

## INTRODUCTION

### 1.1 Prelude : The Urgency of Reform

Domestic trade taxes in India are in urgent need of reform. The reason simply is that the system that is operating at present is antiquated, complex - according to knowledgeable experts, the most complex in the world - and injurious to the economy in many ways. It follows no rational pattern, having evolved over the years mostly through changes made *ad hoc* from time to time in response to exigencies and violates all time-honoured canons of taxation - certainty, neutrality and equity.

Apart from inherent flaws in the structure, the laws and procedures are so complex and there are so many grey areas that assessments are often taken to the courts and they remain locked up for adjudication for years creating uncertainty for revenue as well as taxpayers. Such a system causes incalculable damage to the economy by arbitrarily interfering with the decisions of economic agents and thereby distorting the pattern of trade and industry, adding to their costs, undermining their competitive strength, and misallocating scarce resources. In the absence of transparency, it cannot serve the goal of equity either. Unless radically reformed, the tax system will impede the growth of the economy and realisation of the full potential of the huge common market that the Union of India offers, and the phenomenal economic development that is occurring elsewhere in Asia will bypass India.

The decade of the 1980s witnessed sweeping reform of tax systems across the world reflecting a growing awareness of the significance of the role that taxes play in the performance of the economy and public perceptions about the fairness of the social and economic system. Fairness, efficiency and simplicity have been the guiding aims of the reform. An additional motivation, particularly in the developing countries, was the need for augmenting government revenues to contain the deficits in the budgets that had tended to widen alarmingly in the

wake of the oil shocks in the seventies and the economic crisis that many countries had to cope with in the early eighties. In the structural adjustment programmes adopted by the countries that sought to stabilise their economies and find a solution to their chronic problems, tax reform invariably formed a key component. In fact, all countries which are doing well economically have reformed their trade taxes, both domestic and external, and gone in for a system that promotes neutrality and reduces interference with the functioning of the economy.

The crisis that overtook the Indian economy in 1991 also brought into sharp focus the need to carry out some radical reforms of the tax system which were even otherwise long overdue. Reforms in the trade and industrial policies and the move towards a liberalised outward-oriented economy called for complementary reforms in the tax system to make sure that it did not act as a drag on the growth of domestic industries or their competitiveness in the world markets. The need to recompense the government for the diminution of revenues from customs duties from the lowering of customs tariffs, which is concomitant to liberalization and opening up of the economy to external competition, lent further urgency to domestic tax reform.

The Tax Reforms Committee (TRC) which was set up in 1991 under the chairmanship of Prof Raja J Chelliah has come out with wide ranging measures to improve the system of both direct and indirect taxes. Many of the recommendations particularly for direct taxes and taxes on foreign trade have since been implemented. The focus of the TRC was, however, on the taxes levied by the Centre. Comprehensive reform of domestic trade taxes including the taxes levied by the States as well remains to be undertaken. Reflecting the anxiety of the government to initiate reforms, of the domestic trade taxes, the Union Finance Minister in his Budget Speech for 1993-94 had observed:

".....our long term aim should be to move to a Value Added Tax System. However, a nationwide value added tax system cannot be introduced overnight. There has to be a broad agreement among the Centre and the States on the design of such a system. In order to promote informed discussion and debate, I am requesting the National Institute of Public Finance and Policy to prepare the design of a possible value added tax system."

The report presented below is the outcome of the study undertaken by the NIPFP in this context.

## **1.2 Plan of the Report**

The study seeks to provide a blueprint for the reform of the two principal taxes on domestic production and trade currently in operation, viz., the Central excises and the State sales taxes. The need for a thorough-going reform of the domestic indirect taxes is sometimes questioned on the ground that the system that has evolved over the years and attained a measure of stability should not be cast aside or tinkered with especially in a federal country like India where Centre-State relations are not too easy. Before proceeding to consider the possible options for reform it is, therefore, necessary to take a look at the problems with the present system and their consequences. Correct diagnosis of the ills is a prerequisite for the prescription to be efficacious.

Chapter 2 of the report is, accordingly, devoted to an appraisal of the system that is

in operation at present in order to identify the basic problems, their roots and the costs they impose on the economy. Although they constitute a major component of the trade taxes in the country, sales taxes have not received the attention they deserve in discussions on tax reform. Chapter 3 focuses on the main features of the sales tax systems of the States and their injurious effects. The goals of reform in the current context and the parameters to be kept in view are put forth in Chapter 4. Briefly, it is argued that the existing structures of domestic taxes, on commodities are fundamentally flawed and only a move towards a system of value added tax holds out the promise of a satisfactory and lasting solution - a prescription that is put forward forcefully by the TRC too. The principal forms and basic features of the value added tax are explained briefly in Chapter 5. Options for reforming the present system towards a system of VAT, especially in India's federal context, are examined in Chapter 6. Since, given the compulsions of a federal polity of India's dimension and diversity, it may not be feasible to go in for reforms that might appear to be ideal in the abstract, the scheme which could remove many of the ills of the present system and is also likely to be acceptable is put forward as the best alternative for the foreseeable future. Chapter 7 elaborates the scheme of reforms on the States side. The revenue and economic impact of the proposed reforms is considered in Chapter 8. The administrative and institutional changes required for implementing the VAT at the two levels are discussed in Chapter 9.