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STRUCTURE OF COMMODITY TAXES IN INDIA: SOME POLICY PRESCRIPTIONS FOR REFORMS

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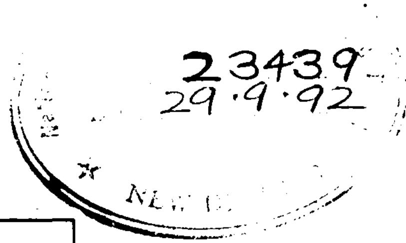

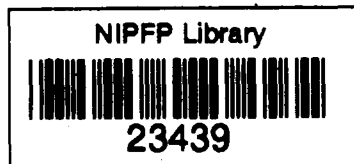

STRUCTURE OF COMMODITY TAXES IN INDIA: SOME POLICY PRESCRIPTIONS FOR REFORMS@

I. The Evolution

At the time of independence, we inherited a system of commodity taxes in which the bulk of revenue came from low rate import duties. Excise duties were levied on about a dozen articles. Sales tax had a limited coverage at low rates. In the years following independence, excise duties began to gain importance over custom duties. This was mainly due to the government's attempt to conserve foreign exchange causing restrictions on imports. Excise duties were raised year after year and the base of the tax was also expanded to bring more and more items into its net. Also, for revenue considerations more and more tax was levied on raw materials and intermediate products in preference of consumer goods. Over time, revenue considerations led to a steady extension of excise duties to more finished consumer goods as well. And through the budget for the year 1975-76, a culmination of the extension was achieved through a lower rate of one per cent imposed on all manufactured goods not otherwise covered by excise duties. This rate was further raised to two per cent in the budget for the year 1977-78.

Import duties were also raised. This was done mainly for providing additional revenue, for giving higher effective rate

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of protection to the domestic industries and for conservation of the scarce foreign exchange. In the middle of 1965, import duties were raised to a very high level due to an unprecedented fall in the foreign exchange reserves.

Sales taxes levied by the State governments steadily increased in importance. The coverage of these taxes was extended to include not only consumer goods but also raw materials, intermediate goods and capital goods. Also, the rates of sales taxes went on increasing causing diversion of trade and large scale evasion of the tax.[1]

II. Fiscal Importance of Commodity Taxes

The evolution of commodity taxes over time has got a special place in the fiscal structure of the country. Both the Union and State governments yield a major proportion of their tax revenue through these taxes. Whereas the combined yield of these taxes was 70.23 per cent of total tax revenue in 1960-61, over time, their proportion has increased to 86.41 per cent in 1989-90 (Accounts) (Table 1). The importance of individual taxes has also increased. However, there has been some change in their relative importance in the fiscal structure. Whereas custom duty has increased from 12.59 per cent in 1960-61 to 23.51 per cent in 1989-90, union excise duty has declined from 37.83 per cent in 1970-71 to 29.86 per cent in 1989-90. The sales taxes, however, have gained considerable importance. Their proportion in tax revenue has increased from 12.14 per cent in 1960-61 to 19.87 per cent during the period under reference.

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1. In addition to the above three principal commodity taxes, there are a few other taxes which are also important for the States' fiscal structure. These are State excise duty, levied on alcohol (i.e., liquor) and on medical and toilet preparations containing alcohol or narcotics; taxes on road transport operations (namely motor vehicles tax and tax on passengers and goods); and octroi levied by local self governments on goods entering into the local area. We would, however, not analyse the details of these taxes.

Table 1

Combined Tax Revenue of the Centre, States and Union Territories: By Selected Sources (Selected Years)

(Rs Crore)

Year	Tax Revenue								
	Direct Taxes			Indirect Taxes					Total tax revenue
	Income taxes	Agriculture income tax	Total	Customs	Union excise	State excise	Sales taxes	Total	
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
1960-61	168.73 (12.49)	9.71 (0.72)	402.07 (29.77)	170.03 (12.59)	416.35 (30.83)	54.91 (4.07)	163.92 (12.14)	948.34 (70.23)	1350.41
1970-71	473.17 (9.96)	10.53 (0.22)	1009.07 (21.23)	524.02 (11.03)	1758.55 (37.00)	201.43 (4.24)	786.40 (16.55)	3743.34 (78.77)	4752.41
1980-81	1506.39 (7.59)	156.85 (0.79)	3268.28 (16.47)	3409.28 (17.18)	6500.02 (32.76)	884.28 (4.46)	4017.86 (20.25)	16575.47 (83.53)	19843.75
1989-90	4310.85 (5.67)	632.10 (0.83)	10336.72 (13.59)	17879.94 (23.51)	22702.18 (29.86)	3699.14 (4.86)	15111.09 (19.87)	65704.14 (86.41)	76040.86

Note: Figures within parentheses indicate percentage of total tax revenue.

III. Existing Structure of Commodity Taxes

a. **Custom Duties**: Custom duties comprise import duties and export duties. As the latter depends upon terms of international trade, the former alone constitute a major source of revenue.

The import duties are levied with three objectives in view, viz., i) protecting domestic industry from imported goods with which it competes; ii) improving country's balance of trade and thereby the balance of payments position; and iii) raising resources. The most important objective, however, is to provide effective protection to the domestic industry. It is, therefore, designed in such a way that it derives a wedge between domestic and international prices, although quantitative restrictions also play a very important role.

The structure of import duties provide three forms namely basic custom duties, auxiliary duty of customs and additional (countervailing) duty of customs. The basic custom duty is levied under Customs Act, 1962. All goods imported into the country are chargeable to this duty. Auxiliary duty of customs is levied under the Finance Act and is also chargeable to all the goods imported. As the base of the basic custom duty and the auxiliary duty of customs is the same, for all analytical purposes both these duties could be added together. Additional (countervailing) duty of customs is levied under the Customs Tariff Act, 1975. This duty is levied on all goods imported into India. The base of the duty is c.i.f value of imports plus the duties levied earlier. This duty is popularly known as countervailing duty.

The rate structure of additional (countervailing) duty of customs is equal to the excise duty on like articles. The auxiliary duty of customs is levied on an annual basis. The rate of this duty was 20 per cent in 1980-81 but was increased to 45 per cent in 1988-89 and continues to be the same thereafter.

The basic customs duty is of two categories: (a) standard rate applicable to all commodities; and (b) rate applicable to preferential areas. The latter category is governed by specific agreement of the countries such as Bangkok agreement, and is applicable only to preferential areas. The standard rate is generally *ad valorem* (with a few exceptions of specific rates), ranges from 0 to 300 per cent. In the budget of 1992-93, the maximum rate of duty has been reduced to 110 per cent.[2] Most common rates of duty are 40, 60 and 100 per cent. Also the average rate in practice is affected by various exemptions granted on different counts. These exemptions could be use-specific or source-specific (i.e., related to the source of origin). Many of these exemptions are not quantifiable.

The nominal tariff rates, after taking account of quantifiable exemptions, are mostly centered in the range of 75 to 110 per cent, the average rate being a little over 100 per cent. The rate for manufacturing sector is, however, higher than the agricultural and mining sector. Also the rate does not change across broad industrial groups, but it does show large variations among individual industries. Such variations can distort incentive structure of the industries. When the rate structure is compared among different sectors, the tariff increases with the degree of processing. In the manufacturing sector, the rate for consumer goods exceeds those for intermediate and capital goods. Non-electrical industries, however, are an exception.

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2. The Tax Reforms Committee has suggested that the maximum duty (basic + auxiliary) rate be reduced to 80 per cent by 1995-96 and average rate of tariff to 50 per cent by 1995-96 and to 25 per cent by 1988-89. See Government of India (1992), *Interim Report of the Tax Reforms Committee* (Chairman: Raja J. Chelliah), New Delhi.

The effective rate of protection (ERP), which is a much more appropriate indicator than the nominal rate of protection (NRP), as it takes into account the tariff on inputs, shows a similar trend as the NRP. The ERP is higher for industries having larger value added[3].

The realised rate of duty of all commodity groups has increased over time. Whereas it was 28.54 per cent in 1975-76, it increased to 56.82 per cent in 1988-89. A major portion of increase could be attributed to increase in duty rates for petroleum products (the contribution has increased from 6.74 per cent in 1980-81 to 65.54 per cent in 1988-89). It is also important to note that the realised rate is higher for 27 out of 32 product groups.

b. **Union Excise Duties**: Union excise duty is levied on all goods manufactured or produced in the country. The structure includes: i) basic excise duty; ii) additional excise duty in lieu of sales tax; iii) cesses on specified commodities; and iv) additional duties of excise on textiles.

The additional excise duty in lieu of sales tax is levied on tobacco, textiles and sugar. This is a rental arrangement between the Centre and the States. The Centre levies additional excise duties on these items in lieu of States' sales tax. The arrangement is that the Centre would levy additional

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3. According to a study of Panchmukhi for the year 1982, the ERP increases from 14.7 per cent for 19 primary product sectors to 65.5 per cent for six semi-processed product sectors and 86.4 per cent for 53 processed finished goods product sectors. See, Panchmukhi, V.R. (1985), *The Indian Tariff System: Some Problems and Directions for Reform* (Mimeo). A similar negative relationship between the level of protection and the share of value-added in output estimated by Goldar and Saleem (1992) shows ERP for 1989-90 as follows: Basic goods 112.10, capital goods 72.60, consumer durables 103.41, consumer non-durables 148.10, and intermediate goods 150.45 per cent. See, Goldar and Saleem, (1992), *India's Tariff Structure: Effective Rates of Protection of Indian Industries* (Mimeo), NIPFP, New Delhi.

excise duties in lieu of sales tax on all these items and the States would refrain from levying sales tax on these items. The proceeds of this duty are to be distributed among the States. The States have, however, complained about excessive exemptions under these duties before the Ninth Finance Commission and the consequent loss of revenue to them.[4]

Cesses on the specified commodities and additional excise duties on textiles are primarily meant for development of related industries.

The structure of basic excise duty shows a large number of rates for different commodities; there are 40 *ad valorem* and 350 specific rates prevailing under the basic excise duties.

MODVAT has been introduced under the basic excise duty with effect from March 1, 1986. Initially the MODVAT was introduced to a select number of commodities (the coverage was limited to 37 chapters out of a total of 91). However, the coverage was extended with effect from March 1, 1987 to all commodities except petroleum products, textiles products, tobacco, cinematographic films and matches. The exclusions from MODVAT though limited in number, is significant from the point of view of revenue - half of the revenue of Union excise duties is being collected through these items. The MODVAT has introduced transparency of the tax, reduced cascading effect of input taxation and has also helped self-policing of its evasion. Studies relating to impact of introduction of MODVAT indicate that industrial units have been able to save on interest (ranging between 0.5 and one per cent of the total duty paid); the effect has been revenue neutral and has not caused any price effect.[5]

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4. These issues were examined in details in a study undertaken for the Ministry of Finance, See Purohit, Mahesh C. (1990), *Exemptions under Additional Excise Duties in Lieu of Sales Tax: An Empirical Analysis of Loss of Revenue to the States,* NIPFP, New Delhi.

5. Ministry of Finance (1990), *Report of the Working Group for Review of the MODVAT Scheme*, Government of India, New Delhi. pp. 6-14.

The MODVAT scheme is different from the VAT prevailing in other countries. First, the coverage is limited to approximately half of the revenue collected. Secondly, there are a few special provisions, namely, notional credit and deemed credit.[6] The *notional credit* was introduced in the Budget of 1986-87 in the context of integration of small-scale exemption for goods covered by Tariff item 68. According to the scheme, a manufacturer who purchases inputs manufactured by small scale industries could take credit of an amount higher by 10 per cent *ad valorem* than the duty actually paid on inputs. To illustrate, if the normal excise duty on an input is 20 per cent *ad valorem*, the small scale unit pays duty at 10 per cent *ad valorem*, but the user of such inputs could take credit of 20 per cent. Since a unit in the large scale sector is in a position to secure a MODVAT credit higher than the duty paid on the inputs when he obtains the inputs from a small scale manufacturer, the scheme is expected to provide advantage to small scale units. However, it was felt that the scheme was being misused and misdirected. Hence, with effect from April 1, 1989 the extent of credit was reduced, from 10 to 5 per cent *ad valorem*. The scheme has also caused fragmentation of manufacturing units for obtaining concessional duty benefits. Also, it is observed that the scheme is discriminatory against the tiny units. It is estimated that the provision of notional credit has caused the exchequer a revenue loss of Rs 1000 million in 1986-87 and about Rs 2250 million in 1987-88.[7]

Under the *deemed credit* facility, a manufacturer can take MODVAT credit at specified rates for certain inputs without production of documents evidencing the payment of duty. This provision keeps in view small manufacturers who are not in a position to buy the minimum quantities that are sold by certain primary manufacturers of metal items and hence buy their requirements from the open market. Since in such cases duty

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6. The scheme of deemed credit has been in operation even before the MODVAT but its scope has now been increased.

7. Ministry of Finance (1990), *op.cit.*, p.V.

payment documents may not be available, it was felt by the Government that MODVAT credit at a specified rate may be allowed. The inputs so specified are deemed to be duty paid unless they are clearly recognisable as non-duty paid. The *deemed credit* so permitted is generally less than the prevailing duty to take into consideration that the stocks of inputs may have paid lower duty than the duty rates.

The *deemed credit* facility was initially given to small scale industries in March, 1986. This was, however, extended to all units after a month. At present, *deemed credit* facility is permitted in respect of steel ingots and rerollables, certain flat products of steel, unwrought aluminium, copper, lead and zinc and wastes/scraps of copper, aluminium, lead and zinc.

Thirdly, the MODVAT is restricted in scope. A manufacturer can avail of MODVAT credit provided (i) the inputs and the final products are both covered within the chapters of the Central Excise Tariff to which the MODVAT scheme has been extended, and (ii) the final products are not exempted from excise duty. Where the raw materials or components or final products are exempted, the benefits of the scheme are not available. Thus, the existing MODVAT is only a step towards adopting a full-fledged VAT.

c. **Sales Tax**: Structure of sales tax in India consists of (a) States' sales tax and (b) Central sales tax. The former is levied on intra-State transactions and the latter on inter-State transactions. The State sales tax known as general sales tax [including sales tax on motor spirit (MST), and certain other purchase taxes such as purchase tax on sugarcane], is levied by all the States and Union Territories, mainly at the first-point. The tax is thus collected from the importers, manufacturers or the wholesalers. The only States having multi-point tax on a few commodities (called residuatory entry) are Karnataka and Kerala.

Some of the States levy tax at the last-point. Notwithstanding variations in the point of levy, a major part of the revenue is derived from the first-point levy.[8]

The general rate of tax in the States levying single point tax varies between 5 and 12 per cent and in the States levying multi-point tax between 5 and 7 per cent. In all the States, there are a large number of variations in the tax rate according to the type of commodities. The tax is levied at low rate of tax on necessities and at the high rate of tax on luxuries. In addition, there are exemptions for necessities, specific institutions and for specifications by the States. As per the provisions of the Constitution, services are also exempt from the levy of sales tax. Owing to a large number of variations for different type of commodities, most of the States have umpteen tax rates. Orissa is one of the States which has six tax rates - the minimum among the States. The other States have rate slabs running upto 17.

Most of the States levy tax on the raw materials and other inputs as well. The tax treatment of these goods ranges from no exemption (such as in Assam) to concessional treatment varying between one to four present (such as two per cent in Gujarat, Kerala and West Bengal, three per cent in Bihar, Rajasthan and Tamil Nadu and four per cent in all the other States not giving complete exemption) to complete exemption in five States namely Punjab, Haryana, Himachal Pradesh, Jammu & Kashmir and Manipur.

The tax base is also affected by the grant of exemptions to finished goods by almost all the States. These exemptions have been provided as part of "incentive schemes". These schemes provide (a) exemption or concessional tax on sale of output, (b) provide for deferment of tax, and (c) make provisions

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8. Purohit, Mahesh C. (1988), *Structure and Administration of Sales Taxation in India*, Reliance Publishing House, New Delhi.

for interest free sales tax loans. Exemptions or concessional rate of tax to new industries is available for pioneer and prestigous industries in two States, small scale and tiny industries in 19 States and medium and large industries in 12 States. In most of these States, specification is provided for area of location of industry (whether developed or backward) and for specific commodities produced in the States. The studies conducted in this regard indicate that the loss of revenue is considerable without having any effect on location of industries.[9]

A new dimension has been added to the sales tax system through recent amendments in the Constitution.[10] Accordingly, sales tax is now levied on works-contracts, hire-purchases and leases. This has given rise to umpteen problems in tax-policy as well as administration under the sales tax system.

The Central sales tax is collected on all inter-State transactions. The tax is levied, collected and retained by the States occasioning movement of goods from one State to another. The rate of tax is four per cent on registered dealers and 11 per cent on unregistered dealers. As the production is centralised for historical or geographical reasons, few select States collect a major chunk of the CST revenue. The 46th Constitutional Amendment Act further envisages levy of tax on consignment transfers. This would aggravate the inequality of tax burden among different States, for the tax is presently being collected on approximately one-fifth of the total inter-State transactions.[11] When extended to all transactions, the richer States would get larger resources from Central Sales Tax, causing further inequality amongst the States.

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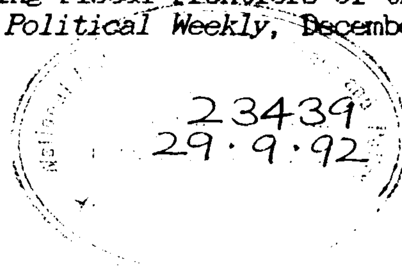
9. Purohit, Mahesh. C. et.al. (1992), *Fiscal Policy for the National Capital Region*, Vikas Publishing House, New Delhi.

10. Government of India (1983), *The Constitution (Forty Sixth) Amendment Act, 1982*, New Delhi.

11. Purohit, Mahesh C. (1990), "Shifting Fiscal Frontiers of the Central Sales Tax", *Economic and Political Weekly*, December 15, pp. 2730-2732.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IV. Assessment of the Present System

The evolution and the existing indirect tax system in India is characterised by the following weaknesses:

a. **Unintegrated System**: The evolution of various taxes over time, suggests that the most significant characteristics of the commodity taxes in India is that the *overall system of taxation is not an integrated one* but a juxtaposition of a number of systems such as custom duties and union excise duties levied by the Union government and sales taxes levied by the State Government, and octroi levied by local bodies. The unintegrated character has given rise to various problems related to economic as well as administrative aspects.

b. **Multiplicity of Levies and Complexity of Structure**: The system is characterised by *multiplicity of levies on the same base*. These levies not only fall on the very same products, but also there is no single authority that looks into their cumulative effect. While individually each tax does pay regard to progression as well as to economic factors, the overall objectives of the country's tax policy are not adequately subserved due to their cumulative effect. Consequently, taxes not only fall on the final products but also on imports and on manufactured goods at the producers level. In addition, the existing structure of all the three important taxes is complex. The rates are large in number and show larger variations in structures among individual industries which could cause distortion of tax incentives.

c. **Cascading Effects**: Cumulative effect of these taxes is that various taxes fall on the taxes levied earlier causing escalation of costs and profits at each stage. As inputs are subjected to excise and/or sales tax, the manufacturer needs a larger amount of working capital to maintain the necessary stock of the inputs. Consequently, the cost of his final product gets raised. Besides, when the manufacturer works out his own profit margin as a percentage of his costs and arrives at a price, he

adds a mark-up which is a higher quantum of profit. This snowballing effect, usually described as the *phenomenon of cascading, raises consumer prices greater than what accrues to the exchequer* by way of additional revenue. Also, the general escalation of costs due to cascading acts as a positive handicap in the efforts to increase exports because it reduces the competitiveness of our products in overseas markets. Although an elaborate system for grants of drawback of duties has been evolved, the procedure is cumbersome and in actual practice, the amount of drawback granted seldom equals the actual customs and excise duties paid. Further, the sales taxes paid on raw materials are not taken into account.

d. **High Tax Rates**: The tax structure is mostly concentrated towards higher side. The import duties, for example, have the nominal tariff rates mostly in the range of 75 to 150 per cent with average duty estimated to be over 100 per cent. Compared to the level of tariff rates generally prevailing among other developing countries, Indian tariff rates are definitely higher. In fact, it is important to note that both nominal rates and realised rates of tariff have been raised since 1980's. Thus, the higher rates have caused increase in effective rate of protection making them non- competitive. However, the high costs limit the size of domestic market causing constraint of ultimate growth. Similar degree of steepness in tax rates prevails in union excise duties as well as sales taxes.

e. **Lack of Transparency**: The existing system results in *uncontrolled incidence* of various taxes. The overall cumulative incidence lacks transparency for an economic analysis. As the cumulative incidence on commodities becomes fortuitous, *it is rather difficult to grade different commodities according to progressivity*. For example, while the nominal rate of excise on insulin (an important anti-diabetic drug) is 2 per cent and sales tax is 4 per cent, the cumulative levy tentatively adds up nearly to 27 per cent of ex-factory price. The lack of transparency obviates exact calculations of tax-incidence.

f. Entails Vertical Integration: The phenomenon of wide spread taxation of inputs *promotes vertical integration*. That is, it militates against the objective of ancillary industries and encourages industries to produce more and more of the inputs needed by them rather than purchase them from ancillary industries. To discourage this trend, the Modified VAT (MODVAT) scheme was introduced in the 1986 Budget in respect of goods covered by 37 specified chapters of the Central Excise Tariff. In the 1987 Budget, the scheme was extended to cover practically all chapters except those relating to petroleum products, textile products, tobacco products, cinematographic films and matches. However, at the State level, the sales tax system does not provide any such mechanism. The levy of sales tax on bought-out components hits the growth of ancillary industries.

g. Manufacturer's and Importers' Sales Tax: An important problem in the sales tax structure relates to the point of levy. There has been a tendency of the States over the years to switch over the point of origin - import or manufacturing stage. Most of the States yield between 70 and 90 per cent of revenue from the first point tax. Such a structure has all the weaknesses of the excise system. In addition, it loses the advantage of capturing value-added in the process and deviates from its destination principle.

h. Taxation of Out-of-State Sales: Taxation of out-of-State sales create many formidable problems. Presently, out-of-State sales (hereinafter referred to as inter-State sale) are taxable at the rate of 4 per cent under the Central Sales Tax Law (CST). Such a tax causes the phenomenon of cascading. Also a high rate of this magnitude increases the incidence of tax and forces the States to surrender their autonomy in deciding the States' sales tax rates. The CST is levied on inter-States sales only, consignments are exempt. It is now proposed that the CST be levied on all these exempted transactions too, which comprise

3/4th of the base. Hence, taxation of all the transactions (including consignments) would be inflationary, inequitions and distortionary.

i. **Narrow Base**: *Services are exempt from taxation* because of the constitutional limitations. Both the Union List and the State List do not cover taxation of services. Hence, the Union excise duties are levied on "goods manufactured or produced in India" and sales tax is levied on "sales or purchase of goods". A few selected services are, nevertheless, separately taxes under specific provisions of the Constitution. These include tax on electricity transportation, entertainment and profession. However, services as such are exempt. Since, services constitute a fast growing sector in the Indian economy, exclusion of services deprives the government of a lacerative source of revenue. In fact, in most countries of the world either under valued added tax (VAT) or under sales tax system, the tax base does include services.

V. Suggested Reforms

In the light of the above assessment of the indirect tax system in the country, we suggest below the possible reforms to reconcile the revenue objective with the objectives of establishing a structure of taxation that would subserve the ends of equity, growth and efficiency. The reforms should, however, be attempted for the immediate-run and for the medium-run.

a. Immediate-run Reforms:

i. *Reducing the number of rates*: The reform related to the multiplicity of rates requires efforts at simplifying the tax structure. Over time, the attempts have been made to attain a large number of objectives (including progressivity) through all these taxes. Hence, the number of rates classified according to their characteristics was increased. The number was further increased due to administrative considerations. Hence, the

present structure has enormous number of rates. Such a structure complicates the administration of all these taxes. Also a very fine gradation through tax rates does not serve any useful purpose of having progressivity. In fact, it complicates both the structure and administration of the taxes and causes evasion of tax. Hence, it is essential that the number of rates are reduced to a minimum. In most of the countries, the number of rates range between 3 and 5.[12]

ii. Lowering Total Tax Incidence: The lack of transparency in the tax structure does not allow us to reveal the cumulative total commodity tax burden in the economy. It is, therefore, necessary to undertake some academic exercise to estimate the tax burden. Also, the total tax burden on a commodity should not be prohibitive. The recent efforts of the government to streamline import duties is a step in the right direction. As envisaged in the Tax Reforms Committee, the import duties should be reduced considerably. The domestic taxes on commodities (viz., excise and sales tax) should also be harmonised to have efficient allocation of resources.

iii. Reforming Sales Tax System: The existing trend in the sales tax system is to push the tax base as close to imports/manufacture as possible. This has considerably reduced the income-elasticity of the tax system.[13] Also, the cascading effects of taxation at initial stage as well as taxation of raw materials need to be rationalised. With a view to safeguarding revenue neutrality and at the same time reforming the tax system, it is suggested that (a) a set-off be given for the taxes paid on raw materials; and (b) the rate structure be shifted towards the last-point, preferably through value-added principle.

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12. Purohit, Mahesh C. (1991), "Designing Value-Added Tax - Lessons from Theory and Practice". *International Journal of Development Banking*, Vol. 9, No. 1, January, pp. 55-62.

13. Purohit, Mahesh. C (1991), *Reforms in Indian Sales Tax System*, No. 3, June, Working Paper, National Institute of Public Finance and Policy, New Delhi, Table 2.

b. **Medium-term Reforms**: In the medium-term, the reforms have to be in the direction of adopting a full fledged Value Added Tax (VAT). Since, a preliminary step towards the reform of a complex structure of taxes has already been attempted by introducing MODVAT, it is right time that we think of its next step to bring about a harmonious functioning of all the major taxes that fall on different products.

As suggested by the Jha Committee[14] and further reiterated by the Chelliah Committee, it is now appropriate time that we go in for a complete change over to a Value Added Tax. Essentially, this would mean that we adopt a form of tax which is levied on all goods and services (except exports and government services), and which falls on the value-added at each stage from the stage of production to the retail stage. From revenue angle, however, we could still have excises on a few select commodities covering all the other items under VAT.

Nevertheless, extension of VAT to retail level would have constitutional problems. Also, the States would not like to surrender their taxing power which yields them 60 to 70 per cent of States' own tax revenue.

As a via media, therefore, it is proposed that we could have two different VATs; one at the Federal level-called Federal-VAT, and another at the State level-called State-VAT; the former would substitute union excise duties and the later would replace sales tax. The State-VAT could, however, have varying rates across the States. It could also consider CST, called Federal-VAT. Each dealer would be required to compute the federal and the State taxes on each sale. Their VAT liability for the period should be the aggregate of all output taxes (for Federal as

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14. Government of India (1978), *Report of the Indirect Taxation Equity Committee, (chairman: L.K. Jha)*, Ministry of Finance, New Delhi.

well as State governments) less the aggregate of all input taxes. The tax would then be deposited in the treasury which would account for different agencies.

The *modus operandi* of the collection of both these taxes in different States is illustrated in Table 2. It is seen from the illustration that each dealer charges both the Federal and the State-VAT and pays the tax to the treasury - the tax collecting agency. This agency would appropriate the tax according to the federal or State-VAT. For example, State `A' would collect Rs 9 - Rs 4 for Federal tax and Rs 5 for the State in which he has his business. The State `B' would have Rs 2 for Federal-VAT and Rs 7 for the State-VAT and so on. The structure and the operation of the Federal-VAT would be more or less the same (excepting set-off) as the existing Central Sales Tax for administrative purposes.

Thus, in the medium-run, the existing complex commodity tax structure needs to be rationalised and replaced by a simple system of Federal as well as State-VAT. The structure of both the VATs should be simple, having small number of rates but the coverage must include services, as recommended by the Study Group on Taxation of Services[15] and further reiterated by the Tax Reforms Committee. That would enlarge the overall base of the tax. These reforms should pave the way for a single unified VAT for the country in the long-run.

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15. Government of India (1991), *Report of the Study Group on Taxation of Services*, Ministry of Finance, New Delhi.

Table 2

Illustrative Calculation of Different State VATs with Federal VAT on Inter-State Transactions

Tax Structure	Manufacturer in State A		Wholesaler in State B		Retailer in State C		Final Tax Allocation
	Sale price Rs 100		Sale price Rs 150		Sale price Rs 300		
	Input Tax	Output Tax	Input Tax	Output Tax	Input Tax	Output Tax	
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Federal tax (Tax rate 4 per cent	0	4	-4	6	-6	12	12
State A (Tax rate 5 per cent)	0	5	0	0	0	0	0
State B (Tax rate 8 per cent)	0	0	-5	12	0	0	0
State C (Tax rate 6 per cent)	0	0	0	0	-12	18	18
Total		9		9		12	30

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