

Chapter 2

Tax Policy Issues

The tax structure of the sub-national (i.e., the State and the local) governments have to follow a number of common principles that are in accordance with national objectives. First, there has to be a reasonable amount of uniformity in tax rates, failing which there might be diversion of trade and commerce as well as industrial activities. This uniformity is far more significant for parts of the three States and Delhi, forming the NCR, as differential tax structures in these States contiguous to Delhi can easily distort the location of trade and industrial activity along its borders. Second, whereas for regional economic development, it is important for the sub-national governments to mobilise greater resources by adjusting tax rates, it is equally important that these governments encourage new industries by offering tax incentives in order to attract investment. At the same time, however, it is essential that the concerned States do not vie with each other in the matter of tax rates and grant of concessions/incentives. Thus, any proposed tax policy for the NCR should necessarily incorporate provisions dealing with these two crucial aspects.

An important issue in framing a tax policy for the States relates to the desirability of granting tax incentives for attracting industries. Presently, tax

incentives are more often than not, based on superficial analysis and the motivation is political rather than economic. In most cases, tax incentives are associated with the opening of a new industry even when the incentive actually plays no role in the decision on its location. Critics of tax incentives see them as little more than a gift to industry from the State exchequer. Its proponents, on the other hand, argue that incentives are essential for attracting new industries because they reduce the effective cost of the industry. Thus, the issues involved in granting tax concession are: (a) Do the incentives have a positive effect on trade, commerce and industrial activity in the region? And, (b) What are the implications of such incentives for the sub-national governments?

An important aspect of a proposed tax policy for the NCR relates to the modus operandi of harmonising the tax rates among the States and the Union Territory of Delhi. Whereas, there is a reasonable amount of uniformity in tax rates among the States, the effective rate of tax in Delhi is substantially lower than in the neighbouring States. It is believed that this variation causes diversion of trade and relocation of industrial activities. If harmonisation is attempted by reducing the States' tax rates, it would have its effect on the whole of each State, major parts of which are not under the NCR and would, therefore, cause loss of revenue. The States would not be expected to agree to revise their rates for that small part which is included in the NCR. Any proposed increase in the tax rates in Delhi, on the other hand, is opposed by the Delhi Administration on the ground that it would vitiate its character as the centre of redistributive trade. One of the necessary tasks would, therefore, be to evolve a tax-mix which placates the vested interests of the Union Territory and the States concerned.

Even in the case of Central Sales Tax (CST), variations exist on account of the provisions under Section 8(5) of the CST Act, which permits variations in rates to suit the specific requirements of a particular State. To illustrate, whereas the rate of tax on the re-export of goods from Delhi is two per cent, in all the States whose areas fall within the NCR¹, this rate is four per cent. Also, in Delhi the CST rates on certain commodities have been reduced, which might cause considerable diversion of trade in the NCR. It would, thus, be relevant to see how uniformity in the CST rates could be achieved to the optimum.

Taxation of road transport is an important issue affecting the NCR Region. In fact, variations in the annual combined tax burden of both the motor vehicles tax and the passengers and goods tax among different States of the NCR might cause diversion of vehicles for registration in the low-tax State. Consequently, the cost of transporting goods could be less and the availability of transport vehicles could be much more in the low-tax area. It would thus, be important to examine whether taxation of transport sector might be a contributing factor in sub-optimal decisions regarding location of industries.

Similarly, local tax policy might also contribute to distortions leading to sub-optimal locational decisions and diversions of trade. In this context, the two important local taxes in the NCR are property tax and octroi. It may be important to examine whether adjustments in these tax rates would contribute to the desired objectives. If the effective rate of octroi varies considerably from one region to another, the cost of movement of goods and ultimately the price of the commodity is affected. Thus, variations in price from one local jurisdiction to another could lead to sub-

¹Hereafter referred to as "NCR States".

optimal locational decisions. This would also lead to diversion of trade from a high-tax municipal area to a low-tax area. Other factors being equal across regions, rates of property tax too might influence the locational decisions for commercial and industrial enterprises, if the difference in tax rates is considerable.

Objectives of Reform

In the light of the policy issues discussed above, the major objectives of reform in a proposed tax structure for the NCR could be stated as follows:

- a. The tax system of the NCR (i.e., of each of its constituent units) should be such as to contribute to the rapid and a balanced development of the whole region;
- b. The system should be in consonance, in some essential respects, with the structures prevailing in the neighbouring States;
- c. It should be uniform in all respects in regard to local commodity taxes and the Central sales tax; and
- d. It should be so administered that evasion of tax due to inter-State transactions within the region is checked through a suitable mechanism.

Keeping in view the above objectives, we shall in the following chapters, analyse the existing structure of taxes, industries and trade in the NCR. We then indicate the structural reforms required for the fiscal policy of the NCR.