ADOPTION OF VALUE ADDED TAX IN INDIA PROBLEMS AND PROSPECTS

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ADOPTION OF VALUE ADDED TAX IN INDIA: PROBLEMS AND PROSPECTS

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Beginning with the introduction of *Taxe Sur la Valeur Adjoutee* in France in 1954, the tax on value added has spread like a praire fire to a large number of countries. Its widespread adoption has specially been witnessed during the recent years. Until the sixties this tax was introduced only by a handful of nations. During the eighties the tax has come to occupy an important place in the fiscal armoury of nearly all industrialised countries and a large number of Latin American, Asian and African countries. More than 30 countries have adopted VAT since 1980. This has brought the total number of VAT-countries to more than 60. Benin, Paraguay, Tanzania, Tobago, Thailand and many other countries of the former Soviet Union have introduced VAT during just the last two years. The trend of the adoption of VAT has thus been the most remarkable event in the evolution of commodity taxes in the present century. In the context of such an evolution of VAT around the world, this paper in its first part analyses the general trends in the structure of VAT which includes rates, base and exemptions of the tax. The second part presents the assessment of the existing commodity taxes in India. And the last part examines the problems in introducing VAT in the context of the federal structure of the country. These problems include psychological, structural and the administrative aspects of the tax.

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I

Structure of VAT

The structure of tax among all these VAT countries suggests that although the rates as well as their coverage vary from one country to another, there is a trend to have a small number of rates[1]. Many of the countries, as shown in Table 1, levy VAT with a single rate. These include Argentina, Benin, Brazil, Denmark, Ecuador, Grenada, Haiti, Israel, New Zealand, Norway, and Paraguay. Some of the countries attempt to introduce progressivity into their VAT structure by having low rate of tax on necessities and high rate on luxuries. These countries have rate categories ranging between two and five. However, the general trend is to have two or three rate categories only. In addition to having a low rate of tax on necessities, many of the countries exempt a few basic food items, medicines, cloth and footwear. Such exemptions to necessities, other institutions, or to specific activities are very limited. The treatment of necessities is either in the form of zero-rating or exempting these items from the tax. The general trend indeed is in favour of exemption in contrast to zero rate. As regards luxuries, these are taxed at a high rate in many of the countries including those from the European, African as well as Asian continents. Further in order to make the structure progressive, many of the countries levy special excises on luxury goods. This is generally limited to tobacco products, alcoholic beverages, mineral oils, and vehicles.

The coverage of the VAT in most countries is broad enough to include final consumption of goods as well as services. For taxation of services, two approaches are adopted. First, there is an *integrated approach* which includes all services under VAT excepting a few stipulated items singled out for exemption. And secondly, there is a *selective approach* which specifies a few select services for bringing these under the tax net leaving the rest of the services out of the purview of taxation. Also the lessons from the VAT countries suggest that the introduction of VAT in all such countries has rationalised their tax structures considerably.

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1. Purohit, Mahesh C. (1993), *Principles and Practices of Value Added Tax: Lessons for Developing Countries*, Gayatri Publications, P.B.No. 8495, Ashok Vihar, Delhi - 110 052.

II

Assessment of the Present System

The existing structure of commodity taxes in India as presented in Annexure I, is an unintegrated one. Also, it is a juxtaposition of a number of systems such as customs duties and union excise duties levied by the Union government, sales taxes levied by the State governments and octroi levied by the local bodies. The unintegrated character has given rise to the following problems related to economic as well as administrative aspects:

a. **Multiplicity of Levies and Complexity of Structure**: The system is characterised by multiplicity of levies on the same base. Not only do these levies fall on the very same products but also there is no single authority that looks into their cumulative effect. While individually each tax does pay regard to progression as well as to economic factors, the overall objectives of the country's tax policy are not adequately subserved due to their cumulative effect. Consequently, taxes not only fall on the final products but also on imports. In addition, the existing structure of all the three important taxes is complex. The rate categories are enormous and show larger variations in structures among individual industries which could cause distortion of tax incentives.

b. **Cascading Effects**: Various taxes fall on the taxes levied earlier causing escalation of costs and profits at each stage. As inputs are subjected to excise and/or sales tax, the manufacturer needs a larger amount of working capital to maintain the necessary stock of the inputs. Consequently, the cost of his final product gets raised. Besides, when the manufacturer works out his own profit margin as a percentage of his costs and arrives at a price, he adds a mark-up which is a higher quantum of profit. This phenomenon of snowballing or cascading effect, raises consumer prices greater than what accrues to the exchequer by way of additional revenue.

c. **High Tax Rates**: The tax structure is mostly concentrated towards the higher side. The import duties, for example, have the nominal tariff rates mostly in the range of 75 to 150 per cent with average duty estimated to be over 100 per cent. Compared to the tariff rates generally prevailing among other developing countries, Indian tariff rates are definitely higher. In fact, it is important to note that both nominal rates and realised rates of tariff have been raised since 1980s. Thus, the higher rates have caused increase in effective rate of protection making the products non-competitive. However, the high costs limit the size of domestic market causing constraint on ultimate growth. A similar steepness in tax rates prevails in union excise duties and sales taxes.

d. **Lack of Transparency**: The existing system results in *uncontrolled incidence* of various taxes. The overall cumulative incidence lacks transparency for an economic analysis. As the cumulative incidence on commodities becomes fortuitous, it is difficult to grade different commodities according to progressivity. The lack of transparency hinders exact calculations of tax-incidence.

e. **Vertical Integration**: The phenomenon of widespread taxation of inputs *promotes vertical integration.* That is, it militates against ancillary industries and encourages industries to produce more and more of the inputs needed rather than purchase them from ancillary industries. To discourage this trend, the Modified VAT (MODVAT) scheme was introduced in the year 1986 in respect of goods covered by 37 specified chapters of the Central Excise Tariff. This scheme was extended to cover practically all chapters except those relating to petroleum products, textile products, tobacco products, cinematographics films and matches. However, as explained in Annexure I, the coverage of MODVAT is not complete. Also, at the State level, the sales tax system does not provide any such mechanism.

f. **Manufacturers' and Importers' Sales Tax**: An important problem in the sales tax structure relates to the point of levy. There has been a tendency of the States over the years to switch over the point of levy to the origin, i.e., the import or the manufacturing stage. Most of the States raise between 70 and 90 per cent of revenue from the first-point tax which has all the weaknesses of the excise system. In addition, it lacks the advantage of capturing additional value-added and deviates from its destination principle.

g. **Out-of-State Sales**: Taxation of out-of-State sales (hereinafter referred to as inter-State sale) create many formidable problems. Presently, these sales are taxable at the rate of 4 per cent under the Central Sales Tax (CST) Law. Although the tax was levied to avoid unnecessary movement of goods among the States[2], it does cause the phenomenon of cascading. Also, a high rate of 4 per cent increases the incidence of tax and forces the States to surrender their autonomy in deciding their sales tax rates. The CST, at present is levied on inter-State sales only; consignments are exempt. It is now proposed that the CST be levied on all these exempted transactions too, which comprise 3/4th of the base. Hence, taxation of all the transactions (including consignments) would be inflationary, inequitous and distortionary.

h. **Narrow Base**: The existing tax base is confined to commodities only; services are exempt from taxation due to the constitutional limitations. Both the Union List and the State List do not cover taxation of services. Hence, the Union excise duties and sales tax do not, in general, cover services, although hotel services are specifically taxed. Also, a few selected services are separately taxed under specific provisions of the Constitution. Since, services constitute a fast growing sector in the Indian economy, exclusion of services deprives the Government of a lucrative source of revenue. In fact, in most countries either under VAT or under sales tax, the tax base does include services.

III

Problems and Options for Reforms

The above assessment of the existing tax system does, however, call for reforms. This is also evident from the fact that a Tax Reforms Committee has already been in existence[3]. Also, the experience of VAT countries suggest that the introduction

2. Purohit, Mahesh C. (1988), *Structure and Administration of Sales Taxation in India*, Reliance Publishing House, New Delhi-8, Chapter 7.

3. The Tax Reforms Committee (TRC) has already submitted recommendations in its Interim as well as Final (Part I) Reports. We would refer to their recommendations as the TRC solution. See Government of India (1991), *Interim Report of the Tax Reforms Committee*, New Delhi, Department of Revenue, Ministry of Finance; and Government of India (1992), *Tax Reforms Committee, Final Report, Part-I*, New Delhi, Department of Revenue, Ministry of Finance.

of VAT in all such countries has rationalised their tax structures. For example, Korea replaced eleven different kinds of indirect taxes by VAT. Eight taxes which were replaced by VAT had 53 rates[4]. Similarly, the Republic of China (Taiwan) replaced three important commodity taxes[5]. In fact, all the countries that have gone in for VAT had a genuine need for simplifying their tax system. India also stands at the crossroads and needs simplification urgently. Thus, for tax reforms in India, it is necessary to recognise the problems that have to be faced prior to its introduction. We envisage three different types of problems. These are psychological, structural, and administrative problems. In this section, we analyse these problems and suggest options for reforms.

1. Psychological Problems

These problems are related to politicians, administrators and dealers. Political problems relate to the inertia of the past.[6] Owing to such an inertia, which ensures that the bulk of revenue is drawn from the existing taxes, most tax laws of future importance take a long time to get implemented. The politicians avoid big changes in taxation because of the likely adverse comments that the new legislation could attract from the vested parties[7]. Like politicians, tax administrators are also risk-averse. They too have apprehensions of loosing revenue and think exclusively of administrative expediency without regard to any other economic criterion. The dealers on their part are bothered about compliance costs in terms of money and time needed for compliance. These problems being psychological, a rational tax structure like VAT is unlikely to suffer a major set-back in its introduction. However, with a view to avoiding the above problems the following measures are essential to be implemented.

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4. Han, Seung Soo (1987), *The Value Added Tax in Korea*, Report No. DRD 221, Development Research Division, World Bank, pp 1-3.

5. Yen, Ching-Chang and Milwide M. Guervara, "The VAT Experience in the Republic of China (Taiwan)", in Yoingco, Angle Q and Milwide M. Guevara (Eds) (1988), *The VAT Experience in Asia*, Asian Pacific Tax and investment Research Centre, Singapore, pp. 48-67.

6. Rose, Richard and Terenee Karran (1987), *Taxation By Political Inertia*, London, Allen and Unwin.

7. Rose and Karran (1987), *op.cit.*,pp. 212-213

a. **Requisite Information and Publicity**: Psychological problems are primarily related to information gap. This could be over come by spending adequate time and money on publicity campaign aimed at both taxpayers and consumers. The experience of countries such as Korea who have recently introduced VAT suggest that it is indeed important that taxpayers fully comprehend the new legislation. This will help to overcome resistance and compliance problems. It is useful to learn, for example, that the Korean government campaigned with the help of the Chamber of Commerce and Industry; daily newspapers; television; radio and other mass media.[8] Similarly, Taiwan also made sincere efforts to educate the masses in general and the dealers in particular.[9] Thus, an important requirement for a successful introduction of VAT is an adequate information campaign aimed both at taxpayers and consumers.

b. **Lead-in Time**: Equally important aspect is the requirement of lead-in time. Although it varies according to the circumstances peculiar to each country concerned, in general, sufficient time is needed to prepare legislation and rules. The length of lead-in time could vary from a few months in a country like Chile which had prior experience of a turnover tax[10] to a longer period of two to three years in Korea and Taiwan.

2. Problems related to Structure of the Tax

The assessment of the existing structure of commodity taxes suggests that the reforms in the overall structure would necessitate harmonisation of all these taxes in the context of the following constraints in the federal structure.

Federal Constraints to be Recognised: Four important constraints appear to affect any quick solution to rationalise the tax system. First, the division of tax powers between the Centre and the States provides both the tiers of governmental

8. Han, Seung Soo (1987), *The Value-Added Tax in Korea*, DRD 221, World Bank.

9. Yen, Ching-Chang and Milwide M. Guervara, "The VAT Experience in the Republic of China (Taiwan)", in Yoingco, Angel Q and Milwide M. Guervara (Eds) (1988), *The VAT Experience in Asia*, op.cit, pp. 48-67.

10. Yoinco, Angel Q and Milwide M. Guevara (Eds) (1988), *The VAT Experience in Asia*, op.cit.

powers to levy taxes falling on the same base. However, 45 per cent of the revenue from excises collected by the Central government is shared among the States. This has been practiced since the recommendations of the Eighth Finance Commission. Secondly, the tax revenue from the excises constitute 43.4 per cent of the total tax revenue of the Centre and that from the sales tax 57.6 per cent of the States' own tax revenue. However, these taxes have considerable fiscal importance for both the tiers of the government. Thirdly, the dependence of the States has been increasing over the years. Presently, 66.5 per cent of the total taxes raised in the country belong to the Centre, leaving 33.5 per cent for the States. Any cut in the resources raised by the States would further reduce their collection. Finally, the Central Sales Tax (CST), a central levy (from the Union List), is levied, collected and retained by the 'exporting' States. Initially, it was a small levy, yielding insignificant revenue. However, over the years its share has increased considerably. Presently, the CST constitutes 15 per cent of the total yield from the general sales tax. When the CST is also levied on consignment sale, the total tax share would be increased considerably causing grave inequitous and cascading effects.[11]

With a view to taking proper care of the above problems we need to introduce reforms into two phases. First, there are immediate reforms which could be attempted without facing any major problem. Once the economy has adjusted to these immediate reforms and the administrative system has suitably developed the machinery to administer the changes, requisite medium-run measures have to be adopted.

a. **Immediate Reform**: The following immediate reforms are essential to pave the way for the major reforms to be taken up in the medium-run.

i. *Reducing the number of rates*: The reform related to the multiplicity of rates requires efforts at simplifying the tax structure. Overtime, the attempts have been made to attain a large number of objectives (including progressivity) through all these taxes. Hence, the number of rates classified according to their characteristics increased. The number was further increased due to administrative considerations. Hence, the

11. As of to-day the CST is being levied on inter-State sales only; consignments are exempt. However, it is proposed that this would also be included under tax in future. This would aggravate the adverse economic effects. See Purohit, Mahesh C (1990), "Shifting Fiscal Frontiers of the Central Sales Tax", *Economic and Political Weekly*, December 15, pp. 2730-32.

present structure has enormous number of rates. Such a structure complicates the administration of all these taxes. Also a very fine gradation through tax rates does not serve any useful purpose of having progressivity. In fact, it complicates both the structure and administration of the taxes and causes evasion of tax as well as endless litigation. Hence, it is essential that the number of rates is reduced to a minimum. In most of the countries, the number of rates range between three and five[12]. It is, therefore, necessary that the tax bracket be reduced to two or three rates, barring the selective excise duty on non-essential commodities or commodities injurious to health which could be levied at higher rates.[13]

ii. *Lowering Total Tax Incidence*: The lack of transparency in the tax structure does not allow us to estimate the cumulative total commodity tax burden in the economy. It is, therefore, necessary to undertake some academic exercise to estimate the tax burden. Also, the total tax burden on a commodity should not be prohibitive. The recent efforts of the Government to streamline import duties is a step in the right direction. As envisaged in the TRC, the import duties should be reduced considerably. The domestic taxes on commodities (viz., excise and sales tax) should also be harmonised to have efficient allocation of resources.

iii. *Reforming Sales Tax System*: The existing trend in the sales tax system is to push the tax base as close to imports/manufacture as possible. This has considerably reduced the income-elasticity of the tax system.[14] Also, the cascading effects of taxation at initial stages as well as of taxation on raw materials need to be rationalised. With a view to safeguarding revenue neutrality and at the same time reforming the tax system, it

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12. Purohit, Mahesh C. (1991), "Designing Value-Added Tax - Lessons fromTheory and Practice". *International Journal of Development Banking,* Vol. 9, No.1, January, pp. 55-62.

13. For Union excise duties, such a recommendation has already been made by the Tax Reforms Committee. For sales tax as well such recommendations have been made for some States. See for example, Chelliah, R.J. and Purohit, Mahesh C., (1985), *Information System and Evasion of Sales Tax in Tamil Nadu,* NIPFP, New Delhi.

14. Purohit, Mahesh. C (1991), *Reforms in Indian Sales Tax System,* No. 3, June, Working Paper, National Institute of Public Finance and Policy, New Delhi, Table 2.

is suggested that (a) the requisite set-off is given for the taxes paid on raw materials; and (b) the States adopt a structure of "two-points-with-set-off" recommended in an earlier study.[15] This would pave way for the adoption of a VAT at the medium-run. However, reforming sales tax would certainly imply following the other recommendations of reduction in tax rates, lowering tax incidence and granting a limited number of exemptions (including industrial incentives) and shifting the rate structure towards the retail-point.

b. Medium-term Reforms: Once the administrative system has absorbed the immediate reforms, the medium-term reforms must aim at having two major changes, viz., (a) adoption of VAT, and (b) broadening of the tax base.

i. Adoption of VAT: The first major reform in the medium-term has to be in the direction of adopting a full-fledged VAT. Since, a preliminary step towards the reform of a complex structure of taxes has already been attempted by introducing MODVAT (Annexure I), it is indeed the appropriate time to think of its next logical step to bring about a harmonious functioning of all the major taxes that fall on different products. We could consider the following *five* options.

Central VAT: As suggested by the Jha Committee[16] and further reiterated by the TRC[17], an important option is to go in for a complete change over to a VAT. Essentially, this would mean that we adopt a form of tax which is levied on all goods and services (except exports and government services), and which falls on the value-added at each stage from the stage of production to the retail stage. From revenue aspect, however, we could still have excises on a few select commodities covering all the other items under VAT. That is, the distribution of tax powers between the Centre and the States would have to be so changed that all taxes on commodities (i.e. excises as well as sales taxes) fall within the purview of the Central Government to enable it to implement

15. Purohit, Mahesh C. (1988), *Structure and Administration of Sales Taxation in India, op. cit.* pp. 113-117.

16. Government of India (1978), Report of the Indirect Taxation Enquiry Comhmittee (Chairman: L.K. Jha), Ministry of Finance, New Delhi.

17. Government of India (1991), *Interim Report of the Tax Reforms Committee, op. cit.*

this suggestion. This would require sharing of revenue with the States on the basis of the formula suggested by the Finance Commission or decided by the National Development Council (NDC). This would also require constitutional amendment which may be difficult under the present political situation of the country. The States would not agree to surrender their power to levy sales tax which yields them 60 to 70 per cent of States' own tax revenue. Also, this could further create financial dependence of the States on the Centre.

The TRC Option: The TRC (Final Report, Part I) has suggested that we could have an admixture of VAT (called MODVAT) at the Central level extended to most commodities and rationalised sales tax system at the State level. The TRC recommends that the MODVAT could be extended to the wholesale level (the quantum of which seems to be indeterminate), which could be Rs. 15 million or Rs. 20 million, depending upon the level of economic activities in the State. The Union Government would collect MODVAT at the level of the manufacturer and the State would collect it at the wholesale level. In addition, a sales tax would be collected from manufacturer or wholesaler depending upon the structure of the sales tax in the State. However, the rationalisation of sales tax would necessitate giving set-off for the sales tax on raw materials. This would be rationalising the tax on manufacturing sectors at the Central and at the State levels. This would, however, create one more tax for compliance by the tax payers.

The Central-VAT and the State-VAT: The third option is to have two different VATs; one at the Central level-called Central-VAT, and another at the State level-called State-VAT; the former would substitute union excise duties and the latter would replace sales tax. The State-VAT could, however, have varying rates across the States.

The State-VAT with Some Exclusions: The Union Government, which is presently distributing 45 per cent of excise revenue among the States on the basis of the recommendations of the Eighth and the Ninth Finance Commission, could think of an option, without loss of its revenue, by limiting their power to levy excise duty on a few (say 10 sumptuary and revenue yielding) commodities which would not be set-off against the VAT. This would be in the nature of special excises levied in addition to

VAT. The rest of the excise would be converted into a system of VAT. The States would be empowered to levy a full-fledged State-VAT in the country. That is, the tax would be levied on all sales beginning with production or manufacture. The tax levied at the stage of manufacture (the existing MODVAT) would be given set-off at the time of levy of sales tax (now VAT). Hence, the tax at the second stage (at the time of sale) would be levied only on value-added. This would be continued to the third or fourth stage of transactions, depending upon the 'exemption limit' and the chain of dealers in a State.

However, for the reasons of administrative efficiency the Centre should continue to levy VAT at the manufacturing level. The revenue so collected by the Centre would be distributed to the States on the basis of collection. This would enable the States to give set-off for the VAT from the sales tax at the next stage. That is, the VAT operations would be divided into VAT at the level of Centre and also at the level of States, both giving set-off for the tax already paid on earlier transactions.

The inter-State transactions would be treated on destination principle, as illustrated in Table 2. Each State would tax the inter-state sales. But the importing State would give set-off for the tax already paid in the exporting State. The existing Central Sales Tax would no longer be necessary. The illustration shows that the State-VAT would be given set-off to have neutrality of the tax system.

The Complete State-VAT: The above option requires determining the commodities that should be excluded from the purview of the State-VAT. Also, from the point of economic effects, the excluded commodities would not be benefiting from the set-off and would, therefore, have the adverse economic effects of cascading. It is, therefore, proposed that we could have a complete State-VAT wherein the total revenue from the Union excise duties is pooled for reimbursing the amount to the States on the basis of collection. This could be implemented as follows:

Assume that the collection of the Central MODVAT from different States is denoted as $X_1, X_2, X_3, X_4 \ldots\ldots X_n$ where the total MODVAT collection equals $X = \overset{n}{\underset{i=1}{}} X_i$. Similarly, sales tax collection for n States is denoted as $S_1, S_2, S_3,$

S_4 ....S_n. When the States have to give set-off for the collections under MODVAT, the State would have reduced collections from sales tax indicated as S'_1, S'_2, S'_3, S'_4,.........S'_n where $S'_i < S_i$. Let $F_i = S_i - S'_i$ indicating fall in sales tax revenue due to set-off. Although the total central collection of MODVAT is equal to X, under the proposed system of complete State-VAT, the Centre would retain only the fixed proportion (say 55 per cent) indicated by α. Thus, the Centre's share would be α.X and the revenue returned to the State would be $(1-\alpha)X$. Of course, would be negotiated on the basis of Centre's cost of collection and its own needs for resources. Under the principles of VAT, the State should be ideally getting $(1-\alpha)X.\dfrac{F_i}{\sum_{i=1}^{n} F_i}$. However, F_i being difficult to estimate, we could use X_i as proxy for F_i. The i^{th} State would thus get from the Centre an amount equal to $\dfrac{X_i}{\sum_{i=1}^{n} X_i}$. Thus, the inclusion of MODVAT commodities under the State-VAT would avoid complete cascading from the system and allow the Centre to retain a fixed proportion of total MODVAT revenue as their cost of collection and its own share.

The above options would help adopting principles of VAT under the Indian federal structure. Once the system of VAT has been introduced, we could expand the tax base by inclusion of services under the tax system, as explained below:

Broadening of Tax Base:

Another reform in the medium-term relates to broadening of the tax base.[18] As suggested by the TRC, broadening the base of the tax system implies

18. As of to-day, only a few select services are taxed by the States under specific provisions of the Constitution. These include tax on electricity, transportation, entertainment, and profession. However, there is no such tax under the Union List. In addition to the above taxes, hotel services are presently being taxed both by the Centre and the States. In fact, there are a large number of taxes on these services. State Governments levy hotel tariff tax at the rate of 10 per cent and sales tax at the rate of 7 per cent. While the former falls on the room rent the latter is levied on the sales of food in the Hotel. In addition, there is a tax levied on the luxuries provided by the Hotel in the rooms for lodging including air-conditioning, telephone, television, radio, etc. at the rates ranging from 5 per cent to 20 per cent. Also, the Union Government levies a tax at the rate of 20 per cent on room rent under the income tax law. The total incidence of the tax consists of 2 components (a) 30 per cent of the room rent and (b) Luxury Tax which is a progressive tax according to hotel tariff.

inclusion of services as well.[19] From the economic point of view, there is hardly any difference between the taxation of commodities and that of services. In fact, the service sector expands at a relatively higher rate as the economy expands[20]. Multifarious services are produced for the benefit of the consumers as well as producers. Any exclusion of service tends to create distortions.

The Committee, however, feels that the tax on services should be levied at the Central level only. Also, it suggests that by virtue of Entry 97 in the Union List, the Union Government is empowered to levy tax on services. The Committee, therefore, recommends that the services to be taxed by the Union Government should include advertising; services of stock brokers; automobile insurance; of insurance of residential property, personal effects and jewellery; and residential telephone services.

The Committee has rightly recommended that the tax on services must be an integral part of the system of value added tax so that the entire system of taxation of services is also devoid of cascading and would not cause distortions in costs or in the allocation of resources.

The TRC has, however, not considered the fact that the States have already been levying tax on services through separate enactments of electricity, transport and entertainment. A tax on hotel tariff was also levied in Maharashtra based on the recommendations of a study.[21] This tax is now levied by some other States such as Karnataka and Uttar Pradesh. It is, therefore, proper to consider the right of the States to levy tax on those services that are regional in base. Hence, it is suggested that the following services could be brought under tax net for raising resources under the States the tax system:

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19. Government of India (1991), *Interim Report of Tax Reforms Committees, op cit,* p.122-23.

20. Such an analysis has earlier been presented in a Study by Lakdawala and Nambiar. See Lakdawala, D.T. and Nambiar, K.V. (1972), *Commodity Taxation in India*, Sardar Patel Institute of Economic and Social Research, Ahmedabad. Similar analysis is also presented in Purohit, Mahesh C. (1975), "Sales Tax Exemptions in India", *Economic and Political Weekly*, Vol. 10, March 8, pp.445-452.

21. The Report with these recommendations, submitted to the Government of Maharashtra, was subsequently published. See Purohit, Mahesh C. (1975), "Sales Tax Exemptions in India", *Economic and Political Weekly*, op. cit., pp. 445-52.

a. Transport Services: Transport sector is presently being taxed by the State Government under Motor Vehicle Tax and Passenger Goods Tax. Any other tax on this service would simply complicate the structure of taxes on vehicles. If necessary, the State government could always increase the tax rate of both the taxes.

A close analysis of the structure of these taxes, however, reveals that most of the State governments levying passenger and goods tax are collecting revenue through compounded levies. There is no actual assessment of these taxes. As the number of vehicles has increased from 306,000 in 1950-51 to 1,865,000 in 1970-71, and to 19,080,000 by 1989-90, this tax has a greater potential for raising resources. However, leaving aside the need to have a separate analysis of the structure of the Motor Vehicle and Passenger Goods Tax, it is still pertinent to note that the services provided by the transporters are distinguished from the vehicles plying on the road. A tax on services, therefore, provided by the transporters i.e., the transport companies, could separately be taxed in the form of a service tax on transporters.

As the transport companies are large in size and provide public services, all of them have to maintain their documents meticulously and a small levy on the services of these transport companies would not affect their business. Over the years, there has not only been a rapid increase in the number of transport companies but also there has been a considerable increase in their turnover. As these companies have come to occupy an important place in the movement of goods all over the country, a small proportion of tax on this service would yield a considerable amount of revenue.

The tax on this service would be related to the number of vehicles owned by a transporter. Hence it is relevant to note that the goods vehicles have increased considerably over the years. Whereas the total number of goods vehicles was 82 thousand in 1950-51, the number has increased to 168 thousand in 1960-61 and to 343 thousand in 1970-71. The growth has been substantial in the seventies and eighties and the number of goods vehicles stood at 19.08 million in 1989-90.

b. **Private Nursing Homes**: Medical services provided by private nursing homes seem to be a potential tax base for taxation of services. Notwithstanding the fact that medical services do fall under the category of social and welfare services, the phenomenon of pricing of these services in private nursing homes suggests that these institutions charge a rate which could be paid by affluent people only. It is, therefore, desirable that all private nursing homes whose total receipt exceeds Rs. 0.2 million per annum and/or charge room rent of Rs.400 per day and above should be brought under the purview of taxation and a small service charge on their room rent be levied.

c. **Computer Maintenance and Consultancy Services:** Computer services have developed in the country over the last few years. Almost all offices, private enterprises and other institutions of repute do take help from the organisations providing maintenance and other consultancy services relating to computers. As this has been a new and growing service, a small tax on it would not affect the consumers in a big way. Administratively, there should not be any difficulty because all these companies maintain their accounts carefully.

The data given in Table 3 indicate that the total number of companies are small and could be administered by the Department without any problem. The companies having turnover of Rs.0.25 million and above are only 61. Also, all these are big and reputed companies. Hence, a small tax on the service provided by these companies would not affect either the companies themselves or the consumers.

d. **Automobile Repair and Services:** Automobile repair and its service is an important base on which a service tax could be levied. Such a tax exists in most of the countries. India has numerous small garages on the road side and, therefore, it would not be possible to collect this levy from all types of garages. However, over the years, there has been a tremendous increase in the number of vehicles as well as a corresponding increase in the show-rooms and repair shops. All the big show rooms provide for service and repairs of the vehicles. However, to begin with, all the shops carrying out repair and providing servicing of the automobiles and having a turnover of Rs. 0.2 million and above must be brought under the tax net. A small service tax on all these repair shops would not create any problem for administration of this tax, as all these shops have proper accounting of services provided and payments received. As the number of vehicles have increased considerably, this tax would be a lucrative source of revenue for the State.

Here, it is important to note that, as pointed out by the TRC, the tax on services must be levied under a system of full-fledged value-added tax only. Under this system, a tax-credit is available when it is paid as business expenses. Hence, there is no cascading of the tax.

3. Problems Related to Administration

Since organisation for tax administration conditions the efficiency of tax collection, it is extremely important that a proper organisation is developed as a pre-condition to have a sound system of taxation. Countries that have earlier experience with administering a turnover tax do not encounter serious problems in switching over to VAT. For others, it is important to have a suitable machinery. With a view to understanding the administrative problems for the introduction of VAT in the Indian context, it is essential to comprehend the existing administrative procedures for MODVAT as well as for sales taxes in the country.

The Existing Administration of MODVAT in India:

Unlike VAT in European and the other countries of the world, MODVAT does not replace Union excise duty but introduces the principle of VAT under the system. The nomenclature so far in usage is "excise duty" and the credit for the duty paid on inputs is known as MODVAT. This system is administered as follows:

a. Declarative Obligations: The administration of MODVAT requires certain documentary obligations to be fulfilled. All the manufacturers (except small scale manufacturers) are required to be registered with the Department. Also, the manufacturer is required to submit declarations regarding the use of input and manufacture of outputs. The declarations are filed by the manufacturer (who intends to take credit under MODVAT of the duty paid on inputs) with the Assistant Collector of Central Excise having jurisdiction over his factory. The manufacturer must indicate in his declaration the description of the final products manufactured in his factory and the inputs intended to be used in each of the said final products.

The rules require that the description of inputs and outputs must be complete. Non-specification of inputs in declaration is not a condonable lapse[22]. However, minor variations in description due to different brand names is permissible. It is also important that the declaration, which is filed at the commencement of the business or at the beginning of the year, must contain specification of inputs in the absence of which credit would not be granted and declaration cannot be changed retrospectively. The manufacturer would be granted a credit for the tax on inputs received in the factory provided there is evidence of either a Gate Pass or an AR-1, or a Bill of Entry. These are supportive documentary proof for the payment of tax by the seller of inputs.

Gate Pass - GP1 - is used by the manufacturer for removal of goods from the factory on payment of duty where the goods are manufactured in a factory under physical control against factories working under Self Removal Procedure (SRP), the clearance document is called AR-1. Unlike the system of VAT where the tax is levied at the time of sale, the excise duty is levied at the time of removal of goods (known as clearance) from the factory. The format of GP-1, reveals the quantum of duty paid[23].

22. Parofood Products vs. Collector of Central Excise.

23. Sometimes the goods are transported from the factory to the godown of the manufacturer. Even in this case GP-1 is issued and tax collected at the time of removal of goods. In some special cases there is a provision for removal of dutiable goods from the factory to warehouse without payment of tax. In such a case GP-2 is issued (Board's letter F. No. 267/68/88-CX-8 dated June 10, 1988).

Subsequent movements of duty paid goods from one manufacturer to another are covered by *Subsidiary Gate Pass* issued by the Superintendent of Central Excise in lieu of the original GP-1[24]. While the document evidencing payment of excise duty on indigenously manufactured goods is GP-1, the Bill of Entry required to be filed at the time of clearance from customs Department in the case of imported goods shows details of countervailing duty (equivalent to the excise duty payable on similar goods produced in India). The manufacturer who receives these imported inputs takes credit for countervailing duty on inputs on the strength of Bill of Entry.

b. Accounting Obligations: The accounting obligations of the manufacturers include maintaining two sets of accounts, viz., Form RG-23A and Personal Ledger Account.

i. Form RG-23A: The manufacturer who receives inputs in respect of which he takes credit of duty paid is required to maintain an account of the inputs received and used (Form RG 23A Part I) and an entry book of duty credit (Form RG 23A Part II). The latter gives particulars of the clearance documents under which credit is taken and utilised. It is a running account and indicates the balance of credit available at any given point of time.

ii. Personal ledger account: The main principle of maintaining account for clearing the goods under the excise law is that before the goods are cleared, the duty must have been paid. For this purpose, a Personal Ledger Account (PLA) is maintained. When money is deposited in government account, credit is taken and debit is made when clearances of goods take place.

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24. Subsidiary Gate Pass called certificate in lieu of GP-1, is issued under the following circumstances where the consignment of duty paid inputs moves first to another consignee or destination and thereafter a part of it is supplied to a manufacturer availing MODVAT.

    i) Where the original manufacturer retains the entire consignment covered by GP-1 in his duty-paid godown and thereafter sends part of the consignment to the manufacturer; and

    ii) Where the original manufacturer supplies the duty paid inputs to another person (dealer/stockist etc.) who stores them in a duty-paid godown and subsequently supplies inputs to different manufacturers.

Both these accounts could be used by the manufacturers to pay duty on the final products cleared by them. That is, the tax could be paid either through PLA or the MODVAT credit shown in RG-23A.

In addition to the above declaratory and accounting obligations, the manufacturer is required to submit a monthly return to the Superintendent of Central Excise. The return must contain (a) particulars of goods manufactured and cleared and the amount of excise duty paid; (b) particulars of inputs received during the month and the amount of duty taken as credit; and (c) extracts of Parts I and II of Form RG-23A giving details of disposal of inputs and utilisation of the credit. The excise officers check the returns and if found in order, the assessment memorandum is completed and a copy returned to the party. If there is a short payment, the manufacturer is asked to pay the duty short paid.

The existing procedures for administration of MODVAT suggests that the levy of tax being at the stage of clearance and not at the time of the sale, there is a problem of valuation of the tax base. This practice of under-valuation creates problems of valuation under the MODVAT scheme. The TRC, therefore, as an interim measure, recommends that to discourage under-valuation of the manufactured goods, the MODVAT could be extended to the wholesale level. That is, the tax would be levied on the manufacturer at the time of clearances and on the wholesaler at the time of the first sale out of the tax net. Since the set-off for the tax paid by the manufacturer would be available to the wholesaler, the manufacturer would not be able to connive with the wholesaler to avoid payment of tax. The extension of MODVAT at the wholesale level would, therefore, avoid under-valuation. In the long run, however, the TRC envisages that VAT would be levied on all transactions covering wholesale as well as retail.

The Existing Administration of Sales Taxes in India:

The administration of sales tax commences with registration of dealers of sales tax commences with registration of dealers. All the dealers above specified exemption limit (which ranges between Rs. 20,000 in Assam to Rs. 150,000 in many of the States like Gujarat, Karnataka and Maharashtra, and Rs. 300,000 in Himachal Pradesh) are registered with the Department of Sales Tax of the State. These dealers collect the tax and pay the same to the Government. On the basis of the given exemption limit, the number of registered dealers range between 40,000 in Assam to 500,000 in Maharashtra.

The basic procedures for enforcement of sales tax varies according to the point of levy. Under the first-point tax (tax on manufacturers and importers) the tax is levied on the first dealer and all subsequent sales (known as tax-paid sale) are exempt. Hence, enforcement of this tax entails two important tasks: (1) ensuring that the first seller pays the tax, and (2) verifying that the dealers have documents to prove that the tax-paid goods have been purchased. In contrast, the last-point levy (retail sales tax) is collected at the time of sale by the last registered dealer to a non-registered entity, i.e. the collection of tax is deferred until that stage. Accordingly, the task of checking relates to ensuring that the last dealer pays the tax, and (2) verifying that the sales have been made to a bonafide registered dealer.

The Tax department employs two devices to carry out these tasks. First, all manufacturers without exception are required to be registered. This ensures that goods manufactured within the State could be captured at the first-point.[25] Second, a road permit is used to import goods into the State.[26] The road permits sent by the importing dealer to his counterpart in another State prior to the import of goods. The trucks bringing the specified goods into the State are expected to carry back these permits for scrutiny and verification at the checkposts.[27] One copy of the road permit is

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25. Instead of covering all importers and manufacturers, some States for the sake of convenience provide for a low exemption level. That is, the importers and manufacturers above a particular turnover only are required to be registered with the Department. For example, importers get exemption limit of Rs 10,000 and Rs 25,000 in Madhya Pradesh and Rajasthan, respectively; and of Rs 20,000 in West Bengal. Similarly, manufacturers have exemption limit of Rs 40,000 and 50,000 in Himachal Pradesh and Rajasthan, respectively; of Rs 20,000 in Madhya Pradesh, of Rs 100,000 in Haryana, of Rs 75,000 in Gujarat and Maharashtra, and of Rs 50,000 in Uttar Pradesh and West bengal.

26. Under this system the intending importer is required to furnish details of goods to be imported and on application by him a permit would be issued, copies of which could be carried on the nature, quantity and value of goods to be imported.

27. As stated earlier, a number of checkposts have been established on the borders of the States as well as in the vicinities of the big cities. The trucks carrying goods are stopped at the checkposts for verification of goods against the road permit.

then sent by the checkpost to the concerned assessing officer. In principle, this system should ensure that all the major imports would be accounted for and hence tax would have to be paid on them.[28]

Another documentation system called "Declaration form" is adopted by the Department to ensure that the earlier dealers in the last-point tax and the subsequent dealers in the first-point tax are not selling commodities which are not "tax-paid". In the case of the first-point tax, the selling dealer issues a declaration form which testifies that the tax has previously been paid on the goods sold. Those goods in respect of whose purchases declaration forms are produced are deemed to have suffered tax and the concerned purchasers need not collect and pay tax on them. Likewise, in the case of the last-point tax, the purchasing dealer issues a declaration form stating therein that he is buying the goods for resale. The difference between the procedures of the first-point tax and that of the last-point tax is that, whereas, in the former case the declaration are to be checked against purchases, in the latter case the declarations are to be verified against sales to a particular dealer.

Processing of tax returns, in general, is common among all the States. However, many of the States require that the dealers having a tax liability of Rs. 2,500 per month or more pay tax on a monthly basis along with a return. Others pay quarterly and submit a return simultaneously. Many of the States have adopted self-assessment scheme for small dealers defined to have turnover below a specific limit. As the classification of dealers according to different grades of turnover indicates that about 55 per cent of the dealers are small who pay only about three per cent of the tax revenue, the self-assessment scheme is gaining momentum among other States too.

Assessment of dealers is attempted for all the registered dealers. This causes increase in arrears for assessment over the years. The delay in assessment is also caused due to the involved procedure of assessment. Also, these delays cause evasion of tax in many of the States through the existence of bogus dealers and '*Hawala*' dealers.

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28. This system prevails in many of the States. It is, however, restricted to some select commodities only.

The process for assessment of first point-tax involves checkposts at the entry gates for the State. These checkposts monitor the inflow of goods into the State. In doing so they record the information provided through the documents (including invoices) brought by the transport carriers. In addition to the information given through the invoices, these transport carriers are required to bring with them a specified "permit" issued by the assessing authorities under whose jurisdiction the importing dealer falls. For example, a dealer in Jaipur would approach his assessing authority for issuance of a permit for importing certain goods from a dealer in Maharashtra. This permit (for which records are maintained in the issuing office) is sent by the importing dealer of Jaipur to the dealer in Maharashtra) who is exporting goods to him. The dealer in Maharashtra, in turn, enters the details of the goods being sent by him (including particulars, quantity, value and other specifications). This permit is then handed over to the transporter carrying goods from Maharashtra to Jaipur. While entering the border of Jaipur, the transporter is required to show this permit at the checkpost through which he is passing. The checkpost authorities record the particulars of goods and the number of permits. Also, they retain a part of the permit at the checkpost which, in turn, is transmitted to the issuing assessing authority. The other part of the permit, being carried through the transporter to the dealer, is maintained by him and shown as a proof for import of goods on which he has to pay the tax as a first dealer. The involved process assumes (a) efficiency at the checkpost and (b) management information system capable of cross-verifying the information flown from the checkposts. As these things are not upto the mark, most of the States are unable to utilise this information. Hence, cross-verification of these documents is almost non-existent.

In view of the above administrative systems of excise and sales taxes, the following administrative aspects seem to be problem areas:

(i) *Staff requirements*: This basically depends on whether the country originally had a turnover tax. For other countries, there could be some requirement for additional staff. However, this is determined by the exemption limit above which all the dealers are brought into the tax net. Generally, the ratio of VAT taxpayers to population is very low in most of the developing countries. Hence, depending upon the efficiency of the tax administration of the country substituting VAT for any sales tax system would not necessarily mean substantial increase in the existing staff.

(ii) *Training of personnel*: Training for the existing staff as well as new staff is of paramount importance. As the VAT administration requires proper understanding of the system, fully trained staff is absolutely necessary.

(iii) *Suitable computational technology*: The requisite computer technology is extremely necessary to be acquired to enable the Department to maintain a masterfile of the dealers. This enables the Department to have an up dated record of payment of tax and of the stop-filers. The computational technology should be sufficiently large in size to be able to cross-verify invoices of the dealers.

(iv) *TIN numbers*: It is important to have a unique identification number, known as TIN (Tax Identification Number). This serves two useful purposes. First, it facilitates the use of computer in detection of stop-filers as well as delinquents. Secondly, it helps cross- verification of invoices. To enable the Department to use the TIN for National Accounts Statistics, it should be based on International Standard Industrial Classification (ISIC).

v. *Auditing of VAT*: Although it is generally suggested that VAT administration has an advantage of built-in policing, various authors have expressed their doubts about its effectiveness.[29] As evasion is already rampant under the existing excise and sales taxes in India, it is essential that the audit of the proposed VAT system is attempted on a regular basis. However, auditing for all kinds of dealers may not be necessary. Selection of cases for auditing has to be made in accordance with the criteria of size of dealers. It might indeed be useful to cull out a fixed proportion of large and medium size dealers for VAT-audit on a regular basis. The experience of *forfait* system of France for small dealers is enlightening. It suggests its suitability for a country like India.[30]

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29. Lent, George E (1973), Milka Casanegra and Michele Guerard, *The Value Added Tax in Developing Countries*, Staff Papers, International Monetary Fund, Vol. 20, pp. 350-52, and Casanegra de Jantscher Milka (1987), *Problems in Administering a Value Added Tax in Developing Countries: An Overview*, DRD 246 Development Research Departmentm, World Bank.

30. Purohit, Mahesh C. "Management of Value Added Tax in France" *International VAT Monitor* (to be published)

Further, the audit of VAT should be supplemented by cross-checking of invoices. As experienced in most countries in general and in Korea, in particular, cross-verification of invoices, in totality, is neither useful nor economical. In fact, a selective check of invoices is meaningful to ascertain whether audit against the VAT liabilities are supported by bonafide documents. Such a cross-verification is extremely useful for detecting taxpayers for further investigations. Other relevant sources such as list of suppliers, number of taxpayers deviating from the normal trend, import data supplied by the customs department, fast growing sectors of the economy, and the sectors involved in "moon lighting" could also be extremely useful in selecting the dealers for audit.

Unlike the existing system of self-assessment under excise as well as sales tax in India, the *forfait* system of France does not have any fixity about the coverage of the dealers. Hence, the dealer is always alert and so is the Department. The Department re-examines the systems of *forfait* for every dealer after two-years. It examines variables related to the dealer such as the trends of turnover, income, fixed assets, and salary paid to the employees of the firm.

The above issues in the administration of VAT are of utmost importance to build up a proper organisation and operations of VAT in India. The existing practice of policing at the factory gates by the Excise department and monitoring of inflow of goods at the checkposts through the Sales tax department are archaic methods of tax administration. The VAT would be able to do away with all these problems. When the advanced countries have the system of "free ways" we can hardly ill-afford to have such a system.

Table 1

Changes in VAT Rates in Different Countries

Country	VAT Introduced or proposed		VAT Rates at Introduction	VAT Rates on January 1, 1993
Algeria	1992			
Argentina	January	1975	16	13
Austria	January	1973	8,16	6,10,20,32
Bangladesh[5]	January	1991	-	-
Belgium	January	1971	6,14,18	1,6,12,9,5
Belorussia	January	1992	28	-
Benin	April	1991	8	8
Bolivia	October	1973	5,10,15	10
Brazil[2]	January	1967	15	7,12
Brazil[3]	January	1967	15	17
Chile	March	1975	8,20	18
Colombia	January	1975	4,6,10	4,6,10,15,20,35
Costa Rica	January	1975	10	10
Denmark	July	1967	10	25
Dominican Rep.	January	1983	6	6
Ecuador	July	1970	4,10	10
Estonia	January	1992	10	
Finland		1976	11.1	19.05
France	January	1968	6,4,13.6,20,25	2.1,5.5,13,1
Germany,	January	1968	5,10	7,14
Grenada[4]	April	1986	20	20
Greece	January	1987	6,18,36	4,8,18,36
Guatemala	August	1983	-	-
Haiti	November	1982	7	10
Honduras	January	1976	3	7,10
Hungary[5]	January	1988	15,25	-
Iceland[5]	July	1989	25	-
Indonesia	April	1985	10	10,20,35
Ireland	November	1972	5,26,16.37,30.26	2.7,10,12.5,16,21
Israel	July	1976	8	18
Italy	January	1973	6,12,18	4,9,12,19,38
Ivory Coast[6]	January	1960	8	5.26,11.11,25,35.13
Japan	April	1989	5	3,6
Kenya	January	1990	17	5,18,30,50,75
Korea	July	1977	10	3,10
Luxembourg	January	1970	2,4,8	3,6,5
Madagascar	January	1969	6,12	15
Mauritius		1983		
Mexico	January	1980	10	6,15,20
Morocco	April	1986	7,12,14,19,30	7,12,14,19,30
Netherlands	January	1969	4,12	6,18.5
New Zealand	October	1986	10	12.5

(Contd.)

Changes in VAT Rates in Different Countries (Table 3.1 Contd')

Country	VAT Introduced or proposed		VAT Rates at Introduction	VAT Rates on January 1, 1993
Nicaragua	January	1975	**6**	6,**10**,15,25
Niger	January	1986	8,**12**,18	10,**17**,25
Norway	January	1970	**20**	**20**
Pakistan[5]	January	1992	12.5	-
Panama	March	1977	**5**	**5**,10
Peru	July	1976	3,**20**,40	**15**
Philippines	January	1988	**10**	
Portugal	January	1986	8,**16**,30	5,**16**,30
Paraguay	January	1992		**10**
Russia	January	1992		15,21,88,**28**
Singapore		1992		**10**
Senegal	March	1961	-	7,**20**,30
Spain	January	1986	6,**12**,33	6,**15**,28
South Africa	September	1991		
Sweden[6]	January	1969	2.04,6,38,**11.1**,3.95	3.95,**12.87**,23.46,25
Taiwan (Province of China)	April	1986	**5**	5,**10**
Tanzania			7	
Thailand				
Tobago				
Tunisia[8]	June	1988	6,**17**,29	6,**17**,29
Turkey	January	1985	**10**	12,**15**
Ukrine	January	1992		**35**
United Kingdom	April	1973	**10**	**17.25**
Uruguay	January	1968	5,**14**	12,**22**

Notes:

1. Rates in bold type are "standard rates" applied to goods and services not covered by other especially high or low rates. Most countries use a zero rate for a few goods, and Portugal, Ireland, and the United Kingdom use it extensively to ensure that substantial amounts of goods and services are free of the VAT.
2. On interstate transactions depending on region.
3. On interstate transactions.
4. Not actual VAT.
5. Proposed or under discussion.
6. The rate given in the table are effective rates. The statutory rates are computed on price including tax. Also for certain goods and services, the rates is applied to 60 per cent or 20 per cent of the price paid.
7. The tax rates in Madeira/Azores regions are: standard rates 12 per cent, reduced rate 6 per cent and increased rate 21 per cent.
8. A number of reduced rates exist. In cases where the Government reduces rate by a special decrease, the rate is valid for the calendar year only.

Source: *Purohit (1993)*

Table 2

Illustrative Calculation of Different State VATs

Tax structure	Manufacture in State A		Wholesaler in State B		Retailer in State C		
	Sale price Rs.100		Sale price Rs.150		Sale price Rs.300		Final allocation
	Input tax	Output tax	Input tax	Output tax	Input tax	Output tax	
State A (Tax rate 5 per cent)	0	5	0	0	0	0	0
State B (Tax rate 8 per cent)	0	0	-5	12	0	0	0
State C (Tax rate 6 per cent)	0	0	0	0	-12	18	18
Total		5		7		6	18

Table 3

Computer Service Companies Classified by Turnover Group (1991)

(Rs.lakh)

Turnover group	Number of companies	Total turnover
1	2	3
5 - 15	37	333
15 - 50	46	1452
50 - 100	22	1457
100 - 250	41	6729
250 - 500	24	8359
500 - 1000	17	11834
1000 - 2500	20	34009
2500 - 5000	6	20339
5000 - 10000	5	31018
Over - 10000	6	85656
Total	224	201186

Source: *Data Quest*, July 1991.

Structure of Commodity Taxes in India

Commodity taxes have an important place in the Indian fiscal structure. These taxes are levied by all the tiers of government. The Central Government levies custom duties and union excise duties; the State Government levy sales taxes (including central sales tax, motor spirit tax, and purchase tax), State excise duty, motor vehicle and passenger and goods tax; and the local self-government impose octroi. All these taxes are levied simultaneously without any credit for other taxes already paid. As the customs duty, the union excise duties, and the sales taxes are the three very important taxes, their details are presented in this Annexure for a better understanding of the existing commodity tax structure in India.

Custom Duties

Custom duties comprise import duties and export duties. As the latter depends upon terms of international trade, the former alone constitute a major source of revenue.

The import duties are levied with three objectives in view, viz., i) protecting domestic industry from imported goods with which it competes; ii) improving country's balance of trade and thereby the balance of payments position; and iii) raising resources. The most important objective, however, is to provide effective protection to the domestic industry. It is, therefore, designed in such a way that it derives a wedge between domestic and international prices, although quantitative restrictions also play a very important role.

The structure of import duties provide three forms namely basic custom duties, auxiliary duty of customs and additional (countervailing) duty of customs. The basic custom duty is levied under Customs Act, 1962. All goods imported into the country are chargeable to this duty. Auxiliary duty of customs is levied under the Finance Act and is also chargeable to all the goods imported. As the base of the basic custom duty and the auxiliary duty of customs is the same, for all analytical purposes both these duties could be added together. Additional (countervailing) duty of customs is levied under the Customs Tariff Act, 1975. This duty is levied on all goods imported into India. The base of the duty is c.i.f value of imports plus the duties levied earlier. This duty is popularly known as countervailing duty.

The rate structure of additional (countervailing) duty of customs is equal to the excise duty on like articles. The auxiliary duty of customs is levied on an annual basis. The rate of this duty was 20 per cent in 1980-81 but was increased to 45 per cent in 1988-89 and continues to be the same thereafter.

The basic customs duty is of two categories: (a) standard rate applicable to all commodities; and (b) rate applicable to preferential areas. The latter category is governed by specific agreement of the countries such as the Bangkok agreement, and is applicable only to preferential areas. The standard rate is generally *ad valorem* (with a few exceptions of specific rates), ranging from 0 to 300 per cent. In the budget of 1992-93, the maximum rate of duty has been reduced to 110 per cent.[31] Most common rates of duty are 40, 60 and 100 per cent. Also the average rate in practice is affected by various exemptions granted on different counts. These exemptions could be use-specific or source-specific (i.e., related to the source of origin). Many of these exemptions are not quantifiable.

The nominal tariff rates, after taking account of quantifiable exemptions, are mostly centered in the range of 75 to 110 per cent, the average rate being a little over 100 per cent. The rate for manufacturing sector is, however, higher than the agricultural and mining sector. Also the rate does not change across broad industrial groups, but it does show large variations among individual industries. Such variations can distort incentive structure of the industries. When the rate structure is compared among

31. The Tax Reforms Committee has suggested that the maximum duty (basic + auxiliary) rate be reduced to 80 per cent by 1995-96 and average rate of tariff to 50 per cent by 1995-96 and to 25 per cent by 1988-89. See Government of India (1992), *Interim Report of the Tax Reforms Committee*, New Delhi.

different sectors, the tariff increases with the degree of processing. In the manufacturing sector, the rate for consumer goods exceeds those for intermediate and capital goods. Non-electrical industries, however, are an exception.

The effective rate of protection (ERP), which is a much more appropriate indicator than the nominal rate of protection (NRP), as it takes into account the tariff on inputs, shows a similar trend as the NRP. The ERP is higher for industries having larger value added[32].

The realised rate of duty of all commodity groups has increased over time. Whereas it was 28.54 per cent in 1975-76, it increased to 56.82 per cent in 1988-89. A major portion of increase could be attributed to increase in duty rates for petroleum products (the contribution has increased from 6.74 per cent in 1980-81 to 65.54 per cent in 1988-89). It is also important to note that the realised rate is higher for 27 out of 32 product groups.

Union Excise Duties

Union excise duty is levied on all goods manufactured or produced in the country. The structure includes: i) basic excise duty; ii) additional excise duty in lieu of sales tax; iii) cesses on specified commodities; and iv) additional duties of excise on textiles.

The additional excise duty in lieu of sales tax is levied on tobacco, textiles and sugar. This is a rental arrangement between the Centre and the States. The Centre levies additional excise duties on these items in lieu of States' sales tax. The arrangement is that the Centre would levy additional excise duties in lieu of sales tax on all these items and the States would refrain from levying sales tax on these items. The

32. According to a study of Panchmukhi for the year 1982, the ERP increases from 14.7 per cent for 19 primary product sectors to 65.5 per cent for six semi-processed product sectors and 86.4 per cent for 53 processed finished goods product sectors. See, Panchmukhi, V.R. (1985),*The Indian Tariff System: Some Problems and Directions for Reform* (Mimeo). A similar negative relationship between the level of protection and the share of value-added in output estimated by Goldar and Saleem (1992) shows ERP for 1989-90 as follows: Basic goods 112.10, capital goods 72.60, consumer durables 103.41, consumer non-durables 148.10, and intermediate goods 150.45 per cent. See, Goldar and Saleem, (1992), *India's Tariff Structure: Effective Rates of Protection of Indian Industries* (Mimeo), NIPFP, New Delhi.

proceeds of this duty are to be distributed among the States. The States have, however, complained about excessive exemptions under these duties before the Ninth Finance Commission and the consequent loss of revenue to them.[33]

Cesses on the specified commodities and additional excise duties on textiles are primarily meant for development of related industries.

The structure of basic excise duty shows a large number of rates for different commodities; there are 40 *ad valorem* and 350 specific rates prevailing under the basic excise duties.

MODVAT has been introduced under the basic excise duty with effect from March 1, 1986. Initially the MODVAT was introduced to a select number of commodities (the coverage was limited to 37 chapters out of a total of 91). However, the coverage was extended with effect from March 1, 1987 to all commodities except petroleum products, textiles products, tobacco, cinematographic films and matches. The exclusions from MODVAT, though limited in number, is significant from the point of view of revenue - half of the revenue of Union excise duties is being collected through these items. MODVAT has introduced transparency of the tax, reduced cascading effect of input taxation and has also helped self-policing in its evasion. Studies relating to the impact of introduction of MODVAT indicate that industrial units have been able to save on interest (ranging between 0.5 to one per cent of the total duty paid); the effect having been revenue neutral and has not caused any price effect.[34]

The MODVAT scheme is different from the VAT prevailing in other countries. First, the coverage is limited to approximately half of the revenue collected. Second, there are a few special provisions, namely, notional credit and deemed credit.[35]

33. These issues were examined in details in a study undertaken for the Ministry of Finance, See Purohit, Mahesh C. (1990), *Exemptions under Additional Excise Duties in Lieu of Sales Tax: An Empirical Analysis of Loss of Revenue to the States*, NIPFP, New Delhi.

34. Ministry of Finance (1990), *Report of the Working Group for Review of the MODVAT Scheme*, Government of India, New Delhi. pp. 6-14.

35. The scheme of deemed credit has been in operation even before the MODVAT but its scope has now been increased.

The *notional credit* was introduced in the Budget of 1986-87 in the context of integration of small-scale exemption for goods covered by Tariff item 68. According to the scheme, a manufacturer who purchases inputs manufactured by small scale industries could take credit of an amount higher by 10 per cent *ad valorem* than the duty actually paid on inputs. To illustrate, if the normal excise duty on an input is 20 per cent *ad valorem*, the small scale unit pays duty at 10 per cent *ad valorem*, but the user of such inputs could take credit of 20 per cent. Since a unit in the large scale sector is in a position to secure a MODVAT credit higher than the duty paid on the inputs when he obtains the inputs from a small scale manufacturer, the scheme is expected to provide advantage to small scale units. However, it was felt that the scheme was being misused and misdirected. Hence, with effect from April 1, 1989 the extent of credit was reduced, from 10 to 5 per cent *ad valorem*. The scheme has also caused fragmentation of manufacturing units for obtaining concessional duty benefits. Also, it is observed that the scheme is discriminatory against the tiny units. It is estimated that the provision of notional credit has caused the exchequer a revenue loss of Rs 1,000 million in 1986-87 and about Rs 2,250 million in 1987-88.[36]

Under the *deemed credit* facility, a manufacturer can take MODVAT credit at specified rates for certain inputs without production of documents evidencing the payment of duty. This provision keeps in view small manufacturers who are not in a position to buy the minimum quantities that are sold by certain primary manufacturers of metal items and hence buy their requirements from the open market. Since in such cases duty payment documents may not be available, it was felt by the Government that MODVAT credit at a specified rate may be allowed. The inputs so specified are deemed to be duty paid unless they are clearly recognisable as non-duty paid. The *deemed credit* so permitted is generally less than the prevailing duty to take into consideration the stocks of inputs that may have paid lower duty than the duty rates.

36. Ministry of Finance (1990), *op.cit.*, p.V.

The *deemed credit* facility was initially given to small scale industries in March, 1986. This was, however, extended to all units after a month. At present, *deemed credit* facility is permitted in respect of steel ingots and rerollables, certain flat products of steel, unwrought aluminium, copper, lead and zinc and wastes/scraps of copper, aluminium, lead and zinc.

Third, the MODVAT is restricted in scope. A manufacturer can avail of MODVAT credit provided (i) the inputs and the final products are both covered within the chapters of the Central Excise Tariff to which the MODVAT scheme has been extended, and (ii) the final products are not exempted from excise duty. Where the raw materials or components or final products are exempted, the benefits of the scheme are not available. Thus, the existing MODVAT is only a step towards adopting a full-fledged VAT.

Sales Tax

Structure of sales tax in India consists of (a) States' sales tax and (b) Central sales tax. The former is levied on intra-State transactions and the latter on inter-State transactions. The State sales tax known as general sales tax [including sales tax on motor spirit (MST), and certain other purchase taxes such as purchase tax on sugarcane], is levied by all the States and Union Territories, mainly at the first-point. The tax is thus collected from the importers, manufacturers or the wholesalers. The only States having multi-point tax on a few commodities (called residuatory entry) are Karnataka and Kerala. Some of the States levy tax at the last-point. Notwithstanding variations in the point of levy, a major part of the revenue is derived from the first-point levy.[37]

The general rate of tax in the States levying single point tax varies between 5 and 12 per cent and in the States levying multi-point tax between 5 and 7 per cent. In all the States, there are a large number of variations in the tax rate according to the type of commodities. The tax is levied at low rate of tax on necessities and at the high rate of tax on luxuries. In addition, there are exemptions for necessities, specific

37. Purohit, Mahesh C. (1988), *Structure and Administration of Sales Taxation in India*, Reliance Publishing House, New Delhi.

institutions and for specifications by the States. As per the provisions of the Constitution, services are also exempt from the levy of sales tax. Owing to a large number of variations for different type of commodities, most of the States have umpteen tax rates. Orissa is one of the States which has six tax rates - the minimum among the States. The other States have rate slabs running upto 17.

Most of the States levy tax on the raw materials and other inputs as well. The tax treatment of these goods ranges from no exemption (such as in Assam) to concessional treatment varying between one to four present (such as two per cent in Gujarat, Kerala and West Bengal, three per cent in Bihar, Rajasthan and Tamil Nadu and four per cent in all the other States not giving complete exemption) to complete exemption in five States namely Punjab, Haryana, Himachal Pradesh, Jammu & Kashmir and Manipur.

The tax base is also affected by the grant of exemptions to finished goods by almost all the States. These exemptions have been provided as part of "incentive schemes". These schemes provide (a) exemption or concessional tax on sale of output, (b) provide for deferment of tax, and (c) make provisions for interest free sales tax loans. Exemptions or concessional rate of tax to new industries is available for pioneer and prestigious industries in two States, small scale and tiny industries in 19 States and medium and large industries in 12 States. In most of these States, specification is provided for area of location of industry (whether developed or backward) and for specific commodities produced in the States. The studies conducted in this regard indicate that the loss of revenue is considerable without having any effect on location of industries.[38]

A new dimension has been added to the sales tax system through recent amendments in the Constitution.[39] Accordingly, sales tax is now levied on works-contracts, hire-purchases and leases. This has given rise to umpteen problems in tax-policy as well as administration.

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38. Purohit, Mahesh. C. et.al. (1992), *Fiscal Policy for the National Capital Region*, Vikas Publishing House, New Delhi.

39. Government of India (1983), *The Constitution (Forty Sixth) Amendment Act, 1982*, New Delhi.

The Central sales tax is collected on all inter-State transactions. The tax is levied, collected and retained by the States occasioning movement of goods from one State to another. The rate of tax is four per cent on registered dealers and 11 per cent on unregistered dealers. As the production is centralised for historical or geographical reasons, few select States collect a major chunk of the CST revenue. The 46th Constitutional Amendment Act further envisages levy of tax on consignment transfers. This would aggravate the inequality of tax burden among different States, for the tax is presently being collected on approximately one-fifth of the total inter-State transactions.[40] When extended to all transactions, the richer States would get larger resources from Central Sales Tax, causing further inequality amongst the States.

Taxation of Services

The general system of taxes on commodities and services in India is primarily confined to taxation of goods; services are completely exempt from the purview of taxation. This is primarily due to the fact that the Indian Constitution does not explicitly cover services under the tax base. The union excise duties are levied on "goods manufactured or produced in India" and sales tax is levied on "sale or purchase of goods". Services are specifically excluded from tax base under the constitution.

A few select services are nevertheless taxed under specific provisions of the Constitution. These include tax on electricity, transportation, entertainment, and profession. All these services are taxed under some specific provisions of the State List. However, there is no such tax under the Union List.

Although a tax on the above services is levied under the State List, the fiscal importance of all these taxes has been negligible. The proportionate yield from taxes on these services has declined over the years. Whereas the contribution of taxes on these services to the total tax revenue in 1960-61 was 6.62 per cent, it declined to 5.82 per cent in 1970-71 and to about 4.51 per cent in 1988-89. Similarly, in terms of revenue

40. Purohit, Mahesh C. (1990), "Shifting Fiscal Frontiers of the Central Sales Tax", *Economic and Political Weekly*, December 15, pp. 2730-2732.

from commodity taxes their contribution has declined from 10.53 per cent in 1960-61 to 8.20 in 1970-71 and to 5.81 per cent in 1988-89. Thus, the overall mobilisation of resources from service sector has so far been negligible.

In addition to the above taxes, hotel services are presently being taxed both by the Centre and the States. In fact, there are a large number of taxes on these services. State Governments levy hotel tariff tax at the rate of 10 per cent and sales tax at the rate of 7 per cent. While the former falls on the room rent the latter is levied on the sales of food in the Hotel. In addition, there is a tax levied on the luxuries provided by the Hotel in the rooms for lodging including air-conditioning, telephone, television, radios, etc. at the rates ranging from 5 per cent to 20 per cent. Also, the Union Government levies a tax at the rate of 20 per cent on room rent under the income tax law. The total incidence of the tax consists of 2 components (a) 30 per cent of the room rent and (b) Luxury Tax which is a progressive tax according to hotel tariff.

Conclusion

The analysis of the existing structure of the three important taxes suggests that the present system of commodity taxes in India is an unintegraded one. It is not a system in itself but a juxtaposition of a number of systems. Also, services are generally excluded from the purview of taxation.

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