

THE CURRENT SYSTEMS AND THEIR PROBLEMS

2.1 India's Tax Structure and Its Shortcomings

In terms of tax ratio - the proportion of tax revenue to GDP - India with a ratio of 16.8 per cent ranks above the average among countries with similar per capita income. At the beginning of the 1950s, the ratio was only about 7 per cent (vide Table 2.1). The tax structure that has emerged in the process of reaching the present level, however, differs significantly from that of developing countries in general.

Over 84 per cent of the revenues of the government (Centre and the States combined) come from indirect taxes, of which nearly 27 per cent is derived from excise duties levied by the Union government, 22 per cent from customs and 21 per cent from the States' sales taxes. In the case of the States, the dependence on indirect taxes is even greater. Nearly 90 per cent of their own-source tax revenues come from indirect taxes, among which the dominant source is the sales tax [vide Appendix Tables A3.1, A3.2(a) and A3.2(b)]. While dependence on indirect taxes is a common characteristic of the tax structure of developing countries, the degree of dependence on taxes on domestic production and trade in India is way above that of even the poorest among less developed countries. The proportion of domestic indirect taxes in the total tax revenue of LDCs, on an average, is only about 28 per cent (in the case of poorest LDCs, 33 per cent), whereas in India it is over 60 per cent.

Such dependence on indirect taxes would not be of much concern if the taxes were imposed in a fair and neutral manner and collected efficiently. This is clearly not the case in India. Operation of both Union excises and sales taxes, the two principal components of the domestic trade taxes, has given rise to problems and inefficiencies that cost the economy dearly in many ways. Briefly, the manner in which the taxes on domestic production and trade are currently structured and administered causes:

- . Loss of output growth and welfare;
- . Inefficiency and high cost in industry and trade;
- . Encumbrance for exports;
- . Impediments to the free flow of trade within the country and growth of the common market that the Indian Union offers;
- . Inter-jurisdictional conflicts; and
- . High costs of compliance and enforcement.

2.2 Basic Problems

The costs enumerated above stem essentially from certain features of the present system. Principally, these are:

- . Heavy reliance on taxes at the manufacturer/first seller level;
- . Exclusion of services from the tax base;
- . Taxation of inputs and capital goods;
- . High level and multiplicity of rates with too many exemptions and concessions;
- . Taxation of inter-State sale and lack of harmony in States' sales tax systems; and
- . Complex laws and archaic administration.

Some of these are common to both excises and sales taxes while some are peculiar to either one or the other.

2.2.1 Taxation at manufacturer level

Under the Constitution, the bases of excise duties and sales taxes, the two principal components of the domestic trade taxes, are distinctly defined - *goods* manufactured or produced in India in the case of excise, and sale or purchase of goods for the sales taxes.¹ In practice, the two bases

1. Entry 84 of the Union List in the Seventh Schedule to the Constitution empowers the Centre to levy excise taxes on tobacco and other goods manufactured or produced in India (except alcoholic liquors and narcotics) while Entry 54 of the State List empowers the States to levy "taxes on the sale or purchase of goods other than newspapers".

Table 2.1
Revenue Receipts of Centre, States & Union Territories
as Proportion of Gross Domestic Product
 (at Current Market Prices)

Taxes/Years	1950- 51	1955- 56	1960- 65	1965- 70	1970- 75	1975- 80	1980- 85	1985- 90	1991- 92(RE)
	(per cent)								
Direct Taxes	2.46	2.53	2.91	2.44	2.51	2.87	2.42	2.39	2.66
of which									
1.1 Corporation Tax	0.42	0.36	1.10	0.95	0.98	1.19	1.15	1.07	1.20
1.2 Taxes on Income	1.43	1.29	1.07	1.04	1.18	1.24	0.90	1.03	1.11
1.3 Land Revenue	0.55	0.77	0.59	0.34	0.23	0.20	0.13	0.14	0.09
1.4 Others	0.06	0.11	0.15	0.11	0.12	0.23	0.25	0.15	0.26
Indirect Taxes	4.23	4.96	6.99	8.07	9.60	11.76	12.76	14.54	14.15
of which									
2.1 Customs	1.68	1.63	1.39	1.50	1.60	2.12	2.79	3.94	3.76
2.2 Union Excise Duties	0.72	1.42	3.10	3.54	4.34	5.00	4.75	4.89	4.54
2.3 State Excise Duties	0.53	0.44	0.35	0.42	0.55	0.62	0.78	0.87	0.92
2.4 Stamp & Registration Fees	0.30	0.30	0.31	0.32	0.30	0.32	0.32	0.38	0.42
2.5 Sales Taxes	0.62	0.80	1.20	1.59	1.96	2.70	3.13	3.43	3.58
2.6 Others	0.38	0.38	0.63	0.71	0.85	1.00	0.98	1.02	0.93
Total Tax Revenue	6.69	7.48	9.89	10.51	12.11	14.63	15.18	16.93	16.81

Source: *Indian Public Finance Statistics* (various issues), Government of India, Ministry of Finance.

have come to overlap. Because of problems in administering taxes at the retail level, most States have moved the point of levy of their sales taxes primarily to the first point of sale, that is, on manufacturers and importers of goods in their respective jurisdictions.

2.2.1.1 Definitional ambiguities

Taxation at the manufacturer level which excise taxation predicates encounters intractable problems as the term "manufacturing" is not as easy to define as might be supposed. Goods may undergo a change of form due to a variety of processing activities performed after their initial produc-

tion or manufacturing (e.g., grinding, twisting, texturing, blending). There are many processes which constitute only "marginal manufacturing". Attempts to bring them all under "manufacturing" for taxation have given rise to disputes and uncertainty. Clarifications have been provided in the law in the form of section/chapter notes to contain the areas of dispute but the uncertainty persists. Some examples of judicial rulings bearing on the definition of "manufacturing" are given in Box 2.1. Box 2.2 illustrates how the law gets complicated when attempts are made to delimit the grey areas through "notes" in the statute rather than addressing the problems at their roots.

Box 2.1

**Definition of Manufacturing
(Some Judicial Rulings)**

- . Adding of water, perfume, colour to liquid soap does not amount to manufacture as no new substance of a distinct name, character or use is produced.
- . Making of aluminium cans out of aluminium slugs does not amount to "manufacture"
- . Application of rubber compound to cotton fabrics does not amount to manufacture of "cotton fabrics rubberised".
- . Assembling of cycle from its parts in CKD condition is not "manufacture", but assembling of fishing rods out of imported components amounts to manufacture.
- . Body building on duty paid chassis is not manufacture.
- . Conversion and sawing of timber logs into different sizes, planks, beams, etc. is not manufacture.
- . Process of mercerising does not amount to manufacture.
- . Evaporator plant built on cement concrete foundation permanently laid and embedded in the ground is immovable property and not 'goods'. Assembly, erection and commissioning thereof does not, therefore, amount to manufacture.
- . Process of coating of steel pipes with cement does not amount to manufacture; coated steel pipes being only steel pipes and not a different product.
- . Process of punching or drilling and galvanising duty paid MS angle and flats of specified sizes not being high intricate, specialised or technical nature does not amount to manufacture.

Source: R.K. Jain's Excise and Customs Case Referencer, 1993 and Excise Law Times.

Box 2.2

**Extracts from Chapter/Section Notes in
Central Excise Tariff Act, 1985**

Note 4 to Chapter 33: "in relation to products under heading Nos. 33.03 (Perfumes and toiletwater), 33.04 (Beauty and make-up preparations and preparations for the care of skin), and 33.05 (Preparations for use in the hair), conversion of powder into tablets, labelling or relabelling of containers intended for consumers or repacking from bulk packs to retail packs or the adoption of any other treatment to render the products marketable to the consumer, shall be construed as manufacture".

In respect of machinery covered by Section XVI, Note 6 of this Section says: "conversion of an article which is incomplete or unfinished but having the essential character of the complete or finished article (including 'blank', that is an article, not ready for direct use, having the approximate shape or outline of the finished article or part, and which can only be used other than in exceptional cases, for completion into the finished article or part), into complete or finished article shall amount to 'manufacture'."

Taxation of sales at first point only has to contend with similar problems. To avoid taxation when the tax is payable by the first seller only, addition of value through, say, processing or packaging of a product is often claimed to be not manufacturing and so not liable to first point sales tax.

2.2.1.2 Malleability of manufacturing value

In taxation at the manufacturer level, determination of manufacturing value also is equally troublesome. Manufacturers often sell their products through their own distributors or through wholesalers and sometimes directly to the consumers. In determining the assessable value at the manufacturer level adjustments have to be made for legitimate trade margins at different trade levels. Sales between related entities also have to be

looked through carefully. Not surprisingly, the basis of valuation for Central excise levy has been a contentious issue throughout. The matter has gone up to the Supreme Court on numerous occasions. To facilitate compliance and administration, the law was amended in 1973 providing further guidance on the basis for valuation, but the issues are not all settled yet.

Dealing with the question whether costs of after-sale service, advertisement and selling, organisation expenses come under manufacturing cost, the Supreme Court ruled in a leading case that it is not the bare manufacturing cost and manufacturing profit which constitute the basis for taxable value (*Union of India vs. Bombay Tyre International*). Even after such rulings, determination of excisable value has continued to present acute problems. In a

subsequent judgement, the Supreme Court directed that deductions be allowed for items like "prompt payment discount", interest on finished goods and stocks from the date the stocks are cleared till date of sale, interest on deferred realisation, but not for warranty discount, year-end bonus, campaign bonus, discounts to government or defence supplies and so on (Assistant Collector of Central Excise vs. MRF Ltd). It seems the judgement in the subsequent case has been recalled and is awaiting review by the Supreme Court.

To circumvent the problem of valuation, the excise system has come to rely heavily on "specific" rather than ad valorem rates. Nearly 60 per cent of excise revenue is realized through specific rates. It is not usually appreciated that specific duties cause economic distortions. For they only tax that characteristic of the product which is mentioned in the law, distorting producer choices in favour of those that go untaxed. Specific duties can be justified on economic grounds only when one wants to internalize externalities (e.g., in the case of tobacco and alcohol or even non-renewable energy products like petroleum). But that does not seem to be the rationale for such heavy reliance on specific rates in Indian excises.

2.2.2 Exclusion of services

Both in excise and sales taxes, the problems in taxation at manufacturer level have been compounded by the exclusion of "services" from the base.

The definition of the powers of excise taxation as well as sales tax refers only to "goods" without any mention of services. As a result, neither Central excise nor sales tax can be applied to services. The distinction implicitly drawn in the Constitution between goods and services is, however, not in accord with the realities of modern economies. Services are often an integral part of manufacturing and trade and the line between goods and services is getting increasingly blurred (e.g., in the manufacture of computer software, desk-top publishing, developing and printing of photographs, photocopying, etc.). Manufacturers may provide a wide variety of

services for the goods manufactured by them such as training, advertising, installation and maintenance. Taking advantage of the definitional ambiguities and the exclusion of services, manufacturers have tried to minimise the assessable value of their products by making sales at artificially low values to a related distributor/wholesaler and by claiming discounts for the so-called "post-manufacturing services" (e.g., transportation, installation and warranty services). Essentially it is exclusion of services from the base coupled with the inability of the Centre to extend taxation of goods beyond the manufacturing stage that underlies the problem of determination of manufacturing value for excise that came up before the Supreme Court in the MRF case referred to above.

Another problem is that the powers of indirect taxation are defined in the Constitution in terms of "goods" that is, things which are tangible and movable. So the processes of erection or fabrication or any such activity that helps in the creation of something immovable, even when integral to a transaction involving production, are claimed as falling outside the definition of "manufacturing" and so not liable to excise taxation. How problems arise in the application of excise taxes because of these ambiguities can be seen from cases commented upon in the recent audit reports of the Comptroller and Auditor General (C&AG).

In one such case, the assessee manufactured ash handling system under contract on turn-key basis. This item falls under one of the headings of the Schedule to the CE Tariff Act. Some of the parts and components used for the "system" were manufactured by the assessee while some were procured from the market. Duty was paid duly by the assessee on the parts manufactured by him. The bought out items were taken directly to the site and used along with the parts manufactured in the assessee's factory to set up the "system" on site. No duty was charged by the Excise Department on the "system" as a whole on the reasoning that the "system" is an *immovable* product

made up of manufactured as well as bought out items. This was objected to by C&AG's audit.

It is not difficult to see that the controversy in these cases arose not so much from the "immovable" nature of the goods in question as from the exclusion of services from the base and the failure to recognise that the essence of manufacturing in the economic sense lies in the addition of value and that the final product consists of both material and service components in various forms.

Similar problems arise in the implementation of first-point sales taxation too. Even where the movability of the product is not in doubt, when services are not included in the base, whether activities such as the following come under "manufacturing" and so liable to sales tax at first-point are not all that obvious and have had to go to courts for a decision:

- . dispensing of medicines
- . grinding of spices
- . chopping of firewood
- . assembling of prescription eye glasses
- . breaking and dismantling of ships.

When the tax is levied only on the first point of sale, sellers of goods providing services such as those noted above do not have to pay tax, if they do not come within the category of "manufacturer" as they can then claim to be resellers only.

Apart from technical problems, taxation of goods only at manufacturer/first-point level, that is, on a base that does not include distribution margins and associated services, tends to distort producer and consumer choices. Items which carry large trade margins (as is usually the case with luxury products) are favoured over essential consumer goods. It also provides an incentive for producers to push as many trading functions forward as possible to keep down the assessable value of their products. Exclusion of services from the base also creates a bias against goods and in favour of services (which are usually consumed more by the rich). With taxation of sales at the first point, sole distributors especially of imported goods get an advantage over other distributors

who usually provide more marketing services, costs of which go into the manufacturer's price.

2.2.3 Taxation of inputs and capital goods

Left with a base constrained by exclusion of trade margins and services and faced with mounting pressures for revenue, both Centre and the States have gone on to extend the coverage of their excises and sales taxes to include inputs and capital goods. This leads to cascading and constitutes another major source of economic distortion. While attempts have been made to alleviate the ill-effects of input taxation through MODVAT in Central excise and concessional treatment or exemption in sales taxation, the distortions persist as the scope of the provision in the law sanctioning the reliefs is restrictive and the procedures cumbersome. As a result, the alleviation is inadequate or ineffective. Purchases which from the economic angle clearly pertain to the manufacture of the commodities are often denied MODVAT credit on technical grounds (see Box 2.3). In any case, no relief is usually available for taxes paid on plant and equipment.² In many States there is now a turnover tax at different stages of trade. This leads to cascading with all its attendant evils (increase in costs by more than the tax, vertical integration and disincentive for specialisation in production). How cascading (that is, increase in selling price by more than the tax element) occurs with taxation of inputs and levy of tax at different trade levels is shown in Table 2.2.

With taxes levied on producer goods and at different stages of production and trade, the system lacks transparency. Effective rates diverge significantly from the prescribed rates (vide Table 2.3). For several commodities (e.g., fertilisers) the gap between effective incidence of sales tax and excise duties combined and the implicit nominal rate (that is, statutory rate) is as high as 12 percentage points.

2. The MODVAT credit has since been extended to capital goods (vide proposals of the Union Finance Minister in the Budget for 1994-95).

Box 2.3

**Audit Objection to Granting MODVAT Credit for Inputs Used
in Manufacture of Iron and Steel Products**

"The MODVAT declaration (in question) was not specific in relation to the inputs for the reasons that the input, ferro molybdenum was not specified. Also steel shredded scrap was not included in the declaration. In respect of aluminium, the declaration was only indicating aluminium and articles thereof under sub- heading 7601.00, whereas credit availed on inputs like aluminium wires and wire rods were covered under different heading 76.12 and sub-heading 7604.10. Mere mention of the chapter sub-heading and availment of MODVAT credit on all the articles of a specific chapter was in contravention of the provision of rule 57A". (Report of the Comptroller and Auditor General on Receipts of the Union Government : Indirect Taxes, No.4 of 1993, p.400.)

2.2.4 High and multiple rates

With a narrow base the rates have to be high to raise the same amount of revenue. Finding it difficult to raise the level of sales taxes at the first point any further, the States are now resorting to additional levies like turnover tax already referred to, additional sales tax, surcharges and so on, making the system totally non-transparent and the tax incidence arbitrary and unpredictable. The multiplicity of tax rates prevailing in different States and their consequences are dealt with further in Chapter 3.

High tax rates aggravate the distortions inherent in a manufacturer's tax. They also provide incentives for evasion and avoidance, and generate pressures for exemptions and concessions. One, thus, witnesses in the excise system multiplicity of rates based on classification of commodities and sectors

often relying on hair-splitting distinctions. As could be expected, the system has proved to be a breeding ground for disputes. Over 30,000 excise cases are pending before the Appellate Tribunal alone (over 12,000 before the High Courts).

While, as briefly noted, most of the problems mentioned above occur in the Union excise systems, some are peculiar and more acute in the State sales taxes. Chapter 3 highlights the main features of the present systems of sales taxation and draws attention to their problems and consequences. Problems with the excise system are no less intractable but these have been discussed in detail in the report of the TRC³ and are not gone into further here.

3. See Chapter 9 of the Interim Report and Chapter 4 of the Final Report - Part I of the TRC. (Ministry of Finance, Government of India.)

Table 2.2
Cascading and Uncontrolled Incidence
under Taxation of Inputs: An Illustration

Manufacturer/ Dealer	Cost of inputs/ purchases	Price before tax (mark up 50%)	Tax @ 10%	Sale price with tax	Value added (pure cost)
A	0	100	10	110	100
B	110	165	16.5	181.5	50
C	181.5	272.25	27.2	299.5	75
			53.7		225

Difference between final selling price and cost: $299.5 - 225 = 74.5$

Tax on value added only: $10\% \text{ of } 225 = 22.5$

Cascading because of tax on inputs: $53.7 - 22.5 = 31.2 \text{ (or } 13.9\% \text{ of value added)}$

Additional cascading caused by price mark-up on tax: $74.5 - 53.7 = 20.8 \text{ (or } 9.2\% \text{ of value added)}$

Note: This takes no account of possible cost increase on account of advance financing of cost.

Table 2.3

Nominal and Effective Rates of Excise duty and Sales Tax for Selected Commodities

(per cent)

Commodity	Sales tax		Excise duty		Sales tax & excise duty	
	Nominal rate	Effective rate	Implicit nominal rate	Effective rate	Implicit nominal rate	Effective rate
1	2	3	4	5	6	7
1. Paddy	2.26	3.51	0.00	1.01	2.26	4.53
2. Wheat	2.60	4.12	0.00	1.24	2.60	5.36
4. Pulses	2.74	3.75	0.00	0.58	2.74	4.34
5. Cotton	5.10	7.28	0.00	1.74	5.10	9.02
6. Coal & Lignite	4.32	6.82	0.07	3.73	4.40	10.55
7. Crude Petroleum, Natural Gas	5.57	6.29	1.46	3.01	7.03	9.30
8. Iron Ore	0.00	1.37	0.00	2.14	0.00	3.50
9. Khandsari, Boora	1.15	2.39	1.92	3.56	3.07	5.96
10. Hydrogenated Oil	8.12	11.60	4.08	8.39	12.20	19.99
11. Oth.Food & Beverages etc.	8.66	10.74	11.15	12.92	19.81	23.66
12. Cotton Textiles	2.36	4.94	1.14	3.60	3.51	8.54
13. Woollen Textile	5.66	7.77	0.50	3.00	6.16	10.77
14. Art Silk, Synthetic Fibre	0.00	1.92	8.90	14.91	8.90	16.84
15. Jute, Hemp, Mesta Textiles	0.00	1.98	1.27	3.49	1.27	5.47
16. Paper & Paper Products	3.98	7.41	3.66	5.34	7.64	12.75
17. Leather & Leather Products	11.14	14.39	1.14	2.44	12.28	16.83
18. Petroleum Products	9.82	13.20	8.40	11.85	18.22	25.05
19. Coal Tar Products	4.25	9.26	0.42	4.60	4.67	13.86
20. Fertilisers	2.94	7.90	0.11	7.83	3.05	15.73
21. Iron & Steel	4.39	7.46	5.11	6.67	9.50	14.13
22. Tractors and Other Agric.	10.20	14.38	2.02	3.36	12.22	17.74
23. Electrical Machinery	11.30	13.98	7.46	8.54	18.76	22.52
24. Communication Equipment	11.75	14.77	3.96	4.74	15.72	19.51
25. Electronic Equipment Inc.	13.10	16.23	21.97	22.56	35.07	38.79
26. Rail Equipment	10.20	13.15	2.49	4.02	12.69	17.17
27. Motor Vehicles	9.89	13.45	14.71	15.95	24.60	29.40

- Source:** Aggarwal (1994): a forthcoming study of the National Institute of Public Finance and Policy.
- Notes :**
1. Nominal rates of sales tax are obtained as simple averages of the nominal rates of 16 States, and relate to the year 1992-93.
 2. Implicit nominal rate of excise duty of a commodity is obtained as the ratio of tax yield to its gross output, and relates to the year 1989-90.
 3. Effective rate of tax includes taxes paid on inputs. The estimates are based on input-output Tables 1989-90, Sales tax rates in various States, Central Excise Tariff Working Schedule (1989), etc.
 4. Nominal rates of sales tax and excise duty are not additive. Hence, the figures in column 6 need to be interpreted with caution. However, sales taxes are assumed to fall on price including excise.