3. Designing the Entry Tax—The Rate Structure, Estimated Yield and its Growth

Introductory

As mentioned in the preceding chapters, our principal aim is to design the structure of entry tax that would replace octroi in the State. In designing the structure, it is important to note that the yield from the new impost should adequately compensate the revenue loss arising from the abolition of octroi, keeping in view its economic effects. Further, the yield from the new levy should grow at least at the same rate as the revenue from octroi.

Given the conditions that the entry tax should yield as much revenue as octroi and should grow at least at the same rate, the designing of the tax requires two necessary steps, namely (i) estimation of the base of the entry tax and its growth over time, and (ii) designing of the appropriate rate structure of the tax to produce the required yield, keeping in view the principles of local taxation. In this chapter, we attempt to undertake these exercises.

Designing the Structure of Entry Tax

There is an important difference between tax design and tax reform. Tax design is done *de novo* on "a clean sheet of paper". While designing the tax every effort should be made to assess the situation existing prior to the designing of the tax. It may not be possible to identify and accurately measure all the economic consequences resulting from the tax, which may become clearer only after its imposition. Moreover, the effect

of a tax structure changes with changing economic conditions which occur over time. Tax reform thus becomes necessary to remedy the inadequacies in the tax design resulting from the information lag and changing economic conditions. Tax reform thus depends on the starting situation and unlike tax design, which is once for all, it is recurring. Any presumption that the structure of the tax designed by us shall be ideal and remain so in future would therefore be incorrect.

While designing the tax structure, principles of local taxation should be kept in view. It is well accepted that the role of local bodies in attaining the objectives of stabilisation and equity is only limited. The open nature of the local economies results in the leakage of multiplier effects of fiscal policy and hence stabilisation of the local economy becomes an impracticable proposition. The mobility of population prevents equity measures from being effective. It is, therefore, contended that the objective of local taxation is merely to raise adequate revenue with minimal resource distortions to finance the desired level of public goods.

Even though the role of local bodies in pursuing a positive redistributive policy is limited, it is incorrect to state that they have absolutely no role to play. Firstly, they may have to bring about redistribution between groups within their jurisdictions, though the effectiveness of these measures is limited by the population mobility. Secondly, the tax policies of the local bodies should not be so inequitable as to make it difficult for the higher levels of government to attain the desired degree of redistribution. Very importantly, care has to be taken to see that the people living in absolute poverty should not be made to pay the taxes.

Given that the local governments are required to primarily provide the required standard of local services, the tax system should largely be based on the benefit principle. While it is not possible to design the tax system entirely on the basis of *quid pro quo*, we may broadly state that people with higher incomes get larger benefits of local public goods. This can be presumed to be true for two reasons. Firstly, a number of

local public goods like fire protection and civic facilities have greater direct benefits for people with higher incomes and those owning larger property. Secondly, *ceteris paribus*, increases in public services result in a higher degree of in-migration into these jurisdictions resulting in increased capitalised value of the local properties. Assuming that income levels and property ownership move closely together, it can be stated that people with higher income levels tend to receive larger benefits from local public goods.

With these broad contours in mind, we might state that the items of consumption that form a large proportion of the consumption pattern of the people living in absolute poverty, and which are exempt from the sales tax, should be exempt for the purposes of entry tax also. Similarly, some of the goods produced by small unorganised producers and those which are perishables exempted from the sales tax for administrative reasons should be exempted from the entry tax also. This would, however, not exclude those items which are exempt from sales tax but are subject to additional excise duties in lieu of sales tax. Further, the rate structure of entry tax should be largely in harmony with the sales tax. In the interest of simplicity, we have grouped the different commodities into four different rate cateogries. This rate structure would maintain the overall progressivity of the sales taxes and would tax broadly those groups who largely benefit from local spending.

The Base of the Entry Tax

Entry tax, like octroi, is a tax on the entry of goods into a local jurisdiction for consumption, use or sale therein. As the definition of the tax is not different from octroi, the base of the tax would be more or less identical. However, octroi being a checkpost-based levy could be collected from all commodities including perishables and those produced by very small producers. But, it may not be feasible to collect entry tax from certain commodities like perishables and those transacted by unregistered dealers. To that extent, the coverage of entry tax would be narrower than that of octroi. Nevertheless, all the commodities exempted from sales tax need not be

exempted from entry tax. Apart from those subject to additional excise duties, the State Government may levy entry tax on some more commodities exempted from sales tax. However, in our estimate of the base, to be conservative, we have included only those commodities subject to sales tax and additional excise duties in lieu thereof.

We have matched the commodity-wise data on octroi collections with the sales tax rate schedule of the State. The data on detailed commodity-wise octroi collections are available for the four Municipal Corporations and 14 Municipalities in 1979-80 and three Municipal Corporations and Municipalities in 1974-75. These data can be taken to be fairly representative as they cover as much as 71 per cent of the total octroi yield from the urban local bodies in 1974-75 and 81 per cent in 1979-80. From the data it is seen that the octroi yield of the commodities exempted from the sales tax, excluding additional excise duty items, formed 5.9 per cent of total octroi revenue in 1974-75 and the corresponding percentage in 1979-80 was 6.5. It is thus seen that even if exemptions are provided to items exempted from sales tax the base of the entry tax would not be significantly eroded. Though the specific nature of the levy on some of the commodities renders it difficult to convert the tax base into value terms, on the basis of commodity-wise octroi yield we may broadly presume that as much as 93 per cent of the octroi base can be subjected to the entry tax. This would imply that the average entry tax rate required to yield equivalent amount of revenue as octroi would be only slightly higher.

Another important policy parameter required to be known is the probable growth of the tax base. Growth of the entry tax base may differ from the growth of octroi base for two important reasons. Firstly, as mentioned earlier, on a number of goods subject to octroi, entry tax can not be levied and the growth of the tax base of these exempted goods from entry tax could be different from the growth of the base of the taxable goods. Secondly, octroi on a number of commodities is a specific levy whereas entry tax, by virtue of its association with the sales tax, would be entirely an *ad valorem* levy. In

the case of a specific tax, the growth of the tax base of a commodity represents only the real growth and this is invariant to the price changes of the commodity. On the other hand the base of the entry tax, being *ad valorem*, grows in response to both the real growth of the base as well as its price changes. Generally, in an economy where commodity prices show increases, the growth rate of the entry tax base should be higher than that of octroi.

Estimating theBase of the Entry Tax

In order to estimate the base of the proposed entry tax in Gujarat, it is necessary to estimate the entry of different goods subject to the tax into the Municipal areas for the purposes of consumption, use or sale. Conceptually, assuming the level of inventories to be constant for each good, the imports (M) can be approximated by taking consumption (C)—[production (P)—exports (E)] within the jurisdiction of each of the urban local bodies.

Symbolically, $C + E - P = M$..... (1)

Assuming further that the export demand is met only after meeting the domestic demand, we can approximate the import of each good into a local jurisdiction by subtracting production of the good in the jurisdiction from its consumption, i.e.,

$C - P = M$..... (2)

if $C > P$, M will have positive values representing import into the local jurisdication. If $P > C$, then M will have negative values representing exports from the jurisdiction.

Though conceptually the base of the entry tax is simple, its empirical measurement poses formidable problems. Commodity-wise household consumption figures within each local jurisdiction can be approximated by assuming uniformity in the consumption pattern throughout the urban areas of the State and by taking the National Sample Survey (NSS) consumer expenditure data. But we do not have the commodity-wise intermediate consumption and production figures within the jurisdiction of each of the local bodies. Agricultural pro-

duction in urban agglomerations is negligible, and hence consumption of these items within the urban local body jurisdictions can be presumed to be entirely from imports from outside the jurisdictions. On the basis of the location of industries according to the *Annual Survey of Industries* (ASI) and small-scale industries survey, it may be possible to arrive at crude estimates of intermediate consumption and industrial production within the precincts of each of the urban local bodies. But time and resource constraints do not permit us such an elaborate exercise.

Fortunately, we have commodity-wise octroi collection figures for all the four Municipal Corporations and 14 out of 51 Municipalities for the year 1979-80. The octroi collections in these urban local bodies in 1979-80 amounted to Rs 37.87 crore of the total yield of Rs 46.77 crore for all Municipal Corporations and Municipalities. This represents about 81 per cent of the total octroi collections in these urban local bodies in Gujarat. Similarly, for 1974-75 we have the data for three of the four Municipal Corporations and 12 of the 51 Municipalities covering about 71 per cent of the total octroi collections from these urban local bodies in the State. Applying the relevant rates of the tax, we have estimated the turnover figures of these commodities that are subject to sales tax and the commodities subject to additional excise duties for these two years. As some of the commodities are subject to specific levies, we had to obtain the retail prices to convert the quantities of turnover into values. As these data are adequately representative, they are blown up to arrive at the value of commodity-wise turnover for all the Municipalities and Municipal Corporations in the State. The value of octroi turnover of these commodities subject to sales tax and addititional excise duty items for 1974-75 and 1970-80 are presented in Annexures IV.1 and IV.2. These results are summarised in Table 3.1.

From this table, it is seen that the potential base of entry tax in Gujarat in 1979-80 was Rs 3179.46 crore. Similarly, the potential base in 1974-75 works out to Rs 1558.41 crore. This potential base of entry tax recorded a compound annual

TABLE 3.1

Base of Entry Tax in Gujarat

(Rs. lakh)

		1974-75	*1979-80*	*Compound growth rate (per cent per annum)*	*Compound real growth (per cent per annum)*
(a)	Municipal corporations	110092.00	210971.22	13.9	9.9
(b)	Municipalities	45752.06	106974.51	18.6	14.6
(c)	All urban local bodies	155841.06	317945.73	15.3	11.3

growth rate of 15.3 per cent. As during this period the consumer price index registered a growth rate of 4 per cent per annum, the real annual growth rate of the base works out to 11.3 per cent.

It should be noted that the above gives us the estimate of only the potential base and not the actual base amenable to taxation. This only represents the upper limit and the actual base available for taxation would be lower than this. The difference between the potential and the actual base arises from the fact that although all imports into the urban local areas are conceptually taxable, it would be administratively infeasible to do so as some of the imports could have been done by individual households and very small dealers. As the proposed administrative arrangement is to collect the tax from the sales tax dealers, the actually taxable base will fall short of the potential base by the amount imported by households and unregistered traders and manufacturers.

It is difficult to assess the difference between the estimated potential base of the tax and the actually taxable base at the outset. In the case of importers (from outside the State) and manufacturers, the turnover limit may not be substantial. But, the limit for the registration of resellers is fairly high at Rs 1 lakh and inter-city trading by those retailers having lower

than Rs 1 lakh turnover could be significant. Besides, we do not have any clue as to the amount of transactions done by unregistered dealers. Estimation of the tax base which can not be captured due to this factor can be done only through a sample study of the dealers in some urban local bodies. Although the three categories of dealers (importers, manufacturers and resellers) having a turnover upto Rs 1 lakh contributed less than 5 per cent of the sales tax revenue in 1977-78[1]. the loss of the tax base due to this factor may be higher than this.

The actually taxable base may fall short of the potential base also for another reason. The complete switching over from the checkpost-based system of taxation in the case of octroi to an account-based system in the case of entry tax may affect the tax compliance adversely in the short run, though in the long run it may show a favourable trend. Further, whereas in the case of octroi the same base may be subject to taxation by more than one urban local body, the system of set-off and refunds that will be evolved in the case of entry tax would limit the taxation to only one place. Thus, for these reasons, in addition to the reasons mentioned in the previous paragraph, the actual tax applicable base may be lower than the potential tax base estimated by us.

As mentioned earlier, with the present data base, it would not be possible to estimate the likely shortfall in the actual taxable base from the potential base. This can be assessed only after octroi is abolished and switchover is made to the entry tax. Informed judgments on the shortfall of the base due to these reasons vary from 10 per cent to 25 per cent. For our purposes we have taken the liberal estimate of the shortfall of 25 per cent.

On this basis, it is seen that, of the potential base of entry tax Rs 3179.46 crore in 1979-80, only Rs 2384.60 crore could have actually been taxed. Similarly, in1974-75, of the Rs 1558.41 crore of potential base, only Rs 1168.81 crore could

[1]See Report of the Gujarat Taxation Enquiry Commission, 1980, Statement 18, p. 301.

have been actually taxed. On this base, to yield the revenue equivalent of octroi, the average tax rate works out to 1.97 per cent in 1979-80 and 1.78 per cent in 1974-75.

Designing the Rate Structure

An important step in designing a tax structure is the design of the tax rates on different commodities. We have already outlined the broad principles to be kept in mind in designing the rate structure of entry tax. Principally, the rate structure should be so designed as to yield the amount of revenue that would be lost by the the abolition of octroi. Secondly the yield should grow at least at the same rate as the growth of octroi in the past. Thirdly, the levying of entry tax should not lead to significant adverse economic effects. Specifically, the cascading effects of the tax should be minimised to a large extent which implies that the inputs should be subjected to low rates of taxation. Fourthly, the rate structure should be so designed as to impose the burden on the beneficiaries from the local public services. On our presumption that high income groups enjoy more than proportionate benefits, these high-income groups should pay more than proportionate taxes. Fifthly, on the premise that although the local bodies are not required to undertake positive redistributive measures, they should not make it difficult for the higher levels of government to achieve the objective of redistributing incomes. Finally, as the tax is closely knit to the sales tax levied in the State, for administrative reasons it is preferable to have the rate structure of entry tax closely resembling the rate structure of sales tax.

Keeping the above considerations in view, we have grouped the various commodities on which entry tax can be levied into four categories, namely, (a) items of common consumption and basic raw materials, (b) semi-durables, semi-luxury items, (c) durable goods, sumptuary goods and items of conspicuous consumption and (d) other consumer goods, other inputs and capital goods. These groupings are shown in Annexure III.1. On these four categories, we recommended the levy of entry tax at the rates of 1.0 per cent, 3.0 per cent, 4.00 per cent and 2 per cent, respectively.

Applying these tax rates on the value of the entry of taxable goods into the jurisdictions of urban local bodies in 1979-80, we have estimated the likely yield of entry tax from the different categories of goods. The value of the tax base, and the estimated yield of entry tax from the four different categories of goods are summarised in Table 3.2.

TABLE 3.2

Estimated Yield From Entry Tax in Gujarat 1979-80

(Rs lakh)

Groups	*Turnover value*	*Adjusted turnover value*	*Tax rate applicable*	*Estimated tax yield*
A. Items of common consumption and basic raw materials	137776.19	103332.15	1.00%	1033.32
B. Semi-durable and items of semi-luxury consumption	34542.17	25906.63	3.00%	777.20
C. Durable consumer goods, sumptuary goods and items of conspicuous consumption	20522.79	15392.09	4.00%	615.68
D. Other consumer goods, other inputs and capital goods	125104.58	93828.44	2.00%	1876.57
All commodities	317945.73	238459.31	—	4302.77

It may be seen that the estimated yield from entry tax in 1979-80 amounts to about Rs 43.03 crore which is only a little lower than the yield from octroi in that year (Rs 47 crore). We are confident that the actual collections would be higher than Rs 43 crore because the actually taxable base would be higher than the base estimated by us for two reasons. First, the shortfall of 25 per cent taken in our estimates is the upper limit and we expect the actual shortfall to be lower than this. Second, we have taken only those commodities which are subject to sales tax and additional excise duties in our entry

tax base calculations. As the State Government can levy entry tax also on some of the commodities exempted from sales tax, the actual base of the tax would be much higher than our estimation. It thus appears that levying of entry tax on the above different groups of commodities at the specified rates would adequately compensate for the loss of revenue arising from the abolition of octroi. Applying these tax rates on the base of the tax in 1974-75 gives the estimate of yield from the tax in the year, which amounts to Rs 22.68 crore. Further, had the tax been levied at the rates specified by us, between the years 1974-75 and 1979-80, the yield from the tax would have grown at the compound nominal rate of 13.7 per cent per annum, given that the average rate of growth of the yield would have been around 9.7 per cent per annum.

If the growth of the economy including the price situation continues to show the past trend, it may be expected that the yield from the entry tax would grow at this rate also in future, at least in the short run. Even in the long run the less adverse economic effects of the levy in comparison with octroi should result in better allocative efficiency and hence higher growth of the economy which in turn should result in faster growth of the entry tax base and its yield.

It is necessary to strike a note of caution at this juncture, that our estimates could vary from the actual realisation of the yield, though not by a considerable degree, for various reasons. Firstly, the tax bases of a few taxable commodities have been lumped with those of exempted goods for lack of disaggregated data and, hence when excluding the exempted items, the value of some of the taxable goods also gets excluded. Due to this, the estimate of tax base would have a marginal downward bias. Secondly, the estimates of octroi yield and base on which the yield from entry tax is estimated are checkpost-based, whereas the entry tax would be account-based. It is very difficult to say at the outset whether the evasion of the tax would be higher in one system or the other. However, the checkpost-based levy is perfunctory and is essentially based on trust of the tax payers and cannot be subjected to satisfactory counter-checks. The account-based

system, in contrast, if properly administered, can be subjected to such scrutiny and, therefore, it is possible to reduce considerably the extent of evasion under this system. Nevertheless, in the short run, a switch-over from the checkpost-based system to an account-based system might result in reduced tax compliance. We have given 25 per cent margin to take care of the imports into local areas by small dealers and reduced tax compliance due to the changed system of taxation, and this should be adequate. Thirdly, as mentioned earlier, all economic consequences of the levy can not be envisaged now and can be perceived only after it is imposed. However, we believe that the actual realisation may vary only marginally from our estimates.

It is necessary to note that the yield of the tax might fall short of the estimates if proper administrative measures are not taken. This is possible because a sudden switch-over from the checkpost-based to the account-based system might reduce the tax complaince in the short run. The sales tax assessees may evade the tax by not submitting the details relating to their purchases from within and outside the jurisdiction of the urban local bodies. We have given a margin of 25 per cent for this factor in the computations; neverthless, it is necessary to state that extreme vigilance should be exercised in the administration of the tax in order to reduce evasion to the minimum.

There are two important decisions the State Government has to take with regard to the rate at which the urban local bodies should be compensated in the ensuing years. Firstly, it should be decided whether the compensation should be made on the basis of the potential yield that would have resulted if the existing structure of the tax prevailed or allowance has to be made for the changes in the structure by assuming that the past trend in taking discretionary measures would continue in future also. If the former alternative is chosen, then the local bodies should be compensated according to the automatic growth rate, whereas if the latter is chosen, the relevant growth rate for the purposes of compensation becomes the total growth rate. We believe that as the

local bodies will have to give up right to change the structure of the tax with the abolition of octroi, they should be suitably compensated. The enhancement of the compensation by a minimum of 9 per cent every year recommended earlier takes this into account. The second decision pertains to the issue as to whether the rate of compensation for the different urban local bodies should be uniform or should be on the basis of their own past performance. Compensation on the basis of past performance might result in the reallocation of resources among the different municipalities in inequitable ways. As the rate of entry tax will be uniform, payment of compensation at different rates on the basis of the growth rate of octroi in different urban local bodies might result in devolving the money to a particular local body from the amount collected from the other local bodies. If a uniform growth rate is used, in addition to the resource reallocation of the type mentioned above, Municipal Corporations and bigger Municipalities, which would have raised octroi at a higher rate, would lose. Perhaps compensating all the Municipalities at one rate and Municipal Corporations at another could be a better *via media*, as the rates of growth of octroi do not differ markedly as between Municipal Corporations and among the different classes of Municipalities. Another alternative could be to compensate each jurisdiction at the average rate of growth of the revenue of all urban local bodies but allow the Municipal Corporations to levy a surcharge on the proposed entry tax subject to a ceiling rate structure. Weightage to population might also be given. We are not requested to go into these issues, but merely to estimate the elasticity of octroi. However, we have raised these issues here so that the State government can keep these in mind while taking the policy decisions regarding the abolition of octroi and compensating the urban local bodies in lieu thereof from the proceeds of entry tax.