

V. Summary of Findings and Recommendations

The study identified certain domestic products suffering a tax disadvantage because of discriminatory higher tax burden of domestic trade taxes on domestic products, *vis-à-vis*, foreign products. In general, discriminatory treatment under domestic taxes may not result in a net tax disadvantage for domestic producers because of prevailing customs duties. In order to recognise the net tax advantage or disadvantage to domestic producers, two approaches were followed. First, computation of effective rates of protection (ERP) for different tax regimes to identify contribution of different taxes to the ERP, and second, computation of composite duty rates on imports and domestic produce, for different tax regimes, to identify contribution of different taxes to the composite duty rates. ERP was computed for sixty broad groups of commodities for which information on input-output matrices was available. Composite duty rates were computed for 205 products subject to basic customs duty not exceeding 10 per cent as such products were considered more prone to suffer a tax disadvantage. The composite duty rates on imports were computed with reference to direct imports as well as purchase of imports from registered traders by the manufactures registered for both union excise duty (UED) and sales tax (ST), as the application of different taxes varies with the mode of acquiring the products. These composite duty rates were compared with those on purchases of domestic inputs by registered manufacturers.

Tax discrimination is computed for the rate structure of 1998-99. In the computation of ERP, the input-output matrices relating to the year 1989-90 have been deployed as that was the latest year for which such matrices were then available. Effect of the change in technology and relative prices on the ERP, if any, is not known. Therefore, the results based on ERP need to be used with caution. Similarly, the results based on composite duty rates need to be deployed with a pinch of salt as they are based on gross protection that ignores protection provided to inputs utilised in the production of a commodity. The main findings, are given below along with policy perspectives that follow.

General findings

Domestic producers of most of the products were found to enjoy high net protection in spite of discriminatory higher burden of domestic trade taxes on domestic products, because of high customs duties. However, domestic producers of some products suffered competitive disadvantage in domestic as well as international markets. The tax disadvantage occurred mainly on account of inherent limitations in the tax structure, such as, inverted duty structure and input taxation without full set off. Customs duties were found to follow an inverted duty structure in respect of *khandsari* and six unmanufactured products (raw cotton, coffee plantation, paddy, wheat, cereals other than paddy and wheat, and tea plantation). In general, full set off for the tax paid on inputs was not allowed under any tax, including UED and countervailing duty (CVD). In fact, no set off was available in respect of special additional duty (SAD) and octroi (OCT). In any of the states excepting Delhi, Haryana, and Punjab, inputs were not fully relieved of the burden of ST.

Important specific findings and remarks

- Most of the manufactured products are subject to protection through customs duties with ERP of 15 to 130 per-cent.
- The discriminatory application of domestic trade taxes to domestic and foreign products has resulted in a substantial tax disadvantage to the domestic producers of many manufactured products. The contribution of each of the systems of CVD and UED, and ST and SAD is significant, and is higher with OCT than without OCT.
- In spite of discriminatory tax treatment of domestic products, most manufactured products enjoy net tax advantage owing to protective customs duties. Some of the products, however, are found to suffer net tax disadvantage.
- Net tax disadvantage on account of discriminatory domestic taxes is not confined to only *nil* or low duty products, it has occurred even for some products subject to moderate customs duty. Such products include paper and paper products, tractor and other agricultural machinery, leather and leather products, some non-electrical machinery, communication equipment, and electronic equipment.

- SAD, introduced through the Union Budget 1998-99 followed an inverted duty structure for lubricating preparations and other petroleum products, raw cotton, coffee plantations, paddy, wheat, cereals other than paddy and wheat, and tea plantations, and contributed to the net negative protection of these products.
- Services (non-tradable) are also subject to negative degree of protection.
- One of the factors contributing to the tax disadvantage to domestic producers is input taxation. In this context, the policy of the Union government to disallow MODVAT credit to the extent of 5 per cent was not appropriate and it was inconsistent with the advice rendered to the states to substitute their sales taxes by value added taxes. In this respect, restoration of full credit in the Union Budget 1999-2000 was a step in the right direction.
- Analysis of composite duty rates in respect of products subject to *nil* or low customs duty (not exceeding 10 per cent) reveals that producers of some such products suffered substantial tax disadvantage, *vis-à-vis*, direct imports of these products by the manufacturers using these as inputs. Some of these products were subject to also *nil* or low special duty (SD) and special additional duty (SAD).
- Tax discrimination across the products was found to be substantial indicating the need for rationalisation of the tax structure. While the producers of some products suffered substantial tax disadvantage, the producers of many products benefitted from the tax advantage, *vis-à-vis*, imports. The tax advantage was not less than 10 percentage points in respect of at least 91 products among the 205 low duty products considered in the study.

Recommendations

Customs duty

Customs duty should be rationalised as follows:

- Inverted structure of customs duties in respect of the identified six products (raw cotton, coffee plantation, paddy, wheat, cereals other than paddy and wheat and tea) should be rectified. This can be achieved, if in

general, the principle of taxing inputs and related outputs at the same rate is followed.

- All end-use exemptions and concessions should be removed. This has partially been achieved through the Union Budget 1999-2000. All project imports, hitherto subject to *nil* or low customs duty, excepting mega power projects have been subject to a duty of 5 per cent, and the number of major customs duty rates have been reduced from 7 to 5. In fact, a minimum customs duty³³ should apply to all imports including imports of products which, at present, are not produced in the country. This will give the right signal to domestic producers to venture into production of these commodities. Absence of the floor rate of duty will discourage them from undertaking production of these products. The floor level can be lowered in line with rationalisation of domestic trade taxes.
- Reduction in the customs duty rates on identified products (chemicals and cinematographic films, lubricating preparations and other petroleum products, certain food items, coal tax products and articles of silk or synthetic fibre) with negative value addition at the world prices should be gradual to facilitate restructuring of these industries if they are to survive.

Domestic trade taxes

- Domestic trade taxes should be rationalised by eliminating input taxation. In this respect all efforts should be made to facilitate proposed conversion of sales tax into a value added tax within a year or two. When this is achieved, there will be no need for a duty like SAD, excepting its application to imports by persons not registered for sales tax. As long as SAD exists, it should be made applicable to imports without any exemptions and end use concessions.

³³ What should be the level of minimum customs duty is debatable. Determination of such a floor level should take into account also the disadvantages suffered by domestic producers because of poor infrastructure and high cost of basic inputs such as electricity, water, and transport. This, however, has not been the focus of the current study. In the absence of authentic estimates of such disadvantages, it may be worth considering a floor level of 10 per cent.

- CVD should always be at par with UED with no exceptions. Existing anomalies should be rectified by discontinuing the current practice of lowering rates of CVD below the level of UED for a product or its specific uses. This also has been partially achieved through the Union Budget 1999-2000. CVD has been imposed on a number of products that were hitherto exempted.

Non-tax factors

- With adequate rationalisation of the tax system, it will be necessary to ensure a level playing field to address infrastructure bottlenecks and dual pricing policies which result in high costs for domestic producers. Infrastructure bottlenecks and dual pricing policies should be phased out along with rationalisation of the tax system within the next 3 to 5 years.