INTER-STATE TRANSACTIONS-OF TAX RATES

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INTER-STATE TRANSACTIONS: UNDERCUTTING OF TAX RATES[1]

In a federal set up where federating units have the power to levy taxes of their own, it often happens that federating units, in their anxiety to accelerate economic activities, reduce tax rates below those in the other units, to attract trade and industry in their respective territories. In India this problem has surfaced in a serious proportion in the case of sales tax, resulting in reduction of tax rates on various high priced goods. For instance, sales tax rate on electronic goods which ranged between 12 and 16 per cent in various States in the late seventies has come down to merely between 2 and 4 per cent: on car and chassis it reduced from 12-15 per cent to 4-5 per cent. The reduction in tax rates as a result of tax competition is of a great concern to centre and state governments because such trend is expected to affect their major source of revenue adversely .

In other federal countries where there is no tax on inter-state transaction, differentials in sales tax between two contiguous States may be quite effective to divert trade from the States taxing at a higher rate to the States taxing at the lower rate. However, in India where 'inter-state' transaction is subject to central sales tax and other restrictions, mere tax rate differentials alone are not reason for trade diversion. The States themselves sometimes employ indirect devices using certain provisions in Central Sales Tax (CST) Act to facilitate trade diversion. The provision under the CST Act that is frequently made use of for this purpose is Section 8(5). This section authorises the

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State Government to reduce the rate of CST below the rates prescribed in Section 8(1), 8(2) and 8(2A). The said provisions deal with the rates of tax applicable to sale effected in the course of inter-State trade or commerce. The devices used by the States are as follows.

First, the States conveniently took advantage of Section 8(5) of the CST Act which empowers them to reduce tax rate on inter-state transaction to 4 per cent or lower than 4 per cent, sometimes even if the transactions are not supported by C-Form. (Under the CST Act, C-form is issued for the transaction in the course of inter-state trade by dealers in the importing State to those in the exporting State, who by virtue of this form can justify such transactions having taken place between two registered dealers and claim exemptions from local sales tax whose rates are higher than the CST rates). This relaxation in the Act facilitates dealers in the exporting States to collect central sales tax at the reduced rates even on those inter-state transactions made by consumers in the importing state which are otherwise subject to 10 per cent or local sales tax prevailing in the exporting State, whichever is higher. This relief also encourages the importing dealer to camouflage inter-state transaction between him and the exporting dealer as one between the latter and the consumer at importing state to avoid local taxes leviable in the importing States. Besides, it encourages the exporting state dealer to show local sale as inter-state sales because local sales tax rates are higher than CST rates and thereby evade local sales tax.

Best example of exercising such power is of Andhra Pradesh Government, which, through a notification on January 27, 1987, reduced rate of CST on cement to as low as two per cent. This hampered the trade of cement manufacturers of its two neighbouring States, namely, Tamil Nadu and Karnataka. Such action led the latter to follow suit. However, the Supreme Court in an important judgement (India Cement Limited and others Vs. State of Andhra Pradesh and Others (1988, 69 Sales Tax Cases (STC) 305) put a stop to such practice.

Another method of undercutting tax rates is through Section 8(2A) of the CST Act, whereby sale of a commodity in the course of inter-state trade is subject to local sales tax rate applicable to the same if such rates are lower than the maximum levied on inter-state sale, i.e. four per cent (under this situation too, C-form is not required to be issued by importing dealers). There is a widespread complaint that union territories levy sales tax at the rates much lower than in other States, particularly on high price goods. A well known example is the three per cent rate on motor vehicles and motor chassis in Pondicherry and Daman. This resulted in diverting the trade of these goods from almost all over India to these territories.

Yet another method of reducing the effective tax burden is related to tax concession and exemption meant for encouraging industrial development in a given State, but have often been used as instrument for reducing effective tax rates in order to divert trade and capital in its territory from other States. In the recent past, concessions were given on the purchase/sale of raw materials produced within the State against those imported from outside. Such discriminatory practices were widely used by Gujarat and Andhra Pradesh. While the former allowed such kind of concession on locally manufactured raw materials used in the production of electronic goods, the latter extended such concessions on locally manufactured cement used in the cement products. Such concessions hampered the trade of these goods manufactured outside the States. However, these practices have been declared ultra-vires by the Supreme Court in their judgement in the case of India Cement Vs. State of Andhra Pradesh (1988, 69 STC 305) and in Weston Electronika and Others Vs. State of Gujarat (1988 70 STC 52).

Of the three above discussed devices, the first and the last can no longer be used, and thus at present the second one is the potential device available to States to facilitate trade diversion.

The primary objective of a State in indulging itself in tax competition is to affect the trade in other States and divert it to its own territory. In order to assess the effects of rate war on flow of trade, it will be useful to know first as to how the diversion in response to rate reduction may take place. It may be of interest to know that some of the ways of the diversion may be purely fictitious and only on the paper without any physical diversion in quantity. Some common methods of diversion are elaborated as follows.

First, buyers themselves visit the States with low tax rates and make purchase from there provided benefits in terms of tax saving are larger or at least equal to the cost of bringing to their own States.

Second, dealers themselves arrange cross-border purchases without final buyers to go over to the States with low rates. The device commonly adopted for this purpose is to colour inter-state transaction between two registered dealers as one between dealer and a cross-border consumer. The seriousness of the problem can be judged from the fact reported in the Parliament (Statesman 14/4/85) by the then Minister of State, Home Affairs that none of the three dealers of Maruti cars in Delhi is paying sales tax as the delivery of the car to the customers registered with the dealers in the capital is effected at the factory situated in Guragaon, Haryana, where tax rate on the car is very low.

Third, dealers in the high-taxed State show local sale as one between consumers in that State and their branch office located in a low-taxed State. The best example is of a automobile company in a major State of South India. A large number of motor chassis sent to Yanam (a very small town of Pondicherry) through 'branch transfer' are in fact sold within the same State. Further sometime inter-state transactions between two high-tax States are shown as one between consumers in the high-tax importing State and dealers in the low tax State. For instance, a dealer of a famous automobile company in Indore (Madhya Pradesh) where tax rate on motor vehicles is very high explains why the delivery of vehicles from the company office in Pune to them are shown as one between the company dealer in Silwasa (the capital of Dadar and Nagar Haveli-a low taxed union territory) and customers in Indore.

It would be worthwhile to show unusual trends in transactions of two commodities in towns located on the border between Bihar and West Bengal. Pulses are exempt from sales tax in West Bengal but taxed at the rate of 4 per cent in Bihar. It is found that transaction of pulses in a Division bordering Bihar is considerably high (Rs 7 crores in 1984-85) as compared to other division of West Bengal. It is apprehended that considerable quantity of pulses is first surresptitiously brought to West Bengal, then despatched by some means to Bihar as this way of transaction of pulses at least helps manufacturers using them as raw materials in Bihar to avoid both central and local sales tax. Mustard oil is taxed at the rate of 2 per cent in West Bengal and is declared tax-free in Bihar in the financial year 1984-85. During this period it was noted that volume of transaction of the oil in the district of West Bengal bordering Bihar has fallen down.

Generally the rate structure of commodity taxes are designed in such a way that luxury goods are subject to higher rate of tax than essential goods. Such a rate structure is expected to impose tax burden more on rich people than the poor. However, tax competition tends to reverse the situation and may result in the regressive tax rate structure. Luxuries being more expensive than essentials are more sensitive to trade diversion induced by tax competition. In order to discourage trade diversion, tax rate on such items get reduced in those States involved in the competition. At present in most of the States, sales tax rate on motor cars and chassis ranges from 4 to 5 per cent, while the tax rate on bicyle ranges from 6 to 10 per cent. Similarly tax rate on electronic goods including Hi-Fi system ranges between 2 to 4 per cent against 2 to 4 percent on cereals in many States. On an average in many States, Sales tax rate on essentials (cereals, pulses, chillies, turmeric, medicine, edible oils and cycles) is as high as on luxuries (motor cars, chassis and video and Hi-Fi electronic system). This is against the principle of commodity taxes.

In short-run tax competition is expected to boost sales tax revenue in the States which reduce tax rate, and may adversely affect the sales tax revenue in the States where the competition diverts the trade away. However, in the long-run its net effect appears to be uncertain. The reason is that the State which first reduces the tax rate may receive some revenue gain in the initial stages from the diversion of trade from other States, but the same disappears as and when other States also reduce the rate on the same commodity in their own jurisdictions. However, such rate reduction, on the other hand, may expand taxable base through income and substitution effects and thereby tax revenue. The net rise in revenue depends upon the magnitude of decline in revenue expected from tax rate reduction and growth of revenue from expansion of taxable base expected from reduction in tax rate. More exactly net rise in tax revenue demands that a rise in taxable base (say a) should be higher than the reduction in tax rate (say e) times $1/(1-e)$, that is, $a > e/(1-e)$. Besides, it causes excess transport cost and intricacies in the economy. For instance, a dealer of Maruti vehicles in Vapi (a town of Gujarat 10 km away from Daman and 167 km from Bombay) accept the money for delivery of Maruti vehicles to consumers, in their office in Bombay, performs all formalities in Vapi but finally delivers the vehicle from his stockyard in Daman. All this is done because tax rate on motor vehicles is merely 2 percent in Daman.

The fact is that competition ends up in zero sum game. Ultimately States are losers at least with respect to revenue point of view. Particularly it badly affects the revenue sources of less-developed States as they cannot be expected to compete on equal terms with its strong neighbours. Besides, it causes distortion in the equity oriented rate structure of sales tax.

Such problem calls for concerted action for its solutions. In the past many efforts are made to solve this problem. It would be worthwhile to highlight such efforts in the past.

First time in 1957, at the instance of National Development Council and with the approval of State Finance Ministers, a decision was taken that State governments would levy sales tax at not less than 7 per cent on 15 items. It was subsequently decided to raise the minimum rate of sales tax to 10 per cent. Further in January 1974 in the joint meeting of four regional councils of sales tax, it was decided that the difference in rates of sales tax should not be more than 2 per cent or 7 per cent depending upon the commodities taxed at the higher rates of sales tax and lower rates of tax respectively. Later, the Central government, in consultation with Planning Commission, drew up a list of 49 commodities which might be considered by State governments for a uniform rate subject to marginal differences. The problem was further discussed in the Chief Ministers' conference held on 16 and 17 September 1980, but no decision could be arrived. In 1984 a committee consisting of the commissioners of sales tax from eight different States (headed by sales tax commissioner of Maharashtra) went into the details of these aspects and came up with a list of 29 commodities which includes luxuries like electronic goods etc.. The committee suggested a uniform rate on these commodities could be levied. In the Chief Ministers' conference held on February 9th and 10th, 1989 the issue of discriminatory rates of sales tax among the States was again examined and a decision was taken to adopt a minimum floor rate of sales tax on the said 29 commodities which were identified and recommended by the Committee of Sales Tax Commissioners in their report. [For detail see: The Report of the Committee Constituted for Considering Nomenclature under Section 14 of the CST Act, 1956 and for Studying the Question of Uniformity in Some of the Items on a National Basis(1984)].

From the preceding section it appears that in spite of the concerted efforts at government level, no concrete steps have emerged so far to bring tax harmonisation or to reduce tax rate differentials across the States. In fact such a solution demands a central agency to coordinate changes in sales tax rates in the States. In order to make the agency work effectively, States may have to be absolved of their power of determining the rates of sales tax which at present they exercise as and when desired. But formulation of such agency will hamper the autonomy of the States. States are unlikely to give up their power. Thus, harmonisation of tax rate does not appear to be a practicable solution in the near future. Some government committees as well as Zonal Councils of Sales Tax and State Excise Duties have already expressed the doubts over the practicability of complete uniformity on sales tax rates across States. Besides there are wide ranging differences in economic and geographical situation of States. The economic compulsions of each State might force the concerned States to have its own tax policy, the result of which are disparate rate of sales tax. Thus it may not be wrong to say that it is impracticable to achieve a uniformity in sales tax rates all over the country.

Alternative to the solution which seeks uniform sales tax rates across the States, attention can be paid on the recommendation by the Committee of Sales Tax Commissioners - a minimum floor level rate on 29 goods, below which no State or Union Territory should fix the tax rate. However, in order to adopt this solution, all States need to agree on two things: (a) extent of the floor rate and (b) the identification of commodities which will be subject to the floor rate. It requires some co-operation among the States. However, past experiences show lack of consensus among States.

Recently, a new method is designed by a few States, namely, Madhya Pradesh, Maharashtra and Rajasthan, to tackle this problem. They employed entry tax to discourage trade diversion of motor vehicles. This tax is levied at the rate of sales tax on the entry of motor vehicles into the local areas. The tax is framed in such a way that it falls only on those vehicles purchased from outside the State. These States appear to have gained some success in discouraging the trade diversion of motor vehicles mainly because the identification of taxable base of these goods is not much difficult as the tax is collected at the time of registration of such vehicles in the State. Thus this tax may not be successful in checking trade diversion of other goods where such checks do not exist.

Solution to this problem appears to demand a detail examination of the same problem in other federal countries such as USA and Australia where States have fiscal autonomy like India. In brief, in the USA an attempt is made to tackle this problem with the help of user tax. The tax is very similar to entry tax levied in India. The States in the USA have started using this tax, recently. Under the provision of this law, sales tax department is allowed to collect the difference in tax rates between that State and the State from where the goods are purchased. Identification of inter-state transaction becomes relatively easy since dealers in the exporting States have to register themselves in the importing states, which is at present not possible under the present fiscal arrangement in India. The user tax is reported to have been successful to, a large extent, in discouraging the diversion of trade. In India too, attention can be paid on exploring the possibility of applicability of the user tax. Such a solution does not require the involvement of a central agency. Thus it will not hamper the existing federal structure of India.

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