Chapter 6

Summary of Conclusions and Recommendations

Taxation is an important factor influencing the location of industries and diversion of trade. The existing literature and available information, however, do not permit us to assess the effects of variations in tax or subsidies on industrial location or diversion of trade in a particular region. This study is an attempt to empirically examine these aspects in the context of the National Capital Region (NCR) which consists of the Union Territory of Delhi, one district of Rajasthan, three districts of Uttar Pradesh and six districts of Haryana. It seeks to analyse the impact of the various taxes in relation to changes in industrial structure and diversion of trade in the region. Finally, it puts forward some policy prescriptions to harmonise taxes of the sub-national (i.e., the State and local) governments within the NCR.

As the tax system of States (including local governments) has to operate within a federal framework, it is desirable that they follow certain common principles in accordance with the goals of national policy. Keeping the national objectives in view and taking care of the issues concerning the NCR, the major objectives of reform in the tax structure 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 promote the rapid and balanced development of the whole region;
b. It should be in consonance, in some essential respects, with the structures prevailing in the neighbouring States;
c. It should be uniform in essential aspects in regard to local commodity taxes and the Central sales tax; and
d. It should be so structured and administered that the scope for evasion through inter-State transactions within the region is minimised.

The above objectives have been kept in view while examining the structural reforms needed for a proposed tax policy of the NCR. In this context, we examine the systems of both state taxes as well as local taxes. The State taxes included in the study are sales tax, motor vehicles tax, passengers and goods tax and electricity duty. The local taxes considered are property tax and octroi.

Tax Structure

Sales tax is among the most important taxes of the States. While Rajasthan and Uttar Pradesh follows predominantly the first-point tax, Delhi and Haryana, by and large, rely on the last-point tax, although in Haryana, a substantial amount of sales tax yield comes from the first-point tax. Delhi levies mostly the last-point tax.

Sales tax rates in Delhi are relatively low for most commodities. In addition, Delhi has no surcharge or additional sales tax whereas Uttar Pradesh levies an additional sales tax of 5 per cent and Haryana and Rajasthan levy a surcharge at the rate of 2 and 10 per cent, respectively. The effective rate of tax in all the neighbouring States of Delhi is, therefore, greater than that prevailing in Delhi.

There are wide variations also in the matter of tax treatment of raw materials and inputs used in industrial production. Whereas Delhi and Haryana allow tax-free purchases by manufacturers, Uttar Pradesh provides for exemption on some raw materials and a concessional rate of 4 per cent on certain specified raw materials. Rajasthan exempts purchase of raw materials for a few select industries but in general provides for a concessional rate of one per cent for the purpose of raw materials by all manufacturers.

Incentives in sales tax are given in all the States of the NCR (except Delhi) to attract new industries. These concessions are in the form of (a) complete and unconditional exemption from payment of sales tax for a limited period of time, (b) conditional exemption depending upon the type of industry and (c) deferment of sales tax payment on finished goods as an interest-free loan for a limited number of years upto a specified limit related to the size of capital or assets of the manufacturer.

Taxation of Road Transport

Motor vehicles tax is levied in all the States, the rates varying according to the type of vehicle. The tax on two-wheelers and cars is levied according to their weight and on taxis and stage carriages according to seating capacity. Goods carriers pay according to their laden or unladen weight.

Goods tax is levied only in Haryana, Uttar Pradesh and Rajasthan; there is no such tax in Delhi. The rates of tax vary from one State to another. However, the statutory rate of tax is normally allowed to be compounded. The amount of the compounded tax (the one which is generally adopted in practice) shows that the burden is lowest in Delhi. It is followed by Haryana, while Rajasthan, which has introduced a special compounded levy, comes third. The maximum incidence is in Uttar Pradesh. Passenger tax is levied in Haryana and Uttar Pradesh only.

Since variations in rates abound, their combined incidence suggests that the lower effective tax rate in Delhi could cause diversion of vehicles for registration in the Union Territory of Delhi. Consequently, the cost of transporting goods should be less and the availability of transport could be much more in Delhi as compared to the neighbouring districts of the NCR.

Electricity Duty

This tax is levied at varying rates in constituent regions of the NCR. The rates are the lowest in Delhi. Tax rates in Haryana and Uttar Pradesh are quite high in spite of some concessions and apparently lower effective rates. However, this levy does not influence the location of industry to any appreciable extent. The important issue is the availability of adequate and uninterrupted power, and not its price or tax rate.

Local Taxation

Among the local taxes, octroi is the most important source of local finances. It is known as toll tax in Ghaziabad, terminal tax in Delhi and octroi in the other local governments. The rates of this tax vary widely from one State to another. Although a comparative study of exemptions and the structure of specific and *ad valorem* rates presents a formidable problem, it is evident that the rates of tax are lower in Delhi.

Another important local levy is the property tax. The scope and bases as well as structures of property tax differ from one local government to another. In general, either a flat rate or a proportional rate is levied in all the States except Delhi where the rates are progressive. Further, in Delhi the tax rate on non-residential property is higher than in other areas of the NCR.

Industrial Structure of the NCR

The NCR has witnessed a substantial growth of industries. The number of registered factories in the NCR increased from 3,296 in 1979 to 4,132 in 1984. Similarly, the capital employed has risen at a rate of 10.95 per cent per annum, total industrial employment at the rate of 7.34 per cent per annum and total output at 2.94 per cent per annum.

Industry-wise analysis of the NCR shows that the food and beverages industry has contributed the maximum output which is followed by chemicals and chemical products. During 1979 to 1984, the share of textiles, furniture and leather industries showed a decline, but food and beverages, footwear, petroleum, non-metallic minerals and non-electrical machinery witnessed an increase in their respective shares in the total output.

The share of industries in employment shows that the maximum contribution is made by food and beverages. Petroleum industry recorded a significant rise in its share of employment from 1.88 per cent in 1979 to 5.47 per cent in 1984. Non-electrical machinery industry's contribution also increased significantly.

A comparative analysis of the industrial structure of the regions in the NCR shows uneven development. Delhi has made impressive strides in industrialisation, as compared to a very low growth of the other districts falling within the NCR. The industrywise distribution of industrial sector in Delhi shows that the share of food and beverages is significant. Among the other industries, major contribution comes from furniture, chemical products, and non-metallic mineral industries. The districts of the State of Haryana contributed roughly 17.62 per cent of the total output in 1979 and 38.66 per cent in 1984, with Rohtak and Karnal leading among them. The industrial development of Bulandshahar district in Uttar Pradesh and Alwar in Rajasthan has been negligible, although in the latter area, there has been some change in recent years.

Analysing the share of each industry by district, we find concentration of wearing apparel and leather and fur products in Alwar. Other industries which contributed approximately 5 per cent share in 1984 were electrical machinery and basic metals. Among the districts of Haryana, food industry is concentrated in Rohtak and Mahindragarh. Textile industry is centered in Rohtak, Karnal and Gurgaon districts. Wearing apparel industry concentrated in Sonepat and Gurgaon, contributed more than half of the total output. Similarly, around 50 per cent of the output of non-metallic mineral industry comes from Karnal and Rohtak and around 64 per cent of the output of petroleum products industry comes from Karnal. Thus, the industries concentrated in Rohtak, Karnal, Gurgaon, Sonepat and Mahendragarh districts, in descending order of their shares in output, are petroleum products, non-metallic mineral products, wearing apparel, textiles and food industries.

Location of industries in a region is dependent upon a variety of factors such as availability of raw materials, transportation facilities, political and cultural barriers and availability of requisite resources. With a view to ascertaining the concentration of industries in various districts we have estimated locational quotients. Estimates of the location quotients indicate that the NCR districts in Haryana have a concentration of industries such as food and beverages, textiles and footwear and non-metallic minerals. Industries concentrated in Alwar district are chemicals, non-metallic mineral and food and beverages, whereas in Meerut food and beverages, basic metals and chemical industries have a high concentration. Further, a comparison of location quotients during 1979 and 1983 shows that there was no significant change in the industrial structures of the region over the two points of time.

The location of industry on *a priori* reasoning seems to be influenced by certain policy and non-policy variables. However, given the limitations of availability of data, we have considered the variables that could affect the cost of locating an industry. Using such variables, regression coefficient is estimated by applying the ordinary least squares (OLS) method. The regression exercise undertaken, highlight the quantitative significance of various factors that could *a priori* be considered important from the point of view of location of industries in the NCR region.

The results are broadly indicative of the influence of both the infrastructure as well as policy variables. In general, the lack of infrastructure facilities like availability of raw materials, cost of inputs, transport bottlenecks, labour availability were found impeding the location of industries. The significance of these variables, however, was uniquely guided by the specific nature of a particular district in the NCR zone. The same was true for the effective tax rate whose influence was significant and seemed to vary with the inter-district variations.

Concentration of Wholesale Trade

Approximately three fourths of the wholesale trade of the NCR is conducted in Delhi alone. Wholesale markets came up in Delhi during the late 19th and early 20th century, and over the years, Delhi has achieved the distinction of being the *entrepot* for the whole of the Northern India. The redistributive character of trade in Delhi is reflected in the fact that the commodities traded in Delhi are procured from and distributed all over Northern India. This is revealed by surveys conducted in 1959, 1969-70, 1978-79 and 1981. The surveys also show that 60 to 90 per cent of the total turnover was accounted for by some commodities that are imported into and re-exported from Delhi. Wholesale trade surveys conducted in Uttar Pradesh, Haryana and Rajasthan suggest that in each of the districts, there are a few wholesale markets. However, the districts of Uttar Pradesh account for a major part of the trade of these districts. The next in order are Haryana and Rajasthan.

The concentration of trade in Delhi is due to a variety of factors: being the centre of political as well as administrative power, availability of requisite infrastructure (such as banking activities, warehouses, transport, communication facilities and marshalling yards), variations in tax rates among the neighbouring districts, differences in prices of commodities (exclusive of tax) in the two markets, i.e., Delhi and the neighbouring districts, and weaknesses in administration of sales tax in regions outside Delhi. There is a general feeling that both dealers and consumers from neighbouring areas make bulk purchases in Delhi, mostly without payment of tax, and carry those goods as personal baggage. Subsequently, dealers often sell them in local areas without payment of the local tax. The provisions of the Central Sales Tax are also no less responsible for unnecessary movement of goods into Delhi; the CST rate on re-export of goods is 2 per cent in Delhi whereas in all the other neighbouring States this rate is 4 per cent.

Policy Recommendations

For an integrated development of the NCR, it is necessary to look at the NCR as an economically unified area. That is, in spite of its constituent parts belonging to different States, for a proper development of the region, the economic policies within the region should be so harmonised that the region comes to have the character of a unified whole and the growth of the different constituents of the region takes place on the basis of their comparative advantages.

In our study of the NCR as an economically unified area, among commodity taxes of the sub-national governments, sales tax and octroi are largely responsible for variations in the cost of production for the industry and creating inefficiencies through an undesirable diversion of trade in the region.

As regards sales tax, the lack of uniformity in the rates is striking. The effective rate of tax in Delhi is very low as compared to the rates prevalent in the adjoining States of Haryana, Rajasthan and Uttar Pradesh.

With a view to framing a tax policy that fulfils the objectives set out in the earlier section, it is important to reform the sales tax system of the NCR States (including the Union Territory of Delhi) in such a way that uniformity exists within a broad framework. We, therefore, recommend the following reforms in the structure of sales tax: First, the existing structure of sales tax in Delhi needs to be replaced by the first-point tax. The experience of all the States in India shows that the evasion of tax is much greater in the last-point levy, which in Delhi has also been unable to capture a large chunk of turnover presently escaping tax. Evidence gathered from different sections of society, the study team of the NIPFP suggests that both consumers as well as dealers from the nearby NCR districts make bulk purchases in Delhi so as to take advantage of the "no-tax-regime", a phenomenon related to the last-point tax. Hence, the proposed switchover would stop diversion of trade meant for avoiding the tax.[1] However, the change in the point of levy is not going to distort the redistributive character of Delhi's trade because the transactions relating to inter state trade would not suffer any tax. Second, a switchover to a first-point tax would further bring down the level of sales tax rate in Delhi in comparison with that prevailing in the neighbouring States. For the sake of parity, the rates of sales tax at the first-point in Delhi would have to be raised. The change in the tax rate would vary for different commodities depending upon the trade (or profit) margin between the first - and the last-point tax. It can be calculated for each commodity by using the formula $FPR=(1+x)r$, where FPR is the rate at the first-point, x is the margin of profit, and r is the last-point rate. Finally, sales tax rates in Delhi should be raised in a few specific cases where diversion of trade is evidenced.

Variations in the rates of Central Sales Tax (CST) among the States of the NCR is an important factor leading to diversion of trade. The concessional rate of two per cent [under Section 8(5) of the CST Act] in Delhi, notified to preserve the *entrepot* character of Delhi, has been used to divert trade from the neighbouring States where the CST rate is 4 per cent. It is, therefore, important that to have a balanced regional development of the NCR and to have this region as a unified economic zone, the States exporting goods from the NCR zone should levy CST at the rate of two per

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[1]It is important to note that very recently Delhi has switched over to a first-point tax in 43 commodities. But the procedure of using Form 31 does not check evasion of tax. This needs to be abolished.

cent on all exports. That is to say, the CST rate should be reduced to two per cent only. This would in the short run affect the yield of the CST in the States of Rajasthan, Haryana and Uttar Pradesh but in the long run, this would be more than offset. As a consequence of the reduction in the CST rate in these States, the exodus of goods to Delhi would come to a halt. Besides, there would be a tremendous growth of trade in the NCR districts because of the savings in transportation costs to Delhi. Finally, the reduced rate of the CST would cause export of goods directly from the NCR States, yielding them the CST revenue.

An important aspect of the sales tax structure relates to input taxation. An examination of the provisions of the sales tax laws of other States of the country shows that raw materials bought by manufacturers are exempt from tax in Punjab, Himachal Pradesh and Jammu & Kashmir. In Himachal Pradesh and Punjab, exemption is granted only for the raw materials used in the manufacture of taxable goods sold within the State. However, a number of other States do not fully exempt inputs bought by manufacturers. Several States provide for some concessional treatment in varying degrees. Maharashtra and Orissa tax raw materials at the concessional rate of four per cent, Madhya Pradesh at two per cent and Bihar at three per cent. Another category of input taxation in the country is of those States who do not grant any concessional treatment. Assam falls in this category.

A careful consideration of the existing provisions of concessions under the sales tax systems in the country suggests, that in the interests of economic development and for creating a higher tax base in the NCR States, it would be advisable not to levy any tax on raw materials used by manufacturers. A move in this direction would be an important step towards an economically rational tax policy for the NCR States. It would give a boost to industrial activity and discourage the unnecessary movement of goods from one State to another.

Incentives

The States have been introducing various concessions and incentives in their sales tax systems.[2] In evaluating these, we have to examine their efficacy and assess the resultant loss of revenue. Information required for such an exercise is not available. We have, therefore, no alternative but to analyse them on *a priori* grounds only.

First, it should be appreciated that in a federal set-up, when one State offers liberal tax concessions, it may, in the short run, succeed in diverting investment from other States, but in the long run, the advantage is neutralised when the affected States follow suit to avoid outflow of investment. It is, therefore, important that the States should give only reasonable tax concessions for industries in backward areas both for attracting them and for making them competitive, until they are established and can stand on their own. At the same time, the States should not vie with one another to attract industries through over-generous tax concessions because, collectively, the NCR States stand to lose revenues and if the concessions influence the location decisions, the regional industrial development of the NCR would be achieved only at the cost of uneconomic location of industries in the region as a whole.

Second, blanket exemption to a small-scale sector is not desirable. It causes an unduly large loss of revenue to the Government and opens up avenues for evasion.

[2]For details of sales tax incentives in different States in India, see Purohit, Mahesh C. (1988), *Structure and Administration of Sales Taxation in India*, New Delhi, Reliance Publishing House.

Besides, a small-scale unit may not necessarily be a very small or tiny unit which could merit concession. To understand this aspect, its implications need to be examined. A small-scale unit is defined as one, whose investment in plant and machinery does not exceed Rs. 3.5 million. Investment, including building may exceed this level. A manufacturing unit having fixed investment of this order, would have a turnover ranging anywhere between Rs 30 million and Rs 80 million or even more. Even at the most conservative estimate, it would be seen that the exemption of a dealer with a turnover of Rs 30 million would not be warranted, while non-manufacturing dealers with as low a turnover as Rs 20,000 to one million are required to be registered with the government and pay taxes.

Keeping the above points in view, the following policy imperatives emerge:

a. Total exemption of small-scale industries is not desirable;
b. All new industrial units could be granted an interest-free "tax loan" for a period of five years. However, in granting the tax-loans, selectivity or industry specification could be introduced. As in many States, specific industries could be given preferential treatment. Also, the States could define their own categories of 'essential' industries for such loans; and
c. Finally, there should be a ceiling on the tax loan as a proportion of the productive capital of the entrepreneur. A reasonable ceiling could be 50 per cent of the productive capital beyond which the collected tax must be paid by the industry.

Taxation of Road Transport

For comparing the tax burden on road transport in the different NCR States, it is necessary to take their combined incidence. It is found that the amount of tax paid by goods vehicles is the highest in Uttar Pradesh. Rajasthan and Haryana follows it. Delhi, with the lowest combined tax burden among the NCR units, exerts a strong gravitational pull on the transport industry in the region. In fact, many of the representations from the trade and commerce submitted to the Study Team of the NIPFP bring out the fact that the easy availability of transport in Delhi is an important factor and also a great hindrance in shifting industry and trade out of Delhi. It is, therefore, important that the effective combined burden of the motor vehicle tax and passengers and goods tax in Delhi be substantially raised to bring it at par with the other States of the NCR.

Octroi

Like sales tax at the State level, octroi is very important at the local government level. It continues to be a predominant and growing source of revenue for these governments in the NCR States. However, there is a general feeling that this tax has several demerits, such as hindrance to smooth traffic flow, corruption in its administration, high cost of collection, regressivity of incidence, collection of large revenue from inputs and producers' goods leading to cascading, and perfunctory assessment of the tax. It is, therefore, necessary that to evolve the NCR as a unified economic region, we do away with such an obnoxious tax. To compensate for the loss of revenue, the States comprising the NCR could adopt entry tax along the lines recommended by the Gujarat Taxation and Enquiry Commission, 1980.[3] However, the entry tax should not be levied on raw materials.

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[3]Government of Gujarat (1980), Report of the *Gujarat Taxation Enquiry Commission*, Gandhi Nagar.

Property Tax

Compared to the other NCR constituents, property tax rates are high in the Union Territory of Delhi. Notwithstanding a gradation of rates according to residential and commercial or industrial use, the concentration of property ownership in Delhi has increased over the years. It is, therefore, recommended that to achieve a synergy effect on the diversification of ownership of assets to neighbouring districts, an additional tax could be levied on the preferences of the persons owning property in Delhi. This could be in the form of an additional tax on new commercial properties constructed in Delhi for commercial and industrial purposes. The rate of the tax should be related to the present tax liability borne by owners. That is to say, the tax would be in the nature of an additional levy on new properties only. While this may not be a great inducement to go out of Delhi, it would surely have some deterrent effect on the decisions to own new property in Delhi. Also, this would collect extra revenue for the use of the infrastructure facilities within the Union Territory of Delhi.

Congestion Tax

As examined in relation to the concentration of trade in Delhi, there is a heavy traffic inflow as well as outflow. From a Trade Flow Survey conducted by the Delhi Development Authority in 1981, it is very clearly seen that the wholesale trade in most of the commodities is concentrated in Delhi for redistributive purposes. This is because of the fact that Delhi works as an *entrepot* for the whole of North India. Although various measures are required to shift the wholesale trade, a token levy in the form of a congestion tax of Rs 10 per truck entering the Union Territory of Delhi could be considered. This would be in the nature of a toll tax on each truck entering the territory. As this would not be related to value, goods of less value and requiring more space would have to pay more in the form of this tax. It would, therefore, possibly be exerting a positive effect on diversifying the wholesale market outside the Union Territory of Delhi for commodities using more space.

Infrastructure Facilities

Notwithstanding the fact that the objectives of our study is to confine our observations to tax policy alone, the area of fiscal policy (the subject matter of the title of the study) is not restricted to tax alone. Fiscal policy covers both aspects, namely, tax and public expenditure. As we do not have data on public expenditure for the districts of the NCR, this study has attempted to examine infrastructure in a very limited way. It has been revealed that the NCR districts, with the obvious exception of Delhi have poor infrastructure facilities. Power, transport, communication, road, warehouses, etc. are conspicuously meagre in most of the districts. This lacuna has been an important factor causing concentration of industry and trade in Delhi. This has been corroborated by the members of the PHD Chamber of Commerce, New Delhi, in response to our questionnaire. In fact, the most important hindrance is the inadequate availability of electricity in these districts, as corroborated by the data made available by the Central Electricity Authority. We are, therefore, of the view that tax policy alone would not be able to diversify industry from Delhi. What is important is to create the requisite infrastructure in all these districts. In this regard it is important to note that the Bombay Metropolitan Regional Planning Board (BMRPB) had taken the right step in setting up the City and Industrial Development Corporation of Maharashtra Ltd. (CIDCO) for shifting the thrust of activity from the island city of Bombay to an area across Thane Creek. In this context, the CIDCO was instrumental in the shifting of wholesale iron and steel market from Bombay to Kalamboli, New Bombay. For this purpose, the CIDCO carried out a detailed study of the existing market of iron and steel. The study included an indepth analysis of flow of goods, movement of trucks, space requirements, housing and commercial space requirements, etc. The result was a new wholesale market with all infrastructure facilities. In this process, the CIDCO invested Rs 40 crore. This has helped reduce a great deal of congestion in Bombay. The CIDCO's experience suggests that specific studies are required to be carried out for each commodity on the basis of flow of goods to and from Delhi in relation to congestion of traffic in the city. On the basis of the recommendations of these studies, new wholesale markets in designated areas outside Delhi would have to be developed by the NCR or by an agency similar to CIDCO. This agency would be responsible for providing all the requisite infrastructure in the designated new markets. Thus, a detailed layout has to be prepared for each of the commodity markets. In addition, a modern truck terminal service as well as transport, communication and housing facilities have to be provided for. To conclude, the push factors to divert industry to the neighbouring districts would be relevant when some pull factors are also created in the neighbouring districts. In the absence of the requisite infrastructure facilities, fiscal policy alone would be ineffective.