

THE OBJECTIVES OF CONSUMPTION TAX REFORM

4.1 Deficiencies of the Present System

The discussion in Chapters 2 and 3 about problems of the current system of domestic trade taxes leads to a set of broad conclusions. It is useful to reiterate them briefly, as a background to the identification of various reform options and their assessment.

First, it is apparent that the Union excises and State sales taxes as they are being levied now, viz., at the level of manufacturing or the first point of sale are not sustainable in the long run. Taxation at that level gives rise to intractable problems of defining manufacturing and the assessable value. Finding no other way to address these problems satisfactorily, the common trend is to extend the tax to the retail stage in the form of a retail sale tax or a value-added tax.

Second, the distinction between goods and services underlying the present structure is archaic and a source of complexity. It facilitates tax avoidance and creates unnecessary distortions in consumer choices. It is desirable to bring services under taxation not only to ensure proper taxation of goods but also to expand the consumption tax base which, in turn, would permit a general lowering of the tax rates. Taxation of services would also lessen the regressivity of the sales and excise taxes, since services account for a relatively larger proportion of the consumption basket among the upper income/expenditure groups.

Third, the current definition of domestic trade tax powers of the Centre and the States is a serious obstacle in the design of an efficient system of taxation of goods and services. The distinctions drawn in the Constitution between the taxation of *goods* and *services* and between manufacturing and subsequent stages of trade are outdated.

Fourth, the origin basis of state sales taxes (i.e., the imposition of the CST on inter-state sales) is a hindrance in the free movement of goods and services within the

Indian common market, and in efficient functioning of the economy. It leads to tax cascading and creates distortions in the location of industry and patterns of trade.

Fifth, the overall structure of consumption taxes, at both the Centre and the States, is extremely complex (believed to be the most complex in the world) and grievously lacks neutrality and transparency. It is irrational, outdated, and injurious to the economy. The narrow base, multiplicity of rates, selective exemptions and ambiguous laws facilitate and encourage tax avoidance and evasion. They increase costs of compliance and administration. The lack of adequate relief for the tax charged on production inputs and machinery and equipment undermines the growth potential of the economy. These problems are compounded by the lack of harmony among the tax systems of different governments and the growing inter-state tax competition.

A system as flawed as the current one cannot be reformed through minor piecemeal changes. It requires a major overhaul. Before turning to specific options for reform, it is useful to discuss the principal objectives that the options must seek to achieve and the political and fiscal constraints within which the reform initiatives need to be carried out.

4.2 Objectives and Parameters of Reform

The primary objectives of domestic trade tax reform have to be to impart neutrality and transparency to the tax system to minimize the scope for distortion, harassment and abuse. The tax system should not cause unintended distortions of producer choices regarding forms and methods of conducting business and of consumer choices for one good over another. To achieve this, the following appear to be the main pre-requisites of reform measures.

4.2.1 Economic efficiency and neutrality

The ultimate function of taxation is to transfer resource from the private to the

public sector in a neutral fashion as possible that is with the least interference with the working of the economy. This means that the tax system should be productive of revenue and also responsive to requirements of revenue but at the same time avoid interfering with economic decisions, that is, should be neutral unless non-neutrality can be clearly shown to be in the social interest.

In the context of consumption taxes, this means that the taxes should apply equally to as broad a base as possible including all goods and services. They should extend beyond the first point of sale and go as close as possible to consumers. As noted earlier, a tax that stops at intermediate stages of trade will not be uniform in its impact on different goods and services because of differences in their pattern of production and distribution. An economy that seeks to reap the advantages of market competition and integrate with the world economy must ensure that its products suffer no tax when traded in the world market. External neutrality, however, cannot be achieved without internal neutrality. This implies that "equal treatment" should be an important criterion for taxation.

Another important requirement for the neutral application of tax is the removal of tax on production inputs including plant and equipments. This could be achieved either through suspension of tax on production inputs or through a system of credits for the tax already collected on purchase of production inputs by registered manufacturers/traders.

Internal neutrality demands that the taxes are so designed that they do not impede the free flow of goods and services within the Indian common market. This has implications primarily for the design of the State taxes and their application to inter-State trade. It is generally recognized that the destination basis of consumption taxes is the most conducive to the objective of free movement of goods and services. This means that goods and services should be taxed in the State where they are consumed and not where they are produced. This system is the norm for the application of national sales taxes to international trade and should also be adhered

to in the design of State taxes and their application to inter-state trade.

4.2.2 Equity

Consumption taxes are generally regressive. The Centre and the States have attempted to lessen the regressivity of excises and sales taxes through differentiation in tax rates and exemptions. However, it is doubtful that it has produced the results that were intended.¹⁰ On the contrary, the system that has emerged through such attempts is so complex and irrational that it is not even possible to determine who bears what proportion of the total tax burden. Because of wide-spread evasion and weak enforcement, there is little congruence between the intended and actual tax incidence. Exemptions and lower tax rates may not be well targeted because the rich may benefit from them as much as the poor. In many instances, the rate structure has become perverse. For example, because of inter-state competition, many States impose tax on automobiles at rates lower or same rate as those applicable to items consumed by the lower-and middle-income households.

While equity is a desirable objective, international experience suggests that consumption taxes with multiple tax rates and exemptions cannot be applied in a fair manner. A tax that is highly progressive on paper can be extremely regressive if it cannot be or is not administered efficiently. Equity is served better if the tax is applied to as broad a base, and at as few rates, as possible, taking into account both social policy and administrative considerations. Any redistributive objectives can then be addressed through spending programmes or income and wealth taxes.

10. Optimum tax literature would seem to provide support for differentiation in rates to achieve least loss of welfare from the point of view of consumer choice. Differentiation according to optimum tax approach would, however, go against distributional considerations. Besides, such differentiation is not possible to work out in practice because of information problem. Hence, only a few rates are advocated by theorists to take care of both efficiency as well as equity objectives. From the angle of ease of administration and compliance, a uniform rate is the best.

Interjurisdictional equity is another dimension of this objective. It figures prominently in the approach of the Finance Commissions in determining inter-State allocation of government revenues. The existence of this mechanism for addressing concerns about interjurisdictional equity should permit a greater weight to be given to economic efficiency in the design of taxes. Besides, the objectives of economic efficiency and interjurisdictional equity are, in fact, complementary in the context of consumption taxes. For example, the application of State taxes on the basis of the destination principle is not only conducive to economic efficiency, but also beneficial to lower-income, consuming States.

4.2.3 Simplification and harmonization

International experience shows that simpler tax laws not only lower costs of compliance and administration, but also contribute to the revenue potential and fairness of the tax system. A neutral design of tax is the most important requirement for its simplicity. Much of the complexity of the current systems is attributable to the multiplicity of tax rates, narrow base and selective exemptions. When the tax is applied to a broad base, at fewer rates, the tax laws would be much simpler, the costs of compliance and administration much lower, and evasion more difficult.

Inter-State and Centre-State harmonization of tax laws and administrative procedures can also make a significant contribution to the objective of simplification. The current tax statutes are cluttered with a variety of ad hoc and outdated rules and procedures. There are no compelling reasons why the administrative procedures, including the design of tax returns, the systems for registration of dealers, appeal and enforcement rules, and penalty provisions, need to vary from State to State and cannot be standardized. Even in areas of tax policy, there is a lot to be gained from inter-State (or, for that matter, Centre-State) harmonization of tax bases and tax rates. The current system, characterized by uncoordinated policies and inter-state competition, does not serve the interests of any government, rather inflict losses on the economy.

4.2.4 Fiscal autonomy of the Centre and the States

While a certain degree of harmonization among taxes imposed by different governments is essential for simplification and effective enforcement, consolidation of all taxes into a single levy administered by only one level of government, to be shared among the Centre and the States, is neither politically feasible nor desirable. It would necessarily mean curtailment of the tax powers of one or the other level of government, to which they would not agree. Consumption taxes constitute the vital sources of revenue for both levels of government and to have them all collected by just one level of government would mean considerable loss of discretionary powers of the other level. The loss of discretion on the tax side could eventually constrain their discretion on the expenditure side of the budget as well. It is doubtful if such an outcome had been envisaged by our Constitution-makers or would be acceptable to them under the current circumstances. As Prof. Chelliah put it, a complete merger of the Centre and State taxes would lead to an extreme centralization of tax raising and could "dilute unduly the content of political federalism".

Given the significance of consumption taxes in the finances of the Centre and the State, it is desirable that they continue to enjoy fiscal autonomy with respect to the broad design features and overall revenue contribution of these taxes. Even though the governments should retain full fiscal autonomy, it would be in their mutual interest to accept certain restraints in the exercise of their tax powers. Such restraints could take the form of agreements to harmonize tax bases, rates, and administrative procedures and to not engage in inter-state tax competition. Even sovereign nations abide by such restraints, either explicitly by entering into binding international agreements (e.g., GATT), or implicitly by ensuring that their trade and tax policies are not out of line with those in their trading partners.

4.2.5 Strengthening of revenue base

Reform initiatives should not impair the overall revenues of the Centre and the States.

Governments need revenues to provide public services, to redirect resources to areas of social and economic priorities, and to reduce inequalities in the distribution of income and wealth. The current state of finances of the Centre and the States in India are far from satisfactory. Their revenue bases need to be strengthened in order for them to maintain and improve the quality of the basic public services and infrastructure.

4.2.6 Efficient administration and effective enforcement

Another important objective of reform of consumption taxes is the improvement of tax administration and enforcement. The replacement of the current structures by a simple and rational system would be an important first step in this task. However, much more needs to be done to streamline administration, quite independently of the design of the taxes. Full benefits of tax redesign cannot be realized without complementary reforms of administrative systems. In fact, there is a risk that without such reforms the new system may amount to no more than a replacement of one set of distortions by another.

It can be easily demonstrated that many of the problems of the present system can be addressed through a harmonized system of consumption taxes. Such a system can operate either in the form of a retail sales tax or a destination based value added tax. If the option of a retail sales tax is ruled out on administrative grounds, as seems to be the case from experience and also is argued later, the only real alternative is a value added tax oriented towards taxation of consumption rather than production. Implementation of VAT in a federal context is, however, not simple. The main attributes of VAT, its possible forms and the issues and options that need to be given consideration in the Indian context are taken up in the chapters that follow.¹¹

11. Much of the critical analysis and statement of the objectives of reform put forward in this and other chapters are given in the reports of the TRC also. Pioneering work in the economic analysis of domestic trade taxes was done earlier by the Indirect Taxation Enquiry Committee of 1976 (known as the Jha Committee). Problems with the present system and the possible directions of reform are also examined in the writings of others. See, for instance, Purohit (1992) and Rao (1993).