

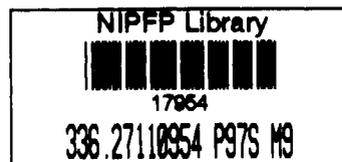
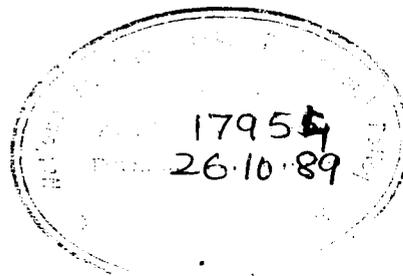


**SHIFTING FISCAL FRONTIERS OF  
THE CENTRAL SALES TAX:  
AN APPROACH TOWARDS EQUITY**

**MAHESH C PUROHIT**

**No. 8/89**

**OCTOBER 1989**



**NATIONAL INSTITUTE OF PUBLIC FINANCE AND POLICY  
NEW DELHI**

**SHIFTING FISCAL FRONTIERS OF THE CENTRAL SALES TAX:  
AN APPROACH TOWARDS EQUITY**

by  
Mahesh C. Purohit \*

A severe obstacle to the formation of a common market with free movement of goods and services within the Indian federation without distortions of competitive conditions relates to the levy of the Central Sales Tax (CST). This levy implies that: (a) some of the States have to surrender a considerable degree of autonomy in exercising their power to levy higher rates of State's sales tax; and (b) all those States who depend primarily upon imports from other States are liable to CST on such imports. This has far-reaching economic implications and adverse effects on the resource mobilisation efforts of the States largely dependent on imports. The situation has been aggravated by the enactment of the Forty-Sixth Constitutional Amendment Act (Government of India, 1983). This Act has authorised the Central Government to levy tax on consignment transfers; a levy which is now imminent. This would mean that whereas hitherto the CST was levied on about approximately 10 per cent of the transactions, it would now cover all inter-State transactions. It is, therefore, necessary that in the interest of the greater degree of autonomy for the States, and for a unified common federal market in the country, the fiscal frontiers of the CST should be shifted from exporting borders to the consuming outlets. This would imply that the basis of the CST would be shifted from origin to destination.

## **Rationale of the CST**

To analyse the rationale of such a shift, it is important to understand that taxation of sales in a federal system does not remain a purely intra-State problem because a commodity may undergo several sales in more than one State before it reaches the consumer. Taxation (or non-taxation) of an inter-State sale, therefore, affects inter-State movement of commodities. With a view to avoiding unnecessary movement of commodities from one State to another and to ensure that no impediments are created in the free flow of goods, certain inter-State problems have to be carefully solved. These are (a) appropriate definition of an inter-State sale; (b) devising tax on inter-State sales to avoid both multiple taxation and the privileged position of such a sale; and (c) effecting uniformity in sales tax laws in all States, the lack of which (partly created by the levy of CST) may lead to discrimination against intra-State trade and commerce and also give favoured position to goods coming into a State from other States, thus encouraging unnecessary movement of goods.

In this context, it is important to note that the Indian Constitution empowers States to levy "taxes on the sale or purchase of goods other than newspapers". But to prevent taxation of the same transaction by other States the Constitution restricts States' powers to levy any tax on inter-State sales. According to Article 286 -

"(1) No law of State shall impose, or authorise the imposition of a tax on the sale or purchase of goods where such sale or purchase takes place:

(a) Outside the State; or

- (b) In the course of the import of the goods into or export of the goods out of the territory of India.
- (2) Parliament may by law formulate principles for determining when a sale or purchase of goods takes place in any of the ways mentioned in Clause (1); and
- (3) Any law of a State shall, insofar as it imposes, or authorises the imposition of a tax on the sales or purchase of goods declared by Parliament by law to be of special importance in inter-State trade or commerce, be subject to such restrictions and conditions in regard to the system of levy, rates and other incidents of the tax as Parliament may by law specify."

Accordingly, Parliament is invested with exclusive authority to enact laws imposing tax on sale or purchase of goods where such sale or purchase takes place in the course of inter-State trade or commerce. In exercise of the authority so conferred, Parliament enacted the Central Sales Tax (CST) Act, 1956.

The CST Act seeks to contend with the problems of taxing inter-State sales and multiple taxation of goods entering into inter-State trade and in export and import transactions. Accordingly, the situs of a sale (in which the different ingredients of a sale take place in more than one State) is to be determined with reference to the principles contained in Section 4 of the CST Act. The key factor which determines the place of sale is the location of goods at a particular time. This particular time for the specific or ascertained goods is the time the contract of sale is made and for the unascertained or future goods it is

the time when their appropriation to the contract of sale takes place. Further, an inter-State sale, as defined by Section 3 of the CST Act, is one which occasions the movement of goods from one State to another, or is effected by a transfer of documents of title to the goods during their movement from one State to another.

Taxation on inter-State sales thus has the two-pronged objective of taxing commodities in such a way that they do not bear heavier burden than the local products and local products do not bear heavier burden than that on imported commodities. Keeping these objectives in view, the CST Act prescribes two different rates of tax: (i) 10 per cent on inter-State sales to unregistered dealers; and (ii) 4 per cent on inter-State sales to registered dealers. The higher rate is chargeable on sales to unregistered dealers because the State sales tax is charged on the sales made by registered dealers but no tax is charged by the State on sales made by unregistered dealers. The higher rate of tax on the unregistered dealer prevents him from entering into inter-State trade for any competitive advantage. On the same logic, the lower rate (of four per cent) is charged from registered dealers because the same commodity is taxed by the importing State also. Thus, the rate differential brings about equity of treatment of registered and the unregistered dealers.

The above rate of four per cent tax on registered dealers has evolved after many changes. Initially, it was imposed at a rate of one per cent. It was raised to two per cent in 1963, to three per cent in 1966 and to four per cent in 1975. Since the commodity in inter-State trade bears the burden of this rate as well as the State sales tax of the importing State, the total burden on inter-State commerce is excessive. In fact, the existing high rate of tax encourages local consumers to buy locally produced goods at the expense of the national economy and economic unity of

the country. This also discourages growth of a common market within the Indian federation. Further, on commodities not produced in all the States (such as cars) the CST puts a higher burden on consumers situated in the importing States than the producing State. Thus, a Central legislation is seen to discriminate between consumers of different States.

It, therefore, follows that the objective of the CST Act being regulation of inter-State movement of goods and not to raise revenue for exporting States, the Central Government should not have levied the CST at a high rate of four per cent. In this context, the yield from the Central Sales Tax (CST) over the years shows that the basic objectives of the policy framers have not been taken care of. The rate has been raised from one per cent to four per cent without giving due consideration to the consequences.

### **Consignment Tax**

An important problem concerning inter-State movement of goods relates to taxation of consignment transfers. Owing to these transfers a large number of dealers all over the country save payment of the CST on consignments sent to different States for sale/consumption therein. Especially, all the big companies have made use of this provision to avoid tax on inter-State transfers. This practice has helped the industry to keep down costs and to avoid the cascading effect. The existing practice has thus been a blessing in disguise and worked as a safeguard against exportation of the burden of the State tax to out-of-State citizens. With the Constitution (Forty-Sixth Amendment) Act, 1982, this concession will no longer be open to dealers undertaking consignment-transfers (Government of India, 1983).

Taxation of consignment transfers has been advocated mainly on two grounds. First, it is argued that for want of any tax on these transactions, dealers are able to avoid sales tax in the name of consignment transfer. Various estimates suggest that the revenue implication of avoidance of tax through such transfers is considerable. It is of the order of three times of the CST yield in groundnuts and 16 times of the CST yield in groundnut oil in Gujarat (Government of Gujarat, 1980). Similarly, the tax on turnover that escapes tax through consignment sale is four times of what is already collected as CST from rubber and 30 times that from tea in Kerala (Government of Kerala, 1976). Likewise, the estimates for Bihar show that the avoidance of tax on potatoes is substantial (Purohit, 1988, p.257). Second, the exemption of tax on consignment transfers discriminates against the small manufacturers inasmuch as the latter are deprived of the facility of stock-transfer. Hence, small manufacturers pay CST on their inter-State transactions and face a difficult competitive situation in the market.

With a view to avoiding the above problems, the Act relating to consignment sale provides for taxation of consignment transfers. However, this is not going to be a step in the right direction in terms of its long-term consequence. Its implementation (with the present rate of CST) would be extremely hazardous. It would only be a revenue-yielding device for the industrialised States of the country. As industrial production in the country is concentrated (for historical as well as geographical reasons), only a few States would benefit; the majority would suffer the burden of the tax.

This apprehension is borne out by data on the proportion of the State's CST yield, given in Table I. The table gives percentage share of the States for the years 1964-65, 1967-68, 1976-77 and 1988-89. In the first year,

as can be seen from the table, CST rate was two per cent; in the next year it was three per cent and in 1976-77 it was four per cent. The last year, 1988-89, indicates growth of CST revenue with the given tax rate. It will be seen that only a handful of States claim a major chunk of the total CST revenue: Tamil Nadu, Maharashtra, Gujarat and West Bengal account for about 50 per cent of the CST yield.

The above data show that the power to tax consignment transfers would yield larger resources for the industrialised States only. It would certainly be a retrograde step, contrary to the principle of `vertical equity` among the States, and hence hazardous to the federal structure of the country. Also, this would conflict with the `principle of destination`, an important criterion of sales taxes.

While recognising the fact that the proposed measure is ill-conceived, various proposals have been put forth to mitigate the adverse effects. One of the proposals is that half of the proceeds of the consignment tax would be retained by the collecting State, the remaining 50 per cent to be placed in a divisible pool to be distributed among the States as per a formula applicable for distribution of excise duty or any other formula as may be devised for this purpose by the Finance Commission or by any other appropriately constituted body.

#### **Approach Towards Tax Harmonisation and Federal Equalisation**

Recognising the problem of vertical imbalance, the proposal of part distribution of the consignment tax yield has been accepted by the States. However, it is important to consider the overall vertical imbalance created by the Central Sales Tax itself.

The CST has its ill effects on both the general economy and on the federal fiscal structure of the country. First, the consuming States of the country have to surrender a considerable degree of their autonomy in using the State's sales tax rates because the rate of the CST (4%) plus the rate of the State sales tax (say, 11 per cent) would be already excessive. The importing State would, therefore, have to rule out raising the tax rate any further. This in fact goes against State autonomy. Secondly, the States are denied the opportunity of raising additional tax resources through discretionary measures. This affects the allocation of resources both through the Finance Commission and the Planning Commission, which take note of such discretionary measures. In fact, it is distressing that through the Central tax legislation, the rich States claim higher tax-income ratio at the cost of the resources from the poor States. Thirdly, the economic effects of both the existing CST and the proposed Consignment Tax (CT), would have its adverse price effects, via cascading of input taxation.

An analysis of the cumulative effects of the tax at early stages of production indicates that normally the effect of the tax is approximately 50 to 100 per cent more than the statutory rate of tax. For example, the statutory rate of sales tax would have the following cumulative rate on a few select commodities:

	Tax Rate	Gumulative Incidence
1. Fertilisers	.03	.043
2. Basic iron and steel	.03	.055
3. Internal combustion engine	.04	.068
4. Machine tools	.04	.088
5. Preserved food products	.08	.117

(Source: Purohit, 1986)

The above cumulative rates, estimated with the help of input-output tables assuming tax on the existing rates only, would be further affected. With the additional burden of the proposed consignment tax, the cumulative rates would be further inflated with adverse consequences for prices.

Further, the incidence of the tax on consignment transfers would discriminate against the developing States of the country, because the tax on inputs would be levied by the raw material despatching States (presumably the less developed States) and further taxation would be resorted to by the developed (industrialised) States. Of the two levies, the incidence of the former alone would be borne by the industrialised States while the incidence of both the levies would be on the citizens of the consuming States. Hence, the developing (poor) States would be made to bear the burden of the tax collected by the developed (industrialised) States of the country.

To illustrate, the loss of revenue to the consuming States can be seen from the available data from Tamil Nadu, as given in Table II. That the consignment sale and other non-taxable out-of-State sales, which get tax exemption according to the present law, would be subject to at least 4 per cent tax on all transactions, is indeed an eye-opener. Presently, many of the commodities are exempted upto the extent of 50 to 90 per cent. Hereafter all these transactions would be taxable. It can be foreseen that this would lead to considerable chaos in the price structure of the poor States.

Also, the provisions of a concessional rate of the CST have caused considerable evasion of sales tax in redistribution or entrepot centres. To illustrate, whereas the rate of tax on the re-export of goods from Delhi is 2 per cent, in all its neighbouring States, this rate is 4 per

cent. Also, the reduced CST rates on a couple of commodities causes considerable diversion of trade from many of the States to Delhi (Purohit, 1987).<sup>@</sup>

This brief analysis indicates that the CST would favour rich States as against the poor States. This is contrary to the assumed principles of vertical equity in a federation. It is important to note that the CST, which is a federal tax, is inadvertently a constraint on vertical inequity among the States. Over the years, analyses of resource transfers from the Centre to the States indicate that on the one hand the fiscal dependence of the States has increased, and on the other, vertical equity has suffered through discretionary transfers. It is important to note that the CST is approximately one-third of the total statutory transfers from the Centre. Hence, this tax must not be allowed to cause any inequity in the federal system. As this tax belongs to the Federal List, there is no reason why the fiscal frontiers of the CST cannot be shifted from the exporting State to the consuming outlet. This would promote vertical equity among the States and would also work for rationalisation of the sales tax system among the States.

Alternatively, the exporting States may be allowed to tax inter-State transactions but the proceeds of the tax needs to be transferred to the consuming States. This would increase the "own tax revenue" of the consuming States. Also, it would give a free handle to the States to adjust their State's sales tax rates. If the EEC is thinking along the lines of a common market, there is no reason why India too, with its numerous federating States, cannot think of an Indian Common Market.

**TABLE I**  
**Distribution of Revenue from CST Among the Indian States**

Sl.No	State	1964-65		1967-68		1976-77		1988-89	
		Rs. Crore	Per cent of Total						
	1	2	3	4	5	6	7	8	9
1	Andhra Pradesh	1.19	1.89	4.36	4.16	19.90	4.28	160.00	7.86
2	Assam	0.36	0.57	0.51	0.49	6.37	1.37	45.52	2.23
3	Bihar	6.16	9.75	7.40	7.06	15.56	3.35	138.75	6.67
4	Gujarat	4.89	7.75	7.64	7.29	45.56	9.80	190.00	8.74
5	Haryana	-	-	3.61	3.44	27.21	5.85	109.20	5.27
6	Himachal Pradesh	-	-	-	-	0.27	0.06	3.15	0.14
7	Karnataka	1.74	2.76	2.44	2.33	27.66	5.95	148.00	7.21
8	Kerala	1.80	2.85	2.62	2.50	10.42	2.24	40.99	1.93
9	Madhya Pradesh	3.66	5.80	7.66	7.30	31.25	6.72	127.72	6.25
10	Maharashtra	14.12	22.38	24.18	23.06	112.15	24.11	399.00	19.09
11	Orissa	2.03	3.22	4.22	4.02	15.49	3.33	68.85	2.32
12	Punjab	-	-	4.37	4.17	18.98	4.08	75.77	2.32
13	Rajasthan	1.09	1.73	2.56	2.44	14.26	3.07	38.97	1.87
14	Tamil Nadu	6.31	10.00	10.16	9.69	42.42	9.12	184.81	9.04
15	Uttar Pradesh	2.00	3.17	3.46	3.30	23.47	5.05	126.00	6.12
16	West Bengal	14.55	23.06	19.68	18.77	54.02	11.61	230.75	11.81
	All States*	63.10	100.00	104.87	100.00	465.10	100.00	2087.00	100.00

Notes: \* It is inclusive of the rest of the States not shown in the break-up.

Sources: 1. Purohit, M. C. (1976), "Growth and Composition of States Tax Revenue in India", Artha Vijnana, 18: 105-169, June for the year upto 1970-71.

2. Reserve Bank of India Bulletins for the rest of the years.

TABLE II

**Proportion of Consignment Sales Tax to Other  
Non-taxable Sales In Tamil Nadu**

Particulars of Commodities	Consignment Sales	Other non-taxable out of State Sales (per cent)
Cinematographic cameras	2381.00	79.90
Milk Food	839.00	-
Tea (Leaf)	13641.00	80.43
Vegetable Products	281.00	-
Mercury	2005.00	-
Aluminium Pure and Alloy	177.00	17.67
Pesticides and insecticides	1776.00	84.21
Jaggery and Gur	282.00	11.60
Cardamom	97510.00	41.73
Timber and bamboo	2035.00	78.03
Hosiery goods made of cotton	25525.00	41.05
Drugs and Medicines	2484.00	97.41
Arecanut	499.00	51.77
Tinned and canned foods	9881.00	84.76
Distempers	1873.00	95.30
Leather goods	83.00	99.71
Rubber products	473.00	41.96
Cotton (unmanufactured State)	18258.00	12.11
Cotton yarn	8173.00	92.91
Iron and Steel	1773.00	95.69
Oil seeds (other than ground nut)	1003.00	20.59
Ground nut	1254.00	45.99
Dressed Hides and Skins	4164.00	99.56
Pulses	5781.00	97.92
Aromatic chemicals	513.00	16.59
Butter, Ghee(etc)	520.00	35.77
	97510.00	41.73
Containers	452.00	82.88
Domestic utensils	25.00	92.01
General goods	10185.00	83.68
Gunnies and Hessian cloths	682.00	73.18
Metals and Minerals	63797.00	20.60
Plastic and its products	789.00	86.73
Printed materials	564.00	48.96
Tamarind	1072.00	99.21
Tapioca products	403.00	19.40
Turmeric	40521.00	13.90
Methi	2.00	82.59
Garlic	137.00	87.36
Others	7493.00	91.09

Source: Government of Tamil Nadu, Deptt. of Commercial Taxes.

## NOTES

- \* The author is Professor at the National Institute of Public Finance and Policy, New Delhi 110067.
- @ Under Section 8(5) of the CST Act, the States are empowered to reduce the CST rate. As in many other places, in Delhi too, this provision has been used to reduced the rate of CST on all exports and on many other commodities. Such variations, firstly, causes substantial shift in the geographic location of sales decision (Purohit, Mahesh C., 1987, Fox, William F., 1986) and secondly and more importantly causes unnecessary movement of goods. In Delhi, the CST rate being 2 per cent on re-export (vide notification S.D. 612 (E) dated October 21, 1975), many of the transactions from the neighbouring States are shown as re-export from Delhi, while actually not paying CST at the respective places (Purohit, 1987).

## REFERENCES

- Fox, William F. (1986), "Tax Structure and the Location of Economic Activity along State Borders", National Tax Journal, 39: 287-401, December.
- Government of India (1983), The Constitution (Forty-Sixty Amendment) Act, 1982, New Delhi.
- Gazette of India Extraordinary No. 5, Part II, Section 1, dated February 3, 1983.
- Government of Gujarat (1980), Report of the Taxation Enquiry Commission, Gandhi Nagar, Gujarat.
- Government of Kerala (1976), Report of the Committee on Commodity Taxation, Trivandrum.
- NIPFP (1981), Sales Tax System in Bihar, Somaiya Publications Pvt. Ltd., Bombay.
- Purohit, Mahesh C. (1986), "Estimating Cumulative Rates of Excise and Sales Taxation in India", Economic and Political Weekly, Pp.
- Purohit, Mahesh C., et.al. (1987), Fiscal Policy for the National Capital Region, NIPFP, New Delhi 110067.
- Purohit, Mahesh C. (1988), Structure and Administration of Sales Taxation in India, Reliance Publishing House, New Delhi 110008.

**NIPFP WORKING PAPER SERIES: 1988-89**

Working paper	Title	Author's name
1/88	Recent Initiatives in Enforcement and Trends in Income Tax Revenue: An Appraisal	Amaresh Bagchi (January)
2/88	Rationing, Dual Pricing and Ramsey Commodity Taxation: Theory and An Illustration using Indian Budget Data	Raghendra Jha M N Murty Ranjan Ray (April)
3/88	Economic Evaluation of People's Participation in the Management of Common Property Resources	Kanchan Chopra G K Kadekodi M N Murty (May)
4/88	New Series on National Accounts Statistics: Some Comments	Uma Datta Roy Choudhury (September)
5/88	On the Measurement of Unemployment	Satya Paul (September)
6/88	Private Corporate Investment and Effective Tax Rates: A Re-examination of a Feldstein-Chirinko Controversy	Raghendra Jha Nisha Wadhwa (October)
7/88	Growth of Capital Goods Sector After the Mid-Sixties: Some Observations	Gopinath Pradhan
8/88	The Distortionary Implications of the Indian Capital Gains Tax	Subhayu Bandopadhyay Arindam Das-Gupta (October)
9/88	Export Demand and Supply Elasticities for Selected Industrial Countries, 1970-1983	A V L Narayana Arvind Panagariya
10/88	On Choice between Expenditure and Taxes on Consumption and Capital Goods	M N Murty (November)
11/88	A Model for Designing the Rate Structure of Sales Tax	Shekhar Mehta (December)

Working paper	Title	Author's name
1/89	Aggregate Demand with Parallel Markets	Arindam Das-Gupta Shovan Ray (March)
2/89	The Exemption Limit and the Personal Income Tax: An International Comparison	Pulin B Nayak Pawan K Aggarwal (May)
3/89	A Model of Local Fiscal Choice	Shyam Nath Brijesh C Purohit (May)
4/89	Tax Evasion and Income Distribution	Shekhar Mehta (May)
5/89	Optimal Mix of Urban Public Services: A Game Theoretic Approach	Partha Ganguli Shyam Nath (July)
6/89	Personal Income Tax in India: Alternative Structures and Their Redistributive Effects	Pulin B Nayak Satya Paul (July)
7/89	Income Inequality and Elasticity of Indian Personal Income Tax	Pawan K Aggarwal (August 1989)
8/89	Shifting Fiscal Frontiers of the Central Sales Tax: An Approach Towards Equity	Mahesh C Purohit (October 1989)