design of an efficient system of taxation of goods and services. The distinctions drawn in the Constitution between the taxation of *goods* and *services* and between manufacturing and subsequent stages of trade are outdated.

Fourth, the origin basis of state sales taxes (i.e., the imposition of the CST on inter-state sales) is a hindrance in the free movement of goods and services within the Indian common market, and in efficient functioning of the economy. It leads to tax cascading and creates distortions in the location of industry and patterns of trade.

Fifth, the overall structure of consumption taxes, at both the Centre and the States, is extremely complex (believed to be the most complex in the world) and grievously lacks neutrality and transparency. It is irrational, outdated, and injurious to the economy. The narrow base, multiplicity of rates, selective exemptions and ambiguous laws facilitate and encourage tax avoidance and evasion. They increase costs of compliance and administration. The lack of adequate relief for the tax charged on production inputs and machinery and equipment undermines the growth potential of the economy. These problems are compounded by the lack of harmony among the tax systems of different governments and the growing inter-state tax competition.

A system as flawed as the current one cannot be reformed through minor piecemeal changes. It requires a major overhaul. Before turning to specific options for reform, it is useful to discuss the principal objectives that the options must seek to achieve and the political and fiscal constraints within which the reform initiatives need to be carried out.

4.2 Objectives and Parameters of Reform

The primary objectives of domestic trade tax reform have to be to impart neutrality and transparency to the tax system to minimize the scope for distortion, harassment and abuse. The tax system should not cause unintended distortions of producer choices regarding forms and methods of conducting business and of consumer choices for one good over another. To achieve this, the following appear to be the main pre-requisites of reform measures.

4.2.1 Economic efficiency and neutrality

The ultimate function of taxation is to transfer resource from the private to the public sector in a neutral fashion as possible that is with the least interference with the working of the economy. This means that the tax system should be productive of revenue and also responsive to requirements of revenue but at the same time avoid interfering with economic decisions, that is, should be neutral unless non-neutrality can be clearly shown to be in the social interest.

In the context of consumption taxes, this means that the taxes should apply equally to as broad a base as possible including all goods and services. They should extend beyond the first point of sale and go as close as possible to consumers. As noted earlier, a tax that stops at intermediate stages of trade will not be uniform in its impact on different goods and services because of differences in their pattern of production and distribution. An economy that seeks to reap the advantages of market competition and integrate with the world economy must ensure that its products suffer no tax when traded in the world market. External neutrality, however, cannot be achieved without internal neutrality. This implies that "equal treatment" should be an important criterion for taxation.

Another important requirement for the neutral application of tax is the removal of tax on production inputs including plant and equipments. This could be achieved either through suspension of tax on production inputs or through a system of credits for the tax already collected on purchase of production inputs by registered manufacturers/traders.

Internal neutrality demands that the taxes are so designed that they do not impede the free flow of goods and services within the Indian common market. This has implications primarily for the design of the State taxes and their application to inter-State trade. It is generally recognized that the destination basis of consumption taxes is the most conducive to the objective of free movement of goods and services. This means that goods and services should be taxed in the State where they are consumed and not where they are produced. This system is the norm for the application of national sales taxes to international trade and should also be adhered to in the design of State taxes and their application to inter-state trade.

4.2.2 Equity

Consumption taxes are generally regressive. The Centre and the States have attempted to lessen the regressivity of excises and sales taxes through differentiation in tax rates and exemptions. However, it is doubtful that it has produced the results that were intended.[10] On the contrary, the system that has emerged through such attempts is so complex and irrational that it is not even possible to determine who bears what proportion of the total tax burden. Because of wide-spread evasion and weak enforcement, there is little congruence between the intended and actual tax incidence. Exemptions and lower tax rates may not be well targeted because the rich may benefit from them as much as the poor. In many instances, the rate structure has become perverse. For example, because of inter-state competition, many States impose tax on automobiles at rates lower or same rate as those applicable to items consumed by the lower-and middle-income households.

While equity is a desirable objective, international experience suggests that consumption taxes with multiple tax rates and exemptions cannot be applied in a fair manner. A tax that is highly progressive on paper can be extremely regressive if it cannot be or is not administered efficiently. Equity is served better if the tax is applied to as broad a base, and at as few rates, as possible, taking into account both social policy and administrative considerations. Any redistributive objectives can then be addressed through spending programmes or income and wealth taxes.

10. Optimum tax literature would seem to provide support for differentiation in rates to achieve least loss of welfare from the point of view of consumer choice. Differentiation according to optimum tax approach would, however, go against distributional considerations. Besides, such differentiation is not possible to work out in practice because of information problem. Hence, only a few rates are advocated by theorists to take care of both efficiency as well as equity objectives. From the angle of ease of administration and compliance, a uniform rate is the best.

Interjurisdictional equity is another dimension of this objective. It figures prominently in the approach of the Finance Commissions in determining inter-State allocation of government revenues. The existence of this mechanism for addressing concerns about interjurisdictional equity should permit a greater weight to be given to economic efficiency in the design of taxes. Besides, the objectives of economic efficiency and interjurisdictional equity are, in fact, complementary in the context of consumption taxes. For example, the application of State taxes on the basis of the destination principle is not only conducive to economic efficiency, but also beneficial to lower-income, consuming States.

4.2.3 Simplification and harmonization

International experience shows that simpler tax laws not only lower costs of compliance and administration, but also contribute to the revenue potential and fairness of the tax system. A neutral design of tax is the most important requirement for its simplicity. Much of the complexity of the current systems is attributable to the multiplicity of tax rates, narrow base and selective exemptions. When the tax is applied to a broad base, at fewer rates, the tax laws would be much simpler, the costs of compliance and administration much lower, and evasion more difficult.

Inter-State and Centre-State harmonization of tax laws and administrative procedures can also make a significant contribution to the objective of simplification. The current tax statutes are cluttered with a variety of ad hoc and outdated rules and procedures. There are no compelling reasons why the administrative procedures, including the design of tax returns, the systems for registration of dealers, appeal and enforcement rules, and penalty provisions, need to vary from State to State and cannot be standardized. Even in areas of tax policy, there is a lot to be gained from inter-State (or, for that matter, Centre-State) harmonization of tax bases and tax rates. The current system, characterized by uncoordinated policies and inter-state competition, does not serve the interests of any government, rather inflict losses on the economy.

4.2.4 Fiscal autonomy of the Centre and the States

While a certain degree of harmonization among taxes imposed by different governments is essential for simplification and effective enforcement, consolidation of all taxes into a single levy administered by only one level of government, to be shared among the Centre and the States, is neither politically feasible nor desirable. It would necessarily mean curtailment of the tax powers of one or the other level of government, to which they would not agree. Consumption taxes constitute the vital sources of revenue for both levels of government and to have them all collected by just one level of government would mean considerable loss of discretionary powers of the other level. The loss of discretion on the tax side could eventually constrain their discretion on the expenditure side of the budget as well. It is doubtful if such an outcome had been envisaged by our Constitution-makers or would be acceptable to them under the current circumstances. As Prof. Chelliah put it, a complete merger of the Centre and State taxes would lead to an extreme centralization of tax raising and could "dilute unduly the content of political federalism".

Given the significance of consumption taxes in the finances of the Centre and the State, it is desirable that they continue to enjoy fiscal autonomy with respect to the broad design features and overall revenue contribution of these taxes. Even though the governments should retain full fiscal autonomy, it would be in their mutual interest to accept certain restraints in the exercise of their tax powers. Such restraints could take the form of agreements to harmonize tax bases, rates, and administrative procedures and to not engage in inter-state tax competition. Even sovereign nations abide by such restraints, either explicitly by entering into binding international agreements (e.g., GATT), or implicitly by ensuring that their trade and tax policies are not out of line with those in their trading partners.

4.2.5 Strengthening of revenue base

Reform initiatives should not impair the overall revenues of the Centre and the States.

Governments need revenues to provide public services, to redirect resources to areas of social and economic priorities, and to reduce inequalities in the distribution of income and wealth. The current state of finances of the the Centre and the States in India are far from satisfactory. Their revenue bases need to be strengthened in order for them to maintain and improve the quality of the basic public services and infrastructure.

4.2.6 Efficient administration and effective enforcement

Another important objective of reform of consumption taxes is the improvement of tax administration and enforcement. The replacement of the current structures by a simple and rational system would be an important first step in this task. However, much more needs to be done to streamline administration, quite independently of the design of the taxes. Full benefits of tax redesign cannot be realized without complementary reforms of administrative systems. In fact, there is a risk that without such reforms the new system may amount to no more than a replacement of one set of distortions by another.

It can be easily demonstrated that many of the problems of the present system can be addressed through a harmonized system of consumption taxes. Such a system can operate either in the form of a retail sales tax or a destination based value added tax. If the option of a retail sales tax is ruled out on administrative grounds, as seems to be the case from experience and also is argued later, the only real alternative is a value added tax oriented towards taxation of consumption rather than production. Implementation of VAT in a federal context is, however, not simple. The main attributes of VAT, its possible forms and the issues and options that need to be given consideration in the Indian context are taken up in the chapters that follow.[11]

11. Much of the critical analysis and statement of the objectives of reform put forward in this and other chapters are given in the reports of the TRC also. Pioneering work in the economic analysis of domestic trade taxes was done earlier by the Indirect Taxation Enquiry Committee of 1976 (known as the Jha Committee). Problems with the present system and the possible directions of reform are also examined in the writings of others. See, for instance, Purohit (1992) and Rao (1993).

VALUE ADDED TAX: CHARACTERISTICS, MODE OF COMPUTATION, MERITS AND WEAKNESSES

5.1 Characteristics[12]

The value added tax or VAT, as it has come to be known, is a method of taxing, by instalments or in stages, final consumer spending in the economy. The method consists of levying a tax on value added to a product or service at each stage of the production and distribution process. For this purpose "Value added" is taken simply as the difference between a business's sales and purchases. Thus, if a firm buys inputs and equipment worth Rs 100 and sells the product or service it produces for Rs 150, its value added is Rs 50.[13] As will be seen presently, the sum of revenues collected from a tax on value added at different stages of production and trade is equivalent to a tax on the aggregate of value added, that is, the price of the product in question at the final or retail point of sale.

To put it differently, the VAT is a multi-stage tax like the turnover tax but with the basic difference that it is levied on the *value added* at each stage and not on the *gross turnover* of the dealer. This difference is crucial in that it ensures that each input going into a final consumer output is taxed *once* and *only once* and not cumulatively as under a cascading turnover tax. Although under a VAT, the tax is realised from producers and sellers of capital goods as well, the base turns out to be only the final consumption, if business firms are allowed to recover the tax paid on capital goods in the same manner as on other business inputs. This is the form in which the tax is levied in most countries. When the base is comprehensive and includes all final goods and services consumed, in the aggregate it is equivalent to the total consumer spending in the economy. This is what is called the consumption type VAT. Commonly, the base of the consumption type VAT comprises all domestically produced goods and services ***minus*** government services and exports, ***plus*** imports.[14] An alternative form of VAT is the "income type". Yet another form, rarely used, is the "gross product type".

In the income type, VAT is initially levied on both consumption and capital goods, but the tax on capital goods is then refunded/credited over the economic life of the goods, in accordance with a depreciation schedule similar to the one used for income tax purposes. It is called income type because its base is equivalent to the total income generated during a given period. When no deduction is allowed for purchase or depreciation of capital goods, the base becomes even broader and the tax is called gross product VAT.

5.2 Mode of Computation : Tax Credit vs. Subtraction Method

There are two primary ways of computing a value added tax - the invoice or tax-credit method and the subtraction method. It is also possible to compute the value added at each stage by adding up the factor rewards, viz., wages, interest, depreciation and net profits.

Under the tax-credit or invoice method, the tax is calculated separately for each purchase or sale, included in the sale price at each stage of the production and distribution and shown separately on all invoices (except

12. Description of the characteristics of VAT presented here draws upon, *inter alia*, National Economic Development Office, U.K. (1971), Shoup (1990) and United States General Accounting Office (1989). A lucid account of the basic features of VAT is also given in the Report of the Indirect Taxation Enquiry Committee, Part II (Government of India, Ministry of Finance, 1978).

13. Where the tax is sought to be levied on income, deduction for purchase of equipment is allowed only by way of depreciation, as explained later.

14. In practice, some other domestically produced goods and services are exempted for administrative and other reasons.

in the case of retail sales to final consumers). In determining the tax payable for a given tax period, say a month or quarter, the dealer has only to deduct the total amount of VAT paid from the tax charged by him on his sales. The difference represents the VAT payable to the government for the period.

Under the subtraction method, the tax for a given accounting period is calculated by multiplying the total value of sales minus the total value of purchases by the tax rate. How the two methods operate is demonstrated in the examples given in Table 5.1 below.

It will be seen that, under a VAT, the tax borne on the product works out exactly to what is indicated by the rate of tax applied to the final sale price even though it is collected at various stages. This does not happen under a cascade-type turnover tax or a single-stage first point tax. Also, with a uniform rate of tax, the same result can be achieved using either method. However, there are important differences between the two in advantages and disadvantages.

The subtraction method (also described as accounts method) has the merit of simplicity. Under this, a dealer can calculate the value added tax payable for a given period from the books of accounts normally maintained by him and no additional records are needed. However, the system loses its transparency under this method unless the tax rate is uniform for all commodities. With multiple rates the effective incidence of tax on the final product may not correspond to the tax levied at the last stage. Suppose, in the example, the tax on the wholesalers and retailers was levied at say 5 per cent while that on the producers was 10 per cent, the total tax on the commodity would then come to 25, that is, about 8.3 per cent of the total cost (value added). The tax-credit or invoice method, on the other hand, allows much more flexibility in the design and allows for exemptions and/or variations in rates to accommodate distributional considerations and also to leave out very small dealers, though at the cost of simplicity.

Tax credit is also more helpful in relieving the burden of taxes totally when felt necessary, e.g., on goods exported internationally. The method adopted for this purpose is called zero-rating. It is possible to provide relief for a given product or sector (e.g., small scale producers or farmers) also by granting exemption, that is, refraining from charging any tax on the products or the sales of the sectors in question. The exemption method, however, results in only a partial relief equal to the tax rate times the value added by the vendor: what is forgone is the net tax that the vendor would have to remit, had he been taxable. The zero-rating method results in complete removal of all taxes whether collected at previous stages of production and distribution or otherwise payable by the vendor at the point of sale. It is this mechanism that facilitates providing complete relief for exports from domestic consumption taxes under the destination principle of VAT (see Section 6.1.2). While the exemption route can be used under both the methods of VAT computation, zero-rating is much simpler with the tax-credit method.

Primarily because of its flexibility, most countries in the world have gone in for the invoice method of VAT. Only Japan preferred to follow the subtraction method when it introduced VAT at a 3 per cent rate in 1989.

The tax base for VAT can be computed also by totalling up the payments to factors of production, including wages, interest and profits, during the tax period. The so-called addition method, however, cannot be used for levying a destination-basis consumption type VAT because of difficulties mentioned above in identifying factor payments for exports and imports, and consumption and capital goods. Besides, it entails all the complexities that arise in the computation of profits for income tax purposes. Thus, the effective options are: either the subtraction or the tax credit method.

5.3 Attributes of VAT

5.3.1 Merits

A striking feature of the change in the tax systems that has occurred in the world in the last four decades is the emergence of VAT as the principal instrument for taxing domestic consumption, sweeping away the cobweb of

Table 5.1

Methods of Calculating a Value Added Tax

	Primary producer (say, steel manufacturer)	Car maker	Wholesale dealer	Retailer	Total
A. Subtraction Method					
Sales	100	200	250	300	
Purchases	0	100	200	250	
Net receipts (value added)	100	100	50	50	
VAT @ 10%	10	10	5	5	30
B. Tax-Credit or Invoice Method					
VAT due on sales	10	20	25	30	
Less: VAT paid on purchases	0	10	20	25	
VAT @ 10%	10	10	5	5	30

taxes on production and trade. VAT is now operating in over sixty countries including many developing countries. In the EU adoption of VAT is compulsory for its membership. The attributes which impel countries to turn to VAT as the best among the instruments of taxing consumption and made it into the "quintessential" tax of this century primarily are: its neutrality, transparency, certainty and self-policing mechanism.

5.3.2 Neutrality[15]

The greatest virtue of VAT lies in its neutrality, that is, non-interference with the choices of decisions of economic agents and equal treatment of products, producers and consumers. Because of its anti-cascading effect, the number of times a product is traded before reaching the final consumer or how much of the value is added at what stage in the production-distribution process are of no consequence under a VAT. It is also neutral regarding choice of production technique as well as business organisation. Other things remaining the same, the tax liability does not vary as between corporate and non-corporate entities, or between integrated or specialised units. With a cascading turnover tax, there is a strong incentive for firms to integrate vertically to the detriment of economies of scale in a given line of production. This is totally absent under a VAT. In short, the

15. The discussion in this and the subsequent subsections draws liberally on Cnossen (1992) and Tait (1991).

allocation of resources is left to be decided by the free play of market forces and competition.

A significant factor in the importance attached to VAT in the EU is its ability to treat intra-community trade as also trade with other countries with complete neutrality that is without any distortion by taxation. This is possible when the VAT is applied according to the destination principle, whereby the tax is levied by the jurisdiction where the product is consumed and not by origin or where it is produced. This was not possible under the cascade-type turnover taxes that operated earlier. A VAT facilitates precise identification and rebate of the tax on exports and thus ensuring that exports bear no tax, while imports are taxed exactly on the same footing as domestic products. A common market cannot function properly without this form of neutrality of the tax system. The principle of border adjustment of taxes (i.e., removing all taxes when goods leave the borders of a given country and subjecting imports to domestic taxes like local products) also accords with the tax provisions of the GATT.

VAT scores over income tax too from the angle of neutrality to incentives to work and save. The disincentive to work is less under VAT because the same amount of revenue can be raised with lower marginal rates for any given average rate, unlike under an income tax that has an element of progression. Also the discrimination against saving inherent in income tax is avoided when the tax is levied only on consumption.

5.3.3 Transparency and certainty

By virtue of the method of computation, the incidence of tax under a VAT can be seen readily from the tax paid on the final point sale. This is not possible when taxes are levied on inputs or intermediate stages of sale without any relief at the subsequent stages. Because of its transparency, under a VAT, it is possible to quantify at any stage precisely the tax borne at the earlier stages. This ensures that exports bear no tax when they leave the border of a country and imports are taxed on equal footing with domestic products.

The transparency is greater when the VAT is levied by the tax-credit invoice method and on a tax exclusive base. Under an ad valorem system of taxation, the same amount of revenue can be raised through a rate of tax in either tax-exclusive or tax-inclusive form. When it is tax-inclusive the rate will obviously be lower than when levied on a tax-exclusive base. (A tax-exclusive rate of 10 per cent is equivalent to a tax-inclusive rate of 9.09 per cent). The tax-exclusive rate is obviously more transparent.

Because it is based simply on transactions and not on a base that calls for complicated definition like income or wealth, the VAT has the merit of certainty and is relatively easy to understand. Also, since it is broad based and applicable to all sales in business, there is little room for differing interpretations. The scope of disputes, tax avoidance and evasion is much less than in, say, taxes on income or wealth.

5.3.4 Self-policing and revenue stability

The invoice method of VAT in particular is believed to be "self-enforcing" in that it induces businesses to demand invoices from their suppliers to obtain credit for the tax paid on their purchases against their total tax liability. This merit is sometimes contested, given the experience of various forms of evasion reported in the EU countries. However, compared to a single-stage tax, the VAT seems to provide better chances of tracking down evasion because of the audit trail it creates. The application of tax at each point of sale means that if the tax is evaded at one stage, the full tax may be realisable at the subsequent point. The tax can be evaded completely only when all firms in a production and distribution chain act in collusion to conceal their sale.

Another attribute of VAT is that it is an exceptionally stable and flexible source of government revenues. In OECD, every 1 percentage point of VAT rate adds roughly 0.4 per cent of GDP in revenue. The stability of VAT as a revenue source stems from the fact that consumption is less volatile than income. Moreover, since it is collected on a *current* basis, it provides a flexible instrument of taxation. Revenue varies directly with a change in the rates.

5.3.5 VAT vs. Retail Sales Tax

The consumption type of value added tax scores also over taxes on income in that it is not biased against saving. However, this virtue is shared by the Retail Sales Tax (RST) too and one may legitimately ask, why, if a VAT is in essence identical to RST then would it not be simpler to collect the tax only at the retail stage? VAT offers several advantages not available with RST.

First, services cannot be taxed effectively under RSTs since it is the small firms which mostly cater to the services purchased by consumers in the economy. Failure to tax services creates a bias in favour of services over goods and thereby distorts economic choices of both consumers and producers and accentuate the regressive impact of the tax, the latter arising from the fact that services are consumed more by the rich and demand for services is more income elastic than goods. Also, if services are not to be taxed, arbitrary distinctions have to be drawn between goods and services delivered in combination.

Second, certain commodities can be used both for consumption as well as production (e.g., sugar can be used in making tea as well as sweetmeat). RST cannot easily distinguish between the two. As a result, many producer goods may get taxed. Similarly, an RST cannot easily distinguish taxable consumer services from services to business which should bear no tax. This does not happen in VAT as the seller always charges tax for which credit cannot be claimed by the buyers unless they happen to be registered for VAT.

Since RST cannot easily distinguish between producer and consumer goods, many producer goods (like fuel, computers, etc.) get taxed. Apart from discouraging the use of efficient technology, this encumbers exports as the tax gets into the costs. For the same reason that is the price of domestic products may include some tax on producer goods, apart from the RST, imported goods from which the tax on inputs (goods and services included) is rebated get an advantage over domestic products.

VAT is also a more robust form of consumption tax. While spreading the collection process over large segments of industry and trade, it partly transfers the burden of proof for tax liability to the taxpayers as the onus lies on them to establish their claim to tax credit. It also helps to penalize dishonesty more than RST, as every invoice coming out of the process of production and distribution amounts to a "public declaration" regarding the tax liability.

Administratively, RST carries a greater risk to revenue as it places the entire weight of collection on the weakest link in the chain - the retailers, who are often small and numerous. The weight is greater when the rates are high. Under VAT, retailers remit only a portion of the total tax. As a result, revenue loss that takes place when retailers evade the tax is likely to be less under a VAT. The audit and invoice trail is also weaker than under VAT. In the case of imports, RST leaves out taxation at the easiest point, that is, the customs border.

In any case, if the retail tax option is ruled out for administrative reasons, then the best alternative for taxing consumption is VAT of the invoice operated type described earlier.

5.3.6 Weak points

A persistent criticism of VAT from many economists has been that it tends to be regressive since the proportion of income spent on consumption is larger for the poor than for the rich. This weakness inheres in all forms of consumption tax such as the current sales taxes. The regressivity would, however, appear to be less significant if taxes on consumption are compared with those on income over a lifetime, rather than annually. Besides, it is possible to moderate the distributional impact of VAT in several ways, e.g., by taxing necessities at a lower rate or by granting refund or a tax credit for the VAT paid against income taxes for lower income taxpayers. Experience with taxes which are on paper progressive also shows that distributional considerations are better accommodated through expenditure programmes of the government, rather than through concessions or exemptions which create complications for administration and compliance with uncertain results. Multiple rates create more problems than they solve while opening up opportunities for abuse. It must be acknowledged that the issue of regressivity is more relevant in less developed countries where social security and income support mechanism for the poor either do not exist or have a limited coverage. When the distributional mechanism is weak, avoiding regressivity in taxation assumes importance and so a single uniform rate may not be acceptable. Even so the need for avoiding multiplicity of rates and redressing regressivity through other means should be kept in mind because of the problems associated with multiple rates.

Another issue that is usually raised in discussions on VAT is the likely impact on prices. VAT, it is often said, is inflationary. There is, however, no intrinsic reason why VAT should have any inflationary impact if it merely replaces an existing equal- yield tax. Relative prices may change but general prices need not. The impact on the overall price index will, no doubt, depend on the weights of the commodities in the basket affected by the price change. A survey of the price effect of introducing VAT in 35 countries suggested that in the majority of the cases (29) it did not alter the rate of inflation.[16]

A major worry about VAT centres around the question of administration and compliance costs. Studies have shown that the costs of administration can increase significantly under a VAT. Accounting costs can go up particularly for smaller firms. These costs have, however, to be weighed against the likely gains. Besides, the burden on small firms can be relieved with a reasonably high exemption limit and simplified structure.

It is sometimes argued that it is collected partly at the pre-retail stages, a VAT entails larger working capital requirement and interest burden of firms than RST. This argument is not tenable since the purchasing firm's claim to a tax credit (and refund) arises simultaneously with the liability of the supplier to account for it. The tax credit on the purchases and the tax liability on the sales become due on the same date, that is, the date of the invoice. There is no need for a taxable firm to bear any carrying charges for inventory accumulation or purchase of capital equipment either, as the tax paid on such items is refunded if the tax on purchases exceed that due on sales. While the position may differ from firm to firm, on the whole the levy of VAT like the RST is likely to bring a cash flow benefit to taxable firms because of the fact that consumers usually pay more in cash than businesses do and payment terms for taxes are often more generous than normal business transactions.

5.3.7 Merits on balance

All in all, VAT has many points in its favour and advantages clearly outweigh the disadvantages. As the EU experience shows, VAT has a special advantage for countries in large economic groupings. It facilitates flow of inter-country or inter-regional trade unhindered by taxes and thereby serves to promote competition and efficiency. EU's decision to make adoption of VAT compulsory for its members was motivated primarily to promote trade and growth of output by removing distortions caused by inter-country trade taxes and thereby providing incentives for competition and increased productivity and industrialization. Latin American countries also have introduced VAT and they too are likely sooner or later to have a harmonized form of VAT in the region.

The need for a harmonized system of commodity taxation is recognised also in federal countries. Brazil and Canada have introduced VAT, and the issues of harmonization of the central and state taxes are under consideration by policy makers. A debate is going on in USA too on the desirability of introducing a federal VAT. It should be noted, however, that the problems of disparate inter-State taxation are much less acute in Canada and USA than in India because of the fact that the sales tax is levied

16. See Tait (1991).

by the provinces/States there mostly at the retail stage on the basis of destination principle. The primary concern in those countries is the cascading that occurs even under the retail sales tax systems.

For countries seeking to reform their tax system and at the same time find ways of raising more revenue VAT provides an attractive instrument. It has helped many countries to move towards a broad-based tax on consumption which can raise large amounts of revenue at relatively low rates, clean up the tax structure by doing away with the cobwebs of multiple levies and introduce a clean, new system with the merit of economic neutrality and a built-in check against evasion. In the Indian context the attraction of VAT lies in the promise it holds for providing a solution to many of the ills of the present system. A move towards VAT is predicated strongly as the only way to cut through the jungle of laws and procedures that govern the system of commodity taxation in the country at present and provide a structure that does not act as a drag on growth.

Chapter 6

OPTIONS FOR VAT IN THE INDIAN CONTEXT

6.1 The Basic Choices

As will be seen from the discussion in Chapter 5, the value added tax basically is a multi-stage tax that seeks to tax consumption of goods and services while avoiding the taxation of inputs. However, its introduction in any country calls for a number of decisions regarding design features. The choices that have a bearing on the character of the levy, its incidence and economic effects relate to the following questions:

1. What type to adopt: consumption, income or gross product?
2. Should it be levied according to origin or on the principle of destination?

In a federal country a crucial choice centres around the question, at which level or levels of government should the tax be levied and administered, and what should be the rule of operation, consistent with the objectives in view?

6.1.1 Consumption, income or gross product type?

As noted in Section 5.1, VAT can be levied in three forms, viz., consumption type, income type, and gross product type. Most countries that have gone in for VAT have chosen the consumption type. Argentina, Peru and Turkey had originally opted for the income type but have now gone in for the consumption type. Because it lacks rationality, the gross product VAT is not in vogue in any major country.

The main advantage with the consumption type is that it is simple to compute; only purchases have to be subtracted from the sales (or tax paid on purchases from that due on sales) and the troublesome distinction between capital goods and others is avoided. There is no need to compute depreciation either. As already pointed out, the consumption type achieves neutrality better than the income type of VAT and enhances competitiveness in international trade. It avoids the double taxation of savings caused by income tax, being neutral between present and future consumption. It is also neutral to the use of capital vs. labour in production.

6.1.2 Origin or destination based?

In principle, a VAT can be levied either according to origin, that is, where the goods and services are produced or on the basis of destination, that is, where they are consumed.

Under the origin principle to which a reference has been made earlier, the tax is levied on all value added domestically, that is, the total value of domestic production, including exports while imports are excluded. Under the destination principle, all value added in goods sold within the country whether produced domestically or imported are taxed. Exports do not bear taxation while imports are taxed in the same manner as domestically produced goods.[17]

A consumption type VAT has necessarily to be destination based. Neutrality, whether external or internal cannot be achieved unless the system follows the destination rule. As already noted, the main reason for making the adoption of VAT as a condition for the membership of the EU is that in this form it is more amenable to the operation of the destination principle.

6.1.2.1 Mechanism for operation of destination rule

Where the tax is levied only by the national government of a country, operation of the destination principle poses no acute

17. Under certain conditions, the origin and destination based VATs can be shown to be equivalent in their economic effects. The equivalence theorem is, however, of little practical relevance since it holds "only if, in the equilibrium position before a change from one of the principles to the other, (a) exports from one country to the other equal imports, and (b) there are no capital flows or transfer payments between the two countries". (See Gillis, Shoup and Sicat, 1990).

problem. For then, rebating for taxes paid at the intermediate stages of the product that is, upto the final point of sale within the country, can be provided for irrespective of the location of the production or sale. Exports out of the country can be relieved of all taxes and imports, taxed like domestic products wherever used or consumed in the country. Problems arise when the tax is levied by sub-national governments in a federation (or by governments of member countries of a block or union like the EU joining together to promote trade and competition without any tax induced distortion). This is because the destination principle cannot operate unless sales between VAT registered dealers across inter-jurisdictional borders within the country (or block) are treated as essentially intermediate sale and relieved of all taxes suffered at the earlier stages of production or trade. Operation of this rule is not simple and calls for a high degree of coordination and harmonization when sub-national governments in a federation or member countries of a large group or trade block exercise their autonomous or sovereign powers of taxation and appropriate the revenues realised for themselves.[18]

In the EU, until recently, the destination principle was operated through border controls administered by customs authorities. No tax was levied on goods crossing country borders but remaining within the community and taxes suffered at the earlier stages were rebated to the exporter on the basis of declarations furnished at the borders. The importing dealer was liable to pay tax at the rate applicable to local products to the government of his country. Since January 1, 1993 border controls have been abolished and the destination principle now operates on the basis of a computerized information system. Under the new system, a registered dealer in one country (say France) selling goods to a registered dealer in another country within the EU (say Germany) can zero-rate his sales (now called "despatches") by checking the identity of the buyer through the computers. The imports ("acquisition") are then taxed in Germany when the goods are sold by the importing dealer. This system - sometimes described as Deferred Payment or Payment Accounting System (PAS) - has in effect shifted the border tax adjustments from the borders to the books of account of the exporting dealer and the first taxable dealer in the importing country. Intra-community sales to unregistered dealers (such as cross-border sales) are taxed in the exporting State.

A possible alternative to this system is the tax credit clearing mechanism. Under the clearing method, intra-community exports would be taxed in the first instance in the exporting country; but importers would get a credit for the tax invoiced by exporters of other member States and the importing country governments could claim the amount of the tax credit so allowed from the government of the exporting country under a mutual clearing system whereby only the balances of the net exporting country would be settled. The usual border tax adjustments would operate for trade with countries outside the EU. This system, however, did not find favour with member-countries and the EU has now adopted the PAS at least for now.

Yet another alternative could be, as suggested by the TRC, to permit the exporting State to levy a tax on inter-State sales for which credit will be given by the importing State against the tax payable on it by the importer, with the stipulation that the exporting State will credit the tax on inter-State sales (and consignments, if these were also brought under taxation) to a pool. The revenue so pooled could be shared among the States according to an agreed formula.[19]

The question of tax assignment - which level of government should have the powers of levying the tax, if a VAT is introduced in India (discussed in Section 6.2 below), has to be considered in the light of the problems of implementing the destination principle in a

18. The problem is much simpler where the Constitution of a federal country vests the power of taxing transactions between dealers across States or provinces with the federal government. In India, although such powers rest with the Centre and the law regulating taxation of inter-State sales has been enacted by Parliament, its implementation has been delegated to the States who also retain the revenue from the tax.

19. See TRC, Final Report - Part I, para 2.16.

multi-level tax system. The experience of EU is of relevance in this context. It may also be noted that a retail sales tax when levied by the States in a federation is by its very nature destination based since no tax is payable until the article in question is sold to the consumer. This is one of the main reasons why the operation of the States sales taxes has not caused the problems in USA and Canada that a tax at the State level on origin basis gives rise to. The origin principle is followed for VAT levied by the States in Brazil though not for international trade. However, Brazil's experience with the origin-based State VATs has not been very smooth and the entire system is currently under review.

6.2 VAT Options for India

By and large, it is the destination-based, invoice-operated consumption type VAT that is prevalent in countries imposing VAT. If the trade taxes are not to interfere with the decisions of producers and consumers for India too this seems to be the preferable form in which the VAT should be levied, if it is decided to reform the excise and sales taxes and replace them with a system of VAT.

In India's context, a crucial question that needs to be addressed before the reforms can be launched relates to the issue of assignment, that is, which level or levels of government should levy the VAT if introduced and how, granting that it should be destination based, consumption type. The question has ramifications going beyond the arena of taxation and needs to be considered from several angles. The considerations that must be kept constantly in view are:

i. the need to remove economic distortions caused by the present system in the matter of business decisions, resource allocation within and between States;
ii. the issue of jurisdiction - inter-jurisdictional conflicts and the need to harmonize relations between States and between all States and the Centre; and
iii. the burden of administration for all levels of government.

Given the federal structure, the options in the matter of assignment of powers for levying a VAT in India broadly are:

1. **A Central VAT** - VAT as a National levy implemented through a Parliamentary legislation and administered by the Centre (or the States on behalf of the Centre) replacing both Central excises and State sales taxes, covering all goods and services, with arrangements for revenue sharing.

2. **State VATs** - Centre withdrawing from domestic trade taxation and leaving it to the States to levy the tax on domestic trade in the form of VATs, replacing both the Central excises and the State sales taxes.

3. **Dual or Joint System** - Both the Centre and the States levying VAT, converting their excises and sales taxes into VAT.

There are several variants of these options, as the discussion below would show.

6.2.1 A National VAT

A unified system of taxing domestic trade in the form of a national VAT imposed and administered by the Centre would appear to be most attractive from many angles. It would, at one stroke, bring about harmonization and help remove the tax on inter-State trade.

In most federations the VAT is levied or controlled by the Centre. In Argentina, Austria, Germany and Mexico the VAT is controlled by the Central government, while the collection is made by the States and the revenue shared. A unified Central levy even if administered by the States would at one stroke achieve harmony and simplification and remove the complaints of trade and industry regarding harassment caused by multi-level taxation. Rough computations show that if applied on a comprehensive base (that is, removing the exemptions but excluding services, with a threshold of Rs 30 lakh and about 50 per cent of agricultural output outside the base) a uniform rate of about 18 per cent could be revenue neutral (that is, would yield the same revenue as currently derived from Union excises and sales taxes combined). If services are included in the base, the revenue neutral rate works out to a little over 16 per cent (vide Table 8.1 in Chapter 8 below).

Though apparently attractive, an exclusively Central VAT would not be advisable for the following reasons:

It would require the States to surrender their powers of sales taxation which is their most important revenue source and compel them to depend on sharing arrangements for the bulk of their tax revenue. At present, the States derive about 68 per cent of their tax revenue from their own sources, the rest (32 per cent) comes from the Centre through devolution of income tax and Union excises. Under the Central VAT option, they would have to depend on the Centre for over 70 per cent of their tax revenue. Their dependence on the Centre for meeting current expenditure would go up from less than 40 per cent at present to about 65 per cent if the powers to levy sales tax were taken away from the States (vide Table 6.1).[20]

It would be objectionable on efficiency grounds as well since, with the tax powers of the States severely limited, fiscal decentralization which is advocated on efficiency grounds (that is, for permitting the citizens to determine the quantum and content of public services at the local levels according to their preference pattern) would be seriously undermined. By widening the divergence between revenue raising and expenditure decisions it would undermine fiscal accountability further.

The Centre will have to depend on the States for administering such a tax for the simple reason that it does not have the machinery to handle the number of dealers who would come within the VAT net even if the tax is levied with a fairly high threshold.[21] If, on the other hand, the revenue is collected by the States but pooled and distributed through a revenue sharing formula, there would be little incentive for the States to take the responsibility for administering it unless the distribution is made largely on the basis of collection.

Even if the aggregate revenues of the States are protected through the mechanism of transfers from the Centre, individual states may lose under this option. The transfers of excise revenues by the Finance Commissions have historically been tilted in favour of the lower-income States because of the significant weight assigned to population and factors like relative income levels and indices of backwardness in the distribution formula. The higher-income States would lose if the revenues from the Central VAT were also to be shared in the same manner. To overcome the likely opposition of the States, one can think of a suitable modification of the sharing formula to keep their losses to a minimum. However, even that would not meet their misgivings regarding loss of fiscal autonomy. They would be reluctant to acquiesce in the arrangement for the fear that it would remain subject to unpredictable political influences. Discussions and interactions with representatives of the States in the course of the present study indicate that most States are unlikely to agree to part with their powers of sales taxation while without a political consensus it will not be possible to carry out the amendment of the Constitution that would be required to introduce a unified national VAT.

6.2.2 State VATs

A polar opposite to a Central VAT, as put forward above, would be a VAT levied and administered by the States, with the Centre withdrawing completely from taxation of domestic production or trade. From the angle of linking spending decisions with revenue raising powers and thereby promoting fiscal responsibility, widening the sales tax base of the States by getting the Centre to vacate the domestic tax field has much to commend itself. In the public finance literature, there is a strong body of opinion that favours assignment of income and capital taxes to the federal government and taxes on

20. This assumes that the States will not be willing or able to raise the yield of the other taxes at their disposal, such as agricultural income tax and land revenue, significantly.
21. At present the Central excise department handles only about 150,000 assessees. A nationwide VAT would involve dealing with at least a million taxpayers even with a relatively high threshold.

Table 6.1

States' Total Current Expenditure, Revenue, Contribution of Devolution and Sales Taxes

(Rs. crore)

	All States	1990-91	1991-92
1.	Total current expenditure	67860	82496
2.	i. Total revenue	62754	77191
	Of which:		
	ii. Tax revenue	44185	52011
3.	Out of 2		
	i. Share of income tax	3983	4959
	ii. Share of Union excises	10056	11876
	iii. Grants from Centre	12384	16153
	iv. Revenue from sales taxes	17548	20928
4.	Total 3(i) to (iv)	43971	53916
5.	Share of Central Taxes [3(i) plus (ii)] as per cent of tax revenue [2(ii)].	31.8	32.4
6.	Share of Income Tax, Union Excise and revenue from Sales Tax [3(i)+(ii)+(iv)] as per cent of tax revenue [2(ii)]	71.5	72.6
7.	Share of Central Taxes and grants [3(i)+(ii)+(iii)] as per cent of current expenditure (1)	38.9	40.0
8.	Share of Central taxes, grants and revenue from sales tax as per cent of current expenditure (4 as per cent of 1)	64.8	65.4

Source: *Indian Public Finance Statistics*, Government of India, Ministry of Finance, 1992.

consumption to the sub-national levels (although the contrary view is also held by some). The diminution in the Centre's revenues that such a scheme would entail could be taken care of by (a) permitting the Centre to levy special (non-rebatable, non-sharable) excises on a few sumptuary items, and (b) bringing down the level of flow of federal funds to the States (devolution of taxes, or grants or both).

Reference may be made in this context to the existing VAT system of Brazil - the only federal country having a system of VAT both at the federal and at the State levels. The VAT at the federal level (IPI) is a tax on industrial production and VAT at the State level (ICMS) is a tax on the circulation of goods within the State. Both these taxes are characterized by multiplicity of rates, complexity of tax structure, large exemptions, double taxation of the same bases, higher effective tax rates and lack of transparency. In addition, there is a cascading tax on the services at the local level. All these taxes cause serious distortions and administrative problems. With a view to rationalizing the existing IPI and the ICMS, proposals are under consideration for having a new State-VAT (IVA) which would replace the existing VATs. If the proposals go through, the new VAT would be levied only by the States. The federal government would withdraw from the field of internal commodity taxes. It is also proposed that the inter-State transactions would be settled through a clearing mechanism and the tax would be based on destination principle. The entire structure of federal financial relations are currently under review in that country.

A regime of exclusively State VATs on the pattern of Brazil or the EU, to replace both Central excises and sales taxes, however commendable in principle, does not seem to be feasible in India in the foreseeable future. The reasons are advanced below.

First and foremost, a pure State VAT would involve such a fundamental rethinking of the tax and financial relationship between the Centre and the States that, even if desirable in the long run, it is not a viable or relevant option at this point of time. It will impair the Centre's revenues grievously and the Centre will not be able to balance its budget unless there is a sharp increase in its revenue from the non-sharable sources or the quantum of devolution of Centre's revenues to the States is reduced drastically or there is a major shift in the distribution of powers and functions between the Centre and the States. Most variants of this scheme envisage that even after vacating the excise field in general, the Centre would levy special (non-rebatable and non-sharable) excises on a few commodities like petroleum, tobacco, and some luxury consumer products like automobiles and aerated waters. Rough calculations indicate that even with special levies like these the Centre will not be able to make up for the loss of revenue likely to result if it gives up the excises.

Revised estimates for 1992-93 show that the Centre derives almost one-third of its tax revenues (net of devolution to the States) from Central excises.[22] Special excises on selected commodities simply cannot make up for the loss if the Centre is to withdraw from the domestic trade tax field altogether. At the most, they can yield Rs 5,000 to Rs 6,000 crore out of an excise revenue of Rs 18,000 crore or so. There would thus be a drop of around Rs 12,000 to Rs 13,000 crore in the Centre's revenue even if special excises are allowed to be levied. There is no way the Centre can make it up especially when customs revenues have to come down to facilitate tariff reduction which is imperative in the process of liberalisation. Improvement in the yield of the direct taxes that would be needed to offset the drop also seems unlikely to come about soon. If services are taxed by the Centre and the revenues retained without sharing, the additional revenue will in all probability not be more than Rs 1,500 crore. The Centre will not be able to balance its budget or reduce its fiscal deficit in such a situation, unless the share of the States in the Centre's revenues is sharply reduced and/or unless there is a drastic reallocation of functions and responsibilities between the

22. Total tax revenue	Rs 58,179 crore
Of which, from Union excises (net)	Rs 18,035 crore

Centre and the States.[23]

Such a shift in revenue accrual to the Centre will also impair its capacity to provide grants to the States. In 1992-93, the total amount of Centre's grants to the States came to about Rs 18,400 crore. Even if the States' share in income tax (Rs 6060 crore in 1992-93) and grants for Centrally Sponsored Schemes were cut down by half, with a drop in revenue to the tune of Rs 12,000 crore, the Centre would not be in a position to make the grants which have a perceptible equalizing effect in the distribution of government revenues (and thereby level of public services) in the country. It is relevant to note that of the total grants budgeted for 1992-93, over Rs 11,000 crore (out of Rs 18,400 crore) was meant for the low income and special category States.

A recent paper on the subject, while proposing the assignment of VAT powers to the States as a long-term solution,[24] recognises the problems mentioned above and concludes that with a system of State VATs and Centre vacating excises, the present practice of tax-sharing and grants from the share would have to end. That, the authors also note, would mean that the five poorest large States would lose upto 40 per cent of their budget and the nine richest major States gain, also upto 40 per cent. They agree that such a redistribution of resources would "not only be next to impossible to achieve politically, it would also be undesirable".

To mitigate these redistributional effects, the paper proposes a system of cross-State transfers whereby each State would remit a certain percentage of its tax to a Central pool which would then be available for redistribution. Their calculations show that as much as 40 per cent of the indirect tax revenue of each State would have to be transferred to the Centre to maintain the pre-reform distribution of revenue among States. Ruling out transfer of such magnitude to the Centre as impracticable, the authors next suggest a tax to be levied on the States at the rate of 2.5 per cent of their GDP.

Given the realities of the Indian political scene, these proposals do not seem to be practicable. If the powers of taxing consumption are to vest primarily in the States, the only viable solution would be to reduce the proportion of revenue shared by the Centre in the form of tax devolution and to use the grants mechanism primarily to help the poor States. Whether or not such a drastic change in the system of devolution and grants that has come to prevail in India since Independence is advisable is for the Finance Commission to consider. Another possibility is to reduce the responsibilities of the Centre and confine its functions strictly to what a federal authority can perform better than the States. Such a radical shift in the role of the Centre in the Indian Union would call for a national consensus. Consideration of the merits of this alternative is beyond the scope of this study.

Second, while it is possible in principle to achieve, under State VATs, some degree of harmonization and reduce tax competition or tax exporting, given the disparities in endowment and levels of development among the States, it would be unrealistic to assume that without Centre's involvement in domestic trade taxation and a Central law to regulate taxation of inter-State trade, States deriving large amounts of revenue from the CST will move away from origin-based taxation. In fact, the chances are that the distortions in location of industries and flow of trade in the country would get more acute. Thus this option is unlikely to remove the ills of the present system arising from origin-based taxation. On the contrary, it may accentuate the disparities by aggravating the concentration of revenue among the relatively advanced States. The Centre would be ill advised to vacate the domestic trade tax field unless the States come forward to accept the logic of destination based consumption taxation and necessary administrative and institutional infrastructure is created for its efficient operation.

23. In 1992-93 (RE) transfers to States from the Centre were of the order of Rs 18,400 crore comprising:

i.	Non-plan grants	Rs. 3262 crore
ii.	Plan grants	Rs. 8332 crore
iii.	Assistance for Central and Centrally Sponsored Scheme	Rs. 6824 crore

24. See Burgess, Howes and Stern (1993).

The proposal for a State VAT regime has also to contend with the fact that not all States are administratively strong enough to take over the task of implementing VAT entirely on their own immediately without the Centre's involvement. For the Centre to withdraw from domestic indirect tax field almost entirely in the present condition would be too risky for the revenue of both the Centre and the States.

Partly in recognition of this reality, one variant of the State VAT schemes envisages the levy of VAT by the Centre at the manufacturing stage (as under MODVAT) with the States levying VAT in place of their sales taxes thereafter, but allowing rebate for MODVAT against their VAT.[25] Under this variant, the Centre would compensate the States for the revenue loss on account of MODVAT rebate. In effect, the Centre would transfer the MODVAT it collects to the States where the goods are subsequently sold. For all practical purposes, MODVAT becomes a tax collected by the Centre on behalf of the States. As can be easily seen, this variant suffers from most of the major problems mentioned earlier (viz., weakening of Centre's finances and accentuation of disparities in the distribution of revenue among States). In addition, it will give rise to problems of cross-system verification and open up opportunities for fraud and evasion. Moreover, if the Centre has to compensate the States for the rebate for MODVAT to be given by the States, it will have little incentive to administer the MODVAT well.

From the viewpoint of trade and industry also the system of State VATs is unlikely to be acceptable unless the States agree first to harmonize their systems as it will mean operation of disparate regimes across the country at different levels of administrative efficiency. For all these reasons, in introducing VAT in India, leaving it entirely to the States in the first instance does not seem to be a feasible proposition even though it might be given serious consideration as a long-term option when the States are able to overhaul their tax administration and also agree to abide by the rules of a destination-based consumption tax.

25. See Purohit (1993).

The foregoing discussion suggests that in exploring the possibility of reforming the domestic trade taxes in India with a system of VAT, one has to think of a dual system in which both the Centre and the States share the consumption tax base in a mutually acceptable arrangement, in other words, a system of VAT levied at the two levels of government independently but preferably with some coordination.

6.2.3 Dual VAT Systems

A dual system essentially connotes parallel exercise of tax powers relating to a given base, by two levels of government. In the context of taxation of domestic trade in India, one can think of at least three variants of a dual VAT :

1. A system of concurrent VATs where both the Centre and the States levy the tax with common base, but allowing the States to determine the rates within specified bands.[26]
2. The Centre levies VAT upto the wholesale stage but the tax at the wholesale level is administered and retained by the States, and the State sales taxes are converted into VAT. This seems to be the pattern suggested by the TRC.
3. The Centre levies the tax only on manufacturing as under MODVAT, but covering all commodities and at least some services and the State sales taxes are converted into VAT, but both operating independently, with or without coordination.

6.2.3.1 Concurrent VAT

A theoretically appealing variant of the dual system is one in which both the Centre and the States have concurrent jurisdiction in taxing goods as well as services going up to the retail or final-point sale. Under such a system both Centre and the States would levy a VAT under a unified law on a common base. To achieve neutrality the base has to be as broad as possible. The States would have

26. The case for a joint federal-State VAT is put forward cogently in Poddar (1990).

the powers to fix the rates but within a harmonized system. Inter-State sales will carry a rebatable Central VAT but will be zero-rated for the State VAT levied by an exporting State and taxed by the importing State. For revenue and other reasons (e.g., externalities) the Centre would have the powers to levy non-sharable special excises on a few sumptuary items.

The Central VAT would apply to all sales throughout the country at the given uniform Central rate. The State VAT would apply to only local sales, not including inter-state sales to registered dealers. Because of difficulties in verification of the final destination of goods sold to non-registered persons, inter-state sales to them would be treated as local sales.

Main elements and imperatives of a possible Concurrent VAT scheme are summarised below:

Concurrent VAT: Main Elements

A: *Constitutional Amendment* to confer concurrent powers to the Centre and the States to tax goods and services traded within the country.

B: *Design of Concurrent VAT*

1: Base as comprehensive as politically and technically feasible.

2: Common base for the Centre and the State VATs.

3: Uniform central rate(s) on sales throughout the country.

4: State rates set by each State, variable within narrow bands.

5: Inter-State sales to registered dealers subject to Central VAT only and zero-rated for State VATs.

6: Inter-state sales to unregistered persons subject to Central and State VATs as local sales.

7: Collection by the Centre of State countervail duties on imports by unregistered persons.

C: *Tax Administration*

1: Common registration for Central and States VATs.

2: Common VAT return, with separate columns for the two taxes.

3: Taxes remitted to Centre and States directly.

4: Full autonomy of Centre and States in other administrative and enforcement matters.

5: Free exchange of information between Centre and States.

D: *Special Excises*

1: Limited to selected final consumer, and demerit goods only.

2: Imposed at the manufacturing level.

Registered dealers would be allowed to claim a rebate or tax credit for the tax paid on their purchases. The Central input tax would be creditable against the Central VAT collected by them on their sales, and the State input tax would be creditable against the State VAT. They would remit the net amounts due under each to the respective governments. Since the tax would be computed for, and remitted to, the two governments separately, there would be no need for a clearing house or such other mechanism to transfer the funds to the governments to which they belong. This would also resolve the problem created by consignment transfers under the CST. When inter-State sales are zero rated, there would be no tax on inter-State movement of goods, regardless of whether it is pursuant to a sale or consignment transfer.

In this scheme, inter-State sales to registered dealers[27] would be treated under the State VAT in the same way as international export sales under the Central VAT, i.e. they both would be zero-rated. This means that dealers would not collect any State tax on inter-State sales, but would be eligible to claim a tax credit for the State tax paid on their purchases. Where the credits exceed the tax collected on sales, the excess may be carried forward. Firms perpetually with excess credits, because they make most of their sales outside the State, should be eligible for cash refunds.

The example in Table 6.2 illustrates the operation of a concurrent VAT as outlined above.

A concurrent VAT extended upto the

27. And similarly, consignment transfers by registered dealers.

Table 6.2

Illustration of a Concurrent VAT

State VAT Levied on Price Including Central VAT

A. All Transactions Within a State : Central VAT @ 10%, State VAT @ 5%

State	Dealer	Sales	Central VAT	State VAT	Sales incl. tax
X	Manufacturer	100	10	5.5	115.5
X	Wholesaler	160	16-10=6	8.8-5.5=3.3	184.8
X	Retailer	200	20-16=4	11-8.8=2.2	231
	Total tax		20	11	

Revenue to Centre: 20
Revenue to States:
State X: 11

B. Inter-State Sale by the Manufacturer : Central VAT @ 10%, State VAT @ 5%

State	Dealer	Sales	Central VAT	State VAT	Sales incl. tax
X	Manufacturer	100	10	0	110.0
Y	Wholesaler	160	16-10=6	8.8	184.8
Y	Retailer	200	20-16=4	11-8.8=2.2	231
	Total tax		20	11	

Revenue to Centre: 20
Revenue to States:
State X: 0
State Y: 11

retail stage would get over many of the problems in administering the taxes at the manufacturing level encountered under the present excise system and first-point sales taxes. The evils of tax exporting and hindrance to inter-State movement of goods would also go. The system would be economically efficient and neutral, remove cascading of tax, strengthen the revenue bases tangible simplification of administration and compliance. Also, it would maintain the fiscal autonomy of the two levels of government.

However attractive for its rationality and simplicity, for reasons specified below, a concurrent VAT does not seem to be practicable in India.

Drawbacks of Concurrent VAT

First, effective administration of a concurrent system would call for a degree of coordination between the Centre and the States that is absent at present and would be difficult to achieve in the near future. There could also be administrative conflicts between the tax authorities at the two levels over assessment of the base that would not be easy to resolve. For instance, what should be done if a State amends a VAT return or liability declared by a taxpayer on the basis of some examination but the Centre does not follow? One tax administered by two jurisdictions will invariably evolve into two taxes. Designing the invoice for operating a concurrent VAT would also not be simple and taxpayers may have problems in accounting for the two VATs on the same form unless the base is identical.

Apart from the conflicts which it might generate, a concurrent VAT will be seen by the States as an invasion into their tax powers. It will call for a major constitutional amendment to confer powers on the Centre to levy a multi-stage tax on domestic trade which it does not possess now. That would give the Centre an even more dominant role than it has at present in the tax field and any chance of its ceding the consumption base to the States would be lost for ever.

Reference may be made in support of the concurrent scheme to the system of consumption tax operating in Canada where both the Centre and the States have concurrent powers of domestic commodity taxation. One however, may wonder whether the Canadian experience is of much relevance for India in the present state of the Centre-State relations. In Canada (or for that matter in USA) the constitutional delineation of powers between Ottawa and the provinces are so firmly established that governments can perhaps agree more readily on the joint imposition of VAT. In India, the "power" position of the States and the Centre is yet to settle down. In this context, the increased "technical" involvement of the Centre in the tax domain of the States will be viewed as a shift in the balance of power in favour of the Centre.

While designing a model of dual VAT, it is thus advisable to explore ways in which both the Centre and the States can move their respective excises and sales tax systems towards a system of VAT within the framework of the Constitution and improve their implementation through better legal and administrative structures. Two variants of dual VAT based on these parameters are considered next.

6.2.3.2 MODVAT extended to wholesale stage along with State VATs

One of the drawbacks of the concurrent VAT option discussed above is that it does not take account of the limitations of the Centre in administering a tax beyond the manufacturer level. The Central Excise Department which administers the Union excises and MODVAT is simply not equipped to handle the number of dealers who would come within the tax net even if the threshold was fixed at a relatively high level. Taking note of this problem and also to circumvent the need for constitutional amendment, the TRC had proposed the extension of MODVAT to the wholesale stage but with the proviso that the tax at the wholesale stage would be administered by the States who would also retain the revenue.

The proposal to extend the MODVAT to the wholesale stage is designed mainly to overcome the problems of taxation at the manufacturer level. Any reduction in tax at the manufacturing level through shifting of marketing or other ancillary activities to a subsequent trade level or through sales to a sister company at low value would be recaptured in the form of an offsetting tax increase at the wholesale stage. It would thus minimize valuation disputes and reduce incentives for manufacturers to understate the value of their shipments for purposes of the ad valorem excise levies. This would, in turn, facilitate conversion of specific excise duties to ad valorem duties that could be applied to the invoice value of manufacturers' despatches/sales.

The TRC has proposed that, for this purpose, wholesalers be defined to include dealers (whether wholesalers or retailers) in excisable goods with annual turnover in excess of, say, Rs.50 lakh or Rs.1 crore. They would pay tax on their value added, i.e. the difference between their selling and buying prices.

While the TRC proposal would resolve some of the valuation problems that currently arise under the MODVAT, there are certain features of the proposal that make its consequences somewhat arbitrary and unpredictable.

For instance, the proposal to allow the States to keep the taxes that they collect from the wholesalers, while necessary to buy their cooperation, would create a conflict of interest between the Centre and the States. The division of tax revenue between the two levels of government would depend upon the value declared by manufacturers for their clearances or sales. This could lead to a situation where the manufacturers are subjected to conflicting valuation instructions from the two levels of government. Such conflicts would scarcely be healthy for the administration of the tax.

Another source of arbitrariness would be the problem of identifying the location of wholesale trade. Under the scheme envisaged by the TRC, the revenues from the tax at wholesale stage would accrue to the States obviously on the basis of origin, i.e., the tax would be retained by the State where the wholesale value-added originated, regardless of the final destination of the goods in question. Thus, the tax on inter-State sales by traders would accrue to the exporting State. This system would suffer from a degree of arbitrariness because the place of origin is not easy to define. Unlike the place of manufacturing or the place of final consumption, the location of an intermediate sale can be altered with relative ease, while every such alternative would have significant consequences for inter-State distribution of revenue. States might also offer inducements to manufacturers to make supplies of raw materials, parts, etc. to other manufacturers through intermediate dealers rather than directly.

The possibility of shifts in the distribution of revenue and accentuation of distortions caused by origin-based taxation can be minimised with a modification of the original TRC proposal whereby the revenue from the tax at the wholesale stage will be pooled for distribution among the States with a large weight assigned to origin.[28] While this might mitigate some of the distributional ill effects of the original proposal, the problems of dual or triple administration of VATs (two for MODVAT and one for State VATs) would remain. Also, unless there is a high degree of coordination between the Central and State tax departments and exchange of information, there would be the possibility of fraud on a large scale, e.g. manufacturers claiming inflated credits under the MODVAT for the tax paid to wholesalers (and collected by the States).

For all these reasons, this model of VAT would not seem to be a workable or desirable option.

One can envisage another alternative system of concurrent dual VAT in which the States exercise their powers of taxing domestic trade by levying the tax at the retail level and the Centre has the authority to extend its VAT to the wholesale level but withdraws partially from the field by limiting the level of its rates. This would give the States more authority and could provide the basis for dual system in which the Centre and States share the consumption tax base in a

28. A modification of the TRC proposals on these lines was suggested by Prof Chelliah in a public address in 1993.

harmonised basis. It would not cause the type of disruption to the pattern of Central transfers which would be implied in a regime of State VATs. Much of the conflict of jurisdiction and distortions arising from the system of sales taxation prevailing in India now would be avoided under such a system. As noted, this, in essence, is how the commodity tax base has come to be shared in Canada. The scheme of domestic indirect taxation suggested by the Indirect Taxation Inquiry Committee (Jha Committee) also ran on similar lines.

Although, in principle, it provides a neat way to rationalise and harmonise the system of consumption tax in a federal country, this pattern is not likely to be acceptable to the States because of their unhappy experience with the retail sales tax and also because it would necessarily imply an extension of the Centre's powers to tax domestic trade. However, this could be considered as a long-term option when Centre-State relations are well settled and harmonious and the States feel confident enough to apply their sales taxes at the retail level only.

6.2.3.3 Independent dual VAT system

Given this background, the only feasible option seems to be a dual system in which the VAT is levied by the two levels of government independently within the existing constitutional framework. This would be possible if the MODVAT now operating through the excise tax system is made into a full-fledged manufacturers' VAT and the States also adopt a destination-based harmonized system of VAT in place of the chaotic sales taxes operating now. Although it would not be the perfect or first best solution to the problems of the present system since the difficulties inherent in the taxation of manufacturing would remain, reform on these lines would go a long way to remove many of its ill effects and lay the foundation for an even more rational regime in the future. Considering everything this seems to be the course along which reform can take off and avoid getting bagged down in controversies and Centre-State wrangles.

On the excise side, the scheme of reforms contemplated under the independent dual VAT system is a logical extension of the present MODVAT system towards what was envisaged as the MANVAT by the Jha Committee to which a reference has been made earlier. The changes that would be needed in the current excise structure to bring this about principally are:

a. Widening of the base to include all goods produced, manufactured or imported and a few selected services;
b. Provision for full and immediate credit of input duty to registered manufacturers and producers for
   - all raw materials and parts used in manufacturing;
   - production machinery and equipment for use exclusively in taxable manufacturing; and
c. Rationalisation of the rates to introduce a structure of not more than three rates at the most and eventually a uniform rate. However, excises would also be levied on selected luxury items and commodities with negative externalities.

As and when VATs replace the States sales taxes, the tax rental agreement with the States whereby additional excise duties are levied on three major commodities, viz., textiles, tobacco and sugar should cease. The Centre should be free to apply the MODVAT to them like other commodities, as at present.

Since the MODVAT would be confined to the manufacturer level and extension of the Central VAT beyond manufacturing is ruled out because of considerations spelt out in the preceding paragraphs it would be necessary to take steps to strengthen the manufacturing base and minimise the ambiguities and scope for abuse and disputes. Despite its limitations, it should be possible to achieve significant improvement through technical amendments in the Central excise laws and procedures.

Exercises carried out with available data show that with excises converted to VAT and the rates reduced to three (10, 15 and 20 per cent) along with (non-rebatable, non-sharable) excises on a few commodities and tax on selected services, it should be possible to carry out these reforms without any loss of revenue. There could, in fact, be a gain of about Rs 1,000 crore to provide a cushion for the change. Details of the reforms of Central excises proposed in the scheme are set out in an appendix to this report (Appendix 1).[29]

Under an independent dual VAT, the State VATs will be based on ex-factory price of products including the Central VAT and no rebate will be allowed for the Central VAT on manufacturers against the State VATs. This, it might be thought, would run counter to the goal of removing cascading. This presumption is not correct. There would be no cascading by way of tax on inputs so long as the Central VAT is a truly single point tax and the State VATs operate on VAT principles. For then there will be only a one-time tax on tax (State VAT on Central VAT) effect equal to the rate of State VAT times the Central VAT, but cumulation should not occur. The additional tax incidence that will occur because of the State VATs being levied on the base including Central VAT would get rebated through the system until at the last taxable sale point. Thus the distortions associated with input taxation because of cumulation or cascading will not occur.[30] An element of extra burden on the final consumer may still remain because of the mark-up on the Central VAT ("pyramiding" as it is sometimes called).

To keep the burden of taxation by both levels of government within reasonable limits, over a period of time, the rate of Central VAT should be brought down to a uniform rate of 10 per cent, so that the cumulative incidence of all indirect taxes - Central and State - is generally not more than 20 per cent. The strategy should be to allow more room for the States to levy their VAT down to the retail level. Such a reform can be attempted only after the indirect tax system in the country as a whole has been rationalised on the lines proposed in this report. This will have to be coupled with an assessment by the Finance Commission of the devolution of finances between the Centre and the States under the proposed structure. A modification in the existing formulae for devolution of individual taxes will be necessary. An ideal arrangement will be sharing of a specified percentage of the Centre's gross tax revenues with the States, as recommended by the TRC.

As the value added principle is already operating in the excise system, changes on the excise should not pose any serious problem in implementation though it must be emphasised that the operation of VAT in its true spirit would call for a radical change in the approach and methods of administration. Introduction of the VAT at the State level would imply a more fundamental change than on the excise side. The focus of the reforms of the domestic trade taxes would therefore have to be on the transformation of the States sales tax systems into State VATs. The main elements of the reform of the State sales taxes are set out and elaborated in the chapter that follows.

---

29. These proposals were drawn up before the Union Budget for 1994-95 was presented in Parliament.

30. The following example illustrates the point. Suppose the ex-factory price of an article is Rs 80 and the excise duty is Rs 20 (assuming that no taxable inputs are used). With a State VAT of say 10 per cent, the manufacturer's (net) VAT liability would be Rs 10 (Rs 8 on his own value added plus Rs 2 on the Central excise). The manufacturer's invoice to the wholesaler will thus show a selling price of Rs 100 plus the VAT of Rs 10 adding up to a total amount of Rs 110. Now, if the wholesaler resells the product to a retailer for say Rs 150, exclusive of VAT, his gross VAT liability would be Rs 15, and net liability, Rs 5. If the retailer sells it for Rs 250, then (net) VAT payable by him would be Rs 10 (Rs 25 on the selling price minus a tax credit of Rs 15).

The total VAT payable by the consumer would thus be Rs 25, consisting of Rs 23, that is, the aggregate of the VAT on the values added by the manufacturer (Rs 80), the wholesaler (Rs 50) and the retailer (Rs 100), plus Rs 2 on the Central excise of Rs 20. Clearly, there are no general tax-on-tax effects, only a one-time VAT-on-excise effect which can be exactly replicated by an adjustment in the rates. If, in the present example, no Central excises were levied, the total VAT base would be Rs 230. To obtain the same amount of revenue, viz., Rs 25, the VAT rate would have to be increased to 10.87 per cent.

REFORM OF STATE SALES TAXES : A SCHEME OF HARMONISED STATE VATs

7.1 Steps to Transform State Sales Taxes into State VATs

The review of the current system of domestic trade taxes presented in Chapter 2 shows that many of their ill effects are attributable to the structure of the sales tax systems and their operation in practice. They cause distortions damaging to the economy and inhibit free flow of trade in the country and impose costs on the economy in many ways. From the revenue point of view also, the system seems to have reached a dead end as States and Union Territories engage in fierce tax competition and tax exporting, and finding no other way to raise revenue are bringing about levies such as the turnover tax which are long discarded by progressive economies. While some of the evil effects of the present system could be alleviated through piecemeal reforms or harmonization of rates among the States, only a move towards VAT could help to get rid of the archaic and debilitating system of taxation that is prevailing today. Measures which the States can take to reform their present sales tax systems within the existing constitutional framework to move them towards a harmonized system of VAT are outlined below. If implemented, these measures would go a long way to impart neutrality, transparency and simplicity to the system while also strengthening the revenue base of the States by providing a stable source of revenue.

If the State sales taxes are to be reformed towards a simple, neutral and productive system of consumption taxation the essential steps would be to:

a. Convert sales taxes into VAT by moving over to a multistage system of sales taxation with rebate for tax on all purchases with only minimal exceptions.
b. Extend the tax base to include all goods sold or leased with minimal exceptions, and services which are integral to the sale of goods. The base should also include services which are predominantly of a consumption nature and can be taxed conveniently by the States.
c. Allow input tax credits for all raw materials and parts, consumables, goods for resale, and production machinery and equipments. (No rebate will be allowed in respect of overhead expenses like repairs, etc., office equipment, construction materials and fixtures and purchases in use for transportation and distribution of goods).
d. Replace the structure of tax rates with two or three rates within specified bands, applicable in all States and Union Territories.
e. Remove the exemptions except for a basic threshold limit and items like unprocessed food and also withdraw other concessions like tax holiday, etc.
f. Zero-rate exports out of the country and also inter-State sales and consignment transfers to registered traders with suitable safeguards against misuse.
g. Tax inter-State sales to non-registered persons as local sales.
h. Modernize tax administration, computerise operations and the information system and simplify forms and procedures.

The measures for harmonization of the rates will call for agreement among States and also the Centre. If the States signal their agreement on such a package, the Centre should permit the States to tax the three additional excise duty items, viz., textiles, tobacco and sugar under State VATs.

Further, under the CST Act at present, there is a ceiling on sales taxes that can be levied on certain commodities considered vital for inter-State trade and commerce (called declared goods) even when sold within a given State. The ceiling is equal to the tax on inter-State sale (i.e., 4 per cent). With the reforms outlined above these restrictions should go. This can be made effective through an amendment in the CST Act.

Because of its inherent neutrality, VAT can be applied in a comprehensive manner to most goods and services in a consumer basket without causing any unintended distortions. In fact, neutrality depends crucially on the coverage of the base. Levied on a comprehensive base it is especially suitable for bringing into the tax net those sectors where compliance under other forms of tax may not be very high. If applied at a uniform or at the most two or three rates, its operation can be simple.

Discussions with State government officials suggest that such a scheme may be acceptable. The rate bands proposed are: 4 to 5 per cent for essential goods and 12 to 14 per cent for all other goods. Basic, unprocessed food items may be exempted, while petroleum and diesel, tobacco, alcohol and narcotics subjected to a non-rebatable tax at a floor rate of 20 per cent. In principle, tax paid on fuels used ought to be rebated. On practical considerations and in the interest of conservation of energy, however, it is advisable not to allow any rebate for the tax on petrol. Consideration may be given to the feasibility of rebating the tax on other petroleum products like lubricants and diesel only when used in manufacturing.

Each of the elements of reform enumerated above is discussed in turn below. Statement 7.1 provides a summary of the likely benefits of the recommended reforms, as also the potential concerns.

7.1.1 Replacement of existing State indirect taxes by a VAT on all goods and selected services

The first step in reforming the State sales taxes would be to introduce VAT replacing all the sales and purchase taxes now being levied by them, including the general sales tax, purchase taxes, surcharges, additional sales tax, motor spirit taxes and the turnover tax. The new regime would be applicable in all of the States as well as Union Territories. In principle, the VAT should also replace the other indirect taxes levied at the States level like the electricity duties, entertainment tax and passenger and goods tax as well as octroi and entry taxes. However, in the first instance, the reforms may be directed towards replacing only the taxes on purchase and sale of goods.

The base of the tax should include all goods sold or leased with very few exceptions or exemptions. To maintain its integrity the VAT should be levied on services too. There are constitutional and practical problems in bringing all services under taxation along with goods at the State level. However, services which are normally rendered along with the sale of goods and also those which mainly go to final consumers and have good revenue potential should be subject to tax by the States. Which services could be brought within the tax net and at what level is examined separately (vide Section 7.2).

The tax would be a multi-stage levy, extending beyond the first point of sale and going as close as possible to the final point. All manufacturers and dealers with turnover exceeding a specified "small business" threshold would be liable for the tax. To avoid cascading, wholesalers and retailers reselling goods that have already borne tax at earlier stages would be allowed to claim a rebate for the tax paid by them at the time of purchase of the goods. As demonstrated in Chapter 5, this system of rebating would ensure that regardless of the number of times the goods change hands prior to the final sale to consumers, the tax would remain a constant percentage of the final selling price. Table 7.1 illustrates the calculation of State VAT at different stages of trade.

Table 7.1

Illustration of State VAT (All transactions within a State)

	Sales	State VAT @5%	Sales Incl. Tax
Manufacturer	100	5	105
Wholesaler	160	8-5=3	168
Retailer	200	10-8=2	210
Total Tax		10, that is, 5% of sale price (exclusive of tax)	

Statement 7.1

Benefits of Reform Measures and Potential Concerns

Tax reform Measures	Benefits	Concerns
Replacement of sales taxes by Value Added Tax	All round simplification. Check on undervaluation and evasion at the first point of sale. Removal of economic distortions created by first-point and cascading multi-point taxes and consequent costs to industry and trade. Inclusion of wholesale and retail margins in the tax base. Maximum retail prices may become more effective.	Cost of both compliance and administration may increase. Opposition from tax practitioners.
Inter-State harmonization and rationalization of rate structure	Reduction in complexity and fewer tax disputes. Improved compliance and simpler tax returns. Reduction in taxpayer harassment. More neutral application of tax and reduced distortion of business decisions. Reduction in revenue loss through inter-State tax competition.	Low tax States may have to raise their level of taxation.
Full rebating of tax on production inputs, including machine and equipment	Reduction in production and investment costs. Improvement in competitive position of domestic firms. Higher economic growth. Removal of bias in favour of vertically integrated firms and encouragement for economies of scale. Reduced pressure for selective industrial incentives. More predictable incidence of tax.	Revenue may suffer.

Contd.

Statement 7.1 (Contd.)

Tax reform Measures	Benefits	Concerns
Removal of exemptions and concessions except for a basic threshold and items like unprocessed food	Widening of the base. Removal of economic distortions and levelling of the playing field.	Possible adverse impact on prices and industrial growth.
Exemption of unregistered sectors	Facility of compliance and administration. Protection of revenue.	Some inequity and arbitrariness in incidence.
Zero-rating of inter-State sales and international exports	Preservation of the national common market. Reduced distortions in production and distribution of goods. Removal of hidden taxes on inter-State and international exports.	Revenue loss for States deriving substantial revenue from CST. Greater risks of evasion.
Extension of State VATs to declared goods and sugar, textiles, and tobacco	Broader tax base. More neutral application of VAT. Simpler tax design. Substantial revenue gain.	
Modernization of administration, including computerization, simpler forms and procedures, and improved staff training	Revenue gain through improved compliance and enforcement. Greater fairness and uniformity in the application of tax.	This will require initial investment.
Overall	Transparency, efficiency and simplicity. Greater control over incidence. Stable revenue source.	Administration and compliance burden.

The proposal to introduce multi-stage sales tax upto the retail point might give rise to apprehensions of administrative problems and compliance hassles for taxpayers. These apprehensions could be greatly allayed if (i) the threshold is fixed at a reasonable level; and (ii) simplified systems are devised for small dealers who still could not come within the tax net. It needs to be emphasised that the fear that taxpayer numbers would multiply to unmanageable level and evasion would be tremendous is not very well founded because under the proposed system of State VATs, the bulk of the tax revenues will continue to be collected from a relatively small number of manufacturers and dealers at the first point of sale. Even though wholesalers and retailers would also be brought into the tax net, the net revenue contribution of small dealers would remain small. Data on the distribution of dealers currently paying sales tax according to size of turnover show that 83 per cent of the total amount of tax is paid by only 24 per cent of the registered dealers (vide Table 7.2). The main reason for extending the tax to the retail level is that it would minimize the incentives for dealers at the first point to under-invoice sales, or to employ other tax avoidance devices. Any reduction in tax at the first point would result in a corresponding diminution in the rebate allowed at the next stage, with no net loss to the government. The tax system would also be simplified as there would be no need to define the first point of sale. What would be an appropriate threshold level is discussed in sub-section 7.1.4.

Table 7.2

Distribution of Dealers under Sales Tax According to Turnover*

Dealers	Number of dealers	Revenue (Rs. lakh)
Small Dealers (0 to 5 lakh)	1001057 (67.92)	83238 (8.16)
Medium Dealers (5 to 10 lakh)	121671 (8.25)	87940 (8.63)
Large Dealers (10 lakh and above)	351184 (23.83)	848331 (83.21)
Total	1473912 (100.00)	1019510 (100.00)

Source: Office of Commissioners of Sales/ Commercial Taxes of the States.

Notes : 1.* Based on data from Andhra Pradesh, Himachal Pradesh, Karnataka, Maharashtra, Orissa, Punjab, Rajasthan and Uttar Pradesh.
2. Figures relate to 1992.
3. Figures in brackets show the percentages of total.

It may be noted further that even under first point (or for that matter, any single point) taxation, intermediate dealers have to file returns even if they are not liable to tax and, where turnover taxes are in operation, those above the prescribed exemption limit are required to pay some tax. If the administration is streamlined and the structure simplified, there is no reason why the new system should mean additional hassles. No doubt, scope for manipulation would get reduced. But so would the scope for harassment.

7.1.2 Rebating of tax on production inputs, including machinery and equipment

To avoid tax cascading, and the resulting loss in economic efficiency and output, it is essential that the VAT collected on raw materials, parts, consumables, and production machinery and equipment be fully rebated to manufacturers. In addition, registered wholesalers and retailers should be eligible to claim rebates for tax paid on goods acquired for resale. No rebates would be allowed for construction materials, office supplies and equipment, and inputs for use in the distribution of goods (e.g., transportation equipment, and advertising inputs). Non-registered persons would not be eligible for any rebates. They would include all consumers, non-commercial institutions, small traders, service sector organizations.

As suggested below (sub-section 7.1.5), inter-State sales will be zero-rated so that goods may be imported by a dealer in one State from another State without payment of tax leviable on domestic sales by the exporting State. The tax on the full resale price of the goods will be charged by the importing State. In the presence of exemptions and zero-rating provisions, it is the tax credit method that is suitable for imposition of VAT at a sub-national level (see Section 5.2).

In a given period when a dealer is building up inventory, the tax paid by him on purchases could exceed the tax collected on sales. In such cases, the excess would be allowed to be carried forward, to be offset against any future tax collections. In other words, the excess would not be refundable (except in the case of registrants with export sales that are not subject to any tax).

The proposed rebating system would have two important advantages. First, it would obviate the necessity of a purchase tax which is currently imposed by many States to make the tax burden on exempt inputs acquired from unregistered dealers equal to the non-rebatable tax paid on inputs acquired from registered dealers. Second, the rebate for production machinery and equipment would be a suitable replacement for selective industrial incentives. The new system would lower the cost of all new manufacturing investments. Its benefits would be available to all in a neutral manner. At present, producers and manufacturers have an incentive to buy their taxable production machinery and equipment outside the State. Such purchases attract CST in the exporting State at the maximum rate of 4 per cent, which is usually lower than the tax that would apply on intra-State local purchases.

To facilitate compliance, until the States are empowered to levy the tax on services like works contracts, construction contractors could be treated as exempt traders. They would pay tax on their purchases of construction materials from registered dealers, with no right of rebate. If they were to be treated as vendors of goods, they would need to be registered, and required to charge tax on the contract price exclusive of the service component. If, as suggested elsewhere (vide Section 7.2), the States are empowered to impose tax on works contracts, consideration should be given to accord them similar powers for the taxation of services of repair, maintenance, installation and such other services that are ancillary to sale of goods.

Lessors of goods would charge tax on their rental receipts, and claim a rebate for the tax paid on the purchase of goods to be leased.

7.1.3 Inter-state harmonization and rationalization of tax rates

One of the basic maladies of the present sales tax systems is the multiplicity of rates. If the system is to acquire transparency and simplicity the rates must be rationalized. For simplicity as also certainty, a uniform rate is the best. The case often put forward for differentiating the rates to distinguish between necessities and luxuries on grounds of equity is not well founded. It is now well recognised that rate variation is a very blunt and ineffectual instrument for mitigating regressivity, creates complexities in the law and generates disputes. In absolute terms, the rich benefit much more than the poor (in some countries twice as much). Also, it is not easy to distinguish higher quality essentials like food (e.g., Basmati rice) from products consumed by the poor (coarse rice) for tax purposes. As a result, lower rates are not very helpful in moderating the regressivity of VAT. Surveys conducted among some of the EU countries show it makes little difference to the incidence of VAT whether the necessities are zero-rated or taxed at a lower rate or the standard rate. While the consumption patterns of the rich and the poor are not the same, there are significant areas in common.

Administration and compliance costs too multiply enormously when the rates are differentiated as it requires classification of commodities which is rarely easy to delineate unambiguously. Compliance costs also go up tremendously especially for small firms. Evidence shows that the incidence of costs fall more heavily on the smaller firms with lower incomes. Further, lower rates for some commodities obviously necessitate higher rates for others than would otherwise be required to raise a given amount of revenue, with all their distortionary and evasion inducing effects. Usually, the higher the tax rates, the more acute are the distortions to producer and consumer choices. High ad valorem rates also tend to affect product quality adversely. For all these reasons, experts favour keeping the structure of VAT rates uniform and helping the poor through other means (expenditure programmes or income transfer). This is, however, not to argue against the levy of excises at higher rates for expenditures on drinking, smoking or motoring.

Despite strong arguments against rate variation, many countries that have adopted VAT provide for concessional treatment of necessities through lower rates or exemption or zero-rating. Appendix Table A3.4 shows the structure of VAT and excises in over 60 countries across the world as of January 1992. It appears that in the EU, variation in rates is common among countries which had a multiplicity of rates to start with. The trend for countries which joined the EU later is to have a uniform rate.

For the proposed State VATs too, a single uniform rate would be helpful in many ways. A major benefit would be that such a rate would be much more moderate than the level at which the standard rate would have to be fixed otherwise. However, considering the sharp disparities in the consumption pattern of the rich and the poor in India, the limited coverage of poverty alleviation programmes and the compulsions of policy makers, it seems that provision has to be made for concessional treatment of necessities as distinguished from others, in the form of exemption or a lower rate than what might be designated as the 'standard rate'. To accommodate these considerations, while minimising revenue loss and economic distortions from inter-state competition, and for facilitating compliance, it is proposed that the basic structure of the VAT be so designed as to permit only three rates at the most, and tax rates be kept within specified bands in all States. For rate purposes all commodities should be divided into the following four categories:

- Basic unprocessed food items sold in their original or "natural" state, exempt from tax;
- Other basic necessities, taxable at the lower rate of 4-5 per cent;
- All other goods, taxable at the standard rate of 12-14 per cent; and
- Tobacco, alcohol, petroleum and aviation fuels, and narcotics, subject to a non-rebatable floor rate of 20 per cent.

Statement 7.2 lists specific items in each of these categories. Tax on high-rated goods as listed against (d) would not be rebatable although the tax paid on their inputs would be creditable against the VAT leviable on them (like in the case of office equipment as indicated in Section 7.1.2). However, care would have to be taken to see that resellers of these commodities get credit for the tax paid on their purchases.

The States/Union Territories would be free to choose any rate within a given rate band. However, all goods within a chosen rate-band category would have to be subjected to tax at the same rate in that State. For example, for the third category of goods, one State could choose to impose tax at 12 per cent, and another at 13 per cent, but a given State will not use 12 per cent rate for some goods and 13 per cent rate for other goods. Essentials like basic unprocessed food will be exempt.

All States and Union Territories should fix their VAT rates within these bands. The Union Territories have a special responsibility in this regard and their compliance would be critical to the success of harmonization as it is often the attempts at tax competition on the part of Union Territories that have queered the pitch.

Exemption as contrasted with zero-rating does not provide full relief from tax because, unlike in zero-rating, no refund (or credit) is given for taxes paid at earlier stages. Hence, at first sight, there seems to be a persuasive case to zero-rate the necessities for providing complete relief to the poor. In UK and Ireland, food except when served in hotels and restaurants is zero-rated. However, operation of zero-rating of the commodities produced in unorganised sectors is cumbersome. Therefore, exemption of food products may be preferable to zero-rating. An exemption for farmers implies that they need not have any interaction with the tax department. If food is zero-rated there would be need for the farmers to keep proper accounts to substantiate their input tax credit claims and file returns periodically.

With the rationalisation of the rates into three bands as proposed above, classification of commodities based on fine distinctions would no longer be needed.

The rates suggested for the middle two categories are illustrative. They should be set so as to yield the same revenues as under the

Statement 7.2

Proposed Commodity Grouping for State VAT Rates

Exemptions

1. Unprocessed cereals including rice, rice flour, wheat, atta, maida, and suji.
2. Pulses.
3. Fresh vegetables and fruits.
4. Fresh meat, fish, and livestock excluding race horses.
5. Unprocessed salt.
6. Fresh milk
7. All types of eggs
8. Plain water not including mineral water, aerated water, tonic water, distilled water, scented water or water sold in sealed containers/sockets, etc.

Rate of Tax (4 TO 5%)

1. Oilseeds, edible oils and oil cake
2. Processed salt
3. Dried fish, vegetables and meat
4. Pasturised milk
5. Chillies, turmeric, tamarind, cumin seed, dried ginger, etc.
6. Kerosene
7. Sugar

High Rate of Tax (Minimum 20%)

1. Diesel, petrol and aviation fuel.
2. Opium, ganja, bhang, narcotics, etc.
3. Liquor
4. Tobacco and tobacco products.

All Other Commodities

Standard Rate (12 to 14%)

current system. In our judgment, the standard rate of 12-14% is rather high, especially when combined with the burden of the central excises. A tax at this rate is bound to encounter resistance from dealers as well as consumers. These rates could be lowered if the introduction of the VAT were accompanied by a tangible improvement in tax enforcement and administration. It would also call for some restraint on the part of the Centre in fixing the rate of MODVAT.

With the rationalisation of rates and rebate for all inputs including capital goods, the exemptions and tax concessions including tax holidays given in sales taxes should go. One of the most potent factors undermining the revenue potential of sales tax systems and causing distortions in the treatment of businesses has been the operation of these concessions. They weaken the States' capacity to strengthen their infrastructure, which is crucial for economic development. It is relevant to note that even business organisations like the Confederation of Indian Industries (CII) have urged the government to provide infrastructure rather than tax concessions. A recent paper by the CII, Gujarat has even described the tax holidays in sales tax as a destructive strategy of industrial development.[31]

7.1.4 Treatment of small businesses and unorganized sector

For administrative reasons and also in order not to burden the small traders and producers, VAT systems usually exclude traders and producers having turnover below a specified level. Dealers falling below this level are not required to register or furnish return to pay the tax or maintain the prescribed records. What would be the appropriate threshold level for State VATs should be left mainly to the judgement of the tax authorities in the respective States. However, by and large, a level of Rs 300,000 of annual turnover would seem to be a reasonable level that would take account of the concerns of both administration and small businesses. In a harmonized system, States would be free to fix their threshold level but preferably within the specified limit.

It should be understood that exemption from paying tax does not relieve the small dealers of the tax completely in that, not being registered, they cannot claim credit for the tax paid by them on their purchases. They have no compliance or other obligations under the tax and are treated the same as households or consumers. They are not required even to register for the tax. Full

31. See Confederation of Indian Industries (1993).

relief is possible only when sales are "zero-rated", for then the vendor is allowed to claim a credit for the tax paid on its purchases, even though no tax is charged on the sales.

The exemption system is beneficial to only those firms that deal mainly with final consumers. If they make sales to other registered dealers, then an exemption system can result in a net increase in tax. This is shown in Table 7.3 for the tax-credit or invoice system. In the example, when it is assumed that a wholesaler is exempted from the tax, the total tax collected by the government increases from Rs. 30 to Rs 50. This occurs because when the wholesaler is exempted, the loss of tax collections from the wholesalers is more than made up by the additional tax collected from the retailer, the next person in the production and distribution chain. The retailer would have remitted only Rs 5 in tax had there been no exemption, but with the wholesaler exempt, the additional tax paid by the retailer is Rs. 25. The difference in the two amounts represents the tax of Rs. 20 paid by the wholesaler on his inputs which is blocked by the exemption mechanism. It is for this reason that most intermediate dealers prefer to be registered and liable for tax under a tax-credit or invoice method of VAT. For the same reason, in principle, an option should be allowed to dealers falling below the threshold also to register and pay tax. However, with a threshold of Rs 3 lakh, it may not be necessary to grant such an option as that might provide scope for spurious firms to spring up and ask for registration.

While exemption will serve to spare small traders from the obligation to register for and pay VAT, there will be a good number of producers and traders, who would be above the threshold yet not large enough to be able to cope with all the formalities and requirements. To take care of taxpayers of the country, many countries operating VAT provide simplified methods for computing their liability or reduce their liability substantially. Some of the practices to this end followed in VAT countries are:

- Small traders exempted from VAT but subjected to an equalization tax (i.e., a higher than normal rate of VAT on their purchases). This presupposes correct reporting of purchases which is not easy to ensure.
- Very small traders exempted, others coming under the category of "small" granted a reduction of VAT liability by a specified fraction of the turnover or the tax. This method requires computation of the normal tax before granting relief.
- Exemption for certain categories of trade (e.g., pedlars, hawkers, etc.).
- Presumptive assessment ("forfait") based on certain external indicators (size of business premises, location, etc.).
- Simplified assessment based on a specified percentage of sales turnover or purchases.

Table 7.4 shows the treatment of small firms under VAT in selected countries. As will be seen, all the methods indicated above have their drawbacks. The simplest seems to be the last method whereby the VAT liability is computed by applying a specified percentage to the purchases or sales of the dealers although even that presupposes faithful recording of purchases and sales. Simplified assessment procedures are not unknown in present sales tax systems and may be adopted for VAT too. In any case, it would be advisable to avoid complicated schemes as they involve drain on administrative resources with little gain in revenue. Besides, under VAT, exclusion of small businesses does not entail great revenue loss because tax on inputs is collected anyway.

7.1.4.1 Treatment of small farmers

Farmers and other primary producers engaged in animal husbandry, horticulture and fishing are also accorded special treatment in recognition of their vital role in the economy. Special attention is called for also in view of the fact that small farmers rarely maintain accounts in the conventional way and, in India, it would be too much to expect them to comply with the obligations that registration for VAT would imply, even with drastic simplification. Exempting them from the tax fold would, of course, relieve them of any tax liability on their value added. Taxes paid on their inputs

Table 7.3

VAT With and Without Exemption of Wholesalers

	Primary	Manufacturer	Wholesaler producer	Retailer	Total
A. VAT with Exemption of Wholesalers					
Sales	100	200	250	300	
VAT on sales @ 10%	10	20	0	30	
Less: VAT paid on purchases	0	10	0	0	
VAT payable to government	10	10	0	30	50
B. VAT without Exemption of Wholesalers					
VAT due on sales	10	20	25	30	
Less: VAT paid on purchases	0	10	20	25	
VAT payable to government	10	10	5	5	30

would, however, remain. Several countries provide compensation for this in various ways.

For instance, Belgium, Ireland, The Netherlands and Spain allow a presumptive tax credit for the tax paid on inputs of agricultural products. Some countries tax primary producers at a rate fixed in such a way that they equal the tax based on their inputs while others compensate the farmers directly for their input tax. In some countries, farmers are exempted without compensation but a lower rate is charged on the main agricultural inputs like feed, seed and fertilizers. All such provisions create complications for the system. The suggested threshold for the liability to register for VAT should be adequate to take care of the problems of small farmers and producers of primary products whose marketable surplus does not exceed Rs 3 lakh.

7.1.5 Zero-rating of inter-state sales

As noted in sub-section 6.1.2, consumption type VAT is levied in virtually all jurisdictions, whether at the national or sub-national levels, on the basis of the destination principle. Under this principle, goods going out of a State/country are relieved of domestic trade taxes while imports are taxed in the same way as domestic products. There are basically two alternative ways of operating the destination rule - the deferred payment or zero-rating and the credit clearing method. Presumably for practical reasons, the EU has adopted the zero-rating route for the present.

Table 7.4

Treatment of Small Firms Under VAT*

	Complete Exemption	Simplified Schemes	Forfait
Hungary	(1) Ft 1 million (US$15,900) (retailers); and (2) Ft 250,000 (US$3,975) (others)		
Indonesia	Rp 60 million (US$33,408).		
Japan	Y 30 million (US$210,000).	Y 30-60 million (US$210,000-220,000) Y 500 million (US$3,500,000) or less, rate is 0.6 per cent of sales, except for wholesalers the rate is 0.3 per cent. Also, if interim tax liability is under Y 300,000, tax payment can be delayed until year-end.	
Korea		W 24 million (US$35,346). W 6 million (US$8,834) (agents, contractors, proxies)	2 per cent of turnover tax (and allowed to deduct 5 per cent of reported input tax).
Mexico		(1) Income must not exceed 32 times the minimum wage; (2) no more than three employers; and (3) business space no more than 50 square meters.	Applied on a presumptive basis if (1) to (3) are met.
Nigeria		Turnover below: CFAF 30 million (US$588,950) (goods); and CFAF 10 million (US$29,650) (services).	
Philippines	P200,000 (US$9,250).		2 per cent turnover tax
Portugal	(1) Esc 7.5 million (US$27,300) (retailers); (2) Esc 800,000 (US$4,850) (entrepreneurs); and (3) Esc 500,000 (US$3,030) (professionals).	Small retailers pay quarterly per cent of tax on purchases.	
Spain	Individual retailers not required to register.	Withholding "markup" VAT applied by suppliers to retailers.	
Taiwan Province of China		NT$2.4 million (US$91,954).	1 per cent of turnover tax (and allowed to deduct 10 per cent of reported input tax).
Trinidad and Tobago	TT$75,000 (US$17,650).		
European Community	ECU 150,000-300,000 (US$144,000-287,000) (suggested).		

Source: Tait, (1991).
Note : * As of 1990.

For the preservation of the national common market, to remove all hidden taxes on exports, and to minimize distortions in business location choices, it is imperative to remove the taxation of inter-State sales and for this purpose zero-rating seems to be the preferable alternative. This means that the CST rate for inter-State sale to a registered dealer should be reduced from 4 per cent to zero. Table 7.5 illustrates the calculation of VAT under the zero-rating system, where the wholesaler selling goods in one State acquires his stocks from a manufacturer located in another State.

Inter-state sales to non-registered persons and consumers would be taxable in the same manner as intra-state sales to local consumers. There could be special provisions for the taxation of inter-state purchases by large institutional buyers, e.g. government departments, that are not registered for the tax. Instead of paying tax to the exporting State, such institutions could be required to get themselves registered and self-assess the tax in the importing State. This would safeguard the revenue of States where the goods are consumed.

Table 7.5

Illustration of State VAT, imposed @ 5% with Inter-State sale by a Manufacturer

State	Dealer	Sales	State VAT	Sales Incl. Tax
X	Manufacturer	100	0	100
Y	Wholesaler	160	8	168
Y	Retailer	200	10-8=2	210
Total			**10** (To State Y only)	

The zero-rating of inter-state sales to registered persons would be limited to only those goods which would have been eligible for tax rebate, had the tax applied to them. This would include raw materials, parts, consumables, production machinery and equipment, and goods for resale. Without this restriction, registered traders would have an incentive to buy non-rebatable goods (e.g., office equipment) from another State on a zero-rated basis, rather than on a tax-paid basis within the State.

Abolition of tax on inter-State sales may adversely affect the States deriving large amounts of revenue from this source. In the case of States like Maharashtra, the loss will in all probability be made up with the extension of the base to include consumption items like textiles and the capture of trade margins beyond the first point under the multi-stage system that VAT implies. For States like Bihar and Madhya Pradesh, where CST on minerals yield substantial revenue, appropriate pricing of their natural resources and a wider base for their VAT should take care of the revenue loss, if any. Estimates presented in Chapter 8 show that with the widening of the base and withdrawal of exemptions and some improvement in administration, it should be possible to protect the revenue of even the exporting States with tax rates within the suggested bands.

Several exporting States have major apprehensions about zero-rating because they feel that it would not only lead to heavy loss of revenue but also lend itself very easily to evasion. In general, it is easier administratively to record and capture the inter-State sale of a good at the point of origin (say, a factory or wholesaler) than to record and capture the same transaction at destination (which may involve a large number of small retailers). The evasion possibilities of a destination-based system, especially in the Indian context where the retail sector is outside the tax net, cannot be dismissed lightly. The perceived advantages of destination-based taxation may be outweighed by severe evasion risks, unless adequate safeguards are built into the system against leakage.

An alternative model for avoiding the problems of cascading and tax exporting *without* the evasion risks of a destination base, could be:

i. All inter-State sales and consignments taxed at origin;
ii. Credit given in the importing State for the tax paid at origin; and
iii. Importing States to be compensated for the net amount of rebate allowed by them vis-a-vis the exporting States and inter-State accounts settled through a clearing mechanism.

A version of this - the tax credit clearing system - was seriously contemplated in the EU as mentioned in sub-section 6.1.2.1 but has been put aside at least for the present.

If the clearing mechanism is considered too complex, one alternative could be to pool the revenues and arrange for their sharing. In fact, the critical issue to be resolved in this model is the distribution of the revenue from tax on inter-State sales. Exporting States feel the revenue can be retained by the State of origin (as is now the case with CST) or at best a part of it could be pooled and shared. Importing States would, on the other hand, prefer such revenue to be transferred entirely to the destination State.

It may be argued that the issue of *sharing* of revenue is quite separate from the principle of origin based taxation and should be resolved independently. However, in reality, the two cannot be viewed totally in isolation. The accentuation in the distribution of revenues that may occur if origin based taxation persists and, what is more, consignment transfers are allowed to be taxed on origin basis, cannot be brushed aside in the context of reforms of the present tax system. It must be recognised that origin based taxation will not be compatible with the destination principle unless the importing States grant rebate on the tax collected by the States of origin. They are unlikely to do so unless the revenues are finally shared fairly. If tax on inter-State movement of goods is to be removed - as is eminently desirable - levy of tax by the State of origin should not be permitted except as a device to minimise revenue loss with full rebating by the importing State. Importing States cannot possibly be expected to give such rebate unless assured of a reimbursement through some mechanism such as credit clearing or pooling of revenue. If the revenues are pooled then the State of origin would have little interest in collecting them. Also, granting rebates for taxes paid in other States would not be very simple or free from risks of abuse. For all these reasons, zero-rating by the exporting States seems to be the best course. Possible safeguards to check evasion under zero-rating are discussed below.

7.1.6 Verification of zero-rated inter-State sales

Zero-rating of inter-State sales would call for special procedures to verify that the zero-rated sales are truly made to registered dealers who would account for tax in the importing State. Under the present system, inter-State sales to registered dealers are relieved of the local sales tax if the buyer produces a "C" form issued by the State of the importing dealer. This system does not seem to be working too well. Inquiries by the exporting States to check the validity of the forms issued by importing dealers are either ignored or given low priority by the importing States. It is understood that often long delays occur even in the issuance of the forms or their verification holding up assessments of the exporting dealers.

In the absence of an effective mechanism for inter-State verification of the registration status of dealers, there is a risk that zero-rating of inter-State sales could become a source of large scale revenue leakage. To guard against this possibility, consideration should be given to the adoption of a special system of pre-payment of tax on zero-rated inter-State purchases.

Under the pre-payment system a registered dealer making an inter-State purchase would make a payment of tax on the total purchase price of the goods to the sales tax department of the importing State. The tax payment receipt (stating the value of purchases, a brief description of goods to be purchased, and the amount of tax pre-paid) issued by the importing State would authorize the export dealer to make the inter-State sale on a zero-rated basis, up to the total value of the goods stated in the tax payment receipt.

The sale would be treated as a local sale, and attract the tax of the exporting State, if the importing dealer fails to provide such a tax pre-payment receipt to the export dealer at the time of sale (or at least before filing the return). Any tax prepaid by the importing dealer would become creditable under normal value-added tax rules, as if the tax was paid to another registered manufacturer or dealer on an intra-State purchase of the goods. The importing State would issue three copies of the receipt, one to be submitted to the export vendor, the second to be attached to the tax return of the importing dealer to support the credit claim, and the third to be retained by the importing dealer. The export vendor would, in turn, attach the prepayment receipt to its tax return to support its claim for zero rated sales. The three copies should be of different colours, or otherwise distinguishable from one another, to prevent their use for multiple zero-rated inter-State sales. This system would have the following merits.

First, it would ensure an unbroken chain of tax collections and input tax credits on all domestic sales, as goods move from manufacturers to wholesalers to retailers, regardless of whether the sale is intra-State or inter-State. The only difference between intra-State and inter-State sales is that in the case of the latter the tax is paid directly to the importing State, as opposed to the vendor.

Second, both importing and exporting States would have a stake in prompt monitoring of inter-State sales. For the importing State it would mean additional revenue inflow to the State. Any tax prepaid to the State would be creditable by the importing dealers against the tax that they charge on their sales. The importing State would thus also have an incentive to verify the validity of tax payment receipts submitted by the importing dealers with their returns. From time to time, the exporting State would send a random selection of prepayment receipts to the issuing State to check their validity. Unlike under the present "C" form mechanism, both importing and exporting States would have a mutual interest in the verification of the receipts.

Third, while the system proposed would require advance financing of tax by the importing dealers, any additional cash flow requirements for the dealers would conceptually be the same as those associated with local purchases. When the goods are bought locally, the tax has to be paid to the vendor at the time of purchase. The timing of tax payments would differ for the intra-State and inter-State purchases only to the extent that the tax charged by the local vendor during a tax reporting period may not be remitted to the government until the end of the reporting period. This timing difference also arises under the MODVAT in the treatment of international imports and domestic purchases. The prepayment of tax to the importing State would work in a manner similar to the countervail duty on imports. Registered dealers under a VAT generally enjoy a cash flow enhancement. They collect tax throughout the tax reporting period as they make taxable sales, but remit it to the government only at the end of the tax period. The prepayment of tax would reduce this cash flow advantage, but not eliminate it. Even this diminution in the cash flow may not take place if the receipt for local tax payment by the importer is timed with the filing of the return by the exporting dealer, as is the practice now for the production of "C" forms.

Fourth, if the State sales tax rates are harmonized, it would be easy for the exporter to verify that the tax pre-paid was correct. Even if there was an error and the tax pre-paid was less than the required amount, the risk of revenue loss to the governments is minimal because any tax shortfall would be offset by a matching reduction in the input tax credit claim of the importing dealer.

The application of the pre-payment system should be extended to movement of goods on consignment or branch transfers. Though such movement of goods does not constitute sale, on considerations of risk to revenue, the prepayment rule has to embrace consignments too. Since any tax paid in advance under this process by a registered dealer in respect of stocks or material transferred to his branches will eventually be rebated against his sales, there should be no distortionary impact.

The prepayment system might come in for criticism on the ground that it would result in blocking of funds in businesses doing inter-State trade. No doubt this would imply some interest cost but the fears on this score should not be exaggerated. The interval between the payment of tax by exporter and getting it credited on payment of advance tax paid by the importer would depend very much on how soon the certificate of advance payment is furnished by the importer. Since the offset would be automatic and operate through the accounts of the exporter, there should be no apprehension of "hold up" by tax departments. To guard against fraud, assessments should, however, be completed speedily within six months of furnishing of return.

An alternative to the prepayment system would be to allow the exporting States to levy the tax at a low rate (2 per cent) with corresponding rebate by the importing State and the revenue collected shared through a pooling arrangement (see Section 6.1.2.1). This, however, would not neutralise the gain from camouflaging intra-State sales as inter-State but could be given consideration as an interim arrangement until the prepayment system is put in place.

7.1.7 Extension of the State VAT to declared goods, and sugar, tobacco, and textiles

Currently, States are not allowed to impose tax on certain goods (commonly referred to as declared goods), which are viewed to be of importance in inter-state commerce and trade, beyond the rate laid down for CST. Under the new regime the neutral design of the VAT makes such restrictions redundant. If inter-state sales are zero-rated, and the tax on production inputs rebated, then the imposition of tax on the declared goods does not in any way hamper inter-state commerce. However the Central legislation to fix the maximum rate of tax on declared goods may be retained to ensure that the States accept and adhere to the harmonized rate structure envisaged here.

The special regime for tobacco, sugar, and textiles also becomes unnecessary under the proposed VAT structure. There are no technical reasons for the continuation of the additional central excise on these goods in lieu of the State sales tax. They can be easily made taxable within the structure of the State VAT.

7.2 Taxation of Services

Under the Constitution as it stands at present the States do not have the power to tax services except those specifically assigned to them, viz., taxes on passengers and goods carried by road and inland waterways, taxes on luxuries including amusements, betting and gambling, and taxes on advertisement other than in newspapers, radio and television. The power to tax services in general (in addition to advertisement in newspapers, radio and television) rests with the Centre by virtue of the residuary entry in the Union List though the Centre has not used the power effectively so far.[32]

As argued earlier, in principle, the base of a comprehensive consumption tax should comprise both goods and services. Exclusion of services from the base creates economic distortions and aggravates the regressivity associated with taxes on consumption. Moreover, services constitute a large and growing sector of the economy and the distinction between goods and services is no longer sustainable. There is, therefore, a strong case for bringing services under the tax base and VAT facilitates a comprehensive approach to the taxation of goods and services. Some exceptions may, however, have to be made for social policy or administrative reasons. Thus, while taxing services comprehensively under their VAT system, the EU and OECD countries exempt certain public interest activities like health,

32. The tax on foreign and inland travel levied by the Centre constitutes an exception. A tax is also imposed by the Centre on amounts charged for accommodation in certain classes of hotels and for food and drink in such hotels under the "Expenditure Tax Act" legislated by Parliament. However, its constitutionality has been upheld by the Supreme Court, as a tax on "expenditure" and not on services as such (Federation of Hotels vs. Union of India, AIR 1990 SC 1637).

education and social services. Financial transactions and life insurance are also usually kept out because of problems in measuring value added in these services. Such problems are inherent also in the taxation of housing services and services provided by government. Excluding these hard-to-measure categories, all other services should be brought within the VAT base. The taxation of services on this way seems to have worked well in Europe. Many countries in Asia also tax services on a comprehensive basis. In New Zealand even services provided by government are taxed.

For several reasons, however, it may not be feasible or even desirable to go in for the taxation of the generality of services at the State level right now.

First, for reasons noted above in bringing services under taxation, exemption has to be provided for several categories of the same service. The line between exempt and taxable services is not always easy to draw (e.g., between health and educational services provided by government and those provided by the private sector). Often arbitrary rules are required.

Second, the bulk of consumer services are provided at the retail level and that too by small firms in the unorganised sector. With a reasonably high threshold few of them would come under the tax net anyway, and so the revenue gain may not be worth the hassles that any attempt to tax them will entail.

Third, there are a range of services, such as transportation, telecommunication, advertising and professional/management consultancy, for which the place of origin or destination cannot be defined without the help of complex rules. For instance, consumption of inter-State transportation services could be defined to occur entirely in the State where the transportation commences, the State where it terminates, or both of the States in proportion to the distance travelled. The gains from advertising in a national newspaper may accrue from all parts of the country, or only from those areas where the advertiser markets his goods or services. There is thus good rationale for the provision in the Constitution whereby powers of taxing advertisements in newspapers, radio and television are assigned to the Centre while that of taxing advertisements through other media is conferred on the States. If the States were to extend their VATs to all services, they would need to agree upon a set of rules for a proper allocation of the tax base for services having inter-State spread. That would add to the enormity of the task of tax reform in India.

For all these reasons, it would seem to be advisable to extend the base of State taxes on consumption to services only selectively, at least to start with. In order that the selection does not proceed arbitrarily and so does not give rise to unintended distortions, some rational criteria should be laid down as a guiding rule. A simple and non-discriminating way of going about this task would be to concentrate on services which are integral or ancillary/incidental to the supply of goods, e.g., installation, works contracts and delivery. In other words, services should be brought under the State tax base only where it is necessary to ensure proper application of the tax to goods. By the same token, services integral or ancillary to the production or manufacture of goods should come within the base of the Central VAT on manufacturers.

The definition of services which are integral, ancillary or incidental to the production or supply of goods would, no doubt, need careful consideration. But once the principle gains acceptance, services integral, ancillary or incidental to the production or manufacture of goods should get taxed at the level of the Centre and all such services related to the sale of goods such as supply and delivery should be taxed by the States. With explicit stipulation in the law in this regard, there would be no scope for disputes over imposition of manufacturers' VAT in cases where the production is done on site or the manufacturing includes installation. Similarly taxability of products of branding, printing, blending or packaging would no longer be in doubt.

This rule would, however, leave out services which are delivered and consumed qua service. The significance of such services is growing fast and several of them figure prominently in the consumption basket of the rich (e.g., the service of photoproduct developing and printing, video filming, xeroxing and telecommunications, decorators, etc.). Keeping them out of the base obviously creates distortions and inequities and undermines the revenue potential of the consumption tax. However, the problem in bringing them under taxation is that identifying them individually would be arbitrary and so open to the charge of discrimination. Moreover, such selective taxation also generates pressures and lobbying for exemption or concession. Hence, as argued at the outset in this sub-section, the ideal course would be to bring all services in general under the tax base (with a few exceptions for social or practical reasons). But for reasons already mentioned, taxation of services on a comprehensive footing might throw up tremendous administrative and compliance problems without commensurate gain. Then there are problems of inter-State allocation of the base in the case of certain services. On these considerations it is desirable to make a beginning by taking up only services which are ancillary or incidental to the production or supply of goods.

In addition, pending the introduction of a generalized scheme, services which are predominantly in the nature of consumption and form a significant component of consumption (that is, those which are not directly related to business) such as photoprocessing or cable TV and video filming services may be brought under taxation with provision for rebating the taxes paid on materials. VAT paid for such services however need not be rebatable even though they are sometimes used in business also (like in the case of office equipment). Powers to tax such services may be given to the States. Only those among such services which have inter-State ramifications may be taxed by the Centre.

Based on the principles advanced above, proposals are put forward in Appendix 1 for the levy of tax on a few services by the Centre. The States should be empowered initially to tax services ancillary or incidental to the supply of goods and those which are essentially for consumption and can be identified as having a good revenue potential. VAT on services which are predominantly consumption in nature need not be rebatable. Eventually, the States should be vested with powers to tax services generally along with goods down to the retail level. Allocation of services with inter-State ramifications should not pose any inseparable problem. It appears fairly satisfactory rules in this regard have been evolved in the EU. However, that is a vision for the future.

For the present, since under the Constitution the Centre alone can legislate for the taxation of services, it would be expedient if legislation for the purpose was made by Parliament and powers in suitable cases delegated to the States as under the CST Act for the sales tax on inter-State sales. Such an arrangement should, however, be only transitional and if the experience is not unfavourable, the State VAT bases may be widened to include services in general except those specifically excluded.

As noted, some services (like entertainments) are at present taxed by the States under the powers conferred by the Constitution. Ideally all taxes on goods and services should be integrated into a single tax. However, given the limited scope of the scheme of State taxes on services proposed for immediate implementation, the continuation of a few taxes on services as separate levies could be justified as a transitional measure, pending a successful conversion of the sales taxes on goods into VAT. Where such integration is possible, e.g., in works contracts, the base should be integrated straightaway.

The revenue impact of the reform scheme proposed above and the likely economic effects are considered in Chapter 8. The legal, administrative and institutional requirements are briefly enumerated in Chapter 9.

REVENUE IMPLICATIONS AND ECONOMIC IMPACT

8.1 Computation of Likely Revenue Impact : The Approach

Proposals for tax reform, even when designed on rational principles, are often put aside because of apprehensions of negative implications for revenue. Revenue neutrality thus forms a critical parameter to be kept in view while formulating any scheme of tax reform. It should, however, be stressed that while revenue effects must be given careful consideration, reforms of an injurious tax structure to remove its basic deficiencies should not be held up for revenue reasons alone unless the impact is likely to be severe and the chances of the loss being made up through other measures such as capping expenditures or using alternative revenue sources or cost recovery seem remote.

Keeping in view the understandable concerns about revenue, exercises were carried out to see what would be the revenue implications of the reforms proposed in this study and to derive an idea of their likely impact on the budget of the Centre and the States. The aim was to derive the rate of tax or set of tax rates within the recommended framework which would be revenue neutral. It should be added that because of data limitations the results derived should be taken only as indicative of the likely order of the revenue gain or loss and not definitive estimates of the budgetary impact. As will be seen, since not all the information required for such estimates is available, the calculations had to proceed unavoidably on the basis of certain assumptions which, though plausible, have a vital bearing on the final figures. However, every attempt has been made to check that the assumptions are plausible and not wide of the mark.

In estimating the revenue impact of a consumption tax, the most straightforward way is to apply the recommended rates of tax to the consumption base after making necessary adjustments for the components which would be outside the tax base either because of "home-grown" consumption or exemption of commodities like cereals or by virtue of the threshold for small dealers. An alternative approach is to base the computations on the figures of turnover available with the sales tax administrations and work out the positive and negative impact of each major component of the reform package itemwise. The former may be called the consumption expenditure approach and the latter, the tax turnover route. In the exercises undertaken for this study, both the methods were used. Once the base is estimated, revenue neutral rates can be derived simply by dividing the revenue from the present taxes by the base. Sensitivity analysis was also carried out to see what would be the impact of alternative assumptions. The reference year for the exercises was 1992-93 (except for one State).

8.2 Revenue Neutral Rates for a Uniform VAT at the Centre and the States

8.2.1 Estimates by consumption expenditure method

Computations made by the expenditure method suggest that in the unlikely event of a consumption type VAT being imposed by the Centre uniformly on all goods without any exemption except for an initial threshold and primary agricultural commodities, the rate of tax that would secure the same amount of revenue as Central excises and countervailing duties on imports would have to be about 9 per cent. This assumes that in addition to VAT the Centre would also levy special excise duties on selected items of sumptuary items and luxury consumption and petroleum products. Revenue neutral rate for a uniform State VAT across the country to replace the sales taxes (including motor spirit taxes and the Central sales tax) works out to about 8 per cent. If services were included, the revenue neutral rates of Central VAT would be a little over 8 per cent and of the State VATs, a little less than 8 per cent. Table 8.1 sets out the estimates for alternative assumptions regarding thresholds and separately for bases comprising goods only and goods and services. It should be noted that these computations proceed by assuming that the

Table 8.1

Revenue Neutral Rates of a Uniform VAT for India: An Illustration for 1992-93

(Per cent)

Taxes to be replaced	Revenue neutral VAT rates with VAT threshold@ at	
	Rs.30 lakh	Rs.5 lakh
A: Taxation of goods only		
I. Central VAT: Central excise and Countervailing duty on imports	9.3	9.0
II. State VAT: Sales tax, CST Motor spirit tax and Addl.Excise Duty in lieu of Sales Tax	8.6	8.3
B: Taxation of goods and services		
I. Central VAT: Central excise and Countervailing duty on imports	8.4	8.1
II. State VAT: Sales tax, CST Motor spirit tax and Addl.Excise Duty in lieu of Sales Tax	7.8	7.5

Source: Relevant Budget Documents.
Note : @ VAT threshold limits relate to annual turnover.

tax bases would be truly comprehensive and there is no leakage on account of evasion or base erosion through concessions, incentives, etc.

8.2.2 By Tax Turnover method

The revenue impact of the suggested reforms on the excise side and the underlying assumptions are set out in some detail in Appendix A1. Attention is confined in this sub-section to the likely revenue implications of the replacement of State sales taxes by VATs to be levied by the States under the scheme outlined in Chapter 7. As it was not possible within the time available to do the exercises for all States, estimates were derived for five, viz., Andhra Pradesh, Gujarat, Maharashtra, Rajasthan and Tamil Nadu. Similar exercises can be carried out for other States depending on the availability of data.

The starting point for applying this approach is the figure of taxable turnover. Basically, the attempt was to estimate first, the base of the tax from the assessed (or reported) figure of turnover for a year after allowing for the rebate on inputs and capital goods for which credit would be allowable under a VAT regime. This essentially involved estimating (i) the total value of goods that go out of the State at present whether in the course of inter-State sale or otherwise as consignment, etc., and (ii) the value of inputs which would be eligible for tax credit in the computation of the VAT payable on the final products. In the absence of data on the inter-State movement of goods, use was made of the data furnished by the Sales Tax Department, Maharashtra, regarding (a) the proportion of goods produced in the State that go out in the form of consignments to those sold inter-State, and (b) the proportion of local inputs in the total inputs used. These data were based on information relating to 142 large dealers. Some adjustments were made in the ratios derived from these data in the light of discussions with officials of sales tax departments of other States. Conservative assumptions were also made for the likely gain to revenue from the widening of the base with the withdrawal of exemptions and tax concessions, and from improvement in administration. Results so derived for the five States for alternative bands of tax rates are given in Table 8.2.

Table 8.2 shows that with the three-rate structure of between 4-5 per cent for essential commodities, a standard rate of 12-14 per cent, and rates ranging from 20 to 32 per cent for the special or sumptuary items would be revenue neutral for all the five States. For some States (Andhra Pradesh and Rajasthan), the standard rate would have to be no more than 8 or 9 per cent to ensure revenue neutrality. This implies that standard rates of 12-14 per cent would produce for the two States revenue substantially larger than what they are getting at present from their sales taxes. It is only in the case of Gujarat that standard rate would have to be in the range of 14 per cent and about 32 per cent for the special category items to achieve revenue neutrality. If a revenue gain of 10 per cent is allowed for with better administration, the standard rate may go down by about one percentage point.

Table 8.2

Revenue Neutral VAT Rates for Selected States : 1992-93

State	With no administrative improvement		With administrative improvement*	
	Tax rate regime	Average rate	Tax rate regime	Average rate
Andhra Pradesh	(4,9,20)	10.3	(4,8,20)	9.5
Gujarat	(5,14,32)	13.0	(5,13,26)	12.0
Maharashtra	(4,11,23)	11.7	(4,10,22)	10.7
Rajasthan	(4,8,20)	10.7	(4,7,20)	10.0
Tamil Nadu	(4,14,20)	13.1	(4,12,22)	12.1

Notes: 1. Figures in brackets give VAT rates for low rated, standard rated and high rated goods, respectively.
2. Figures for Gujarat relate to 1991-92.
3. These computations are based on tax turnover data furnished by the State Sales Tax Administrations.
4. * Assuming a resulting increase of 10 per cent in the tax yield.

It is seen, on certain plausible assumptions, the revenue-neutral average rates derived by the consumption expenditure method are in line with those obtained through the tax turnover approach. The average revenue neutral rate for fifteen major States based on the consumption expenditure method are set out in Table 8.3. Broadly, it would appear that the average rate would be high in States where the level of taxation is currently high. In States where the level is relatively low at present there will be large accretion of revenue if the harmonized rates are applied. Details of the methodology, assumptions and data base are described briefly in Appendix 2.

It should be stressed again that these estimates are based on available data and plausible assumptions. The assumptions are on the conservative side. For instance, it has been assumed that there will be only 10 per cent increase in the tax base from withdrawal of exemptions and tax concessions even in States where the exemptions are extensive (e.g., Maharashtra and Gujarat). Gain

Table 8.3

Revenue Neutral VAT Rates for Major States in India by Consumption Expenditure Method for 1992-93

(with threshold for VAT registration at Rs.5 lakh p.a.)

State	Revenue neutral VAT rates (%)
Andhra Pradesh	8.1
Gujarat@	11.0
Maharashtra	10.6
Rajasthan	6.3
Tamil Nadu	11.0
Assam	8.5
Bihar	6.3
Haryana	7.8
Karnataka	12.7
Kerala	7.1
Madhya Pradesh	6.2
Orissa	7.8
Punjab	5.8
Uttar Pradesh	5.6
West Bengal	7.4
15 States	8.3

Note: @ Figures for Gujarat relate to 1991-92.

assumed from achievable improvement of administration, viz., 10 per cent is also on the conservative side. Further, no account has been taken in these computations of the likely accrual to the States' revenues from taxation of services which, like the works contracts, may come within their purview. Of course, these computations do not allow for the revenue impact from zero-rating of international exports. Roughly, it appears that revenue loss on this account may be of the order of Rs 1,000 crore for the country as a whole. At the same time, it was not possible to estimate the likely gain to revenue from the disallowance of input rebate in respect of items bearing high rate of tax like petrol and diesel. Taking all this into account, one would feel that the estimates are robust and not unrealistic. However, if the reforms are to gain acceptance by all States, there has to be an assurance that large revenue loss to any State will be met, at least for an initial period, out of grants from the Centre. We believe such an occasion will not arise, if serious effort is made to overhaul the administration.

It might be relevant to note in this context that in almost all countries where VAT has been introduced on a comprehensive base, the additional revenue accrual has almost invariably outstripped the estimates. In fact, VAT is opposed by many in the USA on the ground that it constitutes a "money machine" and would enable the government to spend recklessly.

In short, if properly implemented as a package, there should be no apprehension of revenue loss either for the Centre or for the States. On the contrary, the exchequer will gain and/or the rates may be brought down to yield the same revenue as is yielded by the present system.

8.3 Likely Impact on the Economy

This section reviews the potential impact of consumption tax reform on the economy. The analysis is based on the assumption that the reform measures are revenue neutral, i.e., that the tax rates under the new system are set so as to yield the same revenues as under the current system. The issues discussed are the impact of the reforms on prices, distribution of tax burden, and the level of potential output in the economy.

Replacement of the flawed and archaic Central and State sales taxes by a comprehensive VAT (accompanied by suitable measures to streamline the tax administration) would be the single most important tax initiative in India since Independence. It would affect virtually all sectors of the economy and could lead to major adjustments in prices and factor costs. The simpler and rational structure of VAT would reduce distortions in production and consumption decisions, lower the cost of investment and production, and enhance the competitive position of domestic industries in international markets. The overall result would be an increase in India's potential output.

While there can be little doubt about the overall beneficial impact of reform on the economy, the extremely complex and irrational structure of the current system and the paucity of data on its operation render quantification of the impact an extremely difficult task. The discussion below is thus necessarily qualitative in nature. It describes the direction of influence of the principal reform elements, without attempting to quantify the magnitudes.

8.3.1 Effect on prices

The introduction of VAT could have an impact on the overall price level and would cause shifts in relative prices. While a revenue-neutral replacement of the current taxes by VAT may or may not have any impact on the overall price level, relative price adjustments are a pre-condition for the beneficial effects of tax reform to occur. In a market economy, the influence of the tax system is felt mainly through its impact on the prices of inputs and outputs. It is through the distortions caused in the relative prices of goods and services that the current tax system has a detrimental impact on production and consumption decisions in the economy. The reform measures would lead to more output in the economy only to the extent that they are successful in reducing or eliminating such distortions.

The nature and magnitude of price changes would depend upon a variety of factors, including the following:

- the aggregate revenue yield of the old and the new systems;
- the rate of expansion in money supply;
- the statutory tax rates under the old and the new systems;
- the degree of competition in the various sectors of the economy, and the pattern of backward and forward shifting of the tax; and
- the mark-up pricing policies of wholesalers and retailers.

In what follows, we discuss the influence of these factors on absolute and relative price changes.

8.3.1.1 Overall price level

Sales tax reforms are invariably accompanied by intense political debates about their impact on the overall price level. Those opposed to reform assert that it would lead to price increases which would have an adverse impact on the purchasing power of workers in the unorganised sector and those on fixed incomes. Advocates of reform downplay such fears. While such debates are healthy and necessary for proper consideration of the potential adverse effects of reform, international experience suggests that a revenue-neutral replacement of sales taxes by VAT is not inflationary. It may lead to a one-time increase in the overall price index if the reform is not revenue neutral, but it does not by itself set in motion inflationary forces in the economy. Even the one-time price adjustment depends crucially upon monetary policy. The overall price level can go up only if there is an accommodating increase in money supply.

Tait examined the experience of 35 countries (including both developed and developing economies) with sales tax reforms, and found that in 22 of the countries the introduction of VAT had little or no effect on the consumer price index.[33] In seven countries, there was a one-time shift in the price index. Five countries experienced an acceleration in the rate of inflation, and one country experienced both a one-time price increase and an acceleration in the rate of price increase. His examination of changes in the rates of existing VATs also did not suggest any automatic link between VAT rate changes and inflation.

There are no unique features of the Indian tax system or the economy that could cause its experience to differ significantly from that of other countries. Assuming no change in aggregate revenues and the monetary policy stance, the impact of VAT on the overall consumer price index should be limited to a one-time adjustment, the magnitude of which could be influenced by the following two opposing forces.

First, under a percentage mark-up pricing policy of wholesalers and retailers, a tax at the first point of sale results in a much larger increase in the final price to consumers than the tax actually collected by the government. To recall how the present system of sales taxation causes cascading, assume that a product sold by a manufacturer for Rs 100 gets marked-up by 20 per cent, to Rs 120, by the wholesaler, and by 30 per cent, to Rs.156, by the retailer. With a first-point tax of 10 per cent on the manufacturer's selling price, the retail price of the product would be marked-up to Rs 171.6 (=110x1.2x1.3), or Rs 5.6 more than the amount of tax collected by the government from the manufacturer. Under a VAT, the retail price increase would be exactly equal to the tax collected by the government. Assuming no change in mark-up percentages, the introduction of VAT could, in such circumstances, lead to a one-time decrease in retail prices.[34]

Second, it is possible that a part of the tax, that falls on production and distribution of inputs, is not being shifted forward to consumers, but is being borne by business owners in the form of reduced profits. Elimination of tax cascading under the new system could, in that case, simply lead to an enhancement of profits and the tax savings to businesses may not be passed on to their customers. The introduction of VAT would, in effect, result in a replacement of the currently non-rebatable input taxes by the tax on final consumer sales. In the absence of full forward shifting of the tax savings from the rebating of input taxes, the reform could have the opposite effect of leading to a one-time increase in the consumer price index.

33. See Tait (1991).

34. It may be argued that in the real world this effect would be weak because it assumes a non-competitive market. However, in the absence of competition, one should not expect any pyramiding or price increase by more than the amount of the tax, since given any scope for pyramiding, dealers would raise the prices to what the market can bear, tax or no tax. What could cause a downward shift in prices even in the absence of pyramiding is the removal of the tax on tax (and associated interest burden) that unrebated multi-stage taxation gives rise to but is eliminated with VAT.

Overall, the magnitude of the influences noted above is not expected to be significant. It would be unrealistic to assume that the percentage mark-ups would remain unch anged under the new system. Wholesalers and retailers could not be expected to accept a reduction in their profits implied by the constant mark-up assumption. It is likely that they would revise their mark-ups to achieve the target profit amount. By the same token, competitive forces would prevent producers and distributors from keeping all of the windfall gain from the elimination of tax cascading. In fact, with the liberalisation of domestic industrial and international trade policy regime, domestic producers will be facing increasing competitive pressures (in both domestic and foreign markets) and would not be able to keep the tax savings from input tax rebates. Foreign suppliers do not incur Indian taxes on their inputs. Their prices would incorporate only those taxes that apply to the importation or local sale of finished products.

8.3.1.2 Relative price changes

The relative price changes occur primarily because of changes in the effective rates of tax (defined to be the total tax burden on a commodity divided by its pre-tax retail price) under the old and the new systems. The effective rates under a VAT extending to the retail level would equal the statutory rates. However, under the current system there is little congruence between the effective and the statutory rates. The two diverge because of a variety of factors.

First, where the tax is imposed at the first point of sale, the effective rate of tax would be lower than the statutory rate because of the exclusion from the tax base of the subsequent value-addition by wholesalers and retailers. Second, to the extent the burden of non-rebatable input taxes is shifted forward to consumers, the effective tax rate on a product would be higher than the statutory rate applicable to the sale of the finished product alone. Third, because of the application of the CST on inter-State sales, the effective rate on products imported from other States would be higher than the statutory rate applicable to local sales. Fourth, given the extent of tax evasion under the current system, the statutory rates may apply to only a small fraction of total consumption of a given product. The benefit of tax evasion could accrue to the vendor in the form of higher profit, to the consumer making a particular purchase without paying the tax, to all of the consumers of a given product, or to both the vendor and the consumers. Where consumers receive at least a part of the benefit, the effective tax rate would be lower than the statutory rate though the benefit flowing from such divergence would accrue arbitrarily across producers and consumers.

One other general observation that can be made is that under the new system tax collections from luxury consumer items like TVs, refrigerators, cosmetics, automobiles, and VCRs could go up relative to other products. Such products are subject to relatively larger non-taxable value-addition subsequent to the first point of sale. They have also benefited from a substantial drop in the statutory rates, to the level of basic necessities, because of inter-State competition. The new system would eliminate both of these advantages and cause the relative tax burden on such products to increase. This would also be the case for products and services that become taxable for the first time and that do not require a large input of taxable goods (e.g., labour component of works contracts).

It may be of interest to note here that with the introduction of the VAT principle in Kerala sales tax for selected durable consumer goods referred to earlier, retail prices have already come down while revenue has gone up even though the rates of tax have been reduced. The fall in prices per unit has been more than the reduction in the tax incidence.

8.3.2 Distribution of tax burden

Consumption taxes, regardless of. the form in which they are levied, are generally regressive. In the past, governments have attempted to ameliorate the regressivity through exemptions and lower rates of tax for basic necessities that account for a larger proportion of the total consumer basket in the lower-income brackets. As mentioned in the earlier chapters, there is now a growing realization in the industrialized countries that such measures do not lead to a tangible reduction in the overall regressivity of tax, but lead to excessive complexity in the design. Consumption patterns in industrialized countries are such that the rich benefits as much from the exemptions and lower rates as the poor. The burden on lower-income households could be reduced more effectively through an adjustment in their social welfare benefits or a supplementary social transfer payment.

This prescription of a single uniform rate for all consumer goods and services may not be readily acceptable in India, for both economic and social reasons. There are significant differences in the consumption patterns of lower- and upper-income households in India. The basic necessities account for virtually all of the consumer basket in the lower-income brackets. Application of tax to necessities at the full standard rate would impose undue burden on households in these brackets. Moreover, given the absence of any comprehensive system of social transfer payments, there would be no alternate mechanism for offsetting this burden. It is for this reason that the proposed rate structure continues either an exemption or a lower rate for basic necessities.

An assessment of the overall distribution of tax under the old and the new systems requires data not only about the relative price shifts, but also the distribution of consumer expenditures by income bracket. Unfortunately, neither of these data is available in sufficient detail to allow a proper assessment. The difficulties in estimating relative price shifts were noted above. There are no data available on consumer expenditures by income bracket. The only data available is by the size of total consumer expenditures, for the year 1987-88. These data are of limited usefulness because they do not disaggregate households with expenditures in excess of Rs 700 per month. Given this limitation, one can only make some general observations about the likely impact of the proposed tax reform measures.

First, the continuation of the exemption or the lower tax rate for basic necessities should minimize any overall increase in the tax burden on lower-income households. Even where certain necessities become taxable for the first time, it may not necessarily represent a net tax increase. It may represent only a partial substitute for the input taxes or the CST currently collected in the producing States.

Second, the expected increase in the relative tax burden on luxuries, through the elimination of inter-State competition and inclusion of wholesale and retail value-addition in the tax base, should serve to shift the distribution of tax burden toward upper incomes.

Third, the reduction in the number of rates should not have any adverse impact on the overall distribution of tax. There is no rational basis for the current multiplicity of tax rates and it is doubtful that it is designed to serve any well defined income distribution objectives. Even if it were, few would dispute the fact that the administration is incapable of handling such diversity of rates and that it is highly unlikely that the system is producing the intended results.

Lastly, the elimination of the CST and the zero-rating of inter-State sales should enhance the revenue potential of the lower-income consuming States. This enhancement could be viewed as a form of revenue transfer from the upper-income producing States. While its benefits would accrue to all residents of the consuming States, it should lower the overall regressivity of tax, given the preponderance of lower-income households in such States.

8.3.3 Impact on potential output

One of the most significant advantages of VAT is that it can be designed so as to interfere as little as possible with the market decisions of consumers, producers, workers, and investors. It is this neutrality feature that makes VAT conducive to economic efficiency and higher potential output and that is responsible for its rapid expansion around the world. The expected economic efficiency gains are a compelling reason for the introduction of VAT in India as well. The present sales and excise taxes in India are a serious impediment to economic growth. Their replacement by a neutral and rational VAT could yield substantial dividends to the Indian economy in the form of larger output and faster economic growth.

The following are the principal channels through which the proposed reform measures would benefit the Indian economy.

8.3.3.1 Reduced misallocation of resources

The VAT would reduce or eliminate the distortions in the consumer and producer decisions caused by the highly flawed structure of the current taxes, characterized by multiple rates, exemptions, selective incentives and tax cascading. As noted earlier, the current system is so complex and arbitrary that it is not even possible to calculate the effective tax rates on various products, let alone any quantification of their adverse economic effects. Even in the absence of any data, it would not be unreasonable to assert that there are no two products or firms in the economy that bear exactly the same effective tax burden. Such extreme variations in effective tax rates could be inflicting a substantial loss on the economy.[35]

The current system distorts both production and consumption decisions. The production decisions are distorted mainly through the lack of full rebating of input taxes and the resulting distortions in relative factor prices. Producers are prevented from the use of the most efficient techniques of production. They also organize their businesses so as to minimize their purchases of taxable inputs from third parties, e.g., through vertical integration of production of inputs and finished output. The multiplicity of effective tax rates is the main source of distortions in consumer decisions. As noted earlier, the effective tax rates vary not only because of the variation in the statutory rates, but also because of tax cascading, lack of uniformity in tax compliance and enforcement, and the imposition of tax at the manufacturing or the first point of sale.

The reform measures should lead to a greater uniformity in effective tax rates, and reduce the extent of tax cascading. In turn, they would contribute to improved resource allocation, increased competition, higher factor productivity and larger national output. With the reduction in input costs, Indian exports would become more competitive in the world markets.

8.3.3.2 Lower cost of capital and higher investment

The reform measures would result in a lowering of the cost of capital through full rebating of sales and excise taxes on production machinery and equipment. Replacement of the State sales taxes by a VAT extending to the retail level would result in an additional capital cost saving in the form of reduced financing costs for inventory of goods for resale. Under the first-point tax, the inventory of wholesalers and retailers includes the tax already collected by the manufacturer. This results in additional financing costs to them. Under a VAT, wholesalers and retailers enjoy a net cash flow advantage to the extent their tax collections on sales exceed the tax paid on their purchases. This cash flow advantage, which continues until the tax is remitted to the government, serves to lower the overall costs of capital for the registered firms.

Lower capital costs should lead to higher potential output by inducing more investment and encouraging modernization of plant and equipment.

8.3.3.3 Free inter-State flow of goods and services

The CST and tax incentives for location of industry in selected areas result in unhealthy inter-State tax competition and distort the location of business activity in the Indian common market. The reform measures

35. Canada estimated the variations in effective tax rates under its flawed manufacturer's sales tax to cause a loss of as much as 1 per cent of its national output. The flaws of the Indian system are much more serious and would translate into a much bigger loss. Studies carried out for the European Community showed that absence of a harmonized system of commodity taxes probably entailed a loss of output growth by as much as 5 per cent per annum ("Cost of Non-Europe" as it was described).

would result in a virtual elimination of such distortions. The inter-State competition would be eliminated through harmonization of State VAT rates, and embargo on the use of tax incentives for the location of industries in particular regions. The destination principle of VAT would ensure that the final tax burden on a product would no longer be dependent on the location of its production. The tax cascading that occurs through the application of the CST in the producing States would be eliminated with the zero-rating of inter-State sales. The resources that are currently devoted by business firms to contrive a variety of tax planning maneuvers to overcome the tax barriers would be freed up for more productive uses.

In addition to the above, the economy would also benefit from the simplification of the tax system and greater uniformity in its enforcement and compliance. Simpler laws should lead to a reduction in the harassment of the business community. The frequent disputes under the current system impose very substantial deadweight losses on the economy in the form of litigation costs as well as increased uncertainty in business planning.

8.3.3.4 Sectoral and regional benefits

The current system is a source of frustration to businesses throughout the economy, regardless of the sector or region to which they belong. As a result, the benefits of increased output and simpler tax system are expected to be widespread, accruing to all sectors and regions. The level playing field would ensure greater fairness in the application of tax laws and fewer competitive distortions. The resource sectors, such as mining and forestry, would benefit substantially from the reforms because they would be able to claim a full rebate for the tax on their production inputs and any tax collected by them would, in turn, be fully rebatable to manufacturers who buy their output for further processing. Manufacturers of machinery and equipment would likewise benefit from the removal of cascading under the VAT system. The reduced cost of capital would lead to more demand for their output. The wholesale and retail sectors would face reduced harassment and enjoy an enhancement in their cash flow.

The consuming States would benefit from the removal of the CST in the producing States on inter-State sales. The producing States would, in turn, benefit from the removal of hidden taxes on inputs to their production activities. The greater transparency of tax would allow consumers to better inform themselves of the total tax burden on a given product and thereby exercise pressure on the governments in following a more disciplined approach in their expenditures. The new system would provide a more stable revenue source to the governments that is easier to administer.

Chapter 9

LEGAL, ADMINISTRATIVE AND INSTITUTIONAL REQUIREMENTS

Introduction of value added tax poses many challenges for policy- makers, tax administrators and the people. It involves, first, an appreciation of the need for basic reform of the existing tax system on the part of all the players and also the people at large, consensus on the approach to basic issues, and a readiness to adapt the system to new concepts and mode of operation. These reforms also have a profound impact on the economy and the society. Hence, implementation of VAT has been described as one of the most significant development projects undertaken by a country. Success in this as in any other major endeavour requires careful planning and management, while mismanagement can jeopardise the entire reforms programme.

Although the principles of VAT are operating in India through the excise system at the Centre and also have made their inroad into the sales tax system in some States (e.g., in Andhra Pradesh, Kerala and Tamil Nadu) VAT is a relatively new concept for most taxpayers and tax administrators in the country. Its extension at the Centre and, more so, introduction at the State level to replace the sales taxes will call for an overhaul of the legal and administrative systems governing the levy of trade taxes in the country. In many ways administrative reforms are a precondition for the full benefits of the new tax structure to be realised. Without them, the tax structure changes may amount to nothing more than a replacement of one set of books by another on the legislative shelves. Appropriate institutional infrastructure will also have to be evolved for launching and operating a harmonised, destination-based system of VAT at the State level independently of the Centre.

More thoroughgoing reform of administrative organisation and methods than has taken place so far would be needed for operating a fullblooded manufacturers' VAT at Centre too even though the MODVAT has been in operation in the Union excise system for some time. Problems of administration of indirect taxes with reference to customs and Central excises have been examined at considerable length by the TRC and many valuable recommendations are contained in that Committee's Final Report (Part I, vide Chapter 7). The discussion of issues relating to legal, administrative and institutional requirements for the introduction of VAT in this chapter is focused on what would be needed at the State level.

9.1 Main Tasks

The tasks on the legal, administrative and institutional side for the introduction of State VATs may be considered under the following components:

1. Drafting of the law and regulations
2. Formulation of procedures and design of forms
3. Reform of administrative systems and organisation
4. Computerization and modernization of administrative methods
5. Training and reorientation of staff
6. Taxpayer education
7. Creation of institutional infrastructure.

Formulation of concrete proposals under each component would require much more detailed examination than was possible to undertake for this study. However, a few general observations on the possible approach and the essential requirements might be in order.

9.1.1 Legislation

Once a decision has been taken in principle to introduce VAT and broad agreement reached about its basic design features, steps would be needed to prepare the necessary legislation along with supporting regulations. As noted in Chapter 2, the sales tax systems of the States have evolved independently, each with its own laws. In many States the laws are dispersed over more than one legislation. These would have to be scrapped and a consolidated law governing the levy of a VAT would have to be formulated to authorise the levy and provide the necessary legal framework for its enforcement.

Considering that uniformity of basic structure and procedures would be necessary for the harmonization and smooth operation of the system all over the country, a model law should be devised which the States can adopt with suitable changes but retaining the basic structure. The idea of a model sales tax law was mooted some time back and the NIPFP was asked to prepare a draft of a model law for sales taxation. Such a model was prepared and circulated but is still in the discussion stage. A VAT would have design features which would be quite different from those of a sales tax, although there are several common elements. A different model law would therefore be needed for a VAT, although the work done already could perhaps be drawn upon.

Drafting, being a specialised job, has to be undertaken by a team of experts. All major States in India have their law departments and also cells for drafting laws relating to sales tax, manned by experienced legal hands. Few of them would, however, have much familiarity with what legislation for VAT would involve. The States should jointly set up a team consisting of experts drawn from the law departments and legal cell of sales tax departments and officers with background of sales tax administration to undertake the task of drafting the law. Since VAT would be an unfamiliar concept and its rationale may not be apparent to legal experts, it would be necessary to include a fiscal economist in the team. As VAT has been operating in many countries now and there are experts who were associated with preparation of their laws, it may be useful to take the help of consultants from abroad to work with the team to be set up for the purpose. The tasks of the team should include, besides drafting the basic law, formulating regulations and resolving operational issues.

Parallel to the team envisaged above, each State would have to set up a standing legal cell of their own to adapt the model law to local conditions and needs, see the legislation through the State Assemblies, answer queries on legal issues, process amendments whenever needed and get the regulations ratified.

The scheme of State VATs proposed in this study will call for some far reaching amendments in the Central Sales Tax Act of 1956 (e.g., to bring down the rate of CST to nil when the sale is between registered dealers, remove the ceiling on State sales taxes on declared goods and so on). The Sales Tax Cell in the Revenue Department of the Ministry of Finance may undertake the task of identifying the amendments required and draft them for consideration of Parliament in consultation with the Ministry of Law. The present cell may need to be strengthened with officers conversant with the State sales tax systems to undertake the job.

9.1.2 Procedures and forms

Implementation of any tax calls for prescribing operational procedures for

- Registration of taxpayers
- Filing of returns
- Payment of tax
- Assessment and reassessment
- Appeals against assessment.

9.1.2.1 Registration

Under VAT, as in sales taxes, every trader having turnover exceeding a specified limit must be required to register with the tax authorities and obtain a registration number for his/her identification which can be quoted in all tax related documents. Ideally, a unique taxpayer identification number should be allotted to each trader which can be used for other taxes too like the Central VAT and income tax. Creation and maintenance of a central register of taxpayers, however, do not seem to be feasible in the present state of our information system and in the absence of effective coordination between Central and State tax departments. Hence, the task of registering VAT taxpayers and allotting their tax identification numbers (TIN) has to rest with the tax authorities of the States.

Under a system of destination-based VAT, inter-State movement of goods would need to be monitored and transactions between registered dealers across States cross-checked from time to time, even though on a sample basis. Hence, it would be necessary to evolve an all-India coding system. As in the case of registration of motor vehicles, a particular series of registration numbers may be allotted to each State to which additions may be made to identify the district and the administrative division, tax ward/circle and number allotted to the taxpayer registered. The registration number may thus contain boxes to indicate the location of the taxpayer by State, district and identification number as shown below:

$	#	@	*

The first box ($) would refer to the State, the second (#) to the district or administrative division, etc., the third (@) the ward or circle, and the fourth (*) would indicate the individual registration number of the dealer. Allotment of identification numbers to registered dealers in this way would help maintain a master file for all taxpayers in the State. The master file should be maintained on the computer accessable at the head office as well as in the administrative unit.

Information regarding dealers when they are registered and any changes therein should be regularly communicated to the computer centre at the head office as also the concerned administrative unit. The master file would serve to store information regarding every dealer (or at least large dealers) relating to filing of return, payment of taxes, etc. With a view to facilitating compliance under the new system of taxation, publicity should be given through the mass media and through free taxpayer education booklets about the obligations of various players in the system. Publicity material should include information on who should register for payment of tax, where and how to register, where to get the forms and so on.

The procedure for registration and allotment of identification number should be streamlined so that there is little scope for harassment. Since registration would confer certain benefits (such as claim for tax credit for inputs) even while entailing liability to file returns and pay the tax, it would be necessary to make sure that registration is granted only to genuine traders. At the same time, there should be no harassment to applicants. Some simple checks (such as municipal bill, bank account number, telephone number, power connection number, etc.) should be adequate to make sure that the applicant is not a fictitious entity and can be located when required.

At present, registration procedure involves submission of an application by the dealer, along with deposit of a prescribed sum and/or some security. This is followed by departmental verification of the bonafide of the applicant. Verification, however, is not always carried out with the care needed. On the other hand, often there are complaints of harassment by the inquiring staff. This enables fictitious (Hawala) or bogus dealers to thrive. Also, at present, no educative pamphlets are supplied to dealers automatically at the time of registration.

VAT registration should follow a new procedure. The dealer should be required to submit an application in the prescribed form of which a specimen is given at Annex 1. On due verification and processing of the application, each registered dealer should be given a "registration kit" containing VAT Act and Rules along with copies of all the requisite forms and returns. It should also contain a guide to VAT-management explaining the Do's and Don'ts for dealers.

9.1.2.2 Tax Return and other forms

Registration implies responsibility on the part of the trader to file returns and pay tax as required under the law.

Unlike under a sales tax with multiple levies and rates of tax, the VAT return form can be very simple, especially if the rate of tax is uniform. For with a uniform rate (and no exempt item) all that a trader is required to report is his total sales during a given tax period, his purchases and the tax paid. The tax payable can be computed simply on the return itself by multiplying the sales with the prescribed rate of tax and deducting the

Annex 1

Specimen Form of Application for Registration as a VAT Dealer

TIN (Taxpayer Identification Number)	01

Affix a photograph of the signatory

SINGLE PROPRIETORSHIPS/FIRM/COMPANY/COOPERATIVE ETC.
PERSON TO BE REGISTERED

FAMILY NAME (for individual)	FIRST NAME	MIDDLE NAME
02	03	04
05 Age: / 06 Sex:		

NAME OF FIRM, COMPANY, COOPERATIVE, PUBLIC ENTERPRISE, SOCIETY ETC.
07

ADDRESS	NO./STREET	CITY/MUNICIPALITY	PIN CODE
08			

PARTNERS IN FIRM, CHIEF EXECUTIVE IN COMPANY, COOPERATIVE ETC.
09

10 TELEPHONE	11 FAX

ADDRESSES OF ALL BRANCH OFFICES
12
13

ECONOMIC ACTIVITY CODE	ECONOMIC ACTIVITY DESCRIPTION
14	15

SALES OF GOODS AND SERVICES

Last Quarter	16	
Last Year	17	
Expected for the next 12 months	18	

Date of first sale	19	D	M	Y

I ________________ (proprietor/director/secretary or other authorised person) hereby declare that the particulars given herein are correct and I hereby apply for registration for value-added tax.

____
Signature of Taxpayer
or Authorised Officer

Introduced by: ______________

(Bank official/Attorney/
Responsible person

For official use only

Tax Office	20			
Date of regis-ration	21	D	M	Y
Registration refused (for reasons recorded on file)	22			
Received by:				

Adapted from Casanegra de and Silvani (1991).

amount of tax paid on purchases. This is why in some countries where the VAT is in operation the return form is prescribed on a postcard (e.g., in Denmark). With more than one rate, space has to be provided in the return form for reporting sales and purchases under the different rate bands. Even so, the form should be simpler than those in vogue for sales taxes at present, if only the rate bands do not exceed two or three. A specimen VAT form is at Annex 2. This form as also the returns to be filed can be in the computerised format.

The periodicity of return filing and payment of tax would have to be determined in the light of the experience and requirement of each State. Some uniformity in this regard among all States is highly desirable.

9.1.2.3 Invoices and Accounts

Requirement of documents and forms to support a tax return should be kept to a minimum. The most important document for the operation of tax credit-based VAT is the invoice. Tax invoices are required to establish both the tax liability of the seller and the tax credit that can be claimed by the purchaser. Two types of invoices are used under VAT: (1) invoices to register sales and purchases among registered dealers and (2) invoices for final consumers or unregistered dealers.

Only VAT registered dealers should be legally authorised to issue a tax invoice. Such invoices should provide information regarding the particulars (i.e., name, address and TIN) of the seller, date of issue, serial number, particulars of goods sold (quantity, description and unit price), price excluding VAT, amount of VAT charged, and name, address and VAT registration number of the purchaser. The invoice should be prepared in three copies (in different colours): the original, for the buyer for his accounting records, first copy also for the buyer to be provided to the tax authorities, if required, to establish his claim for credit, and the second copy for the seller. A specimen of a VAT invoice is at Annex 3.

Final sale invoices would only serve to register sales to a unregistered purchaser or final consumer for purposes of VAT. This invoice may show only the price including VAT. No extra copy of the invoice apart from one for the seller's accounts would be needed. Use of cash registers in place of invoices may also be permissible provided it records the description of the goods sold and VAT charged, with daily totaling and transfer to a permanent record.

A thorough review of forms in force in sales tax should be undertaken and only those which are absolutely necessary retained, with suitable modifications. All forms should, however, be standardised to facilitate transfer of information without delay.

Dealers registered for VAT (other than those coming within the "small dealers" category) must maintain record of all tax invoices issued and received by them indicating their serial number, date, price charged and the VAT. The records should help to check the accuracy of the return by the tax authorities. The books of accounts usually maintained for running businesses may have to be adapted for the purpose. The manner in which such adaptation may be carried out with the least disruption of the existing practices may be worked out in consultation with the accounting and traders' bodies. Since it may not be possible for tax administration to verify or check the authenticity of all tax credit claims, reliance would necessarily have to be placed on accredited accountants. That would cast a special responsibility on the accounting profession. Tax authorities should, however, have the powers to check any claim that they may feel necessary.

9.1.2.4 Filing of Returns and Tax Payment

Assessees often undergo hassles in filing return and paying their due taxes because of shortage of necessary forms, limited number of tax payment receiving counters, etc. It would simplify life if banks were authorised to receive returns along with taxes with the responsibility to pass on the returns to the tax authorities. Such a system is in vogue in many other countries. A similar system has been introduced in Maharashtra and could be

Annex 2

State of...........
VAT RETURN

[01] For the Month of..............	For Office Use
[02] Registration No...............	S.no Date Stamp
[03] Telephone No..................	Tax due and payable Rs.........
[04] Fax No........................	Penalty/Fine Rs.........
[05] Economic activity code (Manufacturing/Whole-saling/Retailing)..............	Tax Paid Rs.........
[06] Name and address of registered person:	Receipt No...............
	Date..........Initial..........

Purchases	Value (excluding VAT) (Rs)	Tax credit (Rs)
[07] Exempt or non-creditable purchases[1]	....	...NIL.....
Purchases from domestic suppliers:[2]		
[08] at low rate	....	....
[09] at standard rate	....	....
[10] at high rate (where creditable)	....	....
[11] Total [07] to [10]	....	....

Sales	Value (excluding VAT) (Rs)	Tax due (Rs)
[12] Exempt sales	....	...NIL......
[13] Inter-State sales/consignment tramsfers supported by advance tax payment by dealers in importing State	....	...NIL......
[14] International exports	....	..NIL......
Sales taxable at		
[15] low rate	....	....
[16] standard rate	....	....
[17] high rate	....	....
[18] Total [12] to [17]	....	....

1. Non-creditable purchases include those for which no rebate is available under the law.
2. Including suppliers in other States for which advance tax is paid.

Contd.

Annex 2 (Contd.)

VAT Account — Tax due and payable (Rs)

		Tax due and payable (Rs)
[19]	Tax due on account of sales in the current month (18)	....
[20]	Add: Tax/penality due from the previous month	....
[21]	Less: Tax Credit for purchases in the current month (11)	....
[22]	Less: Tax Credit carried forward from previous month	....
[23]	Tax payable to the government (+)/ tax credit carried forward (-)	....

Declaration

I (full name of signatory in BLOCK LETTERS) *MR/MRS/MISS...........

....

....

(a) declare that the information and particulars given in this return in respect of the taxable period shown herein are true and complete and include details for all places where business has been carried on by the registered person named in Part I above, and

(b)* tender the sum of Rs............. representing the tax due and payable shown at item No. 23 above.

(c)* request that the excess amount of tax credit shown at item No. 23 above be carried forward to the next return.

[24] Date.................. Signature.......................

Capacity in which acting...................................

*Delete whichever is not applicable.

For Official Use

Assessment Order

[25] **Tax due:** ....

[26] **Tax underpaid:** ....

[27] **Penalty/Fine:** ....

[28] **Total due:** ....

[29] Notified by letter dated: ....

(Signature of Assessing Officer)

Annex 3

Specimen of a VAT Invoice

INVOICE

ORIGINAL: To be submitted with the return to claim tax credit by the buyer.

Seller's Name ______________________

Address ______________________

____

Telephone No. ____________ Fax No. ____________

Taxpayer Identification No.

Date ____________

Serial No.

Buyer's Name ______________________

Address ______________________

____

____

Taxpayer Identification No.

Terms of Sale

Quantity	Description of goods or services	Unit Price	Value (Rs)	VAT Rate (%)	Amount of VAT (Rs)
	Total				

Signature of Seller

Annex 3

INVOICE

DUPLICATE: Record copy of the buyer. This copy does not entitle the holder to a tax credit.

Seller's Name ____________________

Address ____________________

____

Telephone No. __________ Fax No. __________

Taxpayer Identification No.

Date __________

Serial No.

Buyer's Name ____________________

Address ____________________

____

____

Taxpayer Identification No.

Terms of Sale

Quantity	Description of goods or services	Unit Price	Value (Rs)	VAT Rate (%)	Amount of VAT (Rs)
	Total				

Signature of Seller

Annex 3

INVOICE

TRIPLICATE: Record copy of the buyer. This copy does not entitle the holder to a tax credit.

Seller's Name ____________________

Address ____________________

____

Telephone No. __________ Fax No. __________

Taxpayer Identification No.

Date __________

Serial No.

Buyer's Name ____________________

Address ____________________

____

____

Taxpayer Identification No.

Terms of Sale

Quantity	Description of goods or services	Unit Price	Value (Rs)	VAT Rate (%)	Amount of VAT (Rs)
	Total				

Signature of Seller

Adapted from Silvani and Vehorn (1991).

emulated profitably by other States.

9.1.2.5 Assessment

Procedure for assessment should also be standardised.

Tax administration all over the world is now moving towards a system in which returns filed by the assessees are accepted and thorough scrutiny or audit of only a few cases is taken up on a sample basis. The basis of selection and the proportion of cases to be taken up for audit have to be decided keeping in view the costs and the likely results. It would not be appropriate to indicate any norms *a priori* for this purpose. However, the following suggestions might be of some help.

Returns of large taxpayers that is those with turnover exceeding a certain limit (say Rs 20 lakh or carrying a tax limit exceeding, say Rs 10,000) should be processed with some care. For others, that is those with turnover or tax payable (or paid) below a certain limit - the small traders - the returns may be accepted with only a small sample of cases audited every year. The assessments of small traders may be completed under a simplified procedure with no requirement for the taxpayer to appear in person or produce accounts. A simple acknowledgement after routine checks should signify completion of assessment. It should, however, be open to tax authorities to reopen a case within a reasonable period of time if concealment of any material particular is detected or reported subsequently.

The verification of zero-rating ought to be undertaken promptly, and for this it is imperative to complete the checking of returns which might be taken up for audit, expeditiously, say, within a year.

9.1.2.6 Appeals

The structure of appellate authorities and procedure also should be standardised. With standardisation and harmonization of the system it would be helpful to set up appellate courts having regional jurisdictions, that is covering three or four States. To ensure speedy settlement the appellate machinery should not consist of too many tiers.

9.1.3 Administrative System and Organisation

The current excise and sales tax systems rely more on physical controls and attention to legal detail than accounts-based control and attention to the maintenance of proper books of accounts and their verification. Success in the implementation of VAT hinges critically on financial or accounts-based controls supplemented by physical controls such as field visits by authorised officers. Hence, with the introduction of VAT, tax officers will have to orient their approaches towards examination of accounts instead of relying heavily on physical controls. This would call for reassessment of staff needs, staffing pattern, and retraining and redeployment of the existing staff. It would also require a reorganisation of the tax departments.

9.1.3.1 Staff requirement

Proposals for VAT in India may give rise to apprehensions on the administrative front on two contradictory counts. Many may tend to think that the number of taxpayers would multiply unmanageably when the single point sales taxes are converted into a multi-stage tax on value added while another view could be that with simplification of the laws and administration and more so, with modernisation, a large proportion of the staff in the sales tax departments of many States would be rendered redundant. There may be misgivings also about the promotional prospects of officers, as under the new system, there would be no rationale for having a multi-tier distribution of assessment work with senior officers being entrusted with cases of the higher categories. None of these apprehensions seem to be well-founded. Similar misgivings might arise among tax practitioners too. However, the opposition to reform has to be countered frontally, pointing to the gain that the reforms would confer on the community if litigation was reduced and the tax practice ceased to be as profitable as it seems to be now.

Apprehensions about staff redundancy fail to take into account the increase in the workload that may occur under VAT. At present under the sales taxes, there is a practice of carrying out assessment of all the dealers for every assessment year. But the actual assessment under sales taxes is attempted for dealers dealing in first sale of the goods (by manufacturer or wholesaler) in the State. The other dealers (who deal in tax-paid goods) are only assessed perfunctorily or not at all. Under the system of VAT all dealers will come within the tax-paying category requiring proper assessment of everyone. Thus the introduction of VAT which may necessitate carrying out checks or assessment upto the retail level or final point of sale, should cause an increase in the number of assessing officers as well as the other supporting staff. In general, it would be reasonable to suppose that there would be an overall increase rather than any reduction in staffing requirement.

Data on distribution of dealers according to turnover suggests that under VAT, by and large, full auditing may have to be done only for one-fifth of the dealers; a sample audit would be required for two-fifths; and a system of self-assessment could be adequate for the rest. If such a system is followed, staff requirement would go up even though marginally or at least not decline.

No doubt, in most countries of the world where VAT is in operation, the ratio of staff to taxpayer is quite low, as the following figures would show:

Table 9.1

Staff/Taxpayers Ratio for VAT

Country	Ratio
Belgium	1:123
France	1:173
Ireland	1:130
Italy	1:726
Korea	1:360
Netherlands	1:280
New Zealand	1:350
Portugal	1:215
Sweden	1:250
United Kingdom	1:149

In India, for Central excise the total strength is about 35,000 to handle about 150,000 taxable entities. Of these, about 7500 are on assessment work. The ratio thus works out 1:20 or so. However, the number of dealers per assessing officer is higher for sales taxes and several States compare favourably with other countries in this respect, as may be seen from Table 9.2. However, the ratio (number of dealers per tax staff) goes down sharply if the supporting staff in addition to assessors are also included. With the change in the system of assessment and audit and, what is more, with computerisation, the requirement of staff per taxpayer should decline or at least need not increase. However, as argued above, there should be no fear of any retrenchment with VAT. Only some reallocation of functions and redeployment with emphasis on examination of accounts might be needed.

Reform in any sphere calls for restructuring of administrative organisation. It should not be difficult for governments to work out schemes of organisation keeping in view the need to provide adequate promotional avenues. Given the uneven quality of tax administration among the States and the constraints likely to be faced in many States in switching over to an accounts based system of taxation such as VAT, consideration may be given to the creation of a unified independent Value Added Tax Administration or authority with All India and State Services eventually. This authority should take care of the needs of VAT administration of States and provide assistance by lending the services of officers belonging to the unified service. Besides strengthening the tax administration of the States that would also help to create new promotional avenues and challenges for the officers engaged in tax administration.

9.1.4 Computerisation and modernisation of administrative methods

Modernization of administration with extensive use of computers is a crucial element of reform. Computers provide an extremely powerful and at the same time affordable instrument for administration of taxes and are particularly useful in the

Table 9.2

Ratio of Sales Tax Staff to the Number of Registered Dealers

State	Staff	Number of Regd. dealers under GST	Ratio
1	2	3	4
1. **Kerala (1993-94)**			
Total Staff	4231	104113	1:25
Support Staff	2925		
Officers	1306		1:80
2. **Maharashtra (1990-91)**			
Total Staff	8975	374830	1:42
Support Staff	5736		
Officers	3239		1:116
3. **Punjab (1991-92)**			
Total Staff	2722	130929	1:48
Support Staff	2097		
Officers	625		1:209
4. **Rajasthan (1993)**			
Total Staff	4314	161642	1:37
Support Staff	3453		
Officers	861		1:188
5. **Tamil Nadu (1991-92)**			
Total Staff	9907	303000	1:31
Support Staff	7596		
Officers	2311		1:131
6. **Uttar Pradesh (1992)**			
Total Staff	11649	319000	1:28
Support Staff	10136		
Officers	1513		1:211
7. **West Bengal (1991-92)**			
Total Staff	5514	114738	1:21
Support Staff	3698		
Officers	1816		1:63

operation of a tax like the VAT which calls for monitoring of tax payments and credits availed of continuously and also cross-verification of tax-credit claims even if selectively. EDP can help VAT enforcement in a variety of ways such as in creating VAT register, preparing tax return form and identification labels, validating batches of return received from say the depositors' banks, processing refund claims, maintaining a current ledger account of VAT assessees, selecting dealers for scrutiny, providing support for investigation and following up appeals.

The approach of tax administration towards enforcement also has to undergo a transformation and rely more on gathering information from various sources and processing them promptly minimising the need for any contact with taxpayers. Modern information technology with its capacity for storing data and networking across vast regions has revolutionised tax administration throughout the world with dramatic results. The system of zero-rating of sales between registered dealers among member countries of the EEC operates principally through a computerised information system. While that might be a goal a little too far for India, with the talent available in the country, States in India can make rapid strides towards modernisation of tax administration given the will and some support.

Several States in India have initiated programmes for introducing computer in their tax administration. However, progress has been halting and tardy. Use of computers for enforcement on a significant scale is yet to begin. It is absolutely necessary to draw up plans for computerising tax administration in all States in a time bound programme. The Central government and multilateral aid agencies could perhaps help in this task in a big way by providing the necessary funds to acquire the hardware and software and hiring experts from within or outside the country to set them up. Administration of Central excise department also needs to be modernized for the MODVAT to be expanded and operated efficiently. It is understood that the Department has already embarked on an ambitious programme of computerisation. The programme needs to be speeded up.

9.2 Training

An important pre-condition for the introduction of VAT is intensive training of the tax staff and a proper recruitment policy for the departmental personnel.

Officers of both the Union excise duties and of the sales tax departments are trained to administer, audit, and verify documents related to trade taxes, both single-point as well as multi-point. Their principal emphasis has, however, been physical checks and controls. Under a regime of VAT which is in fact a multi-point sales tax with set-off, the system of administration of the tax will undergo a radical change. Officers meant for auditing of VAT would, therefore, have to be trained afresh. All States would have to organise training programmes to induct them to their new tasks. It would also be necessary to update the skills of the personnel already trained periodically. The VAT Council proposed below may take the initiative to set up training institutions and secure the support they may require in terms of resources.

9.3 Institutional Set-up : Need for a VAT Council of States

Implementation of the reforms will require consultation and discussion among the State governments on a continuing basis. Involvement of the States would be needed for steering the implementation of VAT in the initial stages and also later for overseeing its operation. The process should be initiated as soon as the Central and the State governments agree on the whole package.

Article 307 of the Constitution envisages the creation of statutory authority by the Parliament for the purpose of ensuring free flow of trade, commerce and intercourse within the territory of India. The VAT Council of States can be one such body. To facilitate consultation and chalk out lines of action it would be advisable to set up an All-India VAT Council of the States. This Council will provide the mechanism for bringing all States together and ensuring their active participation. It will concentrate expertise, prepare the draft of a common tax base (like the Sixth Directive of the EEC) and common procedures, play a major role in educating and guiding State VAT officials, provide for review and continuity of the VAT adoption process, integrate policy/analysis with legal drafting, etc. Consultation may take time but is essential if the States are not to drift apart further. The need for a statutory body for inter-State consultation was stressed by the Sarkaria Commission too. Introduction of State VATs would lend urgency to this need.

It would be helpful to set up the permanent statutory institution for consultation among States and overseeing the introduction and the operation of VAT in two tiers: one, the apex body (VAT Council) and another, a functional one below it.

The apex body should be constituted with finance ministers of all the States. Ministerial involvement would be needed to lend the necessary authority for implementing the decisions reached. The major policy issues will have to go to the apex body, that is, the VAT Council for resolution. The Council should be constituted at the earliest to initiate the process of planning for the VAT reform and draw up the agenda. Since the reforms are predicated on an agreement being reached on the basic approaches and adherence to the system of harmonisation, there has to be some mechanism enforceable sanctions against infringement by any State. The Council itself should evolve such sanctions and the mode of enforcement.

The mode of functioning of the Council, whether unanimity should be required for any decision to be effective or whether the convention followed in the National Development Council (NDC) should be adopted, needs further consideration. The NDC would perhaps be the best forum for taking a decision on and recommending to Parliament the creation of a VAT Council and the decision rules. It may only be added that the unanimity condition has been a stumbling block in the reform of the system in Brazil.

At the second tier which would function under the umbrella of the VAT Council, there should be a Standing Committee of officials (Commissioners of Commercial Taxes) who would meet regularly to identify issues and propose solutions. Needless to say, there should be a secretariat to service these bodies.

Disputes between States or taxpayers located in different States may be referred to the Commissioners' Committee first. Inter-State disputes which remain unresolved may, however, have to go to the Supreme Court under our Constitution.

9.4 Taxpayer Education and Publicity

Apart from opposition born out of fears of the unknown, VAT arouses suspicions and misgivings among large sections, often based on misconception about its mode of operation and likely impact and ignorance about its merits. Dissemination of information regarding VAT and the case for reform is thus crucial for the success of any scheme for replacing the present system with a scheme of VAT. Before embarking on the reform, it is necessary to launch a programme of public discussion about the ills of the present system, how VAT could remedy them as well as its weaknesses and the benefits likely to be derived by the community from its introduction. Active participation of the key players, viz., traders and tax administrators in this programme would be necessary. Traders and trade/industry organisations should be consulted in resolving both structural as well as operational issues. That would help avoid pitfalls and needless complexities in law and procedures and advance the acceptability of the entire programme. Publication of pamphlets, open discussion in seminars and on the television and radio with leading intellectuals, politicians and administrators as well as representatives of trade and industry should be on the agenda for reform.

In Korea, before launching the reforms, the government vigorously campaigned for the case of VAT. It took the help of chambers of commerce and industry, daily newspapers, TV and radio and other mass media. A series of articles, question and answer sessions, feature stories and lectures for the need of adopting VAT were mounted. A movie was also made about the VAT and shown in all the theatres in the country. About 30 different kinds of pamphlets on VAT were printed and millions of copies distributed. In addition, three preliminary exercises on filing tax returns were conducted before the actual implementation of the tax. In the latter two programmes most of the potential taxpayers participated. These exercises not only helped the taxpayers understand the new tax but also gave valuable feed back to the government for its improvement.

Along same lines, Taiwan also assiduously campaigned to educate the public on VAT. In addition to seminars, exercises in filing returns, and use of mass media, tax enforcers did a lot of field work by visiting firms and demonstrating the use of VAT forms and the computation of VAT.

9.5 Lead time

With a view to enabling the taxpayer, the public and tax departments to prepare themselves for VAT, adequate lead time would be required. Although no hard and fast rule can be laid down in this regard, preparing the legislation and rules, prescribing the systems of registration, prescription of requisite forms, modernisation of administration, reorganisation and training of staff would all require time.

Experience of several developing countries suggests that a lead time of two to three years is necessary to prepare for VAT. Chile was the only country to reduce the lead time to a few months because of its prior experience with a turnover tax. Also, a sufficient lead time allows governments to anticipate transitory problems associated with reforms and to implement policies and measures to effect a smooth transition.

India has a fairly long experience of trade taxes. Even so, the tasks involved and the creation of necessary institutional infrastructure will take time to accomplish. However, as noted at the beginning, introduction of VAT without adequate preparation or institutional backing can be disastrous. A lead time of two to three years, therefore, is perhaps unavoidable in moving towards a system of VAT in the States.

9.6 Concluding observations

It needs to be stressed that reform of this magnitude cannot be carried through without strong political will and real interest on the part of the Central and State governments and support from the people. Further, because many parties would be involved, a package reform with inter-dependent gains and losses would be preferable to incremental change which is favoured by some on practical grounds. Incremental reform may soon get bogged down and lead to nowhere. Obviously the task will be arduous but, as stressed at the outset, needs to be addressed boldly if the Indian economy is to get free of the shackles of its present irrational and inimical tax system and move forward fast.

REFORM OF CENTRAL EXCISES[36]

A1.1 Introduction

Discussions of the present system of domestic trade taxes presented in Chapter 2 bring out several problems with the Union excises that persist despite reforms carried out in recent years. The basic problems are:

- Definition of manufacturing
- Determination of assessable value
- Restrictive application of MODVAT
- High level and multiplicity of rates
- Too many exemptions

The only effective remedy for the structural deficiencies arising from problems in defining manufacturing and valuation lies in extending the tax base to trade levels beyond manufacturing. However, if, for reasons mentioned in Chapter 6 that is ruled out, then efforts have to be directed towards finding ways to strengthen the present system and rationalise it as best as possible.

Taking note of the various problems in excise taxation, the Tax Reforms Committee (TRC) made wide ranging recommendations for the restructuring of the Central excises. The key recommendations are:

- Extension of MODVAT by stages to cover most manufactured goods except petroleum and tobacco products and matches.
- Gradual reduction in the number of rates moving towards a three rate regime (10, 15 and 20 per cent).
- Levy of non-rebatable selective excises on a few non-essential commodities at 30, 40 or 50 percent.
- Extension of MODVAT credit to all inputs except items like office equipment, accessories and furniture, building material and a few others and granting rebate for taxes paid on capital goods over a period of years.
- Bringing selected services under taxation.
- Extension of reformed Central Excises, to the wholesale stage, (wholesalers being defined as traders whose turnover exceeds a specified level, say Rs 50 lakh or 1 crore), - the tax at the wholesale stage to be administered and the revenue retained by the States.

Drawing on the recommendations of the TRC and the discussion contained in this study, an alternate set of proposals which can be implemented in the course of one or two years is put forward below. The main components of the proposals are:

1. Technical improvements in the method of valuation for more effective taxation at manufacturer level.
2. Extension and generalisation of MODVAT to transform Central excises into a manufacturers' value added tax as envisaged by the Indirect Taxation Enquiry Committee of 1976-77 (Jha Committee).
3. Rate rationalisation on the lines suggested by TRC.
4. Provision of full and immediate credit for tax on inputs including equipment for exclusive use in taxable manufacturing.
5. Broadening the base of excises by withdrawal of exemptions and extension to selected services.
6. Cessation of tax-rental agreement between the Centre and the States in regard to levy of sales tax on textiles, tobacco and sugar.
7. Sharing of additional customs duty (countervailing duty) between the Centre and the States.
8. Levy of countervailing custom duty equal to State VAT on baggage and goods imported for personal consumption.

36. As indicated in the text, the scheme of reform of Central excises proposed here was drawn up before the Union Budget for 1994-95 was unveiled.

A1.1.1 Improvement in the Methods of Valuation

As noted in Chapter 2, valuation has been a subject of numerous disputes in central excises and despite changes in the law and many court rulings, the problems do not seem to have been fully resolved. The problems arise essentially from the attempt on the part of manufacturers to depress the base of excise taxes by setting up sister concerns or artificial markets and/or by pushing some of the cost of production forward to the so-called "post manufacturing" stages. However, under the law as it stands now, the value for excise tax can be determined on the basis of price at which the goods can sell at arms length transactions. There is reason to suppose that the scope for manipulation can be reduced substantially if the tax authorities can establish conclusively the price at which a given product is traded in the wholesale market.

As a general rule, unless there is reason to suspect manipulation, the invoice price should form the basis for valuation. This was the thrust of TRC's recommendations too. For some commodities like sugar and cement, Tariff value may be fixed. In the case of goods covered by the Standards of Weights and Measures (Packaged Commodities) Rules, the TRC recommended that the maximum retail price (MRP) be taken as the basis for deciding the measure for levy of excise duty and a fair abatement be given for various taxes and other items not normally included in the assessable value. These prescriptions are eminently sensible and have been endorsed by the Committee for Common Code for Customs and Central Excise (Rekhi Committee), which submitted its report last year. However the Rekhi Committee favoured a more cautious approach in relying on invoice value.

While the problems inherent in taxing the manufacture of goods to the exclusion of services cannot all be removed, the judicial rulings allow considerable latitude to tax authorities in determining assessable value. It is now well settled that the price of a product in the wholesale market can be taken as a valid base for excise taxation after allowing for reasonable margin for trading profit and transport charges. What is needed to check manipulation of exciseable value is to create a data base for the wholesale prices of goods. Excise authorities would do well to strengthen its machinery for gathering market intelligence regularly in systematic manner. A reliable data base is also needed for fixing tariff values.

A1.1.2 Removing the Limitations of MODVAT

It must be acknowledged that the MODVAT has been a major step towards mitigating the cascading effect of input taxation in the country. In principle, it now covers roughly 80 per cent of the industrial products. The proportion of MODVAT credit to the gross tax due on final products still remains only at 22 per cent whereas the revenue accruing from inputs forms over 40 per cent of the total excise revenue. This is partly because a good proportion of inputs is used in the unorganised sector. Partly this is also due to limited coverage and narrow interpretation of the scope of MODVAT that tend to nullify to a considerable extent the intended benefits. Some of the recurring problems are highlighted below.

Inputs Eligible for MODVAT Credit

The most serious limitation of the MODVAT scheme stems from its restrictive scope. The notification (of 1 March 1986) which authorizes the grant of credit paid on inputs refers to *"input used in or in relation to the manufacture of the final product"*. An explanation below the relevant rule under which the notification was issued[37] stipulates that inputs do not include "machines, machinery, plant, equipments, apparatus, tools or appliances used for producing or processing of any goods". There is a further stipulation that a manufacturer intending to avail of the MODVAT benefit must file a declaration regarding the inputs in respect of which duty credit is sought to be claimed. Interpretation of what constitutes eligible input in a given situation has been a source of disputes and audit objections, tending to defeat the objective underlying the scheme.

37. Rule 57A of the Central Excise Rules, 1944.

MODVAT credit procedures

Another set of disputes and audit objections centre around the question whether the inputs in respect of which credit is claimed were duly declared in advance. Such declaration has to be detailed and specific and not in broad terms since the proforma prescribed for the purpose provides specific columns for the description and subheadings of the inputs and the final products.

Lack of relief for excess credits

Since excises are levied at disparate rates, there is sometimes an excess of the credit over what can be effectively rebated. The excess or surplus however is not allowed to be carried forward or set off against other products even in a multi-product firm, where combined MODVAT account is maintained.

Denial of Credit to Exempt Producers

The law does not allow input tax credits where the final product is exempt, even in cases where the manufacturer of the final product wants to come within the tax net. Initially, such an option was allowed to the taxpayers but this was considered inadmissible in law. As a result of the bar on the grant of MODVAT credit for duty on inputs used in exempt products, even 100 per cent Export Oriented Units cannot avail of MODVAT benefits, as their products are exempt from excise duty. Goods brought into a 100 per cent export oriented unit in connection with manufacture and packing of articles have, however, been exempted from excise duty.

The problems in the working of the input duty relief mechanism operating through the MODVAT scheme narrated above underline the limitations of a system of VAT operating with too many restrictions and the urgency of going in for a fullfledged value added tax with rebate allowed for the tax paid on all inputs and appliances including capital goods. Other measures needed to expand and rationalise the operation of MODVAT as and when the rate structure is rationalised are set out in Section A1.1.5 below.

A1.1.3 Rate Rationalisation

The TRC has recommended a drastically revised rate structure for many commodities and the structure is contained in the Committee's Final Report (Part II, Appendix XI.1). Basically, the recommendation is for a general rate reduction and a three tier structure of 10, 15 and 20% (with high rates of 30, 40 or 50% in the case of non-essential commodities). The TRC had acknowledged that such a rate structure can be achieved only over a period of time. This is obvious because there are constraints in reforming an existing tax structure which has evolved over a period of time. What could be attempted immediately would therefore not be as scientific as TRC's recommendations. Small adjustments in the tax rates, generally in the direction pointed by the TRC, can be made in such a way that, by and large, the rate adjustments are revenue neutral. A rate structure with such modifications has been attempted and set out in Table A1.1.

It would be necessary to retain for the time being the present incidence on a number of commodities where the duty is specific and the revenue yield is substantial. Such commodities include petroleum products, cigarettes and man-made fibres and yarn. There are a few commodities, carrying a very high rates of excise duty and yielding significant amounts of revenue. The duty on these commodities could be brought down to the maximum rate of 20%. These will include tyres and cement. In the case of these two commodities, however, special excise may be levied in order to reduce the adverse impact on revenue, purely as an interim measure, as these commodities do not fall in the category of goods on which special excise could be considered in the normal course.

Table A1.1 also indicates the revenue impact of the changes suggested in regard to commodities yielding 90% of the total revenue. As for the remaining commodities contributing in all about 10% of revenue, it is assumed that it would be possible to make suitable rate rationalisation without any significant impact on revenue.

It should be mentioned that the rates indicated in the table - existing and proposed reflect average incidence on the commodity/commodity group as a whole. There are at present a number of rates within the same commodity group. These rate differentials should eventually go.

Certain measures to be taken in regard to three groups of commodities yielding substantial amounts of revenue are indicated below along with their revenue impact. (The revenue effect has been worked out with reference to the year 1991-92. However, the directions of change and broad dimensions should hold good for subsequent years).

(a) *Petroleum products*

It is being suggested separately below (Section A1.1.5) that MODVAT be extended to petroleum products. In the context of this suggestion and keeping in view the revenue needs of the Centre, it is proposed that the duty on petroleum products be restructured as follows:

1. The Central VAT on petroleum products should be levied at a flat rate of 5 per cent on all petroleum products. [An exception may have to be made in the case of Low Sulphur Heavy Stock (LSHS) for power generation, as there is no excise duty on electricity.] Assuming the total value of petroleum products to be of the order of Rs 25000 crore, this would yield about Rs 1250 crore. (In 1991- 92, the total value of those products was about Rs 22000 crore).
2. Special excises at rates differentiated among products of the group may be levied. Differentiation would take account of distributional considerations. These will be sumptuary excises and will be retained entirely by the Centre.
3. Revenue may also be obtained through a compounded levy worked out on a tonnage basis on the crude throughput of the refineries. If an amount of Rs 500 is charged per tonne of crude - indigenous and imported -, the realisation will be of the order of Rs 2500 crores. (At present cess is charged at the rate of Rs 900 on indigenous crude and the yield is Rs 2466 crore). This amount could be levied as special excise, accruing entirely to the Centre.

The whole structure can be so worked out that the total revenue realisation from the petroleum products remain more or less what is derived at present, and the rate rationalisation does not necessitate any sharp variation in the administered prices fixed by the Government.

A possible rate structure for the major petroleum products is set out in Table A1.2.

(b) *Tobacco products*

In 1991-92 the revenue from cigarettes and biris which are the most important among tobacco products was as follows:

(Rs crore)

Commodity	Basic duty	Addl. duty in lieu of sales tax
Cigarettes	1638	973
Biris	144	53

The duty on cigarettes which is expressed as a single rate on specific basis is distributed between excise duty and additional duty in lieu of sales tax in the ratio of 65:35. As an interim measure, the existing levies of specific duty to which the consumers and manufacturers are accustomed, may continue subject to indexation of the specific rates, where required. It has been suggested later in this paper that MODVAT be extended to tobacco products. The revenue implication of such a measure will be minimal.

(c) *Textiles*

The structure of excise duties on textiles is highly complicated and calls for drastic rate rationalisation. Some of the measures that could be considered are:

1. In the case of spurn yarn i.e., cotton and cellulosic spun yarn and blended yarn the Central VAT should be 10% ad valorem. For these items, which undergo frequent price fluctuations, it would be necessary to fix tariff values, so that valuation does not pose any problem.
2. The duty on fabrics should be so adjusted that the total yield from cotton yarn and fabrics does not undergo any appreciable change and rate rationalisation does not push up the prices of fabrics.
3. The current level of polyester fibre duty may continue. In the long-run, the rate should be 10 per cent ad valorem.
4. In the case of man made filament yarn, which yielded revenue of over Rs.1600 crore during 1991-92, there is a clear case for reduction of duty and this has been recommended by the TRC. This may have to be done in stages, considering the revenue implications. It has been separately recommended that the additional duty on textile and textile articles, which is 15 per cent of the basic duty be abolished. The current incidence on filament yarn is of the order of 60 to 70 per cent. The abolition of additional duty on textile and textile articles itself will bring down the duty by about 10 percentage points. There could be a further reduction of 10 per cent of the basic duty in the first instance, so that the incidence comes down to about 50 per cent which is the maximum rate recommended by the TRC for any commodity.

The revenue implication of the measures suggested above will be such that broadly the revenue accruing from the commodity groups will remain the same. There could be a decrease in the yield from polyester filament yarn to the extent of Rs.163 crore. With the extension of MODVAT to textiles, there should be a basic duty on fabrics. In the case of synthetic fabrics, excise duty is reported to be widely evaded. It will be very difficult to estimate the likely revenue yield from the duty on synthetic fabrics. However, it can be said that this amount is not likely to be less than the drop in revenue from polyester filament yarn that may occur with rate reduction.

A1.1.4 Special Excises

The TRC had recommended reduction of the multiplicity of rates of excise duties to two or three viz. 10, 15 or 20 per cent. The Committee suggested that in addition, there could be selective excise duties on non-essential commodities or commodities injurious to health. The maximum rate on a commodity should not exceed 50 per cent with a few exceptions like cigarettes.

It may not be necessary to levy sumptuary excises in every case on an ad valorem basis. There could be specific duties particularly when the commodity is a finished product not entering the production process. The existing duties on motor vehicles, plastics, refrigerators and air-conditioners, cosmetics, ceramic products and aerated waters could bear special excises so that the incidence does not fall steeply (see Table A1.1). On the other hand, commodities like cigarettes and man-made filament yarn could continue to be subjected to a cumulative duty which need not be split into Central VAT and special excise to avoid any adverse impact on the devolution of proceeds from excise duties to the States. As an interim measure, it may be necessary to levy special excises on tyres and cement, as suggested earlier.

The base for application of special excise when expressed in ad valorem terms should in principle be the assessable value for Central VAT plus the Central VAT. However for the sake of simplicity, it is suggested that the assessable value for special excise may be the same as for Central VAT.

A1.1.5 Extension of MODVAT

The main drawback of the existing MODVAT system arises from the limitations in its application described earlier. The excluded items like petroleum, textiles and tobacco products yield substantial amounts of revenue. At present, as much as 40 per cent of excise revenue is derived from non-MODVAT commodities. To the extent that MODVAT is not applicable to these items, the cascading effect of excise duties in the economy continues.

Another anomaly arises from the specific duty applied in the case of number of commodities. Currently nearly 70 per cent of the Central excise revenue is derived from commodities on which specific duties are leviable. Apart from petroleum, textile and tobacco products (to which MODVAT is not extended), these include sugar, paper, cement, tyres, aerated water and consumer durables such as air-conditioners and TVs. A specific duty in the case of a finished product will mean a constantly changing incidence of duty in an inflationary situation. One of the unfinished tasks of excise reform is to convert the specific duties on commodities for which MODVAT credit is available into ad valorem.

Exemption from Central Excise duty is yet another area which has complicated the operation of MODVAT. There are some products such as tractors, some of which are exempted on the basis of specifications The parts required for the exempted and dutiable varieties are purchased together by the manufacturer and to maintain account on the basis of whether the finished product is exempt or not will be extremely difficult. The TRC has recommended withdrawal of the exemptions to the maximum extent possible and when this is implemented the problem will be eased to a large extent.

It should be possible to extend the MODVAT system to the excluded commodities, namely, petroleum products, tobacco products, textiles, cinematographic films and matches. There could be marginal variation in the rates of duties on the final products in order to provide for MODVAT credit without significant adverse impact on revenue. Extension of MODVAT to tobacco products may not present any problem as the revenue impact of such a measure is not likely to be very significant. In the case of petroleum products, it has been suggested there should be an ad valorem component of duty and this should be permitted as credit when a product is used as an input.

As regards textiles, MODVAT may be extended in stages as recommended by the TRC. The first stage of the reform would consist of introducing MODVAT till the yarn stage in all sectors and provide for input duty relief in the case of cotton textiles, without subjecting grey fabrics to the levy. The input duty relief in the case of independent processors will be on a notional basis whereas integrated mills will follow the regular MODVAT procedure. The same system may be applied later to synthetic and blended fabrics other than those for fabrics made of filament yarn. The duty on filament yarn would have to be progressively lowered so that within three to five years the level of duty on filament yarn is at the same level as the other commodities. At that stage, it should be possible to extend VAT to fabrics made of filament yarn.

In 1991-92, the total yield from additional duty in lieu of sales tax from synthetic fabrics including fabrics of man-made staple fibres was about Rs. 600 crore. A levy of about 25 per cent of the current incidence of additional duty on these fabrics as basic excise duty or Central VAT, it is estimated, would yield adequate revenue to make up for the loss arising out of the proposed duty reduction on filament yarn. (At this stage, there will not be any MODVAT in the case of fabrics made of filament yarn).

The TRC had envisaged that at a future date powerloom factories may be permitted to avail of the small scale exemption applicable in the case of other commodities. It appears that there are practical difficulties in implementing the TRC's recommendation, given the existing threshold for exemption for small scale units. The current threshold level of Rs 30 lakh per year would cover even units having 10 powerlooms. It is reported that a substantial number of powerloom factories in the country are in units with less than 10 powerlooms. So, with an exemption level of Rs 30 lakh of turn over, it would not be possible to derive any significant revenue from the powerloom sector.

The TRC has recommended extension of MODVAT to machinery, permitting credit of duty paid not fully at the time of purchase but in instalments during a subsequent period of years to be laid down in the law. One of the considerations underlying this suggestion is the likely adverse impact on revenue. Granting credit in instalments may however present administrative problems. In a consumption type VAT, it is necessary to grant the credit of duty as soon as the machinery is brought into the factory for installation. No doubt, this may entail revenue loss of the order of Rs.700 crore on account of MODVAT credit in central excise duty and Rs.600 crore on account of MODVAT credit in countervailing duty. To contain revenue loss, it may be provided that excess credits will only be carried forward and not refunded, except in the case of those whose sales consist mainly of exports.

A1.1.6 Withdrawal of exemptions

A system of VAT or MODVAT cannot function effectively if there are large areas of duty exemption in the system. As the TRC has pointed out, in a scheme of value added tax, exempting a few products means exemption only in respect of value added at the final stage since no credit is available for the duty paid on inputs. It is true that in a number of cases, exemption from excise duty has been given to inputs based on end-use. These end-use based exemptions have complicated and distorted the tariff causing difficulties in administration, opening up avenues for evasion. To widen the tax base, it is necessary to withdraw many of the exemptions which are currently in force. The exemptions which have been identified by the TRC are given in paragraph 9.6 of the Interim Report of the Committee. In addition, there are several other exemptions relating to individual products. An attempt has been made for this paper to estimate the gross value added in the major exempted sectors from the National Accounts. Revenue likely to be derived by subjecting these commodities presently exempt to a 10 per cent VAT would be of the order of Rs.2500 crore as estimated in Table A1.3. Needless to mention, the revenue so generated will be shareable between the Centre and the States.

A1.1.7 Tax on Services

The TRC has recommended that the tax base for indirect taxes should be broadened inter alia by covering many, if not most, of the services and a beginning could be made with the taxation of a few services. As argued elsewhere in this study, taxation of services is necessary for broadening the Tax Base.

The TRC had favoured levying of a tax on the following services by the Central Government:

1. Advertising services;
2. Services of stock brokers;
3. Services of automobile insurance;
4. Service of insurance of residential property, personal effects and jewellery; and
5. Residential telephone service.

The pros and cons of taxation of services are examined in Chapter 7. In conclusion, it is suggested that services should be taxed selectively at least for the present and those for which location of consumption is difficult to determine should be taxed by the Centre. By and large, the services recommended for Central taxation by the TRC fall in that category. On the basis of available information, it is estimated that an amount of Rs.1300/- crore should accrue from a tax on the services contemplated by the TRC (other than advertisements), vide Table A1.4. (It has not been possible to estimate the possible revenue yield from advertisement services).

As there is little difference between taxation of commodities and that of services, it is only proper that the revenue accruing from the service tax is also shared between the Centre and the States. However, in view of the fact that the Centre's revenues in the next couple of years may be adversely affected because of the rationalisation and lowering of Customs duties, it is proposed that for the time being, the yield from the Central tax on services may be retained by the Centre, until the entire revenue needs of the Centre and the States are assessed by the Finance Commission.

A1.1.8 Abolition of additional duty in lieu of sales tax

The scheme of levying additional excise duty in lieu of sales tax was implemented through an Act of 1957 in the case of sugar, tobacco and textiles.

There have been persistent demands from many States that they be permitted to levy sales tax on these commodities. An examination of the measures taken to ensure that the promised targets fixed in the case of additional duty in lieu of sale tax were reached shows that these have resulted in a number of complications in central excise tariff.

With the reform of the trade taxes and move towards a harmonised system of consumption tax, the States should be free to levy State VAT on the items of consumption. viz. sugar, tobacco and textiles. Such an arrangement would however be possible only after State VATs get implemented and the tax systems in the States are harmonised and rationalised. Until then, the additional duty in lieu of sales tax may continue to be collected as at present.

A1.1.9 Additional Duty of Customs (Countervailing Duty)

In terms of Section 3 of the Customs Tariff Act, an additional duty of customs equal to the excise duty on a like article manufactured in India is leviable on imported goods. The amount of countervailing duty (CV duty) collected during the last five years is shown below:

(Rs. crore)

Year	Customs duty (Basic+ auxiliary)	Additional Customs duty (CV duty)	CV duty as % of total collection
1988-89	13879	2140	13.36
1989-90	16033	2293	12.51
1990-91	17990	2972	14.18
1991-92	18320	3519	16.11
1992-93	20613	3575	14.78

At present, the revenue from this duty being in the nature of customs duty is retained entirely by the Centre. However, in the case of inputs, the countervailing duty is adjusted against excise duty payable on finished products. Thus the CV duty retained by the Centre goes to reduce the yield from the excise duty which is shareable between the Centre and the States. In equity, the yield from CV duty should be shareable between the Centre and the States. No doubt, only part of the CV duty collected would get adjusted as MODVAT credit, because CV duty falls also on finished products and to some extent the goods may be used as input by the sector exempted from excise duty. There is no estimate of the CV duty which is adjusted as MODVAT credit. It is only after adequate data are collected to make such an estimate, that an appropriate formula for sharing CV duty can be evolved. Till then, the entire amount of CV duty collected may be shared with the States. Sharing of CV duties would also compensate the States for the 'loss' arising out of the introduction of non-shareable special excise duties.

A1.1.10 Countervailing duty equal to State VAT

If the imports are to be taxed on the same footing as domestic products, there has to be a levy of countervailing customs duty equal to the State VAT on domestically produced commodities. However, in the case of imports by registered dealers there would be little point in applying the countervailing duty because the duty would be allowed to be set-off against State VAT, when the goods are sold in the domestic market. This will not be true of imports by unregistered dealers and high-seas sales. There would, therefore, be a case for levying countervailing duty on such imports. This duty can be equal to the maximum of the standard rate prescribed for State VATs. Similarly there should be a State VAT countervailing duty on baggage and other imports for personal consumption.

Assuming imports by unregistered dealers and high-sea sales to be 5 per cent, each of the total imports (Rs.47850 crore in 1991-92) and also providing for a small amount to accrue from personal importations, it is estimated that the yield from such a countervailing duty would be of the order of Rs.500 crore at 1991-92 level of importation. Considering the nature of this levy, it will have to be pooled and shared among the States on a formula to be decided by the Finance Commission. However, levy of such a countervailing duty will have to be considered only after the indirect taxes in the States have been rationalised and harmonised.

A1.1.11 Abolition of Cesses

In addition to excise duties, Central Government levies cesses on certain commodities and these are also administered by the Department of Revenue. (There are certain other cesses which are collected by Ministries/Departments other than Revenue Department).

Several Committees have felt that cesses in general should be abolished and support for particular activities of the Government be provided directly from the budget. In the context of rationalisation of the excise duties, cesses should be abolished and budget support where necessary should be provided from the Consolidated Fund of India. This would result in decrease in the Centre's revenue to the extent of Rs.246 crore at 1991-92 level of collections.

For the same reason, additional duty levied on textiles and textile articles under the Additional Duties of Excise (Textile and Textile Articles) Act, 1978 to finance Janata Cloth Scheme, also should be withdrawn. The revenue to the Centre from these duties was Rs.348 crore in 1991-92.

A1.1.12 Revenue impact of the suggested interim measures of reform

The revenue impact of all the above proposed interim measures is given in Table A1.5. The calculations have been made on the basis of actual collections in 1991-92. It will be seen that overall, the suggested measures will result in additional revenue to the extent of Rs.1113 crore to the Centre and of Rs.160 crore to the States, at 1991-92 level of collections. The increase in the revenue of the Centre would partly neutralise the 'loss' due to reduction in the level of Customs Tariff and enable the Centre to help some of the States to move over to the VAT system.

A1.1.13 Modification of the rate structure over a period of time

The rate structure suggested for Central VAT and special excise is such that the changes from the existing incidence are not too abrupt. The level of duty suggested for a particular commodity/commodity group is based on certain assumptions. It would be necessary to allow the recommended rate structure to work for a year or two and watch the revenue yield and the credit availed of in the case of commodities to which MODVAT is proposed to be extended. Modification can then be made in the rates through a process of iteration to correct any anomaly that might come to notice because of extension of MODVAT. The goal should however be to help move the system towards a true VAT at the Centre.

Table A1.1

Statement Showing Current Yield & Proposed Yield of Central Excise Revenue from Major Commodities

Sl. No.	Commodity	1991-92 (Actuals) Basic duty	Current estimated incidence (Rs crore/ %age)	Proposed incidence: Central VAT (Rs crore/ %age)	Proposed incidence: Special Excise (Rs crore/ %age)	Proposed Total Yield: Central VAT	Proposed Total Yield: Special Excise	Proposed Total Yield: Total
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
1.	Petroleum products	2796	2796	1336	1460	1336	1460	2796
	a. Motor spirit	1245						
	b. Refined Diesel Oil	703						
	c. All others in Chapter 27	433						
	d. Kerosene	246						
	e. Petroleum gases etc.	72						
	f. Furnace oil	57						
	g. Diesel oil NES	40						
2.	Cigarettes	1638	1638	1638		1638		1638
3.	Man-made Fibres & Filament Yarn	2075	2075	1912		1912		1912
4.	Motor vehicles	1805	40%	20%	20%	903	903	1805
5.	Iron and Steel	1431	10%	10%		1431		1431
6.	Rubber products	992	35%	20%	200	567	200	767
	a. Tyres, tubes	811						
	b. Others	181						
7.	Cement	1281	30%	20%	200	854	200	1054
8.	Chemicals	1397	15%	15%		1397		1397
9.	Machinery	1416	15%	15%		1416		1416
10.	Elec. machinery	1368	15%	15%		1368		1368
11.	Non-ferrous Metals	812	10%	10%		812		812
	a. Aluminum	653						
	b. Copper	78						
	c. Zinc	53						
	d. Others	28						
12.	Man-made fabrics	0	0	163		163		163
13.	Sugar	393	8%	10%		491		491
14.	Plastics	792	35%	20%	15%	453	339	792
15.	Pharmaceutical products	426	15%	15%		426		426
16.	Paper and paperboard	388	30%	20%		259		259
17.	Cotton yarn & fabrics	191	4%	10%		478		478
18.	Paints and dyes	343	25%	20%		274		274
19.	Soap and detergents	375	20%	20%		375		375
20.	Refrigerators & Airconditioners	271	40%	20%	20%	136	136	271
21.	Cosmetics	263	75%	20%	30%	70	105	175
22.	Wireless Receiving Sets	232	20%	20%		232		232
23.	Ceramic products	228	40%	20%	20%	114	114	228
24.	Glass & glassware	235	30%	20%		157		157
25.	Wires & cables	271	15%	15%		271		271
26.	Biris	144	144	144		144		144
27.	Articles of base metals	110	15%	15%		110		110
28.	Aerated waters	135	40%	20%	20%	68	68	135
29.	Vegetable products	49	10%	10%		49		49
30.	Matches & explosives	92	8%	10%		115		115
31.	Tea	75	5%	10%		150		150
32.	Wood and wood articles	75	10%	10%		75		75
33.	Elect. Stampings & Laminations	59	15%	15%		59		59
	Total	22158	22158			18301	3524	21825
	Other Commodities	1399	1399	1399		1399		1399
	Gross Revenue	23557	23557			19700	3524	23224
	Refunds and Drawbacks	465	465			465		465
	Net Excise Revenue	23092	23092			19235	3524	22759

Note: In columns 4 to 6, tax yield is reported for goods subjected to specific duty while tax rates are given for goods subjected to ad valorem duty.

Table A1.2

Statement Showing Existing and Proposed Incidence of Duty on Petroleum Products

Sl. No.	Commodity	Price (Rs/ KL)	Basic Rate of duty	Price exct. of ex. duty	Duty incidence	Proposed Incidence: Cen. VAT	Spl. Ex.	Amount of duty	Diff. in duty	Price incl. duty	Diff. in price	Revenue 1991-92	Rev. Central VAT	Rev. Spl. Ex.
1.	Motor spirit	14564	2481	12083	20.5	5	1875	2479.24	-1.76	14562.24	-1.76	1245	304	941
2.	Diesel oil	5606	352	5254	6.7	5	100	362.19	19.19	5616.19	10.19	703	503	200
3.	Kerosene											246		
	(a) Industrial	5515	375	5140	7.3	5	125	381.67	6.67	5521.67	6.67			
	(b) Domestic	2201	335	1866	18.0	5	250	342.90	7.90	2208.90	7.90		81	165
4.	Furnace oil											57		
	(a) Fert. feedstock	2812	0	2812	0.0	5	0	133.90	133.90	2945.90	133.90			
	(b) Fert. fuel	4999	75	4924	1.5	5	0	238.05	163.05	5162.05	163.05			
	(c) For bunkering coastal vessels	4999	11	4988	0.2	5	0	238.05	227.05	5226.05	227.05			
	(d) Other feedstock	4999	110	4889	2.2	5	0	238.05	128.05	5127.05	128.05		57	0
5.	Naphtha for													
	(a) fertilizer	3723	5.5	3718	0.1	5	0	177.29	171.79	3894.79	171.79			
	(b) gas turbine	6075	660	5415	12.2	5	400	670.24	10.24	6085.24	10.24			
	(c) petrochemicals	6075	66	6009	1.1	5	0	289.29	223.29	6298.29	223.29			
6.	LSHS													
	(a) Power generation	2851	0	2851	0.0	0	0	0.00	0.00	2851.00	0.00			
	(b) Other than power generation	4804	175	4629	3.8	5	0	228.76	53.76	4857.76	53.76			
7.	Gases & Diesel N.E.S.											112	80	32
8.	All others (40)											433	310	123
	Total												1336	1460

Notes:

1. The rate of special excise duty has been so worked out as to keep the incidence close to the existing levels.
2. The Central VAT has been applied on the current price minus proposed special excise.
3. The Central VAT on furnace oil and naphtha used in the manufacture of fertilizer will be available as input credit.
4. In the case of kerosene the likely revenue yield has been calculated on an approximate basis assuming the average special excise duty to be Rs.225.
5. The likely yield in the case of sl.no. (7) and (8) from Central VAT and special excise has been estimated in the same ratio as in Diesel Oil.

Table A1.3

A Summary Statement of Likely Gains from Withdrawal of Central Excise Exemptions

	Description		Rs. crore
I.	GVA of Regd.Manufacturing in 1988-89 (Rs.crore)		41760
II.	GVA of exempted goods in 1988-89 (SSI+large-scale) (Rs.crore)		14402
III.	Less:GVA of exempted goods in 1988-89 (SSI below Rs. 30 lakh turnover per annum only) (Rs.crore)		2673
IV.	GVA of large units in the production of exempted goods. (Rs.crore): Potential tax base in 1988-89		11729
V.	Potential tax base as percentage of I		28.1
VI.	GVA of Regd. Mfg.in 1991-92 (Rs.crore)*		60333
VII.	Potential tax base in 1991-92 (Rs.crore)		16953
VIII.	An estimate of potential revenue at a weighted average duty rate of 15% (Rs.crore)**	or say	2543 2500

Notes: GVA = Gross Value Added.
* = As per White Paper, CSO; 1993.
** = The modern small scale industry considered above does not cover some products, namely coir, handicrafts, handlooms and powerlooms. Taking into account the contribution of these sectors to the tax base, it is possible that the revenue potential from withdrawal of exemptions is Rs.2500 crore even at a rate less than 15% say, at about 10%.

Table A1.4

An Estimate of Tax-base of Selected Services

Sl. No.	Items	Tax-base (Rs. crore)	Proposed tax rate (%)	Revenue (Rs. crore)
		(1)	(2)	(3)
1.	Brokerage on sale-purchase of stocks	3000	10	300
2.	Non-life insurance premia net of claims	4000	10	400
3.	Telephone-telex-fax-pay phones etc.	6000	10	600
	Total	13000		1300

Table A1.5

Impact of Interim Reforms in Central Excise on Revenue Based on 1991-92 (Actuals)

(Rs.crore)

Measure	Existing			Proposed			Difference	
	Centre's Share	States' Share	Total	Centre's Share	States' Share	Total	Centre's Share	States' Share
Rate rationalisation (excluding duty on petroleum products & capital goods eligible for MODVAT credit)	12151	9941	22092	10029	8206	18235	-2122	-1735
Extension of MODVAT to petroleum products (C.X duty)	165	135	300	0	0	0	-165	-135
Extension of MODVAT to capital goods (C.X. duty)	385	315	700	0	0	0	-385	-315
Special Excise	0	0	0	3524	0	3524	3524	0
Conversion of crude cess into Special Excise	2466	0	2466	2466	0	2466	0	0
Withdrawal of exemptions	0	0	0	1375	1125	2500	1375	1125
Tax on services	0	0	0	1300	0	1300	1300	0
Extension of MODVAT to capital goods (CV duty)	600	0	600	0	0	0	-600	0
Sharing of CV duty (other than on capital goods)	2712	0	2712	1492	1220	2712	-1220	1220
Abolition of Cess (other than on crude)	246	0	246	0	0	0	-246	0
Abolition of AD (T&TA)	348	0	348	0	0	0	-348	0
Total CX duty & CV duty	19073	10391	29464	20186	10551	30737	1113	160

Notes:

1. From the proposed total yield of Central VAT an amount of Rs.1000 crore has been deducted, being the estimated MODVAT credit likely to be availed of in the case of petroleum products (Rs.300 crore) and capital goods (Rs.700 crore).
2. Special excise and tax on services are treated as non-shareable.
3. CV duty is assumed to be 15% of total collections from customs duty.
4. The total customs revenue from machinery including project imports in 1991-92 was Rs.5820 crore. This includes Rs.1874 crore from project imports which did not carry any CV duty. Assuming 20% of the balance accounted for CV duty, the yield would have been Rs.800 crore. But this will include revenue from items which are not in the nature of capital goods, and items which were exempted from CV duty. Assuming that such items accounted for 25% of the revenue, CV duty from capital goods eligible for MODVAT credit will be about Rs.600 crore.
5. The total central excise revenue from machinery (including electrical machinery) in 1991-92 was Rs.2784 crore. This included (a) machinery supplied to the non-duty paying sector and (b) machinery in the nature of finished goods and machinery components already availing of MODVAT credit. Assuming that (a) accounts for 50% of the revenue and (b) for 25%, the revenue from capital goods becoming eligible for MODVAT credit will be about Rs.700 crore.
6. In the case of petroleum products, MODVAT credit will be available only when they are used as feed stock. Considering the fact that the excise duty for such uses is at concessional rates much lower than the standard rates and that motor spirit and 90% of diesel oil are used for transportation it is estimated that the amount of duty likely to be taken as MODVAT credit will be Rs.300 crore.

ESTIMATION OF TAX BASES UNDER VAT AND REVENUE NEUTRAL RATES

A2.1 Introduction

The revenue implications of various options for reforming the present system of domestic trade taxes of the country towards a system of Value Added Tax can be examined from two angles (i) what would be the yield of the tax at the recommended rates, and (ii) what would be the rates which would make the change revenue neutral, that is, assure the same revenue as yielded by the taxes to be replaced. The exercises carried out for assessing the revenue implications of the reforms proposed in this report were focused more on finding out the likely range of revenue neutral rates than on quantifying the revenue effect of alternative rate regimes, although an attempt was also made to estimate the likely magnitudes of the latter alternative scenarios.

A2.2 Estimation of a VAT Base - Possible Approaches

Once the base is estimated with given rates, the yield can be worked out straightaway by multiplying the base with the rates, while revenue neutral rates for a given amount of revenue can be derived simply by dividing the revenue to be secured by the estimated base. Thus, whichever way one looks at it, any assessment of the revenue implications of alternative VAT regimes requires, first, an idea of the likely size of the base.

For a destination based consumption type VAT, levied comprehensively, the base comprises the value of goods and services consumed in the economy during a year. It is possible to estimate this base by taking the figure of GDP as the starting point. To this one has to add the value of imports and deduct that of exports. The resultant figure represents the total expenditures on private consumption, government consumption, fixed capital formation and change in business inventories. For arriving at the VAT base, deduction should be made for the value of services of exempted sectors, government wages, fixed capital formation and net consumption abroad. To this must be added, purchases of intermediate goods and capital goods of exempt sectors including government and agriculture, not eligible for tax credit. Value of output of goods and services as also imports and exports is given on an annual basis in the National Accounts Statistics. The adjustments for the exclusion and inclusion on account of the exempted sectors, however, require disaggregated data on the value of goods and services to be excluded and, where the tax is leviable on dealers above a prescribed threshold, information regarding their distribution according to size of turnover. While it is possible to estimate the base at the all-India level by this method, application of this method at the State level becomes problematic because of absence of reliable data on *inter alia* inter-State "exports" and "imports".

An alternative way of estimating the consumption base which can be applied in the case of the States too is to take the total consumption expenditure in the economy, or Statewise, as the case may be, and estimate the VAT base from this figure by making the necessary adjustments. Figures of aggregate private consumption expenditure for the economy as a whole are also provided in the NAS. Statewise figures of consumption expenditure are thrown up by the National Sample Surveys (NSS) conducted by the NSSO from time to time. These data do not furnish all the information required for the adjustments but provide a basis from which the consumption at the State levels can be computed by making appropriate assumptions. This method of estimating the base may be designated as the "Consumption Expenditure" approach.

It is possible to estimate the VAT base at the State level in another way. Figures of turnover of goods subjected to sales tax at present are available, at least in some States, from the respective Sales Tax Departments. With suitable adjustments, one may figure out the likely order of a consumption VAT base for a given State from these figures which can then be used to derive estimates of the revenue impact of alternative rate regimes as well as the likely order of revenue neutral rates. This is referred to here as the "Tax Turnover" approach. Since the basic figures required for the Tax Turnover approach are compiled directly from the tax returns filed by dealers for sales tax, estimates made with this method might be regarded as firm and more reliable than those obtained by the aggregative consumption expenditure approach.

Both the methods, however, involve a series of steps and assumptions to provide for the adjustments and/or to make up for deficiencies of data. The steps to be gone through to derive the base under each method and the underlying assumptions are described briefly below. The results of the exercises are also set out in some more detail than given in the text. For further details reference may be made to the Technical Note being brought out by the Institute separately.

A2.2.1 Consumption Expenditure Approach

In working out the base for a VAT by this method, adjustments have to be made to the aggregated consumption expenditure data available from the NAS to allow for: (i) exemption of agricultural products and (ii) exemption of dealers with turnover below the taxable limit. Further allowance has to be made for consumption of services if the services are not included in the base. While the adjustments for exclusion of services from the base can be made with the help of information provided in the NAS, those for the exemptions have to be made on the basis of whatever evidence is available regarding the proportion of unprocessed agricultural products in total consumption and the share of dealers who would be exempt in aggregate consumption expenditure of the State, under alternative assumptions regarding thresholds. The tax base for a countrywide VAT was derived in this way for the present study by relying on indirect evidence and employing plausible assumptions where no information was available to provide a basis.

Once the base is estimated, revenue neutral rate for a VAT levied at a uniform rate throughout the country by any one level of government to replace both Central excises and State sales taxes can be worked out straightaway by dividing the revenue to be replaced by the base. However, since this model has been ruled out as the possible option of VAT for India being undesirable and impracticable, an attempt was made to estimate first, the revenue neutral rate of a Central VAT to replace Central excises, assuming that such a Central VAT would be applicable to the total consumption base after making the adjustments mentioned above. Next, estimates were made for a revenue neutral VAT at the State level if it is levied at a uniform rate in all the States on the same base. These estimates, worked out for 1990-91 and 1992-93, along with estimates of the tax bases are presented in table A2.1. The estimates provide an idea of the revenue neutral rates both for the Central and State VATs with alternative thresholds, viz., Rs 5 lakh, Rs 10 lakh and Rs 30 lakh.

The proposals put forward in this Report envisage replacement of Central excises by a Central VAT only upto the manufacturer level and of State sales taxes by a State VAT down to the retail level. Hence, estimates were made of revenue neutral rates for State VATs by the consumption expenditure method for each of 15 major States individually. For individual States, figures of only household consumption expenditure are available from reports of NSS. Further, the data on relevant components of the consumption expenditure required for making necessary adjustments were not available for individual States. An attempt was therefore made to estimate the magnitude of these components from all-India data which could throw light on them relying on certain assumptions. Consumption expenditure bases were estimated by this method for 1990-91 and then projected for 1992-93. Revenue neutral rates were computed on the bases so estimated for the two years with reference to the actual revenue for 1990-91 and revised estimates for 1992-93. The results showing the revenue neutral VAT rates for 15 major States for 1992-93 are given in Table A2.2.

A2.2.2 Tax Turnover Method

The starting point under this method is the total turnover data for a given State. These data include both final consumption products and services as also inputs. Since under a VAT, the tax paid on inputs would be rebated, when used by a VAT registered dealer, it is necessary to estimate, in addition to the value of exempt products and services under the contemplated VAT regime, the total amount of rebate which would have to be allowed for tax on purchases when sales taxes are replaced by VAT. However, only locally (i.e., within the State) produced inputs would be eligible for tax rebate. So an estimate has to be made of the inputs which are locally produced. For this purpose, in the present exercise, use was made of the input-output tables at all-India level, as also data on the sales and purchases of 142 major dealers of Maharashtra provided by the Sales Tax Commissioner, Maharashtra. These data provided information on the proportion of locally made inputs in the total input used, the value of inter-State sales, transfers by consignment and so on. Using these data as also other relevant information and after discussions with senior officials of State sales tax departments, ratios required for estimating the input rebates were set up. Every care was taken to see that the assumptions were realistic and plausible.

From the figures of tax base so computed, the likely revenue yield of selected VAT rate regimes were worked out for five major States for which data could be obtained for the year 1992-93 except for one State. The States are Andhra Pradesh, Gujarat, Maharashtra, Rajasthan and Tamil Nadu. The results are reported in Tables A2.3 to A2.7. A VAT rate regime of low rate (t_1), standard rate (t_2) and high rate (t_3) is represented by (t_1, t_2, t_3). The basic estimates obtained through these tables are put together in Tables A2.8 and A2.9. Table A2.8 gives the estimates of tax yield under the current sales tax systems as well as under two alternative VAT rate regimes for each of the five States while Table A2.9 displays estimates of revenue neutral VAT rate regimes for the said five States.

From Table A2.8 it would be seen that Andhra Pradesh, Maharashtra and Rajasthan may be able to obtain a significant revenue gain by substituting their sales tax systems by VAT even at the lower limits of the rate bands proposed in Chapter 7 (Section 7.1.3), viz., with the VAT rate regime (4,12,20), (see columns 2 to 4). With a high rate VAT regime (5,14,25), Gujarat may still have a small shortfall in revenue but Tamil Nadu will obtain substantial revenue advantage. The shortfalls disappear even for Gujarat if one allows for some increase in collections through improvement in administration. In fact, if one assumes only a 10 per cent increase in the tax base from improvement in administrative efficiency because of introduction of VAT, then the low rate VAT regime (4,12,20) works out to be revenue neutral even for Tamil Nadu (columns 5 and 6).

Table A2.9 suggests that, with no improvement in administrative efficiency, to ensure revenue neutrality, the standard rate for some States such as Andhra Pradesh and Rajasthan would have to be no more than 8 or 9 per cent, and the average rate across the States would vary from 10.3 per cent for Andhra Pradesh to 13.1 per cent for Tamil Nadu (columns 2 and 3). Even a small improvement in tax compliance and administrative efficiency would facilitate lowering of standard rates (columns 2 and 4) and average rates (columns 3 and 5) by about 1 percentage point.

A comparison of the revenue neutral average VAT rates with those obtained by using the consumption expenditure approach reveals that these rates are higher than those under the latter for all the five States (column 3 of Table A2.9 and column 11 of Table A2.2) and, for some States, the gap is significant. Possibly, in these States a significant part of the potential consumption base remains outside the fold of taxation. However, with expected improvement in tax administration usually associated with switchover to a VAT, it is unlikely that a State would need to have revenue neutral average rate higher than 11 per cent.

Sensitivity analysis was also carried out under both the conditions: with and without improvement in administrative efficiency, by varying two of the three ratios used for estimating the value of rebatable inputs in taxable turnover. The results under the assumption of no administrative improvement are given in Table A2.10. These results indicate that revenue neutral average VAT rates do not vary much even if one allows for a 10 per cent margin in one or both of the ratios (columns 3,5 and 7). The increase in the average VAT rate for a State following a 10 per cent increase in both the ratios does not exceed 1.1 percentage points, and the increase for Andhra Pradesh and Rajasthan is only of the order of 0.3 or 0.4 percentage point (columns 3 and 7). The results obtained with the assumption of improvement in administrative efficiency also were not very sensitive to variations of 10 per cent in the ratios bearing on input rebate.

It should be noted that these estimates do not allow for the revenue impact of zero-rating of international exports. Roughly, the loss on this account may be of the order of Rs. 1000 crore for the country as a whole. This might have given an upward bias in the estimates of revenue and a corresponding downward bias in the estimates of revenue neutral rates presented here. It may, however, be added that it was not possible to estimate the gain in revenue likely from the disallowance of input rebate which is envisaged in the proposed scheme in Chapter 7 in respect of items bearing high rate of tax, viz., petrol, diesel, aviation fuel, liquor and tobacco whereas the Study envisages that the State VATs on these commodities will not be rebatable. The omission of this gain would correct at least partly, the bias resulting from the omission of revenue loss likely from international exports from the computations. Notwithstanding these shortcomings, the estimates presented here provide a reasonable basis for assessing the revenue impact of the proposed reforms. With the data normally available with the State tax authorities it should be possible to replicate these exercises for all States.

Table A2.1

Revenue Neutral Rates for Uniform Central and State VATs for India: An Illustration for 1990-91 & 1992-93

Type of VAT/ threshold limit	Revenue being replaced by VAT in the year		Estimated tax base in the year 1992-93		Revenue neutral rates (per cent)			
	1990-91	1992-93	goods	goods & services	goods only		goods & services	
	(Rs.cr.)	(Rs.cr.)	(Rs.cr.)	(Rs.cr.)	1990-91	1992-93	1990-91	1992-93
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
A. Central VAT with threshold limit								
i. Rs. 5 lakh	20149	28070	312268	345939	8.3	9.0	7.5	8.1
ii. Rs.10 lakh	20149	28070	308375	342047	8.5	9.1	7.6	8.2
iii. Rs.30 lakh	20149	28070	302153	335825	8.6	9.3	7.8	8.4
B. State VAT with threshold limit								
i. Rs. 5 lakh	19129	26034	312268	345939	7.9	8.3	7.1	7.5
ii. Rs.10 lakh	19129	26034	308375	342047	8.0	8.4	7.2	7.6
iii. Rs.30 lakh	19129	26034	302153	335825	8.2	8.6	7.4	7.8

Notes: 1. VAT threshold limits relate to annual turnover.
2. The Centre is assumed to raise revenue partly through non-rebatable excises and partly through the Central VAT. The revenue raised through non-rebatable excises was Rs.5278 crore in 1990-91 and Rs.9720 crore in 1992-93 which is taken to have been raised also under the proposed scheme of uniform Central VAT. The revenue figures shown in columns 2 and 3 are exclusive of non-rebatable special excise.

Table A2.2

Revenue Neutral VAT Rates for 15 Major States in India: An Illustration for 1992-93
(Threshold for VAT registration is Rs.5 lakh per annum)

States	Consumption expenditure on goods and services	consumption expenditure net of exemptions and inclusions under scenario:[2]			Taxes to be excluded from consumption[3] expenditure (ST+ADEILST)	Tax base[4] under the VAT with scenario:			Revenue being replace by VAT[5]	Revenue neutral VAT rates under scenario		
		S1 (10,60)	S2 (20,60)	S3 (10,50)		S1 (10,60) 90% of Col.(3-6)	S2 (20,60) 90% of Col.(4-6)	S3 (10,50) 90% of Col.(5-6)		S1 (10,60)	S2 (20,60)	S3 (10,50)
	(Rs.cr.)	(Rs.cr.)	(Rs.cr.)	(Rs.cr.)	(Rs.cr.)	(Rs.cr.)	(Rs.cr.)	(Rs.cr.)	(Rs.cr.)	(%)	(%)	(%)
1	2	3	4	5	6	7	8	9	10	11	12	13
Andhra Pradesh	41233	31756	31532	31705	1898	29858	29634	29807	2184	8.1	8.2	8.1
Gujarat[1]	20270	20394	19616	20220	1462	18932	18154	18758	1876	11.0	11.5	11.1
Maharashtra	53501	58611	55855	57993	4428	54183	51427	53565	5182	10.6	11.2	10.7
Rajasthan	29437	19488	19844	19568	989	18499	18855	18579	1055	6.3	6.2	6.3
Tamil Nadu	36574	33353	32045	33060	2672	30681	29373	30388	3035	11.0	11.5	11.1
Assam	9936	5119	5735	5257	290	4829	5445	4967	370	8.5	7.5	8.3
Bihar	41054	22283	24527	22786	913	21370	23614	21873	1217	6.3	5.7	6.2
Haryana	12664	11416	11471	11428	520	10895	10951	10908	767	7.8	7.8	7.8
Karnataka	24003	20800	20244	20675	1827	18973	18418	18849	2162	12.7	13.0	12.7
Kerala	19207	21076	21013	21061	1166	19909	19846	19895	1276	7.1	7.1	7.1
Madhya Pradesh	34409	23331	23698	23414	1028	22303	22669	22385	1248	6.2	6.1	6.2
Orissa	16045	8842	9702	9034	469	8373	9233	8566	587	7.8	7.1	7.6
Punjab	18184	16326	16019	16257	600	15726	15419	15657	817	5.8	5.9	5.8
Uttar Pradesh	74861	48695	50587	49119	2208	46487	48379	46912	2349	5.6	5.4	5.6
West Bengal	41521	32703	32396	32634	1664	31039	30732	30970	2079	7.4	7.5	7.5
15 States	472899	374696	374696	374696	22133	352562	352562	352562	26203	8.3	8.3	8.3
All States	506321	401068	401068	401068	26034	375034	375034	375034	26325	7.7	7.7	7.7

Notes:
1. Figures for Gujarat relate to 1991-92.
2. Scenarios:Under scenario S1,we assume that home-grown or exempted products together account for 10% of private final consumption expenditure in the most urbanised state-Maharastra and 60% in the least urbanised state-Assam.Briefly we write it as [10,60]. Thus scenario S2 refers to [20,60] and S3 to [10,50]. Among the other States, this ratio has been varied according to the degree of urbanisation.
3. Includes devolution of Addl.Excise Duties in lieu of Sales tax (ADEILST) and Sales tax other than CST.
4. Taxbase is reduced by 10% i.e. 90% of columns 7,8 & 9, in order to obtain revenue neutral rates on the conservative side.
5. Includes sales taxes (including CST) and ADEILST. The revenue figures relate to bugdet estimates except for Andhra Pradesh, Gujarat, Maharashtra, Rajasthan and Tamil Nadu for which revised estimates were used.

Table A2.3

Revenue Implications of the Proposed State VAT for Andhra Pradesh: 1992-93

(Rs.crore)

Description/Scenario	S1 (5,14,25)	S2 (4,12,20)	S3 (4,10,20)	S4 (4,9,20)	S5 (5,8,20)
A. Total revenue for the year	2184	2184	2184	2184	2184
i. General Sales Tax (GST)	1670	1670	1670	1670	1670
ii. Central Sales Tax (CST)	286	286	286	286	286
iii. Share in ADEILST	142	142	142	142	142
iv. Tax on diesel, petrol etc.	*	*	*	*	*
v. Purchase tax on sugarcane	86	86	86	86	86
B. Taxable local turnover (LT)	20616	20616	20616	20616	20616
C. Inputs in B (51/100 of B)	10514	10514	10514	10514	10514
D. Input tax in B(4% of C)	421	421	421	421	421
E. Taxable local turnover net of input tax (B-D)	20195	20195	20195	20195	20195
F. Base broadening due to withdrawal of exemptions, etc. (10% of E)	2020	2020	2020	2020	2020
G. Total taxable local turnover (E+F)	22215	22215	22215	22215	22215
H. Inter-state sales turnover (CST/0.04)	7150	7150	7150	7150	7150
I. Consignment transfers (same as H)**	7150	7150	7150	7150	7150
J. Input tax in H&I(4% of 51/100 times H&I)	292	292	292	292	292
K. Total turnover (G+H+I-J)	36223	36223	36223	36223	36223
L. Inputs qualifying for VAT rebate (21/100 times (K-25% of E))	6547	6547	6547	6547	6547
M. Plant & Machinery for VAT rebate.(100%)	497	497	497	497	497
N. Average rate of VAT (%): Turnover based	15.12	12.75	11.11	10.30	9.53
O. Tax on local turnover liable to VAT (GxN/100)	3358	2831	2469	2288	2116
P. Tax rebate on L&M,((L+M)*N)/100	1065	898	783	725	671
Q. Net revenue (O-P)	2293	1934	1686	1562	1445
R. VAT on sugar, textiles and tobacco***	750	628	558	523	494
S. Gain from capturing value added in multistage taxation (N times 15% of (1-51/100) of G)	247	208	181	168	156
T. Revenue loss due to raising of the threshold limit to Rs 3 lakh p.a.(1% of Q)	23	19	17	16	14
U. Total revenue under VAT (Q+R+S-T)	3267	2750	2409	2238	2081
V. Gain in revenue under the proposed State VAT (U-A)	1083	566	225	54	-103

Notes:
1. ADEILST: Additional duties of excise in lieu of sales tax.
   - * Included in A(i).
   - ** Assuming a ratio of 50:50 between inter-State sales and consignment transfers.
   - *** Consumption of sweeteners between sugar and khandsari and gur is taken as 65:35. This is computed on the basis of per capita consumption of sugar, khandsari and gur. Total consumption of tobacco products between those subjected to ADEILST and those subjected to sales tax is taken as 90:10. Total consumption of textiles between these bases is taken as 85:15. Further, the tax base under ADEILST is reduced by 5 per cent due to VAT threshold of Rs.3 lakh.
2. Turnover figures are inclusive of turnover relating to plant and machinery.

Table A2.4

Revenue Implications of the Proposed State VAT for Gujarat: 1991-92

(Rs crore)

Description/Scenario	S1 (5,14,25)	S2 (4,12,20)	S3 (5,14,30)	S4 (5,14,32)	S5 (4,15,20)
A. Total revenue for the year	1876	1876	1876	1876	1876
i. General Sales Tax (GST)	1354	1354	1354	1354	1354
ii. Central Sales Tax (CST)	414	414	414	414	414
iii. Share in ADEILST	108	108	108	108	108
iv. Tax on diesel, petrol etc.	*	*	*	*	*
v. Purchase tax on sugarcane	*	*	*	*	*
B. Taxable local turnover (LT)	15666	15666	15666	15666	15666
C. Inputs in B (51/100 of B)	7990	7990	7990	7990	7990
D. Input tax in B(4% of C)	320	320	320	320	320
E. Taxable local turnover net of input tax (B-D)	15346	15346	15346	15346	15346
F. Base broadening due to withdrawal of exemptions, etc. (10% of E)	1535	1535	1535	1535	1535
G. Total taxable local turnover (E+F)	16881	16881	16881	16881	16881
H. Inter-state sales turnover (CST/0.04)	10350	10350	10350	10350	10350
I. Consignment transfers (same as H)**	10350	10350	10350	10350	10350
J. Input tax in H&I(4% of 51/100 times H&I)	422	422	422	422	422
K. Total turnover (G+H+I-J)	37159	37159	37159	37159	37159
L. Inputs qualifying for VAT rebate (21/100 times (K-25% of E))	6998	6998	6998	6998	6998
M. Plant & Machinery for VAT rebate(100%)	417	417	417	417	417
N. Average rate of VAT (%): Turnover based	12.67	10.75	12.88	12.96	13.04
O. Tax on local turnover liable to VAT (GxN/100)	2140	1815	2174	2187	2201
P. Tax rebate on L&M((L+M))*N/100	940	797	955	961	967
Q. Net revenue (O-P)	1200	1018	1219	1226	1234
R. VAT on sugar, textiles and tobacco***	465	389	490	499.57	453
S. Gain from capturing value added in multistage taxation (N times 15% of (1-51/100) of G)	157	133	160	161	162
T. Revenue loss due to raising of the threshold limit to Rs 3 lakh p.a. (1% of Q)	12	10	12	12	12
U. Total revenue under VAT (Q+R+S-T)	1810	1530	1856	1875	1837
V. Gain in revenue under the proposed State VAT (U-A)	-66	-346	-20	-1	-39

Notes:

1. ADEILST: Additional duties of excise in lieu of sales tax.
   * Included in A(i).
   ** Assuming a ratio of 50:50 between inter-State sales and consignment transfers.
   *** Consumption of sweeteners between sugar and khandsari and gur is taken as 65:35. This is computed on the basis of per capita consumption of sugar, khandsari and gur. Total consumption of tobacco products between those subjected to ADEILST and those subjected to sales tax is taken as 90:10. Total consumption of textiles between these bases is taken as 85:15. Further, the tax base under ADEILST is reduced by 5 per cent due to VAT threshold of Rs.3 lakh.
2. Turnover figures are inclusive of turnover relating to plant & machinery.
3. Revenue from works contract in the year 1991-92 did not exceed Rs 3 crores.

Table A2.5

Revenue Implications of the Proposed State VAT for Maharashtra: 1992-93

(Rs crore)

Description/Scenario	S1 (5,14,25)	S2 (4,12,20)	S3 (4,11,20)	S4 (5,11,20)	S5 (4,11,23)
A. Total revenue for the year	5182	5182	5182	5182	5182
i. General Sales Tax (GST)	3564	3564	3564	3564	3564
ii. Central Sales Tax (CST)	754	754	754	754	754
iii. Share in ADEILST	218	218	218	218	218
iv. Tax on diesel, petrol etc.	598	598	598	598	598
v. Purchase tax on sugarcane	48	48	48	48	48
B. Taxable local turnover (LT)	48910	48910	48910	48910	48910
C. Inputs in B (51/100 of B)	24944	24944	24944	24944	24944
D. Input tax in B(4% of C)	998	998	998	998	998
E. Taxable local turnover net of input tax (B-D)	47912	47912	47912	47912	47912
F. Base broadening due to withdrawal of exemptions, etc. (10% of E)	4791	4791	4791	4791	4791
G. Total taxable local turnover (E+F)	52703	52703	52703	52703	52703
H. Inter-state sales turnover (CST/0.04)	18850	18850	18850	18850	18850
I. Consignment transfers (same as H)**	18850	18850	18850	18850	18850
J. Input tax in H & I(4% of 51/100 times H & I)	769	769	769	769	769
K. Total turnover (G+H+I-J)	89634	89634	89634	89634	89634
L. Inputs qualifying for VAT rebate (21/100 times (K-25% of E))	16308	16308	16308	16308	16308
M. Plant and Machinery for VAT rebate.(100%)	479	479	479	479	479
N. Average rate of VAT (%): Turnover based	14.55	12.36	11.46	11.49	11.69
O. Tax on local turnover liable to VAT (GxN/100)	7669	6512	6041	6057	6160
P. Tax rebate on L&M,((L+M)*N)/100	2443	2074	1924	1929	1962
Q. Net revenue (O-P)	5226	4438	4117	4128	4198
R. VAT on sugar, textiles and tobacco***	693	580	548	560	569
S. Gain from capturing value added in multistage taxation (N times 15% of (1-51/100) of G)	564	479	444	445	453
T. Revenue loss due to raising of the threshold limit to Rs 3 lakh p.a. (1% of Q)	52	44	41	41	42
U. Total revenue under VAT (Q+R+S-T)	6431	5453	5068	5092	5178
V. Gain in revenue under the proposed State VAT (U-A)	1249	271	-114	-90	-4

Notes:

1. ADEILST: Additional duties of excise in lieu of sales tax.
   * Included in A(i).
   ** Assuming a ratio of 50:50 between inter-State sales and consignment transfers.
   *** Consumption of sweeteners between sugar and khandsari and gur is taken as 65:35. This is computed on the basis of per capita consumption of sugar, khandsari and gur. Total consumption of tobacco products between those subjected to ADEILST and those subjected to sales tax is taken as 90:10. Total consumption of textiles between these bases is taken as 85:15. Further, the tax base under ADEILST is reduced by 5 per cent due to VAT threshold of Rs.3 lakh.
2. Turnover figures are inclusive of turnover relating to plant & machinery.
3. Taxable turnover relating to plant & machinery is assumed to be 1% of taxable turnover.

Table A2.6

Revenue Implications of the Proposed State VAT for Rajasthan: 1992-93

(Rs.crore)

Description/Scenario	S1 (5,14,25)	S2 (4,12,20)	S3 (4,10,20)	S4 (4,8,20)
A. Total revenue for the year	1055	1055	1055	1055
i. General Sales Tax (GST)	860	860	860	860
ii. Central Sales Tax (CST)	66	66	66	66
iii. Share in ADEILST	129	129	129	129
iv. Tax on diesel, petrol etc.	*	*	*	*
v. Purchase tax on sugarcane	*	*	*	*
B. Taxable local turnover (LT)	7905	7905	7905	7905
C. Inputs in B (51/100 of B)	4032	4032	4032	4032
D. Input tax in B(4% of C)	161	161	161	161
E. Taxable local turnover net of input tax (B-D)	7744	7744	7744	7744
F. Base broadening due to withdrawal of exemptions, etc. (10% of E)	774	774	774	774
G. Total taxable local turnover (E+F)	8518	8518	8518	8518
H. Inter-state sales turnover (CST/0.04)	1650	1650	1650	1650
I. Consignment transfers (same as H)**	1650	1650	1650	1650
J. Input tax in H&I(4% of 51/100 times H&I)	67	67	67	67
K. Total turnover (G+H+I-J)	11751	11751	11751	11751
L. Inputs qualifying for VAT rebate (21/100 times (K-25% of E))	2061	2061	2061	2061
M. Plant & Machinery for VAT rebate(100%)	256	256	256	256
N. Average rate of VAT (%): Turnover based	16.20	13.52	12.12	10.72
O. Tax on local turnover liable to VAT (GxN/100)	1380	1152	1032	913
P. Tax rebate on L&M,((L+M)*N)/100	375	313	281	248
Q. Net revenue (O-P)	1005	838	752	665
R. VAT on sugar, textiles and tobacco***	516	432	385	337
S. Gain from capturing value added in multistage taxation (N times 15% of (1-51/100) of G)	101	85	76	67
T. Revenue loss due to raising of the threshold limit to Rs 3 lakh p.a. (1% of Q)	10	8	8	7
U. Total revenue under VAT (Q+R+S-T)	1612	1347	1205	1063
V. Gain in revenue under the proposed State VAT (U-A)	557	291	149	7

Notes:

1. ADEILST: Additional duties of excise in lieu of sales tax.
   - * Included in A(i).
   - ** Assuming a ratio of 50:50 between inter-State sales and consignment transfers.
   - *** Consumption of sweeteners between sugar and khandsari and gur is taken as 65:35. This is computed on the basis of per capita consumption of sugar, khandsari and gur. Total consumption of tobacco products between those subjected to ADEILST and those subjected to sales tax is taken as 90:10. Total consumption of textiles between these bases is taken as 85:15. Further, the tax base under ADEILST is reduced by 5 per cent due to VAT threshold of Rs.3 lakh.
2. Turnover figures are inclusive of turnover relating to taxable plant and machinery. In case of many industries,purchases of plant and machinery are exempt.

Table A2.7

Revenue Implications of the Proposed State VAT for Tamil Nadu: 1992-93

(Rs crore)

Description/Scenario	S1 (5,14,25)	S2 (4,12,20)	S3 (4,13,20)	S4 (4,13,25)	S5 (4,14,20)
A. Total revenue for the year	3035	3035	3035	3035	3035
i. General Sales Tax (GST)	2507	2507	2507	2507	2507
ii. Central Sales Tax (CST)	363	363	363	363	363
iii. Share in ADEILST	165	165	165	165	165
iv. Tax on diesel, petrol etc.	*	*	*	*	*
v. Purchase tax on sugarcane	*	*	*	*	*
B. Taxable local turnover (LT)	24409	24409	24409	24409	24409
C. Inputs in B (51/100 of B)	12449	12449	12449	12449	12449
D. Input tax in B(4% of C)	498	498	498	498	498
E. Taxable local turnover net of input tax (B-D)	23911	23911	23911	23911	23911
F. Base broadening due to withdrawal of exemptions, etc. (10% of E)	2391	2391	2391	2391	2391
G. Total taxable local turnover (E+F)	26302	26302	26302	26302	26302
H. Inter-state sales turnover (CST/0.04)	9075	9075	9075	9075	9075
I. Consignment transfers (same as H)**	9075	9075	9075	9075	9075
J. input tax in H&I(4% of 51/100 times H&I)	370	370	370	370	370
K. Total turnover (G+H+I-J)	44082	44082	44082	44082	44082
L. Inputs qualifying for VAT rebate (21/100 times (K-25% of E))	8002	8002	8002	8002	8002
M. Plant and machinery for VAT rebate(100%)	239	239	239	239	239
N. Average rate of VAT (%): Turnover based	14.19	11.87	12.50	13.18	13.14
O. Tax on local turnover liable to VAT (GxN/100)	3733	3121	3289	3466	3457
P. Tax rebate on L&M,((L+M)*N)/100	1170	978	1030	1086	1083
Q. Net revenue (O-P)	2563	2143	2258	2380	2374
R. VAT on sugar, textiles and tobacco***	454	380	401	428	422
S. Gain from capturing value added in multistage taxation (N times 15% of (1-51/100) of G)	274	229	242	255	254
T. Revenue loss due to raising of the threshold limit to Rs 3 lakh p.a. (1% of Q)	26	21	23	24	24
U. Total revenue under VAT (Q+R+S-T)	3266	2731	2879	3039	3026
V. Gain in revenue under the proposed State VAT (U-A)	231	-304	-156	4	-9

Notes:

1. ADEILST: Additional duties of excise in lieu of sales tax.
   - * Included in A(i).
   - ** Assuming a ratio of 50:50 between inter-State sales and consignment transfers.
   - *** Consumption of sweeteners between sugar and khandsari and gur is taken as 65:35. This is computed on the basis of per capita consumption of sugar, khandsari and gur. Total consumption of tobacco products between those subjected to ADEILST and those subjected to sales tax is taken as 90:10. Total consumption of textiles between these bases is taken as 85:15. Further, the tax base under ADEILST is reduced by 5 per cent due to VAT threshold of Rs.3 lakh.
2. Turnover figures relating to Tamil Nadu are inclusive of turnover relating to plant and machinery.
3. Taxable Turnover relating to plant and machinery is assumed to be 1% of taxable turnover.
4. Average rates based on turnover are taken to be 15% higher than those based on consumption.

Table A2.8

Estimate of Revenue under the Current Systems and with Alternative VAT Rate Regimes Based on Tax Turnover Data

State	Revenue under the current system of sales tax	VAT rate regime			
		Revenue with no administrative improvement and with VAT rate regime		Revenue with administrative improvement and with VAT rate regime	
		(5,14,25)	(4,12,20)	(5,14,25)	(4,12,20)
(1)	(2)	(3)	(4)	(5)	(6)
Andhra Pradesh	2184	3267	2750	3529	2971
Gujarat	1876	1810	1530	1977	1671
Maharashtra	5182	6431	5453	7027	5959
Rajasthan	1055	1612	1347	1720	1436
Tamil Nadu	3055	3266	2731	3556	2973

Notes: 1. A VAT rate regime (t_1, t_2, t_3) represents VAT rates applicable to low rated, standard rated and high rated goods respectively.
2. The figures relate to the year 1992-93 excepting Gujarat for which the reference year is 1991-92.

Table A2.9

Estimate of Revenue Neutral VAT Rates for Selected States (Based on Tax Turnover Data)

State	With no administrative improvement		With no administrative improvement	
	Tax rate regime	Average rate	Tax rate regime	Average rate
(1)	(2)	(3)	(4)	(5)
Andhra Pradesh	(4,9,20)	10.3	(4,8,20)	9.5
			(4,7,24)	9.2
Gujarat	(5,14,32)	13.0	(5,13,26)	12.0
			(4,14,20)	12.3
Maharashtra	(4,11,23)	11.7	(4,10,22)	10.7
	(4,12,20)	12.4		
Rajasthan	(4,8,20)	10.7	(4,7,20)	10.0
Tamil Nadu	(4,14,20)	13.1	(4,12,22)	12.1
	(4,13,25)	13.2		

Notes: 1. Figures in brackets give VAT rates for low rated, standard rated and high rated goods respectively.
2. Ratios used are input-output ratio of taxable sectors (51%) purchase of inputs from taxable sectors to total inputs (68%) and local purchase of inputs to total inputs (60%).
3. Revenue neutral VAT rates are obtained with reference to the year 1992-93 except for Gujarat for which the reference year is 1991-92.

Table A2.10

Sensitivity Analysis of Revenue Neutral VAT Rates for Selected States (Based on Tax Turnover Data)

(Per cent)

State	With estimated ratios (Rebate factor:21/100)		With one of the two ratios higher by 10% (Rebate factor: 23/100)		With both the ratios higher by 10% (Rebate factor:25/100)	
	Tax rate regime	Average rate	Tax rate regime	Average rate	Tx rate regime	Average rate
(1)	(2)	(3)	(4)	(5)	(6)	(7)
Andhra Pradesh	(4,9,20)	10.3	(4,9,20)	10.3	(4,9,23)	10.7
					(5,9,22)	10.6
Gujarat	(5,14,32)	13.0	(5,14,40)	13.3	(5,14,52)	13.8
			(5,15,30)	13.6	(5,15,42)	14.1
Maharashtra	(4,11,23)	11.7	(4,11,28)	12.1	(4,12,23)	12.6
	(4,12,20)	12.4	(4,12,20)	12.4	(4,11,34)	12.5
Rajasthan	(4,8,20)	10.7	(4,8,20)	10.7	(4,8,22)	11.2
					(5,8,21)	11.0
Tamil Nadu	(4,14,20)	13.1	(5,14,20)	13.5	(5,14,25)	14.2
	(4,13,25)	13.2	(5,13,25)	13.6		

Notes:
1. Figures in brackets give VAT rates for low rated, standard rated and high rated goods respectively.
2. Various ratios used are input-output ratio of taxable sectors (51%), purchase of inputs from taxable sectors to total inputs (68%), and local purchase of inputs to total inputs (60%). Sensitivity analysis is carried out by varying the last two ratios.
3. Factor x/100 gives proportion of rebatable inputs in taxable turnover.
4. Revenue neutral VAT rates are obtained with reference to the year 1992-93 except for Gujarat for which the reference year is 1991-92.

STATISTICAL TABLES

Table A3.1

Share of Direct and Indirect Taxes in Total Tax Revenue of Centre, States and Union Territories

(per cent)

	Taxes/Years	1950-51	1955-56	1960-65	1965-70	1970-75	1975-80	1980-85	1985-90	1991-92 (RE)
	Direct Taxes of which	**36.79**	**33.75**	**29.45**	**23.30**	**20.81**	**19.87**	**16.11**	**14.09**	**15.84**
1.1	Corporation Tax	6.28	4.76	10.81	9.18	8.10	8.17	7.57	6.34	7.12
1.2	Taxes on Income	21.37	17.20	10.91	9.79	9.76	8.66	6.05	6.03	6.62
1.3	Land Revenue	8.23	10.28	6.19	3.25	1.95	1.44	0.85	0.83	0.55
1.4	Wealth Tax	0.00	0.00	0.50	0.34	0.45	0.41	0.32	0.26	0.25
1.5	Agriculture I.Tax	0.57	1.00	0.53	0.32	0.19	0.37	0.18	0.17	0.20
1.6	Gift Tax	0.00	0.00	0.06	0.05	0.06	0.04	0.03	0.02	0.01
1.7	Estate Duty	0.00	0.23	0.22	0.19	0.15	0.09	0.08	0.02	0.00
1.8	Others	0.35	0.29	0.22	0.17	0.14	0.69	1.03	0.43	1.09
	Indirect Taxes of which	**63.21**	**66.25**	**70.55**	**76.70**	**79.19**	**80.13**	**83.89**	**85.91**	**84.16**
2.1	Union Excise Duties	10.78	18.92	31.38	33.42	36.07	34.15	31.33	29.00	27.03
2.2	Customs	25.08	21.72	13.85	14.64	12.95	14.24	18.23	23.21	22.34
2.3	Sales Taxes	9.63	11.11	12.55	15.26	16.37	18.79	20.79	20.38	21.38
2.4	State Excise Duties	7.95	5.88	3.62	3.95	4.50	4.22	5.08	5.13	5.47
2.5	Stamp & Registration Fees	4.43	4.01	3.21	3.01	2.55	2.19	2.14	2.22	2.51
2.6	Taxes on Vehicles	1.24	1.96	2.34	2.20	2.13	1.99	2.01	1.97	1.81
2.7	Electricity Duties	0.50	0.76	1.08	1.36	1.22	1.11	1.17	1.48	1.46
2.8	Tax on Passengers and goods	0.02	0.46	0.78	1.23	1.45	1.65	1.52	1.30	1.12
2.9	Others	3.57	1.42	1.75	1.63	1.95	1.78	1.63	1.22	1.04
	Total	**100.00**	**100.00**	**100.00**	**100.00**	**100.00**	**100.00**	**100.00**	**100.00**	**100.00**

Source: *Indian Public Finance Statistics* (various issues), Government of India, Ministry of Finance.

Table A3.2a

Share of Direct and Indirect Taxes in Own Tax Revenue of States and Union Territories

(per cent)

	Taxes	1950-51	1960-65	1965-70	1970-75	1975-80	1980-85	1985-90	1991-92 (RE)
	Direct Taxes of which	**24.96**	**21.58**	**11.72**	**7.09**	**6.24**	**4.01**	**4.14**	**3.50**
1.1	Land Revenue	22.36	19.35	10.17	6.14	4.25	2.48	2.48	1.60
1.2	Agricultural I.Tax	1.62	1.64	1.02	0.59	1.16	0.53	0.45	0.58
1.3	Others	0.98	0.60	0.53	0.36	0.84	1.01	1.20	1.33
	Indirect Taxes of which	**75.04**	**78.42**	**88.28**	**92.91**	**93.76**	**95.99**	**95.86**	**96.50**
2.1	State Excise Duties	21.56	11.16	12.38	14.11	12.44	14.19	14.49	15.23
2.2	Taxes on Vehicles	3.40	7.33	6.89	6.60	6.05	5.75	5.71	5.15
2.3	Sales Taxes	27.15	39.46	47.15	50.93	55.64	58.05	58.05	59.50
2.4	Entertainment Tax	3.64	3.38	3.83	4.00	3.81	3.09	1.98	1.32
2.5	Stamp & Registration Duties	11.72	9.44	8.97	7.58	6.35	6.04	6.52	7.13
2.6	Tax on Passengers and Goods	0.05	2.70	3.91	4.71	4.79	4.20	3.69	3.14
2.7	Electricity Duties	1.41	3.59	4.34	3.81	3.43	3.41	4.36	3.94
2.8	Others	6.12	1.35	0.81	1.17	1.24	1.25	1.05	1.10
	Total	**100.00**	**100.00**	**100.00**	**100.00**	**100.00**	**100.00**	**100.00**	**100.00**

Source: *Indian Public Finance Statistics* (various issues), Government of India, Ministry of Finance.

Table A3.2b

Statewise Population, SDP and Revenue from General Sales Tax & Central Sales Tax

Sl. No.	States	Population (Rs. crore)	SDP@ (Rs. crore)	General Sales Tax (Rs.crore) 1988-89	1989-90	1990-91	Central Sales Tax (Rs.crore) 1988-89	1989-90	1990-91
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
	High Income States								
1.	Maharashtra	7.89	55439	1919.31	2203.95	2552.57	467.30	541.32	621.85
2.	Gujarat	4.13	24665	989.84	1259.39	1430.22	304.78	275.18	309.76
3.	Haryana	1.65	11317	234.52	265.64	316.96	136.04	149.54	177.74
4.	Punjab	2.03	17101	360.92	411.87	416.73	112.82	125.31	152.99
	Sub Total	15.70	108522	3504.59	4140.85	4716.48	1020.94	1091.35	1262.34
	Middle Income States								
5.	Andhra Pradesh	6.65	30112	1045.56	1145.73	1198.73	61.14	91.70	226.78
6.	Karnataka	4.50	21328	819.51	890.82	1088.32	167.73	190.39	228.60
7.	Kerala	2.91	11499	638.16	702.81	800.77	52.25	65.93	96.67
8.	West Bengal	6.81	31618	768.36	845.16	979.63	190.98	222.48	246.97
9.	Tamil Nadu	5.59	24841	1201.77	1419.04	1787.86	212.59	235.94	278.08
	Sub Total	26.45	119398	4473.36	5003.56	5855.31	684.69	806.44	1077.10
	Low Income States								
10.	Bihar	8.64	21789	580.87	469.05	585.24	0.81	174.80	215.16
11.	Madhya Pradesh	6.62	23043	468.65	552.21	600.22	146.25	168.18	198.45
12.	Orissa	3.17	9929	226.60	285.34	336.64	11.74	11.87	17.94
13.	Uttar Pradesh	13.91	48077	993.88	1243.34	1560.39	96.34	94.05	119.98
14.	Rajasthan	4.40	17578	514.52	556.21	616.79	25.74	36.19	37.17
	Sub Total	36.73	120416	2784.52	3106.15	3699.28	280.88	485.09	588.70
	Special Category States								
15.	Arunahal Pradesh	0.09	420	1.14	0.31	0.32	0.00	0.00	0.00
16.	Assam	2.24	8492	192.94	168.86	243.49	0.00	62.45	69.05
17.	Himachal Pradesh	0.52	2441	39.55	46.07	55.20	5.31	6.52	6.91
18.	Jammu & Kashmir	0.77	NA	48.45	50.95	46.73	0.00	0.00	0.00
19.	Manipur	0.18	694	9.61	4.47	8.90	0.00	0.00	0.00
20.	Meghalaya	0.18	598	11.55	7.60	8.07	5.99	7.42	9.39
21.	Nagaland	0.12	404	8.68	9.08	13.00	0.00	0.00	0.00
22.	Sikkim	0.04	NA	0.00	2.72	3.08	2.37	0.00	0.00
23.	Tripura	0.28	NA	10.24	11.32	13.34	0.00	0.00	0.00
24.	Goa	0.12	955	38.67	44.51	53.43	3.46	4.27	5.28
25.	Mizoram	0.07	NA	0.09	0.12	0.68	0.00	0.00	0.00
	Sub Total	4.60	14004	360.92	346.01	446.24	17.13	80.66	90.63
	Total (25 States)	83.49	362340	11123.39	12596.57	14717.31	2003.64	2463.54	3018.77

Sources: 1. RBI Bulletin,(various issues)
2. Indian Public Finance Statistics,1992.
3. Census of India,1991.

Notes : 1. Classification of the States is as per the Ninth Finance Commission Report.
2. @ : Quick Estimates of SDP at Current Prices for the year 1990-91.
NA : not available
SDP : State Domestic Product.

Table A3.3

Commodity-wise Rates of Sales Tax in the States

(Per cent)

	Commodity	Andhra Pradesh	Bihar	Goa	Gujarat	Haryana	Kerala	Karnataka	Manipur	Madhya Pradesh	Maharastra	Orissa	Punjab	Rajasthan	Tamil Nadu	Uttar Pradesh	West Bengal
	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17
1.	**CEREALS AND PULSES**																
1.1	Cereals and Pulses	4FP	4	E	E	4LP	1/4FP	3F	PE	2FP	E	4FP	2FP	4FP	3FP	3.5/4FP	E
1.2	Paddy	4FP	3	E	E	4LP	1FP	3F	PE	4LP	E	4PT	4FP	4FP	EFP	4FP	E
1.3	Atta, Maida and Suji	2FP	4	E	E	4LP	4FP	E	E	3FP	E	4FP	4FP	4FP	3FP	4FP	E
2.	**OTHER FOOD ARTICLES**																
2.1	Edible oils	4FP	9	1FP	4FP	6LP	8FP	4/3FP	7FP	3FP	1.5FP	4FP	8FP	6FP	3FP	2FP	1MP
2.2	Vanaspati ghee	6FP	9	1FP	7FP	8FP	8FP	4FP	7FP	6FP	2.75FP	8FP	8FP	6FP	5FP	6FP	8FP
2.3	Ghee (pure)	6FP	8	E	12FP	8FP	8FP	13FP	7FP	6FP	6FP	12FP	8FP	6FP	5FP	6FP	8MP
2.4	Potatoes and Onions	E	5	E	E	E	E	E	E	E	E	E	E	E	E	E	E
2.5	Fresh Fruits	E	E	E	E	E	E	E	E	E	E	E	E	E	E	E	E
2.6	Meat and Fish in Containers	9FP	8	7FP	E	8FP	E	12FP	E	8FP	2FP	12FP	8FP	12FP	E	8FP	15FP
2.7	Eggs	E	E	E	E	E	E	E	E	E	E	E	E	2FP	E	E	E
2.8	Khandsari	E	8	E	E	E	E	4FP	E	E	E	4LP	E	E	3FP	2FP	E
2.9	Salt (in Containers)	E	E	E	E	E	E	E	E	E	E	E	E	E	E	E	E
2.10	Gur (Jaggery)	7FP	E	E	E	4FP	6FP	3FP	E	2FP	E	4FP	4FP	6FP	E	8FP	8FP
2.11	Tea Leaves	6FP	9	2FP	12FP	4FP	7FP	3/8FP	7FP	10FP	6FP	12FP	3FP	10FP	E	8FP	4MP
2.12	Coffee Powder	6FP	9	2FP	12FP	8LP	8FP	13FP	10FP	10FP	6FP	12FP	3FP	10FP	5FP	8FP	15FP
2.13	Pepper	5FP	9	7FP	6FP	8LP	5LP	6FP	7FP	8FP	6FP	8FP	8FP	10FP	3FP	4FP	11FP
2.14	Other Spices	5FP	9	7FP	6FP	8LP	8FP	6FP	7FP	8FP	6FP	12FP	8FP	6	5FP	8FP	8FP
2.15	Curd, Lassi and Buttermilk	E	E	E/3/6/15LP	E	E	6FP	E	E	E	E	12FP	E	E	E	4/5LP	E

Contd

Table A3.3 (Contd.)

(Per cent)

Commodity	Andhra Pradesh	Bihar	Goa	Guja-rat	Haryana	Kerala	Karna-taka	Manipur	Madhya Pradesh	Mahar-astra	Orissa	Punjab	Rajas-than	Tamil Nadu	Uttar Pradesh	West Bengal
1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17
2.16 Cooked Food and Sweets	5FP	6	E/3/6/15LP	13/8FP	8FP	6FP	5FP	7FP	3FP	E/2FP	4FP	E	6FP	5FP	5LP	8MP
2.17 Milk Food and Powder	4FP	8	E/2FP	5FP	8FP	10FP	4FP	7FP	8FP	6FP	12FP	4FP	6FP	12FP	-	8MP
3. BOOKS AND STATIONERY																
3.1 Students' Exercise Books	E	6	E	E	E	E	E	E	5FP	E	E	E	E	E	6FP	E
3.2 Writing and Other Papers	7FP	6	7FP	10FP	8FP	E	4FP	4FP	5FP	6FP	8FP	8FP	6FP	5FP	6/10FP	E
3.3 Other Stationery	6FP	E/6	7FP	12FP	6LP	E	8FP	4FP	6FP	10FP	12/16LP	8FP	E	8FP	8FP	E
3.4 Instrument Boxes	6FP	8	E	E	6LP	E	E	E	6FP	4FP	12FP	8FP	E	8FP	E	E
3.5 Books and Maps	E	8	E	E	E	E	E	E	E/6FP	E	E	8FP	E	E	E	E
4. DOMESTIC FUEL ITEMS																
4.1 Firewood	3FP	7	E	E	8LP	8FP	6FP	6FP	3FP	E	E	E	4FP	E	4FP	8MP
4.2 Coal and Coke	4FP	4	4LP	4FP	4FP	4FP	4FP	4FP	4FP	4FP	4FP	4LP	10FP	3FP	4FP	4MP
4.3 Kerosene	4FP	6	E	3.6FP	8 -	5FP	8FP	3FP	3FP	E	E	8LP	10FP	3FP	8FP	E
4.4 Kerosene Superior	4FP	6	-	8FP	8 -	5FP	8FP	3FP	3FP	4FP	-	8FP	10FP	4FP	8FP	E
4.5 Kerosene Inferior	4FP	6	-	-	8 -	5FP	8FP	3FP	3FP	4FP	E	8FP	10FP	4FP	8FP	E
4.6 Cooking Gas	10FP	9	E	17FP	8FP	20FP	6FP	7FP	16FP	10FP	12FP	8F	10FP	12FP	8FP	15FP
4.7 Charcoal	3FP	E	E	E	4LP	5FP	6FP	7FP	3FP	E	E	4FP	10FP	3FP	8FP	4MP
4.8 Furance Oil	4FP	8	17Fr	12FP	8FP	10FP	13FP	7FP	8FP	10FP	12FP	8FP	10FP	12FP	5FP	8FP
4.9 Candles	6FP	7	7FP	E	8FP	E	E	7FP	12FP	10FP	12LP	8FP	E	8FP	8FP	E
4.10 Match Boxes	3FP	9	E	E	4FP	5FP	8FP	4FP	3FP	2FP	E	8FP	6FP	5FP	8FP	7FP
5. TOILET ARTICLES																
5.1 Tooth Paste/Powder	10FP	8	7FP	15FP	8FP	10FP	15FP	7FP	12FP	8FP	12FP	8LP	12FP	12FP	12FP	8FP
5.2 Washing Soaps	5FP	8	7FP	7FP	10FP	8FP	10FP	7FP	12FP	6FP	12FP	8LP	12FP	12FP	8FP	8FP

Contd.

Table A3.3 (Contd.)

(Per cent)

Commodity	Andhra Pradesh	Bihar	Goa	Gujarat	Haryana	Kerala	Karnataka	Manipur	Madhya Pradesh	Maharastra	Orissa	Punjab	Rajasthan	Tamil Nadu	Uttar Pradesh	West Bengal
1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17
5.3 Toilet Soaps	8FP	8	7FP	10FP	10FP	8FP	13FP	7FP	12FP	6FP	12FP	8LP	12FP	16FP	12FP	8FP
5.4 Hair Oils	10FP	8	7FP	16FP	10FP	20FP	15FP	7FP	12FP	4FP	16FP	8LP	12FP	16FP	12FP	8FP
5.5 Razors and Razor Blades	7FP	8	7FP	15FP	10FP	8FP	8FP	7FP	12FP	8FP	12FP	8LP	6/8FP	16FP	6/8FP	11FP
5.6 Other Shaving Products	10FP	8	7FP	11FP	10FP	15FP	15FP	7FP	12FP	15FP	16FP	8LP	12FP	16FP	12FP	11FP
5.7 Cosmetics	10FP	15	12FP	15FP	10FP	20FP	15FP	15FP	16FP	15FP	16FP	12LP	12FP	16FP	12FP	15FP
5.8 Boot-polish	6FP	8	7FP	14FP	10FP	8FP	15FP	7FP	12FP	6FP	16FP	8LP	10FP	8FP	12FP	11FP
5.9 Tooth Brushes	10FP	8	7FP	11FP	10FP	10FP	8FP	7FP	12FP	8FP	12FP	8LP	10FP	12FP	8FP	8FP
6. MEDICINES	8FP	7	3FP	7FP	8FP	8FP	10FP	6FP	6FP	4FP	4FP	8FP	6FP	5FP	6FP	4FP
7. GARMENTS AND FOOTWEAR																
7.1 Cotton Hoisery Products	2FP	5	E	1/5FP	4FP	6FP	E	4FP	3FP	2FP	4LP	4LP	4FP	3FP	4FP	E
7.2 Readymade Garments	2FP	7	1FP	5FP	4FP	6FP	5FP	10FP	3FP	4FP	4LP	2LP	4FP	5FP	4FP	2MP
7.3 Footwear	8FP	8	7/EFP	13FP	8FP	10FP	8/10FP	12FP	10FP	8/12/15FP	12LP	8LP	10FP	8FP	6LP	4/8/11MP
8. CYCLE AND ACCESSORIES	2FP	8	E/7LP	7FP	8FP	5FP	3FP	7FP	8FP	4FP	4FP	5FP	3FP	8FP	3MP	
9. REFRESHMENT ARTICLES																
9.1 Bread	6FP	4	E	E	E	E	2FP	E	E	E	E	8FP	E	5FP	5LP	E
9.2 Cakes and Pastries	9FP	8	E	12FP	8FP	6FP	13FP	7FP	12FP	E	12FP	8FP	10FP	12FP	5LP	8MP
9.3 Toffees and Chocolates	8FP	8	7FP	14FP	8FP	10FP	13FP	7FP	12FP	8FP	12FP	8FP	10FP	12FP	8FP	15FP
9.4 Aerated Water	7FP	8	7FP	14FP	8FP	12.5FP	13FP	15FP	12FP	12FP	12FP	12FP	15FP	8FP	8FP	15FP
9.5 Country Liquor	E	E	7FP	54FP	E	50+12.5DP	50FP	-	E	E	E	E	E		E	E

(Contd.)

Table A3.3 (Contd.)

(Per cent)

	Commodity	Andhra Pradesh	Bihar	Goa	Guja-rat	Haryana	Kerala	Karna-taka	Manipur	Madhya Pradesh	Mahar-astra	Orissa	Punjab	Rajas-than	Tamil Nadu	Uttar Pradesh	West Bengal
	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17
9.6	Foreign Liquor	25FP	25	17FP	12FP	20FP	100FP	50FP	30FP	E	25FP	4LP	12FP	25FP	50FP	26FP	11MP
9.7	Indian made Foreign Liquor	25FP	25	17FP	12FP	20FP	75FP	45+5DP	30FP	E	E	4LP	12FP	E	25FP	26FP	11MP
9.8	Bhang	-	E	7LP	18FP	E	8FP	150FP	-	E	15FP	E	E	36FP	8FP	E	E
9.9	Ganja	10FP	E	7LP	18FP	E	75FP	150FP	-	E	15FP	E	E	36FP	8FP	E	E
9.10	Opium	10FP	E	7LP	18FP	E	75FP	150FP	-	E	15FP	E	E	36FP	8FP	E	E
9.11	Ice	6FP	7	E	14FP	8FP	6FP	8FP	7FP	12FP	4FP	12FP	8FP	10FP	5FP	8FP	8FP
9.12	Biscuits	7FP	9	7FP	12FP	8FP	10FP	10FP	7FP	12FP	8FP	12FP	8FP	10FP	12FP	5FP	11FP
10.	**CONSUMER DURABLES INCLUDING GOLD AND SILVER**																
10.1	Gold and Silver and their Coins	2FP	2	7LP	1FP	2LP	10FP	2FP	15FP	2FP	2FP	4FP	2FP	1FP	1FP	8FP	1MP
10.2	Bullion and Spieces	2FP	2	7LP	0.5FP	0.5LP	1FP	2FP	15FP	2FP	1FP	4FP	4FP	1FP	1FP	2FP	8MP
10.3	Articles of Gold and Silver	2FP	4	3LP	1FP	2LP	4FP	2FP	15FP	1FP	1FP	4FP	4FP	2.5FP	3FP	4LP	3/8/11MP
10.4	Ivory Products	8FP	13	12FP	19FP	8LP	12.5FP	10FP	15FP	6FP	8FP	16FP	8FP	10FP	12FP	8FP	8MP
10.5	Marble and its Products	10FP	13	10FP	14FP	8LP	12.5FP	15FP	15FP	16FP	10FP	16FP	8FP	15FP	16FP	8FP	20FP
10.6	Synthetic Gems and their Stones	7FP	10	7LP	12FP	8LP	12.5FP	8FP	15FP	12FP	12FP	16LP	8FP	E	12FP	10FP	11MP
10.7	Gold and Embroidery Work	-	8	7LP	14FP	2LP	5FP	8FP	15FP	6FP	6FP	16FP	8FP	E	3FP	-	3MP
10.8	Articles of Stainless Steel	6FP	11	7LP	7FP	3FP	12.5FP	4MP	12FP	12FP	12FP	12FP	12FP	15FP	5FP	8/12FP	8MP
10.9	Ladies Hand-bags	7FP	10	10FP	14FP	8LP	8FP	13/8FP	12FP	12FP	E	16LP	8FP	10FP	8FP	-	15MP

(Contd.)

Table A3.3 (Contd.)

(Per cent)

Commodity	Andhra Pradesh	Bihar	Goa	Gujarat	Haryana	Kerala	Karnataka	Manipur	Madhya Pradesh	Maharastra	Orissa	Punjab	Rajasthan	Tamil Nadu	Uttar Pradesh	West Bengal
1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17
10.10 All kinds of Leather Goods	7FP	8	12FP	14FP	10LP	10FP	13FP	10FP	12FP	E	12LP	12FP	10FP	8FP	8FP	15MP
10.11 Suit Cases and Attache Cases	6FP	10	7FP	15FP	8LP	10+1DP	15FP	7FP	12FP	E	12LP	8FP	10FP	8FP	8FP	8MP
10.12 All kinds of Stoves	7FP	8	7/ELP	8FP	8LP	1FP	10FP	7FP	10FP	10FP	12FP	8FP	E/10FP	8FP	8FP	8MP
10.13 Incandescent Lanterns and Lamps	-	9	7LP	11FP	8LP	8FP	10+3DP	7FP	12FP	10FP	16FP	8FP	15FP	E	8FP	8FP
10.14 Domestic Electrical Appliances	10FP	12	10FP	15FP	10FP	12.5FP	12FP	12FP	12FP	10FP	12FP	12FP	15FP	12FP	8FP	11FP
10.15 Clocks and Time Pieces	10FP	13	10FP	12FP	10FP	8FP	12FP	12FP	12FP	20/10FP	16FP	12FP	12FP	3FP	12FP	11MP
10.16 Refrigerators and Air-conditioners	10FP	16	6FP	17FP	10FP	12VA	15FP	15FP	16FP	12FP	12/16FP	12FP	12FP	16FP	12FP	20/15FP/MP
10.17 Wooden Furniture	5FP	12	7LP	7FP	8LP	12.5FP	12FP	10FP	10FP	15FP	16LP	12FP	12FP	8FP	12FP	8MP
10.18 Steel Safes and Almirahs	10FP	13	10FP	7FP	10LP	12.5FP	15FP	10FP	14FP	15FP	16FP	12FP	10FP	8FP	12FP	15FP
10.19 Other Steels Furniture	10FP	13	10FP	7FP	10LP	12.5FP	12FP	10FP	14FP	15FP	16FP	12FP	10FP	8FP	12FP	11FP
10.20 Aluminium Furniture	6FP	10	7LP	7FP	10LP	12.5FP	12FP	10FP	12FP	15FP	16FP	12FP	10FP	8FP	12FP	15FP
10.21 Wireless Reception Instruments	10FP	10	12FP	4FP	10LP	20FP	15FP	12FP	16FP	15FP	16FP	12FP	12FP	3FP	12FP	11MP
10.22 Sound Transmitting Equipments	10FP	10	12FP	15FP	10LP	20FP	20FP	12LP	16FP	15FP	16FP	12FP	12FP	3FP	12FP	11MP
10.23 Cinema Equipments	10FP	13	12FP	14FP	10LP	20FP	8FP	12LP	16FP	15FP	16FP	12FP	10FP	8FP	12FP	11MP

(Contd.)

Table A3.3 (Contd.)

(Per cent)

Commodity		Andhra Pradesh	Bihar	Goa	Guja- rat	Haryana	Kerala	Karna- taka	Manipur	Madhya Pradesh	Mahar- astra	Orissa	Punjab	Rajas- than	Tamil Nadu	Uttar Pradesh	West Bengal
1		2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17
10.24	Motor Cyles and Combinations	4FP	10	3FP	4FP	10FP	4FP	8FP	4FP	10FP	8FP	6FP	10FP	12FP	5FP	10LP	6FP
10.25	Heavy Motor Vehicles	10FP	12	3FP	4FP	4FP	15FP	10FP	4FP	3FP	8FP	6FP	12FP	6FP	8FP	8LP	6FP
10.26	Motor Cars	4FP	12	3FP	4FP	10FP	5FP	6FP	4FP	10FP	8FP	6FP	3.5FP	10FP	8FP	3/4LP	6FP
10.27	Lifts Operated by Power	10FP	8	7LP	12FP	10FP	20FP	18FP	12LP	12FP	15FP	16LP	12FP	10FP	16FP	8FP	15FP
10.28	Tyres and Tubes	7FP	9	6FP	10FP	4.5FP	8FP	10FP	7FP	12FP	8FP	12FP	9/10/12FP	12FP	5/8FP	10FP	8FP
10.29	Aluminium Wares	6FP	8	2LP	1FP	3FP	6FP	2/8FP	7FP	12FP	4FP	8/12LP	8FP	12FP	3FP	8FP	8FP
10.30	Motor Parts	10FP	10	5FP	14FP	10FP	6FP	10FP	10FP	12FP	8FP	12LP	12FP	12FP	5/8FP	10FP	8MP
10.31	Fur and its Articles	10FP	13	12FP	14FP	10LP	8FP	20FP	15FP	16FP	20FP	16LP	12FP	10FP	8FP	12FP	11MP
10.32	Tabulating and Calculating Machines	10FP	16	10FP	15FP	10LP	20FP	20FP	12FP	16FP	15FP	16FP	12FP	10FP	3FP	6FP	11MP
10.33	Binoculars and Telescopes	10FP	15	12FP	14FP	10LP	20FP	13FP	15FP	16FP	12FP	16FP	12FP	10FP	16FP	12FP	15FP
10.34	Sewing Machines	6FP	8	2FP	5FP	8LP	8FP	6FP	7FP	6FP	6FP	12FP	8FP	10FP	5FP	8FP	8MP
10.35	Vacuum Flasks	9FP	10	12FP	12FP	10FP	12.5FP	10FP	12FP	16FP	12FP	16FP	12FP	10FP	12FP	12FP	15FP
10.36	Playing Cards	10FP	13	12FP	14FP	8LP	12.5FP	15FP	12FP	12FP	12FP	12FP	8FP	10FP	8FP	10FP	8MP
10.37	Crockery and Cutlery	6FP	8	10FP	15FP	10LP	12.5FP	10FP	7FP	14FP	10/12FP	12FP	12FP	12FP	8FP	10FP	15FP
10.38	Floor and Wall Tiles	4FP	13	6FP	14FP	10LP	12.5FP	13FP	15FP	16FP	10FP	16FP	12FP	10FP	5FP	12FP	15FP
10.39	Arms and Ammunition	10FP	16	12FP	14FP	10LP	25FP	15FP	15FP	16FP	15FP	16FP	12FP	15FP	16FP	14FP	11MP
10.40	Fireworks	10FP	7	7FP	12FP	10FP	12.5FP	10FP	10FP	16FP	10FP	16FP	8FP	6FP	8FP	8FP	15FP
10.41	Cigrette Cases and Lighters	10FP	15	12FP	14FP	10LP	20FP	15FP	12FP	16FP	12FP	16FP	12FP	10FP	16FP	12FP	15FP

(Contd.)

Table A3.3 (Contd.)

(Per cent)

Commodity	Andhra Pradesh	Bihar	Goa	Gujarat	Haryana	Kerala	Karnataka	Manipur	Madhya Pradesh	Maharastra	Orissa	Punjab	Rajasthan	Tamil Nadu	Uttar Pradesh	West Bengal
1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17
10.42 Sheets, Cushions and Pillows	10FP	10	10FP	18FP	10FP	10+5DP	13FP	12FP	16FP	10FP	16FP	8FP	12FP	12FP	12FP	15MP
10.43 Other Rubber Products	9FP	10	7LP	14FP	8FP	10FP	10FP	7FP	16FP	8FP	12FP	8FP	10FP	8FP	8FP	15MP
10.44 Pile Carpets	10FP	13	10FP	18FP	10LP	20FP	15FP	15FP	16FP	10FP	16FP	12FP	E	16FP	10FP	15MP
10.45 Precious Stones	7FP	10	7LP	12FP	8LP	12.5FP	8FP	15FP	16FP	12FP	16FP	12FP	E	12FP	10FP	15MP
10.46 Dry Fruits	6FP	9	7LP	14FP	8FP	10FP	10FP	10FP	16FP	8FP	12FP	3.5FP	10FP	8FP	8FP	15FP
10.47 Dry Cell Batteries	9FP	8	7FP	14FP	8LP	12.5FP	13FP	7FP	6FP	12FP	12FP	8FP	8FP	8FP	8FP	8FP
10.48 Glass Bangles	E	E	E	E	E	EFP	E	7FP	E	E	E	E	E	E	4FP	E
10.49 Locks and Keys	5FP	7	7LP	14FP	8LP	10FP	10FP	10FP	12FP	10FP	12LP	8FP	10FP	8FP	3FP	8MP
10.50 Bedding Stuff with Cotton	10FP	7	7LP	14FP	E	8FP	8FP	10FP	12FP	2FP	12LP	8FP	10FP	8FP	8FP	8MP
10.51 Musical Instrument	6FP	7	7LP	E	8LP	20FP	E/6FP	12FP	12FP	4FP	12LP	8FP	E/10FP	8FP	8FP	8MP
10.52 Plastic Goods	9FP	8	7LP	10FP	10LP	10FP	6FP	7FP	12FP	10FP	12LP	12FP	10FP	5FP	8FP	8MP
10.53 Synthetic Mica Products	6FP	13	7LP	14FP	10FP	10+5DP	8FP	12FP	12FP	10FP	16FP	12FP	10FP	8FP	8FP	8MP
10.54 Air Circulators and Fans	10FP	12	10FP	14FP	10FP	10FP	10+3DP	12FP	12FP	10FP	16FP	8FP	12FP	12FP	8FP	11FP
11. RAW MATERIALS																
11.1 Mica	3PT	E	7LP	5FP	-	10+5DP	13PT	7FP	12FP	10FP	16FP	8FP	4FP	8FP	2FP	8MP
11.2 Manganese	5PT	8	7LP	5FP	-	8FP	13PT	7FP	12FP	10FP	16FP	8FP	10FP	3FP	2FP	8MP
11.3 Hides and Skins	4FP	4	4LP	4LP	4FP	4LP	4PT	4FP	4FP	E	4PT	2FP	4FP	2FP	4LP	4MP
11.4 Coal and Coke (Section 14 of CST)	4PT	4	4LP	4FP	4PT	4FP	4FP	4FP	4FP	4FP	4FP	4FP	4FP	3FP	4FP	4MP
11.5 Oil Seeds (Section 14 of CST)	2FP	4	4LP	4LP	4FP	4FP	4FP	E	4FP	4FP	4PT	4FP	4FP	3FP	4PT	4MP

(Contd.)

Table A3.3 (Contd.)

(Per cent)

Commodity	Andhra Pradesh	Bihar	Goa	Guja-rat	Haryana	Kerala	Karna-taka	Manipur	Madhya Pradesh	Mahar-astra	Orissa	Punjab	Rajas-than	Tamil Nadu	Uttar Pradesh	West Bengal
1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17
11.6 Jute (Section 14 of CST)	4PT	2	4LP	4FP	4LP	4FP	4FP	E	4FP	4FP	4PT	4FP	4FP	3FP	4FP	4FP
11.7 Cotton Yarn (Section 14 of CST)	4FP	2	E	4FP	2LP	4FP	4FP	E	4FP	2FP	E	2FP	2FP	2/3FP	2FP	E
11.8 Cotton Waste	5FP	8	7LP	7FP	4LP	6FP	8FP	E	4FP	2FP	12FP	2FP	4FP	5FP	4FP	8MP
11.9 Iron and Steel (Section 14 of CST)	4FP	4	4FP	4FP	4FP	4FP	4FP	4FP	4FP	4FP	4FP	4FP	4FP	4FP	4FP	4FP
11.10 Sewing Thread and Balls	5FP	2	E	2FP	2LP	5FP	5FP	7FP	3FP	6FP	E	4FP	4FP	4FP	8FP	8MP
11.11 Cement and its Items	9FP	11/8	10FP	15FP	12FP	12.5FP	15/8FP	7FP	12FP	10FP	12FP	10FP	16/12FP	12FP	10FP	8FP
11.12 Manure (Organic)	E	E	1FP	E	E	E	E	6FP	12FP	E	12FP	E	E	E	E	3FP
11.13 Chemical Fertilisers	4.5FP	6	1FP	7FP	E	2.5FP	2FP	-	3FP	4FP	2FP	E	4FP	3FP	5FP	3FP
11.14 Pesticides	5.5FP	4	7FP	7FP	2LP	2.5FP	3FP	-	3FP	6FP	E	2FP	4FP	3FP	6FP	4FP
11.15 Fungicide	5.5FP	4	1FP	7FP	2LP	2.5FP	3FP	-	3FP	6FP	E	2FP	4FP	3FP	6FP	4FP
11.16 Bamboos	5FP	12	7LP	7FP	8LP	8FP	8FP	7FP	12FP	E	12LP	8FP	E	5FP	8FP	8MP
11.17 Timber	10FP	12	7LP	14FP	8LP	4+4DP	13FP	7FP	18FP	8FP	12FP	8FP	10FP	8FP	12FP	8MP
11.18 Betel Leaves	E	E	E	E	8LP	EFP	E	E	E	2FP	E	E	E	E	E	E
11.19 Tendu Leaves	6FP	12	12LP	E	E	5FP	8FP	E	18FP	10FP	16FP	E	E	E	10FP	8MP
11.20 Copper Wire	6FP	8	8LP	14FP	8LP	10FP	10FP	-	12FP	4FP	12LP	8FP	4FP	8FP	4LP	8MP
11.21 Goat Hair	4FP	8	7LP	E	8LP	8FP	8FP	-	12FP	10FP	12FP	8FP	-	8FP	8FP	8MP
11.22 Raw Wool, Wool Tops and Yarn	4FP	8	7LP	2FP	2LP	8FP	5PT	-	E	E	12LP	2FP	4FP	3FP	4LP	2FP
11.23 Woollen Knitting Yarn	E	7	7LP	4FP	8LP	8FP	8FP	4FP	12FP	10FP	12LP	4FP	2.5FP	3FP	4FP	2FP
11.24 Staple Yarn	5FP	2	E	4FP	2LP	2.5FP	2FP	-	12FP	1FP	12FP	2FP	1.5FP	8FP	2FP	2FP
11.25 Non-Ferrous Metals	6FP	8	7LP	5FP	8LP	10FP	8FP	-	12FP	4FP	12LP	8FP	4FP	8FP	2FP	8MP
11.26 Cotton	4FP	4	4LP	4LP	4PT	4FP	4PT	-	4FP	4FP	4LP	4FP	4FP	3FP	4LP	E

(Contd.)

Table A3.3 (Contd.)

(Per cent)

Commodity		Andhra Pradesh	Bihar	Goa	Gujarat	Haryana	Kerala	Karnataka	Manipur	Madhya Pradesh	Maharastra	Orissa	Punjab	Rajasthan	Tamil Nadu	Uttar Pradesh	West Bengal
1		2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17
12. FUELS ITEMS																	
12.1	Motor Spirits	18FP	9	17FP	E	6FP	20FP	20FP	7FP	16FP	E	12FP	E	16FP	16FP	E	10FP
12.2	Lights Diesel Oil	12FP	14	17FP	8FP	8FP	17FP	20FP	7FP	16FP	10FP	16FP	8FP	16FP	16FP	E	12FP
12.3	High-speed Diesel Oil	12FP	14	17FP	E	8FP	17FP	20FP	7FP	18FP	E	16FP	8FP	10FP	16FP	E	12FP
12.4	Aviation Spirits	18FP	25	20FP	E	8FP	12.5FP	22FP	10FP	14FP	E	16FP	8FP	10FP	20FP	12FP	9FP
12.5	Aviation Gasoline	18FP	25	20FP	E	8FP	12.5FP	22FP	10FP	14FP	E	12FP	8FP	10FP	20FP	12FP	9FP
12.6	Aviation Turbine Fuel	18FP	25	20FP	E	8FP	20FP	22FP	10FP	14FP	E	12FP	E	10FP	20FP	12FP	25/9MP
12.7	Crude Oil	4FP	4	4FP	4FP	8FP	4FP	4FP	4FP	4FP	4FP	4FP	8FP	4FP	3FP	4LP	8MP
12.8	Petrol	18FP	9	17FP	20FP	8FP	20FP	22FP	10FP	18FP	E	16FP	7FP	18FP	20FP	E	10FP
13. LUBRICANTS AND OTHER AIDS TO PRODUCTION																	
13.1	Dyes, Paints and Lacquers	9FP	12	7FP	15FP	4FP	12.5FP	12FP	7FP	16FP	15FP	16FP	8FP	15FP	5/12FP	12FP	8/11MP
13.2	Lubricants	10FP	9	7FP	14FP	8FP	15FP	15FP	10FP	12FP	8FP	16FP	8FP	10FP	12FP	8FP	11FP
13.3	Caustic Soda and Soda Ash	5FP	7	7LP	8FP	8LP	10FP	6/8FP	7FP	12FP	4FP	8FP	8FP	10FP	8FP	6FP	8MP
13.4	Potash and Explosives	5FP	8	12FP	14FP	10FP	10FP	6/8FP	15FP	16FP	10FP	16FP	8FP	12FP	8FP	8FP	8MP
13.5	Other Chemicals	5FP	8	7LP	6FP	8LP	10FP	4FP	7FP	12FP	4FP	12FP	8FP	10FP	8FP	8FP	8MP
13.6	Starches	6FP	8	7LP	5FP	8LP	4FP	8FP	7FP	12FP	4FP	12LP	8FP	10FP	5FP	8FP	E
14. MACHINERY OF ALL KINDS		6 FP	8	7LP	7FP	8LP	10FP	13FP	7FP	12FP	10FP	16LP	8FP	10FP	8FP	5FP	8MP
15. PACKING MATERIALS																	
15.1	Empty Tins and Empty Barrels	5FP	8	7LP	6FP	-	4FP	4FP	7FP	4FP	10FP	12LP	8FP	4FP	8FP	4/8FP	8MP
15.2	Wooden Boxes	6FP	8	7LP	6FP	-	4FP	4FP	7FP	4FP	10FP	12LP	8FP	4FP	8FP	6FP	8MP

(Contd.)

Table A3.3 (Contd.)

(Per cent)

Commodity	Andhra Pradesh	Bihar	Goa	Guja-rat	Haryana	Kerala	Karna-taka	Manipur	Madhya Pradesh	Mahar-astra	Orissa	Punjab	Rajas-than	Tamil Nadu	Uttar Pradesh	West Bengal
1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17
15.3 Empty Bottles and Corks	6FP	8	7LP	6FP	-	4FP	4FP	7FP	4FP	10FP	12LP	8FP	4FP	12FP	8FP	8MP
15.4 Polythene and Alkaline	6FP	7	7LP	6FP	-	4FP	4FP	7FP	4FP	10FP	12LP	8FP	4FP	3FP	8FP	8MP
15.5 Bitumen as Packing Materials	5FP	8	7LP	14FP	4FP	4FP	8FP	7FP	4FP	8FP	12LP	8FP	4FP	8FP	8FP	8MP
15.6 Cartons	7FP	9	7LP	6FP	-	4FP	4FP	7FP	4FP	10FP	12FP	8FP	4FP	5FP	8FP	8MP
16. GENERAL RATE	6	8	7	14	8	8	8	7	8	10	12	8	10	8	8	8

Note: - Indicates non-availability of data.

Abbreviations:
FP = First Point
LP = Last Point
MP = Multi Point
PT = Purchase Tax
DP = Double Point
VAT = Value Added

Table A3.4

Value-Added Taxes: Survey and Basic Characteristics, January 1992

Area and Country (62)	Year of Introduction	Scope: Coverage[1]	Scope: Tax Base[2]	Rates (Per cent)[3,4]: Standard	Rates (Per cent)[3,4]: Lower[5]	Rates (Per cent)[3,4]: Higher	Excise System: Nature[6,7]	Excise System: Luxury products[8]
NAFTA(2)								
Canada	1991	R	G+S	7	0	-	Limited	-
Mexico	1980	R	G+S	10	0;6	-	Limited	-*
European Community								
Belgium	1971	R	G+S	19	6;17	25;33	Limited	-
Denmark	1967	R	G+S	22	-*	-	Intermediate*	-
France	1968	R	G+S	18.6	5.5*	22	Limited*	-
Germany	1968	R	G+S	14	7	-	Limited	-
Greece	1987	R	G+S	18	8*	36	Limited	-
Ireland	1972	R	G+S	21	0;10;12.5*	-	Limited	-
Italy	1973	R	G+S	19	4;9*	38	Intermediate	-
Luxembourg	1970	R	G+S	12	3;6	-	Limited	-
Netherlands	1969	R	G+S	18.5	6	-	Limited	-
Portugal	1986	R	G+S	17	0;8	30	Limited	-
Spain	1986	R	G+S	12	6	33	Limited	-
United Kingdom	1973	R	G+S	17,5	0	-	Limited	-
Other European Countries (7)								
Austria	1973	R	G+S	20	10*	32	Limited	-
Cyprus	1992	R	G+S	5	0	-	Limited	-
Finland	1976	R	G+S	21.2	-	-	Limited*	-
Hungary	1988	R	G+S	25	0;15	-	Intermediate	CT*
Iceland	1990	R	G+S	24,5	-	-	Limited	-
Norway	1970	R	G+S[10]	20	-*	-	Limited*	-
Sweeden	1969	R	G+S	25	-*	-	Limited	-
South America (8)								
Argentina	1975	R	G+ST[12]	16	X	-	Extented	CT*
Bolivia[13]	1987	R	G+S	11	-	-	Intermediate	CT*
Brazil (States)	1967	R	G+CG[14]	20.5	15	-	Extended[16]	CT*
Chile	1975	R	G+S	18	-	-	Intermediate	-
Colombia	1974	R	C+ST+CG	12	X*	35*	Limited	-
Ecuador	1970	R	G+ST	10	X	-	Limited	-
Peru[17]	1981	R	G+ST[18]	14	X	-	Extended	CT*
Uruguay	1973	R	G+ST	22	X;12	-	Limited	-
Central America and Caribbean (9)								
Costa Rica	1975	R	G+ST[12]	13	0	-	Extended	CT*
Dominican Rep.	1983	R	G+ST+CG	6	X	-	Extended	CT
Grenada	1986	R	G+S	20	0;8*[20]	-	Limited	-
Guatemala	1983	R	G+S[21]	7	0	-	Extended	CT
Haiti	1982	R	G+S+CG	10	X	-	Limited	-
Honduras	1976	R	G+ST+CG	7	X	-*	Intermediate	CT
Nicaragua[22]	1975	R	G+ST[23]	10	X*	15*	Limited	-
Panama	1977	R	G+S	5	X	-	Limited	-
Trindad and Tobago	1990	R	G+S	15	0	-	Intermediate	-
Asia (9)								
Bangladesh	1991	M	G+ST	15	X	-	Extended	
Indonesia	1985	W	G+ST	10	X	-	Intermediate	CT
Israel	1976	R	G+S	18	-*	-	Extended	CT
Japan	1989	R	G+S	3	-	-	Limited	

Contd.

Table A3.4 (Contd.)

Area and Country (62)	Year of Intro-duction	Scope: Cove-rage[1]	Scope: Tax Base[2]	Rates (Per cent)[3,4]: Stand-dard	Rates: Lower[5]	Rates: Higher	Excise System: Nature[6,7]	Excise System: Luxury products[8]
Korea	1977	R	G+S	10	X	-	Intermediate	CT
New Zealand	1986	R	G+S	12.5	-	-	Limited	-
Pakistan	1990	M	G+ST+CG	12.5	X;10	30	Extended	-
Philippines	1988	R	G+S	10	X	-	Intermediate	-
Taiwan	1986	R	G+S	5	X	-	Intermediate	CT
Turkey	1985	R	G+S	12	8	20	Limited	-
Africa (14)								
Algeria	1960	M	G+CG[24]	25	7.5;11.1	42.9;66.7*	Limited	-
Cote d'Ivoire	1960	M	G+CG[25]	25	11.1*	35.1	Limited	-
Egypt	1991	M	G+ST+CG	10	X;5	20,30	Limited	-
Ethiopia[26]	1990	M	G+ST+CG	12	X*	-[27]	Limited	-
Kenya	1990	M	G+ST	18	X	35,50,100	Limited	-
Madagascar	1969	R	G+S	15	X	-	Extended	CT
Malawi	1989	M	G+ST	35	X;5	55,85	Limited	-
Mauritius	1983	W	G	5	X	-	Limited	-
Morocco	1986	W	G+S	19	X;7;12;14*	30	Limited	-
Niger	1986	R	G+S	17	X;10	25	Limited	-
Senegal	1990	W	G+S	20	7	30*	Limited	-
Togo[28]	1984	R	G+S	14	3[29]	-	Limited	-
Tunesia	1988	R	G+S	17	X;6	29	Limited	-
South Africa	1991	R	G+S	10	0	-	Limited	-

Source: Compilation by Prof. Sijbren Cnossen (Erasmus University, Rotterdam).

Notes:

1. The letters have the following meaning:
   R = Value-added tax extending through the retail stage
   W = Value-added tax extending through the wholesale stage
   M = Value-added tax extending through the manufacturing stage

2. The letters denote the following:
   G = Goods
   S = Services
   ST = Services taxed selectively
   CG = Capital goods

3. Rates are expressed as a percentage of the tax-exclusive value of taxable commodities which is the practice in most countries. Algeria, Bolivia, Brazil, Cote d'Ivoire and Finland have tax-inclusive rates. Tax-inclusive rates (t) can be converted into tax-exclusive rates (t_e) by dividing them by (1-t).

4. An asterisk (*) denotes special lower or higher rates, often technical in nature, which apply to only one or two commodities.

5. The letter "X" means that essential products are exempted rather than zero rated.

6. Three types of excise systems are distinguished: Limited, intermediate and extended excise systems. *Limited* excise systems comprise at least the traditional excise goods: tobacco products, alcoholic beverages and petroleum products, as well as various forms of road use and entertainment. Some food products such as sugar, confectionery and salt, various beverages such as coffee, tea and cocoa, as well as some services such as insurance may also be included in the base. In addition to the items covered under a limited system, an *intermediate* excise system covers a large number of luxury products such as cosmetics, furs, precious stones, audio-visual equipment and household appliances. Obviously, the taxes on these products serve the same function as a higher VAT-rate. An extended excise system would include in its base the commodities covered by a limited system and an intermediate system, but also a large number of producer goods.

7. An asterisk (*) means that a large number of low-rate, special-purpose excises are imposed to earmark their revenues or to achieve various regulatory objectives, e.g. pollution abatement. These levies are left out of consideration in defining the nature of the excise system.

Contd.

Table A3.4 (Contd.)

8. CT denotes that a consumption tax is imposed separate from the (traditional) excises. CT* means that the consumption tax, usually levied at the manufacturing level, has a tax credit feature akin to VAT.

9. In Finland, the coverage of services is confined to telecommunications and waiting services in hotels and restaurants. The credit for tax on fixed assets with an economic life of more than 3 years is limited.

10. Norway levies a separate tax on investment goods at a varying rate which is used to influence the business cycle. The current rate is 7 per cent.

11. In Argentina, the provinces and the federal district levy gross receipts taxes at rates ranging from 1-10 percent depending on the jurisdiction and the nature of the taxable transaction.

12. In Argentina, the inclusion of services has been agreed upon, but awaits further implementing measures.

13. Bolivia also has a 2 percent gross receipts tax.

14. Under the Brazilian constitution, the right to tax services is reserved to municipalities which tax nearly all services except intermunicipal transportation and communication (reserved to the federal government) and banking. The taxes on services are turnover type levies without a credit for tax levied in previous stages.

15. In Brazil, lower rates of 7.5 per cent and 14.9 per cent are imposed on interstate sales between registered taxpayers, while sales at retail across state borders are taxed at a rate of at most 20.5 per cent.

16. The Federal Government in Brazil levies a highly rate-differentiated, tax credit type industrial products tax. Unlike the VAT at the state level, the tax credit is available for a wide range of capital goods. A zero rate applies to almost 4,000 items including chemicals, medicines, paper, textiles, and common metals. The rates are highly product-specific.

17. Peru also levies a 2 per cent gross receipts tax for municipal development purposes which is added (without tax credit) to the VAT.

18. In Peru, the tax credit on capital goods purchases is prorated over 4 years.

19. Grenada also levies a 2 per cent gross receipts tax.

20. Grenada applies the 8 per cent rate also to locally manufactured goods.

21. In Guatumala, the credit for tax on capital goods must be taken in 5 annual instalments.

22. Nicaragua also has a 2 per cent gross receipts tax levied by municipalities and social welfare boards.

23. In Nicaragua, the Minister of Finance can fully or partially disallow the tax credit attached to the acquisition of capital goods or fixed assets, or prescribe that the credit should be taken in annual instalments.

24. Algeria has a separate turnover type tax on services levied at differentiated rates. Construction is subject to VAT.

25. In Cote d'Ivoire, the VAT base is confined to goods, but businesses rendering services may elect to become taxable. Also, the country has a separate turnover type tax on services levied at differentiated rates. However, building contractors are subject to VAT.

26. Ethiopia also levies a 7 per cent production tax, as well as a 1 per cent turnover tax.

27. Ethiopia taxes imports at 24 per cent under its VAT.

28. Togo also levies a turnover type business tax at rates ranging from 0.5-3.0 per cent.

29. Togo has a lower rate of 3 per cent under its VAT which applies to all first sales which have not been subject to the 14 per cent rate. This contrasts with the usual situation in which the lower rate is reserved for essential commodities.

REFERENCES

Aggarwal, Pawan K. (1994), Incidence of Major Indirect Taxes in India, New Delhi: National Institute of Public Finance and Policy. (In progress)

Balasubramanian, K.N. and K.B. Vijay Srinivas (1991), *Classification of Goods for Sales Taxation: Principles, Practices and Problems,* Bombay: Legal Information Services.

Burgess Robin, Stephen Howes and Nicholas Stern (1993), "The Reform of Indirect Taxes in India", EF No.7, STICERD London School of Economics, November.

Cnossen Sijbren (1992), "Key Questions in Considering a Value Added Tax for Central and Eastern Europe Countries", *IMF Staff Papers,* June, pp.211-55.

Confederation of Indian Industries (1993), *Sales Tax Holiday: A Competitive or Destructive Strategy for Industrial Development,* Gujarat. (mimeo).

Gillis. M.C. Shoup and P. Sicat (eds.) (1990), *Value Added Taxation in Developing Countries,* Washington D.C.: World Bank.

Government of India (1978), Report of the Indirect Taxation Enquiry Committee, Ministry of Finance, Department of Revenue.

Government of India (1992), *Indian Public Finance Statistics,* Ministry of Finance.

Government of India (1991), *Tax Reforms Committee: Interim Report,* Ministry of Finance, Department of Revenue, December.

Government of India (1992), *Tax Reforms Committee: Final Report Part-I,* Ministry of Finance, Department of Revenue, August.

Government of India (1993a), *Tax Reforms Committee: Final Report Part-II,* Ministry of Finance, Department of Revenue, January.

Government of India (1993b), *National Accounts Statistics,* Central Statistical Organisation.

Jain, R.K. (1993a), *Central Excise Tariff of India 1993-94,* New Delhi: Centax Publications.

Jain, R.K. (1993b), *Excise and Customs Case Referencer,* 1993, New Delhi: Centax Publications.

Casanegra de, Jantscher Milka and Caolos Silvani (1991), "Guidelines for Administering a VAT" in Tait, Alan A. (ed.) (1991), *Value Added Taxes: Administrative and Policy Issues,* Washington D.C.: International Monetary Fund, p.39.

Krishnan, M. (1993), "ST on Packing Material", *Economic Times,* New Delhi, July 29.

Mehta, N.C. (1993), "Inter-State Sales Tax and Supreme Court", *Economic Times,* New Delhi, August 19, September 16 and November 4.

Murthy, S. Krishna (1994), *The Andhra Pradesh General Sales Tax Act,* Hyderabad: Lakshmi Publications.

National Economic Development Office (1971), *Value Added Tax,* London: HMSO.

PHD Chamber of Commerce and Industry (1993), *Central and State Governments Incentives for Industrial Development,* September, New Delhi.

Poddar, S.N. (1990), "Options for a VAT at the State Level" in Gillis, M. C. Shoup, and P. Sicat, (eds.), *Value Added Taxation in Developing Countries,* Washington D.C.: World Bank.

Purohit, M.C. (1992), "Structure of Commodity Taxes in India", in Centre for Professional Development, Contemporary Issues in Business, *Finance and Taxation,* Delhi: University of Delhi.

Purohit, M.C. (1993), "Adoption of Value Added Tax in India: Problems and Prospects", *Economic and Political Weekly,* March 6, pp.393-404.

Rao, M.G. (1993), "Impediments to Internal Trade and Allocative Distortions in India", NIPFP Working Paper No.3.

Shoup, C. (1990), "Choosing among types of VATs", in Gillis, M. C. Shoup and P. Sicat (eds.), *Value Added Taxation in Developing Countries,* Washington D.C.: World Bank.

Silvani, Carlos and Charles L. Vehorn, (1991), "Invoices, Books of Accounts, and Tax Return Forms for VAT", in Tait, Alan A. (ed.) (1991), *Value Added Taxes: Administrative and Policy Issues,* Washington D.C.: International Monetary Fund, pp.42-43.

Tait, Alan A. (1988), *Value Added Tax: International Practice and Problems,* Washington, D.C.: International Monetary Fund.

United States General Accounting Office (1989), *Tax Policy: Tax Credit and Subtraction Methods of Calculating a Value Added Tax* (Report of the Joint Committee on Taxation, U.S. Congress), Washington D.C.: General Government Division.

Reprinted at Rachit Printer, New Delhi-68

ABOUT THE BOOK

This is the report of a study undertaken by the National Institute of Public Finance and Policy, New Delhi, at the instance of the Ministry of Finance, Government of India, to prepare the design of a possible system of Value Added Tax for India.

The study addresses the task by first reviewing the existing system of domestic trade taxes in order to identify its glaring deficiencies and problems. Keeping in view the objectives and the parameters, the study avers that a destination based consumption-type VAT would provide effective remedy for most of the ills of the present system. After briefly describing the principal forms and characteristics of VAT and their mode of computation, it spells out the options in the Indian context and proceeds to outline a scheme on which there could be a broad consensus. The study also provides an idea of the revenue implications and economic impact of the proposed reform. The legal, administrative and institutional requirements are also outlined.

Rachit Printer, New Delhi-68,

ISBN 81-900518-0-6