

STATE SALES TAXES

3.1 Main Features of the Current Systems

Sales taxes are levied by the States in diverse forms, each under its own legislation enacted in exercise of the powers conferred by the Constitution. They vary in structure - viz., the points of levy and the rates - as well as administrative procedures, although some common features are discernible. Neither the structures nor the procedures are, however, simple in any State. Also, as briefly noted already, with the shift in the point of levy to the first point, the problems in excise taxation associated with definition of manufacturing, undervaluation and commodity classification are revisited when one looks at the sales tax systems. In sheer complexity and irrationality, the sales tax systems, as they are structured and implemented at present, surpass the excises even at their worst. In this chapter, we first outline the main features of the present sales tax systems, and then proceed to discuss the problems they have generated and the consequences.

3.1.1 Point of levy

Initially, the systems of sales taxation in India took two main forms - the Madras (or multipoint) system and the Bengal (retail taxation) system. Over the years, to avoid the problems of administering a tax at the retail level and dealing with too many dealers which multipoint taxation entailed, all States have now turned to taxation mainly at the first point to raise the bulk of the revenue. Vestiges of the original system, however, remain. Thus, in the States which started with the retail point tax, the general rate is still applied at the last point falling on commodities not specifically mentioned elsewhere, although the main revenue yielding commodities have been brought under the first point. Similarly, the residuary items in the States which had adopted the Madras model are still, by and large, subject to the multipoint levy. Ironically, Tamil Nadu has switched to the first point system. Some States (e.g., Gujarat) divide taxable goods into three categories with the first category taxed at the first point of sale, the

second at the last point and the third at both first and last points. Points of levy and the rates of tax prevailing in different States are given in Appendix Table A3.3.

Driven by pressures to raise more and more revenue, most States have resorted to levies in the form of surcharges (SC), on the one hand and additional sales tax/turnover tax (TOT), etc., on the other. The surcharges are currently in operation in a majority of the bigger States, the base in some being the amount of general sales tax (GST) and in some, the total of both GST and TOT payable. The TOT in most cases is a multipoint tax. It is levied on gross turnover of dealers with sales in excess of the exemption threshold, and this applies to intermediate dealers even in States where the general sales tax is largely leviable at only one point.

To minimise the problem of collecting tax from sale of farm produce like paddy, sugarcane and fruits, a commonly followed practice is to levy the tax on purchase at the last point (e.g, on the rice miller for the purchase of paddy).

The changes in the systems described above have come about either through amendments in the basic law governing the levy of sales tax, or through enactment of supplementary laws. In several States, the laws relating to sales tax are embodied in more than one legislation. A classic example is that of West Bengal. The tax on sale and purchase of goods is governed in that State by as many as four legislations, viz.:

- The Bengal Finance (Sales Tax) Act, 1941;
- The West Bengal Sales Tax Act, 1954;
- The West Bengal Motor Spirit Sales Tax Act, 1974; and
- The Bengal Raw Jute Taxation Act, 1941.

Then there is the Central Sales Tax Act of 1956, the legislation authorizing the levy of tax on inter-State sales, enacted by

Parliament with the powers delegated to the States to administer it and retain the revenue.

Recommendations for reform of the systems by consolidating the laws into one do not seem to have been taken seriously by policymakers except possibly in one or two instances. A consolidated law was reported to be ready for placing in the Assembly in West Bengal since long but its enactment is still to come. Taxpayers dealing with commodities subjected to tax under the five legislations are still required to file as many returns every year and assessments have to be made for each of them individually (unless the case in question comes under the Self Assessment Scheme). As a result, assessments in arrears keep piling up and the government of the State is obliged to clear the backlog by declaring, periodically, the pending assessments as deemed to have been completed.

3.1.2 Rates

The complexities of multiple levies and legislations are compounded by the multiplicity of rates.

Invoking considerations ranging from social justice and equity to promotion of trade and industry within the State, the rates of sales tax are differentiated across commodities. As may be seen from Table A3.3, the number of rates in most States is at least six or seven and in some (West Bengal and Maharashtra) as many as twelve or more, varying from 0 and 1 per cent to 150 per cent. In general, non-luxury foods and certain other basic necessities are taxed at approximately 4 per cent, while other items attract tax at rates in the range of 8 to 15 per cent.

The TOT is levied mostly at graduated rates. For instance, in Andhra Pradesh, the rates of the TOT which was introduced recently (August 1993) for dealers having (gross) turnover of Rs 10 lakh or more, are as follows:

| Turnover (Rs.) | Rate of TOT |
|--------------------|-------------|
| Below 10 lakh | Nil |
| 10 to 50 lakh | 0.5% |
| 50 lakh to 1 crore | 1.0% |
| More than 1 crore | 2.0% |

The rates of surcharge vary from 5 to 25 per cent. In some States, the rates of surcharge are graduated according to the size of turnover (Table 3.1). In Tamil Nadu, a uniform surcharge is levied all over the State to supplement the income of local governments; an additional surcharge is levied in the greater Madras area for water supply schemes.

3.1.3 Exemptions

Most States provide a variety of exemptions, either to lessen the regressivity of the tax, or as incentive to industry.

Exemptions to lessen the regressivity are provided for items like basic food products sold in unprocessed form, books and maps (including students exercise books), and bicycles. There are, however, significant inter-State variations in the list of exempt food items. For example, Haryana, Punjab, Rajasthan, Uttar Pradesh, and Orissa apply tax to cereals and pulses, while many States exempt them. Tamil Nadu, exempts cereals, but not pulses. Andhra Pradesh exempts pulses but not wheat or rice (vide Table A3.3).

Industrial incentives take various forms such as deferment of sales tax, sales tax holidays, repayment of term loans from sales tax collected, etc. (Table 3.2). Such incentives are generally limited to new industrial enterprises or units locating in specific areas, small scale enterprises, and the amount of sales tax foregone or deferred under the incentive provisions is usually tied to the amount of fixed capital investment by the enterprises. The exemption for khadi cloth and cottage industry products granted in many States, also constitutes a form of industrial incentive to promote production and employment.

Another category of exemptions is related to end-use. These are exemptions for specific organizations and institutions, such as military canteens, public hospitals and so on.

3.1.4 Treatment of inputs

Except for commodities specifically

Table 3.1

**Structure of Additional Sales/Turnover Tax
and Surcharge in States Sales Taxes
(as of January 1994)**

| State | Additional Sales Tax | | Turnover Tax | | Surcharge on Sales Tax | |
|--------------------|--------------------------------|--------|-----------------------|----------------|------------------------|------|
| | Turnover Limit (lakh) | Rate | Turnover Limit (lakh) | Rate | Turnover Limit (lakh) | Rate |
| 1 Andhra Pradesh | | | 10 - 50 | 0.5% | - | 10% |
| | | | 50 - 100 | 1% | | |
| | | | 100 & above | 2% | | |
| 2 Bihar | On the sale of specified goods | 1% | - | - | 05 - 10 | 5% |
| | | | | | 10 & above | 10% |
| 3 Chandigarh | - | - | - | - | - | 2% |
| 4 Delhi | - | - | - | - | - | - |
| 5 Goa | 20 - 40 | 10% | - | - | - | - |
| | 40 & above | 15% | | | | |
| 6 Gujarat | - | - | 50 & above | 1.00% | - | - |
| | | | 200-400 | 1.5 lakh+1.25% | | |
| | | | 400-800 | 4.0 lakh+1.50% | | |
| | | | 800 & above | 10 lakh+2.00% | | |
| 7 Haryana | - | - | - | - | - | 10% |
| 8 Himachal Pradesh | - | - | - | - | - | 10% |
| 9 Karnataka | - | - | 10 -200 | 1.25% | - | - |
| | | | 200 -500 | 1.75% | | |
| | | | 500 & above | 2.50% | | |
| 10 Kerala | 01 - 10 | 5% | - | - | - | - |
| | 10 & above | 8% | | | | |
| 11 Madhya Pradesh | - | - | - | - | - | - |
| 12 Maharashtra | - | - | 12 -100 | 1.25% | 10 & above | 12% |
| | | | 100 & above | 1.50% | | |
| 13 Manipur | - | - | - | - | - | - |
| 14 Orissa | - | - | - | - | 10 & above | 10% |
| 15 Punjab | - | - | - | - | - | 10% |
| 16 Rajasthan | - | - | - | - | - | - |
| 17 Tamil Nadu | 10-40 | 1.25% | - | - | -* | 15% |
| | 40 - 100 | 1.50% | | | | |
| | 100 - 500 | 2.00% | | | | |
| | 500 - 1000 | 2.25% | | | | |
| | 1000& above | 2.50% | | | | |
| 18 Tripura | 10 & above | .0825% | - | - | - | - |
| 19 Uttar Pradesh | - | - | - | - | - | 25% |
| 20 West Bengal | - | - | - | - | - | 15% |

Source: Commissioners of Sales/Commercial Taxes of various States.

- Notes :** 1. In Andhra Pradesh and Bihar the surcharge is also levied on additional sales tax.
2. * Additional surcharge @ 5% on tax in Madras urban area only
3. denotes 'not applicable'

Table 3.2
Incentives for Industries under States Sales Taxes*

| States | Years for which available | | Tax holiday applicable to Sales/RM |
|----------------------|---------------------------|-------------|------------------------------------|
| | Deferment** | Tax holiday | |
| 1. Andhra Pradesh | 10 | 5 | Sale |
| 2. Assam | - | 7 | Sale and RM |
| 3. Bihar | 5 | 5 | RM |
| 4. Gujarat# | 6 to 9 | 6 to 9 | Sale and RM |
| 5. Goa | 12 to 15 | 12 to 15 | Sale |
| 6. Haryana# | 5 to 9 | 5 to 9 | Sale |
| 7. Himachal Pradesh# | 6 to 12 | 4 to 12 | Sale |
| 8. Jammu & Kashmir | 10 | 10 | Sale and RM |
| 9. Karnataka# | 6 to 8 | 4 to 7 | Sale |
| 10. Kerala# | 10 | 7 | Sale |
| 11. Madhya Pradesh | 2 to 11 | 2 to 11 | Sale and RM |
| 12. Maharashtra# | 3 to 10 | 3 to 10 | Sale and RM |
| 13. Meghalaya | 5 | 5 | Sale and RM |
| 14. Orissa | 5 | 7 | Sale and RM |
| 15. Punjab | - | 7 to 10 | Sale |
| 16. Rajasthan | 7 to 11 | 7 to 11 | Sale |
| 17. Tamil Nadu | 10 to 14 | 5 to 7 | Sale |
| 18. Tripura | - | 5 | Sale |
| 19. Uttar Pradesh | 8 to 10 | 8 to 10 | Sale |
| 20. West Bengal | 5 to 9 | 4 to 9 | RM |

Source: Central & State Governments Incentives for Industrial Development, *PHD Chamber of Commerce and Industry*, September 1993.

Notes : * The incentives are usually subject to certain conditions such as the size of the unit, location and so on.

** In some States this benefit is called interest free loan.

An industrial unit may opt for either exemption or deferment.

- Denotes not applicable.

Abbreviations: RM = Raw material

exempted, sales tax is generally levied on the sale or purchase of all commodities including raw materials, inputs and capital goods. To alleviate the cascading effect of taxes on inputs, various remedies are applied such as total exemption or taxation at a concessional rate (vide Table 3.3).

However, no State allows a full rebate of tax on all business inputs. The only rebate that is allowed is in respect of raw materials, parts and consumables for use in manufacturing. Even for such items, the

rebate is in some States often only partial and is designed to reduce the tax to approximately 4 per cent. Some States deny or reduce the input tax rebate in respect of goods that do not subsequently attract the State sales tax. For example, in Maharashtra, manufacturing inputs are subject to a tax of 4 per cent, where the manufactured goods attract the CST or the local sales tax. (In addition, turnover tax and additional sales tax are charged depending on the turnover of the selling dealer.) Where the manufactured goods leave the State under a consignment arrangement, without bearing

any sales tax in the State, the net tax on inputs used in the manufacture of those goods is increased to 6 per cent through a complex claw-back formula.

No rebate is allowed in respect of production machinery and equipment, or for inputs used in the distribution of goods.

Table 3.3

Sales Tax Rates on Goods used as Raw Materials by Manufacturers

| States | Basic rate (per cent) |
|---------------------|-----------------------|
| 1. Andhra Pradesh | 4 |
| 2. Bihar | 3 |
| 3. Delhi | 0 |
| 4. Goa | 0 |
| 5. Gujarat | Set off on purchase |
| 6. Haryana | 0 |
| 7. Himachal Pradesh | 1 |
| 8. Karnataka | 4 |
| 9. Kerala | 2.5 |
| 10. Madhya Pradesh | 4 |
| 11. Maharashtra | 4 |
| 12. Manipur | 0 |
| 13. Orissa | 4 |
| 14. Punjab | 0 |
| 15. Rajasthan | 0 to 3 |
| 16. Tamil Nadu | 3 |
| 17. Uttar Pradesh | 0 to 4 |
| 18. West Bengal | 2 |

Source: Office of Commissioners of Sales, Commercial Taxes of the States.

3.1.5 Taxation of inter-State sales

Although the powers of the States to levy the tax on sale and purchase of goods are meant to be exercised only in respect of transactions within their respective jurisdictions, in practice sales tax is levied by them on inter-State sales also. To regulate the taxation of inter-State sales taking place

between dealers or between dealers and consumers, a law was enacted by Parliament in 1956 designated as the Central Sales Tax (CST) Act. While powers to tax inter-State sales under the Constitution belong to the Centre, the States have been authorised to levy the CST on such sales originating in their territories and retain the proceeds. There is a ceiling on the rate of tax which can be levied. Initially fixed at 1 per cent, the rate currently stands at 4 per cent. This rate applies to sales to a registered dealer. Sales to an unregistered dealer (such as a consumer of a final product) attracts tax at 10 per cent or the rate applicable on local sales including additional sales tax and surcharge, whichever is higher.

Since the CST is applicable to sales, inter-State movement of goods as consignment has not been liable to any CST in the exporting State. Finding that this was being used on a large scale to defeat inter-State sales taxation, the States pressed for legal remedy and the Constitution was amended in 1982 (46th Amendment) to authorise the levy of sales tax on consignments. The legislation to implement the levy on consignments is still awaited. As explained below, taxation of inter-State sales has been a major source of inefficiency and inequity in the system.

3.2 Problems and Consequences

3.2.1 Complex structure

Even a bare description of the sales tax laws presented above would provide an idea of the complexity of the prevailing structure. It would not be an exaggeration to say that the States sales tax systems in India are one of the most complex around the world. The rules and procedures laid down for compliance and enforcement make the systems even more complex than might appear from the primary legislations alone.

In fact, judging by the complexity of the system and frequency with which changes are made, one wonders whether the tax officials themselves can keep abreast of them or fully comprehend them. The complexity of the systems is vividly illustrated by the design of some of the prescribed tax return forms which

typically run into several pages. By contrast the VAT returns in most industrialised countries contain no more than a single page. Then there are the variations in laws and procedures from State to State. An enterprise having business transactions spread over more than one State has to keep track of the sales tax laws and procedures in each in order to comply with them - the structure of the various levies, the threshold for each, the rates, the forms required for claiming reliefs and exemptions/concessions, the periodicity of return filing and so on. In several States (e.g., Maharashtra), the number of forms prescribed for compliance with the sales taxes run to 40 or more. The hassle and cost involved in complying with all the regulations can be easily imagined. The costs of administration are also not small.

Complexity makes the tax system unfair by imposing a disproportionate compliance cost burden on small businesses. Also, the complexities create inequities by providing unequal opportunities for evasion and avoidance depending on the nature of the commodity and the operation of the trade channels.

3.2.2 Pitfalls of first-point sales taxation

Primarily for reasons of administrative convenience, the States have tended to apply the tax more and more at the first point of sale, falling either on manufacturers or on importers from other States or from abroad. Apart from the definitional conundrums associated with taxation at manufacturer level, in sales tax first point taxation has its own set of problems. It is susceptible to evasion and avoidance and can also cause serious economic distortions and inequity in the incidence of tax among competing firms. These are:

The base being narrow, when the tax is levied at the first point of sale, the rates of tax have obviously to be high to yield a given target amount of revenue. The high rates, in turn, induce business firms and consumers to find ways of avoiding the tax and generate pressures for relief through concessions and exemptions. Differentiation in the rates reflect the outcome of these and the anxiety of the

governments to make the systems acceptable.

Under a first point tax, the tax falls either on manufacturers or on importers. As in the case of excises, what constitutes "manufacturing" gives rise to disputes over questions such as, does cutting of marble slabs from rocks or twisting of yarn constitute manufacturing? Then there are problems of valuation especially when services fall outside the ambit of the tax.

Like in Union excises, first point sales taxation creates opportunities for tax avoidance through making of sales to a sister concern at artificially low prices, and shifting of certain services related to the sale of goods beyond the first point. To counter tax avoidance, Kerala Sales Tax (KST) Rules contain a specific rule debarring deduction of post-sale expenses from sale value except where it is shown separately in the bill (Rule 9 of KST Rules). Similar rules prevail in other States too. Even with all this the margin between the first sale and the sale to the final consumer is found to be as high as 100 per cent or more in many instances. Information gathered from one State shows that for several consumer goods, the gap between first point price and the price at the second point of sale varies from 4 per cent to over 300 per cent of the first sale price (vide Table 3.4). The value added on the subsequent sales, after the first point - whether genuine or artificial - goes totally untaxed under the first point sales tax.

Again, as under excise taxation, exemption which is extended to the small scale producers in some States, facilitates tax avoidance by farming out production to SSI units with the large units acting as distributors effecting second sales only under their own brand names, but acting as sole sellers. There are instances of a hotel business being split up with the kitchen shown as a separate unit owned by the spouse of the hotel owner. Similarly, exemption granted to charitable institutions also has opened up opportunities for tax avoidance through this device. In the case of exemptions granted to new manufacturing units, the exempt units set up in one State move to

Table 3.4
Difference in Unit Price of Products
Between First Sale and Second Sale

| Items | Unit | First sale Price (Rs.per unit) | Second sale Price (Rs.per unit) | Difference (Rs.) (Col.3 -Col.2) | Difference (%) (Col.4/Col.2) |
|-------------------------------------|-------------|--------------------------------------|---------------------------------------|---------------------------------------|------------------------------------|
| 1 | 2 | 3 | 4 | 5 | 6 |
| 1. Suitcases | | | | | |
| a) B.Belt II-2 | 1 | 522 | 850 | 328 | 63 |
| b) Calive -21 | 1 | 509 | 915 | 406 | 80 |
| c) Valet | 1 | 401 | 659 | 258 | 64 |
| 2. Air Coolers | 1 | 3825 | 5732 | 1907 | 50 |
| 3. Paints | | | | | |
| a) 2021 | 50 kg | 685 | 1016 | 331 | 48 |
| b) 3011 | 50 kg | 685 | 1016 | 331 | 48 |
| c) 4221 | 50 kg | 685 | 1016 | 331 | 48 |
| 4. Dental Cream | | | | | |
| a) 200gms | 1 Dzn | 168 | 262 | 95 | 57 |
| b) 100gms | 1 Dzn | 94 | 148 | 54 | 57 |
| c) 50gms | 1 Dzn | 53 | 81 | 28 | 53 |
| 5. Tooth powder | | | | | |
| a) 200 gms | 1 Dzn | 130 | 232 | 103 | 79 |
| b) 100 gms | 1 Dzn | 73 | 133 | 61 | 84 |
| c) 50 gms | 1 Dzn | 49 | 74 | 25 | 51 |
| 6. Talcum powder | | | | | |
| a) 100 gms | 1000 pieces | 7556 | 18896 | 11340 | 150 |
| b) 400 gms | 1000 pieces | 18790 | 46750 | 27960 | 149 |
| 7. Whisky empty bottles | | | | | |
| a) 375 ml | 1 Dzn | 21 | 90 | 69 | 329 |
| b) 180 ml B.P | 1 Dzn | 14 | 45 | 31 | 221 |
| c) 750 ml B.P | 1 Dzn | 15 | 40 | 25 | 167 |
| d) 5 bottles in corrugated boxes | 1 Dzn | 150 | 540 | 390 | 260 |

Source: Office of Commissioner of Sales Tax, Andhra Pradesh.

another on the expiry of the tax holiday. As used machinery bought from outside the State is regarded as new investment for purposes of the exemption, they are able to extend the exemption period through relocation to another State.

Looking at the actual operation of the sales tax systems in various States, even the arguments of administrative simplicity of tax at the first point of sale do not seem to be very convincing. The number of registered dealers in the larger States is quite large, and includes many dealers beyond the stage of manufacturing. Even under a single-point taxation at the first stage intermediate dealers are required to register and file returns simply to establish their eligibility for the exemption. Exemption of intermediate dealers operates on the strength of evidence of purchase or invoice from another registered dealer who is supposed to have already collected the tax from the purchaser. The invoices are often faked ("Hawala") and the tax department is often hard put to establishing that the intermediate dealer is a fictitious entity. The standard of evidence insisted upon by the courts is almost impossible to meet in most cases. That there is a thriving market in bill trading goes to show that the claim of administrative advantage in the first point taxation is exaggerated.⁴ Another reason why the number of registered dealers is not small even under first point sales tax is that intermediate dealers usually sell goods imported from other States or they are subject to a turnover tax that applies at all points of sale.

Registered dealers selling goods acquired from other States are required to charge tax on their selling price of imports under the first point tax. However, they may also carry in their inventory goods acquired within the State, which can be resold without any further tax. (This dual tax regime for imports and intra-State goods which presumably many dealers

have to contend with requires complex inventory accounting procedures, increases costs of compliance, and creates opportunities for evasion. To check evasion of tax under the first point system checkpoints are established at the State borders and permits are required for imports into one State from another. In Andhra Pradesh, there are checkpoints even around the city of Hyderabad.

To reiterate the point briefly mentioned in Chapter 2, a tax at first point alone leads to economic distortions because the first point of sale could represent a sale at different trade levels, such as a manufacturer, a national distributor, a regional wholesaler, a local wholesaler, or a retailer. In each case, the price would be different. Even if the tax were to apply at a uniform statutory rate on the actual selling price at that point, the effective tax rate (defined as the ratio of tax to the final consumer price) would not be uniform because of variations in the extent of value addition at different trade levels. Table 3.5 (and Chart 3.1) provide illustration of how the trade margins beyond manufacturing vary across products. The effective tax rates can vary not only across products, but also across different dealers for a given class of products. This lack of neutrality in the application of tax creates distortions in production and distribution channels, and creates inequities in the application of tax to competing firms. Such distortions and inequities force even otherwise honest dealers to resort to activities that are unethical or in contravention of the law. Also, the first point tax without full set off for the tax on inputs tends to encourage vertical integration.

3.2.3 III effects of excluding services

Exclusion of services has tended to narrow the base and created scope for avoidance of sales tax in some peculiar ways.

Because of the exclusion of services from the base in the law as ruled by the Courts, States were debarred from levying sales tax on goods sold in the course of execution of works contracts and by hotels as part of their catering service. The Constitution had to be amended to permit the levy of sales tax on goods sold as part of a

4. In Delhi, the Capital of India, forms evidencing sales by a registered dealer (ST-I form) are reported to be selling for anything between Rs 2000 and Rs 5000 for each form ("Sales Tax Evasion Racket Unearthed", Statesman, New Delhi, 19 November 1993).

Table 3.5
Tax Component and Trade Margins
for Selected Commodities

(per cent)

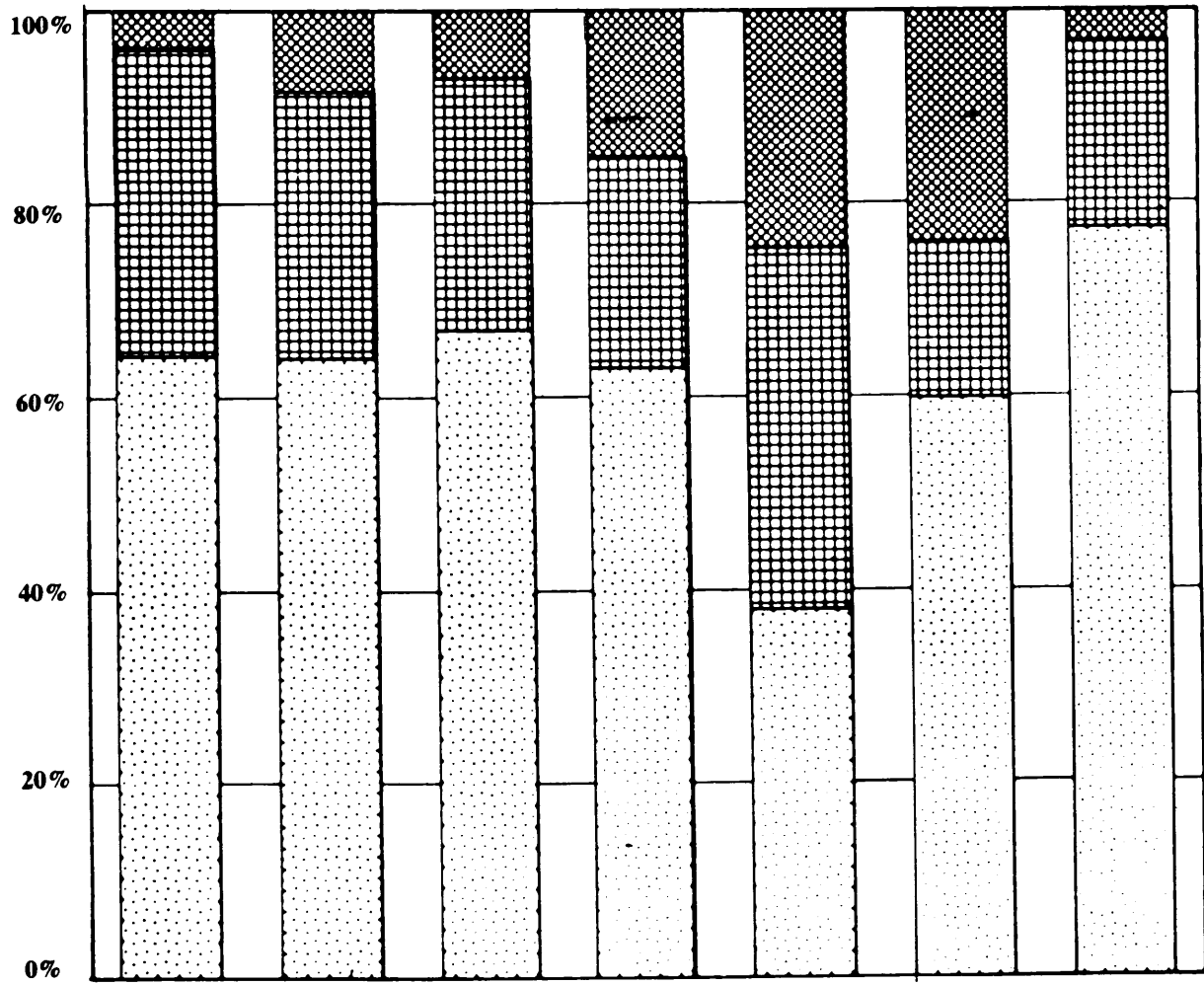
| Name of the product | EFP/MRP | EXD+ST/ MRP | TM/MRP | TM/EFP |
|--------------------------------|---------|----------------|--------|--------|
| Compressor | | | | |
| Type-1 | 0.43 | 0.52 | 0.05 | 0.13 |
| Type-2 | 0.63 | 0.30 | 0.07 | 0.11 |
| Cement | 0.58 | 0.31 | 0.11 | 0.19 |
| Agricultural tractors | | | | |
| Model-1 | 0.83 | 0.12 | 0.05 | 0.06 |
| Model-2 | 0.84 | 0.12 | 0.03 | 0.04 |
| Automobiles | 0.64 | 0.32 | 0.04 | 0.06 |
| Motorcycles | 0.64 | 0.27 | 0.08 | 0.13 |
| Refrigerators | | | | |
| 1. 165 litres | 0.76 | 0.21 | 0.03 | 0.04 |
| 2. 305 litres | 0.67 | 0.26 | 0.07 | 0.11 |
| 3. 300 litres (Double door) | 0.70 | 0.26 | 0.04 | 0.06 |
| Television | | | | |
| Model-1 | 0.63 | 0.22 | 0.15 | 0.24 |
| Model-2 | 0.64 | 0.21 | 0.15 | 0.23 |
| Model-3 | 0.65 | 0.21 | 0.14 | 0.22 |
| Model-4 | 0.64 | 0.22 | 0.14 | 0.22 |
| Model-5 | 0.70 | 0.21 | 0.09 | 0.13 |
| Lipstick gleamers | 0.38 | 0.37 | 0.25 | 0.64 |
| Ointment | 0.60 | 0.16 | 0.24 | 0.40 |
| Toilet soap | 0.77 | 0.19 | 0.03 | 0.04 |

Source: NIPFP Survey (1993).

Notes : EFP = Ex-Factory Price.
SIP = Sales Invoice Price.
MRP = Maximum Retail Price.
EXD = Excise Duty.
ST = Sales Tax.
TM = Trade Margin.

Chart 3.1

Composition of Price for Selected Consumer Items



Automobiles Motorcycles Refrigerators Television Lipstick Gleamers Ointment Toilet Soap



Ex- Factory Price



Excise Duty and Sales Tax



Trade Margins

composite contract or service (46th amendment). Disputes have arisen over the question of segregating the service part in a works contract when the States proceeded to tax works contracts in exercise of the powers conferred through the 46th amendment. A recent judgement of the Supreme Court in this regard serves to bring out how the fracturing of the base into goods and services can pave the way to avoidance and evasion by loading on services part at the expense of goods in a works contract (vide Box 3.1). Similar difficulties are encountered in the taxation of leasing and hire purchase, and it seems, legislations intended to bring lease rentals under sales taxation are locked up in disputes pending before the courts.

Exclusion of the service component in works contracts or job work also tends to thwart standardisation while it is through standardisation that efficiency is achieved in production in advanced countries. When a plant or a building component is made at the site, it is not possible to adhere to standards to the extent possible in a mass production factory under strict quality control. Failure to tax services obviously makes it cheaper to undertake manufacturing at the work site, to the detriment of efficiency. Exclusion of services from the base thus has consequences going beyond mere complexity.

The States have sought to circumvent the restrictive effect of exclusion of services in several other ways, e.g., by seeking to tax the sale of intangibles like import licence and lottery tickets. The reference to "goods" only in the relevant entry in the State List, however, raises doubts about the legality of extending sales taxation to such items and the matter has been taken to courts.

3.2.4 Multiplicity of rates and levies

With a narrow base, the rates of tax have obviously to be higher than when the base is broader. To mitigate the effects of such high rates, relief is provided for selected commodities - particularly essential items - in the form of exemption or concession in rates. However, search for revenue or considerations which are not always apparent have led to differentiation in the rates between commodities which are difficult to

implement. As a result, innumerable cases have been taken to the highest courts for adjudication on whether a given commodity falls in one category or another for purposes of sales taxation (vide Box 3.2).

The levies imposed as supplements to sales tax are also often structured to serve the objective of progressivity while raising additional revenue. Thus the "turnover" taxes are in most cases graduated with reference to the size of the turnover. The result again is bizarre.

For instance, if the total number of rates in a State are ten and three rates are presented for the TOT depending on the turnover, the number of rates actually charged for different commodities goes up to thirty. If, in addition, there are surcharges, the rates can multiply further. In Andhra Pradesh sales tax is charged on a base that includes sales tax and the appendages like surcharge and TOT. Consequently, the rates at which tax is payable by dealers are not what they apply on their sales. A ready reckoner for the effective rates for dealers in different ranges of turnover sets out as many as 100 and odd rates (vide Table 3.6).

In some States, the law prohibits the dealers from passing on the TOT. This, however, is only a wishful act on the part of the policy makers since traders cannot possibly be prevented from passing on as much of the tax as they can to their buyers. Since there is a ceiling on CST, TOT or its equivalent cannot, however, be passed on when the sales are made inter-State. How convoluted the rules can be to ensure this can be seen from a circular issued by the CCT, Tamil Nadu (Box 3.3).

Sometimes, the quest for equity takes curious forms. For instance, in Kerala, a fee is payable annually by dealers for registration. The rates fixed are as follows:

| | |
|--------------------------------------|--|
| For yearly turnover of Rs 1 crore | Rs 4,250 |
| For yearly turnover above Rs 1 crore | Rs 1,750 plus Rs 50 for every lakh above Rs 50 lakh subject to a maximum of Rs 10,000 |

Box 3.1

Supreme Court in Builders' Association of India

Vs.

State of Karnataka & Others (1993) 88 STC 248

The charges for labour and services which are to be deducted in establishing the value of goods involved in the execution of works contracts are:

- a. Labour charges for execution of the works;
- b. Amount paid to the sub-contractor for labour and services;
- c. Charges for obtaining on hire or otherwise machinery or tools used for the execution of the works contract;
- d. Charges for planning, designing and architects' fee;
- e. Cost of consumables used in the execution of the works contract which are not transferred in the execution of the contract;
- f. Cost of establishment of the contract to the extent it is relatable to supply of labour and services;
- g. Other similar expenses relatable to supply of labour and services; and
- h. Profit earned by the contractor to the extent it is relatable to supply of labour and services.

Earlier, for dealers having turnover of Rs 30 crore or even more the registration fee was Rs 850 only. One wonders whether the fees in question can legitimately be regarded as part of sales tax or a fee for service (registration) and whether and how the dealers are arranging to recover it from their customers. Also, it is not clear how a dealer can anticipate what his turnover is going to be in a given year. Uncertainty also arises when there is a dispute between the taxpayers and the tax authorities as to where a

commodity belongs for purposes of rate. As the disputes take long time to resolve, the correct amount of tax payable remains indeterminate for years. The upshot is acute complexity and total obscurity as to what is the final incidence of the taxes and who bears how much of the burden.

3.2.5 Economic distortions and tax cascading

A complex and irrational commodity tax

Box 3.2

Hair-splitting Under Sales Tax

According to some high courts:

Cosmetics and toilet articles include:

- Kajal
- Hairpins and clips
- Mehendi
- Combs

According to others:

Cosmetics and toilet articles do not include:

- Bhimseni kajal
- Safety razor and shaving brush.
- Sindoor
- Combs

Source: Balasubramanian and Vijay Srinivas (1991)

system can be a source of distortion in resource allocation and thwart growth in ways which may not be obvious to laymen. There is reason to think that the sales tax systems prevailing in India constitute a serious impediment to capital formation and efficient functioning of the economy and is inimical to growth in a variety of ways.

First, the imposition of sales taxes at the first point of sale is itself a source of distortion as it induces manufacturers and dealers to shift value addition beyond the first point in order to minimise tax. Economic distortions result where not all competing firms enjoy the same flexibility to shift value addition. Even where firms do not engage in

any tax-motivated shifts in value addition, the application of tax is not neutral because the first point of sale does not represent a uniform trade level.

Second, taxation of inputs results in cascading and encumbers industries more than what is warranted by the tax alone (as demonstrated in Table 2.2). Hence, sales tax systems of all States seek to provide relief for tax on inputs either by suspending the levy or by lowering the rate. However, these concessions do not apply universally and are often nullified through claw-back provisions. Then there are the TOTs. Non-rebatable turnover taxes were prevalent in Europe during the fifties, but were subsequently

Table 3.6
Basic Rates and Effective Rates of Tax
in Andhra Pradesh

| Basic rate of (%) | Turnover tax at 1/2% | Surcharge at 10% of tax and turnover tax due | Effective rate chargeable by the department for dealers whose total turnover is: | | Effective rate chargeable by dealers whose total turnover is: | |
|--|----------------------|--|--|--------------------|---|--------------------|
| | | | Less than Rs.10 lakh | Rs.10 lakh or more | Less than Rs.10 lakh | Rs.10 lakh or more |
| 1 | 2 | 3 | 4 | 5 | 6 | 7 |
| FIRST SCHEDULE (Sale point goods) | | | | | | |
| 0 | 0.50 | 0.05 | 0.00 | 0.55 | 0.00 | 0.58 |
| 1 | 0.50 | 0.15 | 1.10 | 1.65 | 1.11 | 1.63 |
| 2 | 0.50 | 0.25 | 2.20 | 2.75 | 2.25 | 2.83 |
| 3 | 0.50 | 0.35 | 3.30 | 3.85 | 3.41 | 4.00 |
| 4 | 0.50 | 0.45 | 4.40 | 4.95 | 4.60 | 5.21 |
| 5 | 0.50 | 0.55 | 5.50 | 6.05 | 5.82 | 6.44 |
| 6 | 0.50 | 0.65 | 6.60 | 7.15 | 7.07 | 7.70 |
| 7 | 0.50 | 0.75 | 7.70 | 8.25 | 8.34 | 8.99 |
| 8 | 0.50 | 0.85 | 8.80 | 9.35 | 9.65 | 10.31 |
| 9 | 0.50 | 0.95 | 9.90 | 10.45 | 10.99 | 11.67 |
| 10 | 0.50 | 1.05 | 11.00 | 11.55 | 12.36 | 13.06 |
| 11 | 0.50 | 1.15 | 12.10 | 12.65 | 13.77 | 14.48 |
| 12 | 0.50 | 1.25 | 13.20 | 13.75 | 15.21 | 15.94 |
| 13 | 0.50 | 1.35 | 14.30 | 14.85 | 16.69 | 17.44 |
| 17 | 0.50 | 1.75 | 18.70 | 19.25 | 23.00 | 23.84 |
| 25 | 0.50 | 2.55 | 27.50 | 28.05 | 37.93 | 38.99 |

Source: Krishna Murthy (1994).

Note : Effective rates chargeable under the APGST Act applicable to dealers whose total turnover is Rs.10 lakh or more but less than Rs.50 lakh, (effective from 18.07.1993).

abandoned and replaced by the VAT because of their pernicious influence on the economy. The most objectionable feature of the tax is that its burden cascades every time goods change hands. The larger the number of dealers in the distribution chain, the larger is the burden of tax. It creates incentives for vertical integration of firms to the detriment of specialisation in production. In addition, in the absence of a satisfactory system of rebating of all taxes collected at prior stages, it has a detrimental impact on the competitive position of local firms in export markets (including both inter-State and international trade).

Even with concessional treatment, from estimates based on available information it would appear that, in the aggregate, unrebated-tax on business inputs accounts for approximately 30 per cent of sales tax collections of all of the States. From an economic perspective, this magnitude of tax cascading (i.e., taxation of inputs as well as finished output) is perhaps the most harmful aspect of the State sales tax systems. It increases the cost of investment and production and creates pressures for tax incentives for new industries. The incentives themselves become a source of economic distortions, when granted in a selective

Box 3.3

**Method of Arriving at Central Sales Tax Rate
for Goods Covered by C/D Forms**

"Section 8(1) says that the rate to be charged is either at a flat rate of 4% or the local rate, whichever is lower. Therefore, if the local rate (which includes Surcharge, Additional Surcharge and Additional Sales Tax) is lower than 4%, only that lower local rate will be charged. If it exceeds, only 4% will be charged. It may be noted that when a flat 4% is charged, it is the rate specified in the Central Sales Tax Act; therefore, there is no Additional Sales Tax component to it as such and the entire 4% can be billed and passed on to the consumer. However, if only the local rate is charged, only the basic rate, the surcharge and the Additional Surcharge can be explicitly billed and passed on to the consumer, and the Additional Sales Tax component cannot be so passed on to the consumer. (This will be so in the other cases also, i.e., where local rate is made applicable as the equivalent Central Sales Tax rate, Additional Sales Tax component cannot be passed on; but, if any flattened rate like 4% or 10% under the Central Sales Tax Act is made applicable, it has no Additional Sales Tax component explicitly and the entire rate can be passed on)."

(Extracts from Circular No. Acts Cell III/43921/93, dated 29.4.1993 issued by the Special Commissioner & Commissioner of Commercial Taxes, Government of Tamil Nadu, Madras.)

manner. They undermine the competitive position of existing firms not eligible for the incentives, apart from opening up opportunities for abuse.

In the past, under a system of high tariff and regulatory protection of domestic industries, it was relatively easy for businesses to pass on the burden of input taxes to final consumers. As a result, the adverse effects of tax cascading may not have been that serious. This would no longer be the case under the new regime of economic liberalisation. Foreign goods enter the country free of all foreign taxes. If the domestic goods are to compete with foreign goods, they will need to be freed of the burden of input taxes.

Another undesirable feature of cascading is that it makes the effective burden of tax on a given commodity unpredictable. This means that the tax may lead to unintended changes in relative prices and that the governments do not have any control on the final incidence of tax.

Economic distortions are created not only by the flawed structures of the sales taxes, but also by the lack of uniformity in their enforcement. State administrations vary in the degree of computerisation, and the use of other modern technologies and procedures in the enforcement of tax. The other major reason for variation in enforcement is the collusion between the tax officials and the assesseses. The lack of uniformity in

enforcement could mean a wide and unpredictable divergence between the statutory and the effective tax rates.

Lastly, the current tax treatment of inter-State sales is also a major distorting factor in the operation of the Indian economy. Given the importance of this issue in the overall design of the State sales tax systems, and the strongly-held views on the appropriate treatment of inter-State sales, the issue is gone into separately as follows.

3.2.6 Pernicious effects of inter-State sales taxation and tax competition among States

The CST Act which authorises the levy of tax on inter-State sales (to which a reference has been made already) was designed, on the recommendations of the Taxation Enquiry Commission (TEC) of 1953-54, as an instrument to regulate the taxation of sales occurring between dealers located in more than one State. While it has no doubt helped to restore some order in the tax treatment of inter-State sales, the operation of the CST has impeded growth and diminished welfare by acting as a barrier to free trade and specialisation within the country. It has also given rise to problems which constitute a serious roadblock to the reform of domestic trade taxes. The problems basically are three-fold: (i) cascading; (ii) tax exporting and tax competition; and (iii) evasion/avoidance. The manner in which the States have gone about to export their taxes to consumers in other States on the one hand and, on the other, to undercut each other to attract trade and industries (e.g., by reducing their sales tax rates and/or extending concessions in various forms) has added not a little to the complexity, inequity and damaging effect of the entire system.

3.2.6.1 Cascading and distortions in the location of industry

The tax on inter-State sales falls on all commodities including inputs when sold in an inter-State transaction. No relief is available to users in the importing State even when these are used as industrial input while some relief is commonly extended for taxes paid on

locally purchased inputs. As a result, the effective rate of tax on goods produced in another State is higher than when locally produced and consumed.

The difference in the incidence of tax is large in the case of durable goods like motor cars and because of this there is considerable diversion of trade in these commodities. When CST is avoided by opening branches in the other States and consigning goods, the price increase in the State where there is no branch is so great that the consumers of that State go to the other States for these goods. Sometimes even government agencies of a State buy their requirements of vehicles, etc. in a low-tax State.

Since the CST is leviable on each inter-State sale of goods, regardless of the application of the tax at prior stages, when the goods go through a chain of purchase and resale in several States, the tax cascades in a manner similar to a multistage turnover tax. For example, if a Karnataka dealer imports paper from Maharashtra and then resells it to a dealer in Tamil Nadu, the CST would apply twice, for a total burden of 8 per cent. Obviously, this becomes a handicap for the Karnataka dealer, compared with one who can arrange a sale directly from Maharashtra to Tamil Nadu. There are provisions to grant exemption from CST for "transit sales", but the conditions stipulated are so stringent (e.g., the dealer in Karnataka must not take delivery of the goods in question) that dealers engaging in such transactions are often hard put to satisfy the tax authorities that the sales indeed came under the "transit" category.

3.2.6.2 Hidden tax on international exports

Cascading of sales taxes affects international exports too. The States' powers of taxation do not permit levy of sales tax on sale or purchase in the course of international exports or imports. Under a provision of the CST Act, introduced in 1976, the last sale or purchase preceding the export is also "deemed to be in the course of such export" and so outside the purview of sales taxation. However, the exemption is available provided "the last sale or purchase took place after and was for the purpose of complying with the

agreement or order for or in relation to such export"

In practice, to qualify for exemption, exporters must purchase the commodities in question against confirmed orders. As a result, exporters cannot make purchases in anticipation to take advantage of favourable market conditions. Moreover, disputes arise now and then as to whether a given sale can be regarded as a penultimate sale. For instance, nearly a hundred cases are understood to be pending before the courts on the question whether purchase of cashew kernel by exporters of cashew nuts can be regarded as a purchase in the course of export. In a recently reported case, the point of dispute was whether purchase of polythene bags by exporters of hosiery products could be regarded as a purchase in the course of exports.⁵

In any case, sales tax is payable on sales at all stages earlier to the penultimate to exports and these do not get rebated. This is true of inter-State sales taxes as well. There is no provision in law for refund of CST paid by export traders to the suppliers in other States. Even if such a provision was there and governments were willing to refund the tax on export products or their inputs, it would not be easy to do so for the simple reason that to design a suitable rebate system for exports under the existing regime is an impossible task because of difficulties in identifying and quantifying the magnitude of taxes borne by exports at all prior stages.

Sales taxes paid on export products or inputs like packing material do not get fully rebated even when the purchases/sales are all within the State for the prevailing understanding seems to be that the exemption from sales tax is available only to export traders and not to manufacturers who export their own products. In Maharashtra, export-producers have to pay sales tax at 4 per cent on almost all materials, purchased and used by them in the manufacture whether the products are exported or sold locally.⁶

5. [(1991) 81 STC 228].

6. See Krishnan (1993).

It is because of the burden it imposes on exports that no country in the world has chosen to apply indirect taxes to international trade on an "origin basis", that is, taxation by the country of origin. VAT and other forms of indirect taxes are levied on the principle of "destination" or the country where the goods are finally consumed. Under the origin principle the exporting country or State levies the tax and the importing country/State then applies its tax on either the full resale value of the goods ("cascade type origin tax") or only on the difference between the selling price and the purchase cost (non-cascading type). Under the destination principle, the exporting country/State does not collect any tax on sale of goods that move out of its boundary, leaving the importing State free to levy tax on the full resale value of the goods so imported.

The principle of destination is followed not only for taxation of international exports but also in the case of inter-State or inter-provincial sales in federal countries. For example, in the United States and Canada, the States and the provinces follow the destination principle in levying their retail sales taxes. The only example of a general sales tax levied on the basis of origin is that of the ICMS (Imposto Sobre Operacoes Relativas A Circulacao De Mercadorias E Sobre), levied by the Brazilian states. Given the difficulties that Brazil has encountered in the design and operation of this tax, it is not an example that Indian States should emulate. It is generally recognised that it is the origin basis of tax that is one of the main causes of the problems.

3.2.6.3 Valuation of inter-State sales

A sales tax based on the origin principle in an unharmonized regime gives rise to the problems of valuation of inter-State sales among sister companies, similar to the problem of transfer pricing under the income-tax system. When the tax on inter-State sales is not rebatable against the tax on the resale of the goods in the importing State, both the exporting and the importing dealers have an incentive to undervalue the inter-State sale.

3.2.6.4 Tax exporting

The system prevailing in India is a form of restricted cascading type origin tax. The exporting State levies the CST, though subject to a ceiling of 4 per cent, and the importing State applies its local rate on the resale value of the goods imported including the CST paid to the exporting State. This system hinders the smooth flow of inter-State trade and growth of a common market with its benefits that a country of India's dimension could offer. It raises issues of inter-jurisdictional equity which need to be resolved in the interests of unity and political stability of the country.

For various reasons, some historical, the levels of development and income in India are marked by sharp disparities among different regions. As Table 3.7 would show, nearly 30 per cent of the State domestic product in India originates from only four States accounting for less than 20 per cent of the population. A good part of the production of these States get exported to the remaining twentyone States. With an origin based tax, the producing States are able to export taxes too to citizens of the consuming States and thereby making inroads into their tax base. As column 5 of the table will show, the four high income States account for nearly 45 per cent of the total revenue from CST. The low-income States are the net importers and so they lose out in the game even though some of them also find this route a convenient device for deriving revenue from export of raw materials like minerals and tobacco leaves (e.g., Bihar and Madhya Pradesh vide Table 3.8).

An argument often put forward on behalf of producing States in support of origin based taxation is that they need to collect at least some tax from inter-State sales in order to recover the cost of infrastructure and public services provided by the State governments to the industries producing the goods which are consumed in other States. This line of reasoning is based on the assumption that in the absence of a tax on inter-State sales, the location of export industries within their jurisdiction would not contribute to the tax revenues of the exporting State. This is clearly fallacious. Any value addition

(through production or distribution) in a jurisdiction necessarily means extra income in the hands of residents of that jurisdiction. Spending of this income on consumer goods expands the sales tax base of the producing States and, thereby, contributes to their revenues. In fact, to the extent that consumer expenditures are dependent on the level of income of the residents of a State, it is the producing States that stand to gain the most in additional sales tax revenues (even under the destination basis of consumption taxes) from increased export output. It is for this reason that countries are prepared to let exports leave their boundaries free of any domestic taxes. If zero tax makes sense for exports to other nations, it should make equal sense for exports to other States. It is shortsighted on the part of the exporting States to try to export taxes as that ultimately harms their own economy not to speak of the economy of the country as a whole. As for costs of infrastructure, these should be charged to businesses who benefit and not recovered in a way that goes against the interest of the State's economy.

3.2.6.5 Inter-State tax competition and fillip to avoidance/evasion

While the CST enables the States to extend their sales tax jurisdiction beyond their territories and thereby realise revenue from citizens of other States, the lack of harmony in the tax structures has promoted tax competition that closely resembles a negative-sum game. In the bid to attract trade and industry Union Territories and some States reduced the rates of tax on sales in their territories compared to those prevailing in the neighbouring areas.

Union Territories (e.g., Pondicherry and Dadra and Nagar Haveli), in particular, have reduced sales tax rates to attract shoppers from neighbouring States. Many States have had to lower their sales tax rates on consumer durables (and even automobiles) to stop revenue loss from such inter-State shopping. For example, in its 1993 budget, Orissa reduced the sales tax rates on motor vehicles, earth moving equipment, TVs and other electronic goods from 6 per cent, 16 per cent and 16 per cent respectively to a uniform 4 per cent, largely in response to competition

Table 3.7

**Statewise Distribution of Population, SDP
and Revenue from Sales Tax**

(per cent)

| States | Population | SDP@ | G.S.T* | C.S.T* |
|--------------------------------|---------------|---------------|---------------|---------------|
| 1 | 2 | 3 | 4 | 5 |
| High Income States | | | | |
| 1. Maharashtra | 9.46 | 15.30 | 17.37 | 21.78 |
| 2. Gujarat | 4.95 | 6.81 | 9.57 | 11.89 |
| 3. Haryana | 1.97 | 3.12 | 2.13 | 6.19 |
| 4. Punjab | 2.43 | 4.72 | 3.09 | 5.22 |
| Sub Total | 18.80 | 29.95 | 32.16 | 45.08 |
| Middle Income States | | | | |
| 5. Andhra Pradesh | 7.97 | 8.31 | 8.82 | 5.07 |
| 6. Karnataka | 5.39 | 5.89 | 7.28 | 7.84 |
| 7. Kerala | 3.49 | 3.17 | 5.57 | 2.87 |
| 8. West Bengal | 8.15 | 8.73 | 6.75 | 8.82 |
| 9. Tamil Nadu | 6.69 | 6.86 | 11.47 | 9.71 |
| Sub Total | 31.68 | 32.95 | 39.89 | 34.31 |
| Low Income States | | | | |
| 10. Bihar | 10.35 | 6.01 | 4.25 | 5.22 |
| 11. Madhya Pradesh | 7.93 | 6.36 | 4.22 | 6.85 |
| 12. Orissa | 3.79 | 2.74 | 2.21 | 0.56 |
| 13. Uttar Pradesh | 16.66 | 13.27 | 9.88 | 4.15 |
| 14. Rajasthan | 5.27 | 4.85 | 4.39 | 1.32 |
| Sub Total | 44.00 | 33.23 | 24.95 | 18.10 |
| Special Category States | | | | |
| 15. Arunachal Pradesh | 0.10 | 0.12 | 0.00 | 0.00 |
| 16. Assam | 2.68 | 2.34 | 1.57 | 1.76 |
| 17. Himachal Pradesh | 0.62 | 0.67 | 0.37 | 0.25 |
| 18. Jammu & Kashmir | 0.92 | N.A. | 0.38 | 0.00 |
| 19. Manipur | 0.22 | 0.19 | 0.06 | 0.00 |
| 20. Meghalaya | 0.21 | 0.17 | 0.07 | 0.30 |
| 21. Nagaland | 0.14 | 0.11 | 0.08 | 0.00 |
| 22. Sikkim | 0.05 | N.A. | 0.02 | 0.03 |
| 23. Tripura | 0.33 | N.A. | 0.09 | 0.00 |
| 24. Goa | 0.14 | 0.26 | 0.36 | 0.17 |
| 25. Mizoram | 0.08 | N.A. | 0.00 | 0.00 |
| Sub Total | 5.51 | 3.86 | 3.00 | 2.52 |
| Total (25 States) | 100.00 | 100.00 | 100.00 | 100.00 |

Sources: [1] RBI Bulletin, (various issues).
 [2] Census of India, 1991.
 [3] Indian Public Finance Statistics, 1992.

Notes : Classification of the States is as per the Ninth Finance Commission Report.
 @ = Quick Estimate of SDP at current prices for the year 1990-91.
 * = Average for the years 1988 to 1991.

Abbreviations:
 NA = Not Available, GST = General Sales Tax, CST = Central Sales Tax,
 SDP = State Domestic Product.

Table 3.8
Share of Central Sales Tax in Total Sales Tax Revenue
(For Major States)

(per cent)

| State/Year | 1980-85@ | 1985-90@ | 1990-92@ |
|-----------------------------|--------------|--------------|--------------|
| 1 | 2 | 3 | 4 |
| High Income States | | | |
| 1. Maharashtra | 22.43 | 20.26 | 18.92 |
| 2. Gujarat | 21.93 | 20.33 | 17.81 |
| 3. Haryana | 40.69 | 37.61 | 35.72 |
| 4. Punjab | 21.12 | 22.01 | 24.35 |
| Middle Income States | | | |
| 5. Andhra Pradesh | 16.17 | N.A.# | 15.85 |
| 6. Karnataka | 20.23 | 16.11 | 17.10 |
| 7. Kerala | 7.93 | 7.72 | 9.66 |
| 8. West Bengal | 28.94 | 22.41 | 21.55 |
| 9. Tamil Nadu | 16.72 | 14.78 | 13.47 |
| Low Income States | | | |
| 10. Bihar* | 24.26 | 27.47 | 27.31 |
| 11. Madhya Pradesh | 23.94 | 24.18 | 27.14 |
| 12. Orissa | 19.18 | 10.75 | 15.75 |
| 13. Uttar Pradesh | 9.90 | 8.50 | 6.89 |
| 14. Rajasthan | 10.04 | 5.63 | 7.38 |
| Total (14 States) | 18.80 | 17.41 | 17.20 |

Source: Budget Documents of various States.

Notes : * = Revised Estimates from RBI Bulletin have been used for the years 1978 to 1992 to obtain consistent data.

= Consistent data are not available.

@ = Average for the period.

from neighbouring States. At the same time, the tax on certain basic food items was proposed to be increased from zero per cent to 4 per cent to compensate for the revenue loss from the rate cuts. Punjab has been obliged to reduce its sales tax rate on motor vehicles to 3.5 per cent while taxing cereals like rice and wheat at 4 per cent because of the tax rates prevailing in the Union Territory of Chandigarh.

There are two distinct forms of tax-motivated inter-State transactions and trade diversion. First, a registered manufacturer may buy production machinery and equipment, parts and other inputs from another State and pay only the 4 per cent CST. If the same goods were to be acquired from local dealers, they would attract tax at the full local sales tax rates which could be higher than 4 per cent. Second, consumers

and unregistered businesses may buy goods in a lower-tax jurisdiction by paying the applicable local sales tax rates in that jurisdiction.

The first type trade diversion is of differential tax incidence by location of purchase. If the tax on production inputs were fully rebatable, there would be no incentive for manufacturers to go to other States for their inputs or capital goods.

The revenue loss from inter-State shopping by consumers and unregistered persons is of more serious concern and needs to be addressed on a separate footing. Even if the taxes were levied under a rational structure like VAT, this phenomenon would continue unless the tax rates were uniform in all the States, or some other mechanism were found to equalize the tax burden on purchases in different jurisdictions. Some States (e.g., Maharashtra) have indeed devised a method of such equalization (e.g., by levying the octroi or entry tax on motor vehicles brought into the State from outside). But that is not a very satisfactory solution to the problem of tax competition.

Perhaps unwittingly the CST Act seems to have abetted the practice of tax competition among the States by permitting them to reduce the rate of tax on inter-State sales to unregistered dealers (who may be final consumers) below the maximum rate of CST [through notifications issued under Section 8(5) of the CST Act]. For instance, Andhra Pradesh taxes inter-State sale of electronic items even without "C" form (that is, unregistered dealers) at 2 per cent while the local rate is 4 per cent. The diversion of trade in the goods taking place from neighbouring States will no doubt compel them to fall in line soon. Some States even went to the extent of reducing the rate of tax on such inter-State sales below the rate applicable to local sales. This practice, though frowned upon by the Supreme Court as violative of free flow of trade and commerce within the country, still seems to be practised in various ways.

The tendency to discriminate between inputs produced locally and those bought from other States was also held

unconstitutional by the courts. The practice of granting concessions like tax holiday to new industries has been considered constitutionally permissible. And so, almost all States have schemes of concessions or deferment of tax for new manufacturing units. The gain again to any one particular State is dubious. Rather these have eroded the tax base and spawned schemes for avoidance by taking advantage of first point taxation as pointed out earlier.

The "rate war" as it has come to be known has had its toll on the buoyancy of revenue from sales tax. During the 1980s, the buoyancy of revenue from sales tax with reference to SDP for all the 14 large States suffered a set back (vide Table 3.9) and this despite all the additional imposts like surcharge, TOT and all.

The operation of inter-State sales tax has led businesses to find ways of avoidance and evasion. A simple and widely practised way is to camouflage inter-State sale of goods as transfer on consignment, or a depot or branch transfer. While there is no firm estimate of how much of the products of one State goes out in the form of consignment, it is widely believed that the volume is sizeable and in some cases (like pharmaceutical products of Maharashtra) the proportion is said to be as high as 80 per cent. According to knowledgeable persons, on an average, not less than 50 per cent of the inter-State movements of goods go as "consignment" transfers some of which, of course, could be genuine intra-firm transfer.

In response to the demand from States, the Constitution was amended to permit the levy of "taxes on the consignment of goods (whether the consignment is to the person making it or to any other persons) where such consignment takes place in the course of inter-State trade or commerce" (entry 92B of the Union List). Necessary legislation to authorise the levy of the tax is, however, yet to be introduced in Parliament, although the Central government had agreed to propose the legislative measure for imposing the tax.

While there seems to be a *prima facie* case for levying the consignment tax as long as inter-State sales are subjected to tax, it

Table 3.9
Buoyancy Coefficients* of Revenue from
Sales Tax in 14 Major States for
the 1970's and 1980's

| States/year | 1970-71 to 1979-80 | 1980-81 to 1989-90 |
|-------------------|--------------------------|--------------------------|
| Andhra Pradesh | 1.69 | 1.36 |
| Bihar | 1.49 | 1.07 |
| Gujarat | 1.40 | 1.26 |
| Haryana | 1.64 | 1.19 |
| Karnataka | 1.48 | 1.34 |
| Kerala | 1.60 | 1.38 |
| Madhya Pradesh | 1.60 | 1.09 |
| Maharashtra | 1.21 | 1.12 |
| Orissa | 1.60 | 1.18 |
| Punjab | 1.25 | 1.09 |
| Rajasthan | 1.54 | 1.16 |
| Tamil Nadu | 1.62 | 1.18 |
| Uttar Pradesh | 1.86 | 1.18 |
| West Bengal | 1.52 | 1.09 |
| All States | 1.52 | 1.16 |

* With respect to State Domestic Product.

should be recognised that such a measure will only compound the ill effects of origin-based tax on the economy. It will exacerbate inter-jurisdictional inequity in the accrual of revenue. It should not be overlooked that genuine depot or branch transfers have mitigated the harmful effects of the CST and thereby benefitted the economy and the poorer States. Implementation of a tax on consignment will also pose a new set of problems, such as valuation, treatment of depot transfer, verification of movement of consignments, and keeping of record to indicate stocks moving on consignments through more than one State.

As it is, the question when does a sale constitute inter-State sale has not been as simple to answer as might be supposed. There has been a string of decisions from the Supreme Court on the question in specific cases, yet no general principle has emerged. It depends on the facts of each case. In a recent case, purchases were made by a firm in Uttar Pradesh as a commission agent for its

principals located in other States. The contention of the firm was that these purchases had taken place in the course of inter-State trade, and so no purchase tax on agricultural commodities purchased by him could be levied. The sales tax department contested the claim and the matter had to go up to the Supreme Court for a final decision. In another case, sales tax authorities in Tamil Nadu sought to charge purchase tax on sugarcane purchased by the Government of Kerala from Tamil Nadu for a cooperative sugar factory under an express understanding with the Government of Tamil Nadu. Again the Supreme Court upheld the contention of the buyer that it was an inter-State purchase. For qualifying as "inter-State" sale the dicta laid down in these cases run as follows:

"the movement of the goods is *occasioned by sale*, or inextricably connected with the sale/purchase, there is no break between the purchase and the movement of goods and so on".

However, as one commentator notes, what is the difference between a *contract of sale* and a *sale*, what is the incident of a contract of sale and a sale, how inextricable is the connection between movement of goods and sale are matters on which one has to find light from the judgements of the Supreme Court delivered since 1952. "In order to determine the true nature of the transaction, the seller has to enquire of the buyer, the purpose for which the goods are purchased by him and whether he is bound to despatch the goods outside the State any time, and afterwards the goods were actually despatched outside the State....If due to non-availability of booking, the goods are not despatched even after a period of time, the seller will have to switch over his liability for payment of tax, treating his sale as one governed by the State sales tax law."⁷

What should be the appropriate rate chargeable on inter-State sale to unregistered dealers has also not been free from difficulty. While the CST Act enjoins that for cross-border sales to unregistered dealers, the tax payable on local sales or 10 per cent

7. See Mehta (1993).

whichever is higher will apply, what is the appropriate local rate in this context has generated controversy.

3.2.6.6 Disputes and court challenges

As in the case of Union excise, the complex and irrational structure of the sales tax system has created a huge backlog of unresolved disputes before the appeal authorities and courts. The number of cases pending for decision before the appellate authorities exceeded 57,000 in one State alone (West Bengal). Even in a relatively small State like Kerala, over 20,000 cases were reported to be pending for adjudication before the Appellate Tribunal only.⁸ In the Union Territory of Delhi, nearly 40,000 cases were pending before the appellate authorities at the end of 1991-92, whereas the total number of registered dealers was no more than 119,243. It speaks ill of a tax system where assessments are disputed on this scale and remain undecided for long periods. In commodity taxes in particular, such litigation creates uncertainty in incidence for years. When the cases are finally decided, problems arise in the implementation of the judgements. If they go in favour of the assessee, refunds can lead to "undue enrichment", while adverse judgements cause problems to assessees as they cannot recover the tax from their customers.

3.2.7 Vicious circle of sales tax problems

Perhaps enough has been said to show that the systems of domestic trade taxation

operating at present are far from simple or conducive to growth. They lack so utterly in transparency that any assertion about their equity or rationality must be regarded as an article of faith.

The various problems discussed above are interconnected and form a vicious circle, as illustrated in Chart 3.2. The starting point in this circle is the poor compliance by taxpayers and weak enforcement of tax laws by administrators. The enforcement may be weak because of administrative inefficiencies, and also because of the prevalence of unethical practices. These factors lead authorities to impose tax at the first point of sale. The narrow tax base at this point necessitates higher tax rates, extension of tax to business inputs with nil or only partial rebates, and experimentation with supplementary taxes in the form of surcharges and turnover taxes. The higher rates and tax cascading lead to increased tax avoidance and inter-State tax competition, and create pressures for industrial incentives. These forces further undermine revenue potential of the tax system, and elicit policy response in the form of yet higher rates, supplementary taxes, ad hoc adjustments and even more harmful taxes like the octroi or entry tax.⁹ The result is a more and more complex tax structure, which can only worsen compliance and enforcement. The problems with sales tax system have become so acute and intractable that little room is left for any maneuver on the part of any individual State singly. Thorough going reforms are needed if the problems are to be removed.

8. These include cases in agricultural income tax but the bulk related to sales tax.

9. Octroi/entry taxes are outside the scope of this study and are therefore left out of consideration here.

Chart 3.2

State Sales Tax Systems:
Caught in a Vicious Circle

