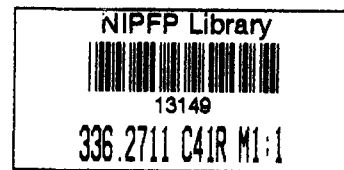
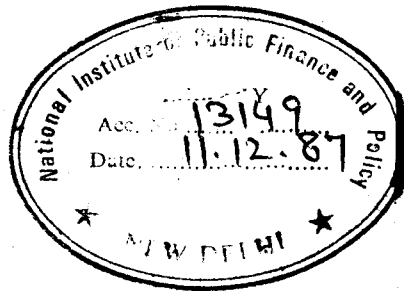




REFORM OF THE SALES TAX

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by

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1. Introduction

The sales taxes levied by the State governments have come under increasing criticism from trade and industry, and in spite of the attempts made by several of those governments to alter the structure of sales taxation ostensibly to minimise inconvenience and to plug loopholes, a section of the trade in the country has pressed for the 'abolition' of the sales tax through its merger with the Union excise duties. Fiscal economists, on the other hand, have been arguing that in any proposed reform, the indirect tax structure as a whole must be looked at and that not merely the revenue and administrative aspects but also the economic and political aspects should be kept in view. The Jha Committee clearly brought out the ways in which the major indirect taxes in the country, viz., import duties, excises, sales taxes and the octroi inter-acted with one another and exerted an impact on prices and the allocation of resources, and stressed the need for the harmonisation of the indirect taxes.

Thus, the reform of the sales tax must not be considered in isolation but as part of the process of rationalisation and harmonisation of the whole structure of indirect taxes, particularly the three major taxes falling on domestically produced

* The views expressed in this paper are personal and should not be taken to reflect the official views of the National Institute of Public Finance and Policy.

and consumed goods - excises, sales taxes and the octroi^{1/}.

2. Tax Overlapping

The fathers of the Indian Constitution decided against overlapping tax powers and assigned particular taxes exclusively to one level of government or the other. In the realm of commodity taxation, excises on production and customs were assigned to the Centre and taxes on sale, purchase and movement (entry) of goods to the States. (The tax on entry of goods into specified areas has been delegated by the States to the local bodies.) In the sphere of direct taxation, taxes on non-agricultural income and on the capital value of assets (other than agricultural land), corporation tax and estate and succession duties (except in respect of agricultural land) were assigned to the Centre, while the States were given the powers to levy taxes on agricultural incomes, on land and buildings, and estate and succession duties in respect of agricultural lands.

While there is no overlapping of tax powers in the sense that no one technically or legally distinguishable tax has been assigned to more than one level of government, assignment has not been so contrived as to prevent or minimise the overlapping of implicit bases of taxation. Effective overlapping arises by the use of the same base by more than one level of government. Thus the excises levied by the Centre, and the sales tax levied by the States overlap to a considerable extent, since they both fall on the products of the industrial sector. The octroi by the local

1/ The latter two also fall to some extent on imported goods.

bodies overlap with both excises and sales taxes since, in practice, wherever it exists, it falls on both industrial and agricultural products.

It is possible that the Constitution-makers had not envisaged that such extensive overlapping would develop, since excise taxation was conceived of at that time to be selective in its coverage. However, using its power under Entry 84 in the Seventh Schedule to the Constitution to levy "duties of excise on tobacco and other goods manufactured or produced in India", the Central government has gradually extended the coverage of excises. The logical culmination of this process was the introduction in 1975-76 of a general levy on all manufactured goods in the factory sector "not elsewhere specified".

As the Centre was extending the excise duties during the last 25 years or so, the States were extending and developing their sales taxes. Conceptually, three types of sales tax can be said to be levied: the single-point, the double-point and the multi-point, the last having the character of a general turnover tax. In practice, there are generally mixtures of these types in the different States. The majority of States levy in the main a single-point tax. Maharashtra and Gujarat apply the double-point tax to some commodities, and a few States such as Kerala and Karnataka formally impose the multi-point tax. But even in the States having a multi-point levy, the major part of the revenue is now derived from items subject to a single-point tax. Except for Jammu and Kashmir and Rajasthan, most other States having a single-point levy used to formally impose the tax at the last point, but the tax on a number of commodities

has been gradually shifted to the first point presumably to minimise the scope for evasion. It would be, by and large, true to say that a major part of the sales tax revenue is now derived from the single-point levy in most of the States.

Even the single-point sales tax is a multi-stage levy in the sense that it falls on successive stages of processing or manufacture of most products. It is in general levied on raw materials, intermediates, components, and final products. While the first-stage tax is usually levied at the manufacturers'/ importers' level, the multi-point and the last-stage levies cover also the value added at the wholesale and retail levels. Since the excise tax system got gradually extended, it has now become in fact a multi-stage manufacturer's sales tax. Therefore, from the economic point of view, we can say that there are two independent systems of (sales) taxation operating at the manufacturing level. And since both the taxes are levied on a gross value basis (i.e., not on a value added basis), they have produced the familiar problems of cascading^{1/}, distortions (i.e., unintended changes) in relative factor prices, escalation of costs, and uncontrolled incidence of taxation on final products. The tax on tax and the mark-up on tax cascading produced by the widespread excise taxation of inputs is compounded by the sales tax falling on the same products. Thus the sales tax is levied on the price inclusive of the excise^{and the excise} is collected on the sales tax paid at earlier stages. It is obvious, that unless co-ordination is achieved and the structure is rationally designed, incidence on particular products would be fortuitously determined and social

^{1/} By cascading is meant here an increase in price to the consumer greater than the revenue yield of a tax to the government.

objectives might be defeated. This is especially so because both the present excises and sales taxes are predominantly of the cascading type and fall on inputs as well as final products. Besides, the unintended re-allocation of resources and the unwarranted cost escalation arising from multiple taxation and cascading are no longer matters of secondary importance, given the high rates of excises and sales taxes. One line of argument is that if, instead of having two independently operated tax systems, we could have one integrated tax system, it would be possible to achieve a much greater degree of rationality and avoid multiple taxation.

3. Shortcomings of Prevailing Sales Tax Systems

Apart from the harmful effects flowing from the interaction of excises and sales taxes (assuming away the octroi for the moment), many criticisms are levelled against the sales taxes as they are now levied by the State governments. They may be summarised as follows:

- i) Sales taxes are levied on both the destination and the origin principles. That is to say both the consuming State and the producing State attempt to tax one and the same commodity. If the sales tax is not to get intermeshed with production processes and is to be prevented from distorting factor prices and allocation of resources, it ought to be mainly a consumption tax falling on the residents within the State. As it is, the unrestricted power to levy taxes on inputs and even the right to levy an inter-

State sales tax, albeit under Central regulation, enable one State to tax the citizens of other States.

- ii) Inter-State taxation, though regulated by the Central government, violates the principle of a unified market within the country. Such taxation at a low rate might be a necessary evil, for checking evasion of taxes on intra-State sales. Also, some might argue that a small share should go to the producing State. And it might not have done much harm in practice so long as the rate had been kept at the original level of 1 per cent. But since the Central sales tax (CST) has been mistakenly looked upon as a legitimate revenue raiser and the rate of CST has been increased by stages to 4 per cent, it does act as a hindrance to the free flow of trade across State borders, and enables the industrially more advanced States to export part of their taxation to consumers in other States. Thus if the cost of inputs taxed at an average rate of 8 per cent in the producing State forms about 50 per cent of the ex-factory price of a product which is sent out, the product would have already borne an effective rate of sales tax of 8.3 per cent when it arrives in the consuming State (4 per cent CST on a product already bearing 4 per cent tax). The available data indicate that the more industrialized States have gained at the expense of the rest. States producing certain key raw materials such as petroleum and steel also stand to gain. The poorer and less developed States tend to lose.

- iii) A high rate of inter-State sales tax has also induced larger producers to establish warehouses in different States where the products are to be sold and to transfer them from the point of production to the warehouses without payment of inter-State sales tax. Thus, there has arisen tax-induced artificial diversion of channels of distribution and the incurring of additional costs. Moreover, it is obvious that the smaller manufacturers are not in a position to adopt the above device and are, therefore, placed at a disadvantage.
- iv) States do give concessional treatment to several raw materials and components, but the practices vary and it can be said in general that inputs are not actually free of taxation. Apart from the spill-over effects referred to earlier, the taxation of inputs tends to promote vertical integration and discriminates against manufacturers who buy their components from other producers. This goes against the national policy of encouraging the small-scale producers to manufacture components for the large-scale manufacturers. Sales taxation of inputs also leads to cascading. Also, the relative prices of components in the economy as a whole are changed by the decisions of individual State governments. Moreover, a duty drawback is available in respect of import and excise duties deemed to have been paid on inputs, but no such drawback is available for sales taxes paid. It would indeed be extremely difficult to trace the sales taxes paid to different

State governments at different stages of production of a particular export product.

- v) Not only the basic structure of the sales tax and the stage at which it is levied, but also several details of administrative procedure such as the exemption levels, the types of forms to be filled in, and even the methods of assessment vary among the States. Manufacturing establishments, located in the States where the sales tax is collected at the first point, have to deal with both the Central excise department and the sales tax department in relation to one and the same transaction. Those businesses which have dealings in more than one State have to cope with different State sales tax laws. Thus the cost of tax compliance tends to increase more than proportionately with the geographical scale of business operations, apart from the inconvenience involved in dealing with many authorities.
- vi) Sales taxation, particularly if it takes the form of a multi-point tax or a last-stage tax, is said to lead to harassment of the small dealers who find it difficult to cope up with the necessary requirements of keeping accounts, etc. Even if he does keep proper accounts, the smaller assessee, it is alleged, is particularly vulnerable and is often subjected to harassment of petty officials eager to augment their meagre salaries through illegal means.
- vii) The sales tax administration in most of the States leaves much to be desired. In general, the sales tax officers are ill-paid, ill-equipped and

inadequately trained. It is far more difficult to deal with them than with the excise or income tax authorities - so the traders argue. The numerous forms that have been introduced as part of the means of enforcing the different types of levies create problems and even hardship for the assesseees. Not only there is considerable work involved in filling these forms but often they are unobtainable at the required time. Thus a declaration form is to be obtained and produced by the resellers to claim exemption from the first-point levy in many of the States. They complain that they cannot get this form from their sellers in time because the latter is unable to obtain sufficient quantities of them from the sales tax authorities. This holds up the assessment of the resellers. Similarly, the difficulty in obtaining the 'C' form prescribed under the CST Act hinders the flow of inter-State trade.

There is another form of permit that is required to be obtained in some of the States which rely primarily on the first-point levy. This permit is to be obtained in triplicate by the intending importer from the sales tax officer prior to the act of importation. Then it is to be despatched to the seller in another State to be filled in by him giving details of the goods being despatched. It has to be carried by the transport operator who brings the goods into the State and has to be shown to the officers at the border checkpost. These officers are supposed to verify the contents of the trucks against details

described in the permit. In cases of discrepancy the goods might be detained and penalty imposed. Again, if the permit is not carried, the goods would not be allowed to be transported beyond the checkpoint until the tax and penalty, if any, are paid. It is easy to imagine the kind of harassment that could be caused to the traders and transporters by this system. A threat to unload the entire consignment for purposes of verification itself could bring the trader or the transporter to his knees who may then be induced to pay up. There are also other means of causing delay which are said to be resorted to by several checkpoint personnel. While honest traders could thus be harassed, dishonest people could pass through the checkpoints if they could bribe the officials. It is of course not to be assumed that all officers working at the checkpoint are corrupt. Undoubtedly, the complaints of the traders are somewhat exaggerated. However, it is also clear that the requirement to produce this kind of permit and the operation of the checkpoints are sources of corruption and it cannot be denied that corruption on a scale sufficient to cause concern is being practised by the checkpoint personnel in general.

- viii) The exemption for registration, which in turn carries with it the liability to pay the sales tax, is kept fairly low in most of the States. While prices have risen steeply over the last 20 years or so, the exemption levels for registration have been increased in general by a much smaller percentage with the result

smaller and smaller dealers have been brought within the tax net. These dealers not only find it difficult to comply with all the requirements of the sales tax law but also are small enough to be intimidated for the purpose of obtaining illegal gratification. With the increasing reliance on the first-point levy the State governments have been anxious to bring most of the manufacturers and importers within the coverage of the sales tax. For this purpose in some States no exemption level has been specified in respect of these two categories of dealers, while in others an exemption level much lower than the general exemption level has been prescribed for them. This means that even very small manufacturers and importers are required to deal with the sales tax authorities.

- ix) It would be fair to say that the State governments in general have paid little attention to the modernisation of the sales tax administration. A tax which brings in more than 50 per cent of the revenue of these governments and which affects almost every kind of business except the sale of services should properly speaking receive priority of attention, and every effort should have been made to administer it on scientific lines based on a proper information system and with the aid of well trained personnel carefully selected and adequately compensated. In actual practice, while the structures of the sales taxes have been modified from time to time on the basis of the recommendations of different Committees, the day-to-day administration of the tax is still being

carried on in the majority of States on antiquated lines.

Because the independent sales tax systems of the State governments are hindering the pursuit of a rational and purposeful tax policy at the national level, because they are shown to produce several harmful economic effects, both on their own and by compounding the defects of the excise tax system, and finally, since many feel that sales taxation falling after the manufacturers level leads to the harassment of small traders, there has been an increasing demand for a radical reform or abolition of sales taxation.

The sections of trade and industry which have been vociferous in criticising the sales tax for its numerous shortcomings including economic demerits have not generally cared to evaluate the existing structure of excise duties and to bring out their harmful effects. It is only fair to point out, as did the Jha Committee, that the extended system of excise duties falling on raw materials, inputs and final products and with only limited provisions for set off is the more important force for the escalation of costs and mis-allocation of resources than the sales taxes. This is because the overall rate of excise duties is much higher than that of sales taxes. This fact must be kept in view in discussing the various proposals for the reform of the existing system of indirect taxes.

There can be no denying the need for a radical reform of the sales tax systems of today. In any proposed reform, economic considerations - the promotion of economic efficiency, the

preservation of the common market and the minimisation of cost escalation - should be given due importance. But the proposals generally talked about give little weight to these criteria. The States themselves while justifiably insisting on retaining the power to levy the sales tax in order to preserve their fiscal autonomy, have fashioned their systems of sales taxes mainly with a view to achieving short-run revenue objectives with the least administrative botheration, although a secondary objective has been to attract industries into their respective territories. But the version of the tax which the tax administrators have generally voted to be administratively the most commendable - the tax only at the stage of first sale in the State - has brought with it, in many States, checkpoints, import permits, declaration forms et al, and raised a howl of protest from the assessee^{1/}. Trade and industry, particularly trade, is content to live with an excise tax system that is inimical to the interests of industry and exports, if only it does not have to deal with more than one tax authority. The Central government, on its part, has hesitated to take the bold steps needed to rationalise the indirect tax structure because it would then have to start with excises. It has allowed itself to be persuaded by revenue-gatherers to permit an increase in the inter-State sales tax rate to 4 per cent even though that clearly acts as an export duty on goods exported to one State from another, breaks up the common market into unequal segments, through which the poorer and smaller State suffer. And to cap it all, having induced and made profitable the stock transfer of goods through the increase in CST, the Centre is now proposing to amend the law to enable the taxation of inter-State

1/ The new Maharashtra Act proposing to levy tax exclusively at the first stage is a case in point.

movement of goods even without sale! The equity and economic aspects are totally neglected. (The bulk of CST is collected by the more developed States; if it is lowered, the poorer States can tax their own citizens more.)

The question of reform of the indirect taxes could be approached by asking first what would have been taken as the ideal indirect tax structure if India had been a unitary country. Then an approximation to this ideal could be thought of, with the modifications and deviations necessary to satisfy to the best extent possible the requirements and demands of our federal polity.

4. Merger of Sales Tax with Central Excise

The argument of a section of trade is that the political aspect may be safely ignored and that administrative and economic considerations are overwhelmingly in favour of a unified tax system. This system is to be achieved through the abolition of Entry 54 in the Seventh Schedule to the Constitution empowering the States to levy "taxes on the sale or purchase of goods other than newspapers..." and the replacement of the existing sales taxes by an enhancement of the rate of excise duty so as to recoup the loss of revenue. If, at the same time, as one would hope, the octroi is also done away with, there would be only one system of commodity taxation in the country at the stage of production, and a large number of dealers would be freed of the botheration of dealing with the complex problems relating to any form of commodity taxation, except when they happen to be importers.

Confining commodity taxation to the level of production has certain inherent, economic and also administrative demerits. However, having a unified system in the place of the existing uncoordinated dual system will undoubtedly bring in several benefits. First, there would be much less variations in the tax burden on any given exciseable product in different parts of the country. Second, as the inter-State sales tax would also be abolished, one important hindrance to the free flow of trade across State borders would be eliminated; also the more developed States would not be able to emerge as net exporters of their taxes to the less developed States. Third, the tax-on-tax cascading arising from the interaction of sales and excise duties would be eliminated. Fourth, since manufactured products and their inputs would be subject only to import and excise duties, it would be easier to work out the amounts of duty drawback to be given to different kinds of exports.

As can be readily seen, the economic gains that would follow from the abolition of the sales tax are substantial. But the merger would leave several major problems unresolved and, for reasons given below, could not be considered a satisfactory long-term solution to the problems caused by the existing systems of excises and sales taxes.

- i) Obviously, the mere abolition of sales taxes and a compensating upward revision of excise tax rates would in no way mitigate the cascading and distorting effects of excises arising from the subjection of inputs to excises. Indeed to the extent that sales taxes on inputs are loaded on to excises, there might be a

worsening of the situation because at present some of the States are quite liberal in their treatment of raw materials and intermediates. Indeed, so long as the excise tax system is irrational, the economic harm caused by it would only increase if the sales tax burden is loaded on to it.

- ii) A major drawback of this proposal is that several commodities will be freed from taxation without any justifiable economic reasons. Excise taxation is levied at the point of production; in practice, mostly industrial production is covered. While, legally speaking, excises could be imposed also on agricultural producers, it would simply be impracticable and uneconomic to try to tax millions of small agricultural producers. Even within the sphere of industry, the production that takes place in numerous units in the unorganised sector are, and would have to be, left out of the excise net for administrative reasons. This is where the general sales tax plays a useful role, because through this tax it becomes possible to cover agricultural commodities and other goods that cannot be taxed at the stage of production. It is easy to see that by shifting the tax to the wholesale or retail stage we are able to tax several goods through a tax on a single seller.
- iii) It seems to be generally assumed by protagonists of the proposal for merger that the loss in revenue arising through the abolition of the sales tax could be easily made up by raising the rates of excise duties. Sales

taxes (including the general sales tax, the sales tax on motor spirit, and CST) bring in roughly 53 per cent of the yield of excise duties. This being so, given the present coverage of excises, the rates of excise duties would have to be increased on an average by about 50 per cent, if the revenue lost through the abolition of sales taxes is to be fully recouped through the "merger". Since the excise duty rates are already high in many cases, it would seem unwise to effect such a large rate increase.

- iv) It might be thought that with the abolition of the sales tax, the effective burden on goods now subject to excise as a whole will not and need not go up. This impression is not correct. According to estimates made by the National Institute of Public Finance and Policy, there were about 22 broad items not liable to excise, the sales taxes on which yielded around Rs 500 crore in 1974-75. (These estimates were based on commodity-wise yield data supplied by 13 major States for 1973-74.) Some of these have since been brought under the general 8 per cent levy. Nevertheless, the products of the non-industrial sector and the decentralised sector are, by and large, outside the scope of excise. On a rough estimate, it could be stated that nearly Rs 600 crore of sales tax are currently being collected on goods, such as agricultural products and products of small manufacturers including those producing some high value articles such as jewellery, which for administrative reasons Central excises do not reach. Thus, with the abolition

of the sales tax, even if the erstwhile sales taxes on goods subject to excise are merged with the respective excise duties, there would still be a loss of revenue of about Rs 600 crore. To avoid this, the rates of existing excise duties would have to be revised upward not only to make up for the sales taxes on industrial goods but also to recoup the revenue presently being collected from non-industrial goods and the products of sectors of industry not subject to excise. Thus, the burden on the industrial sector and on the consumers of its products would be considerably increased, while direct consumption of non-industrial products would be freed from taxation. (It may be noted that the revenue presently derived from sales taxes falling on imported goods also would have to be recouped. This could perhaps be done through an increase in the level of import duties.)

- v) Revenue from excises and sales taxes together account for about 53 per cent of the total tax revenue of the Centre and the States. The merger proposal would result in an attempt to raise such a large proportion of total tax revenue from one single tax - the excise on production - levied mostly at the stage of industrial production. Confining taxation to the point of production and that too only industrial production (with a few exceptions), not only does not make economic sense, but, with such a heavy burden, is most likely to lead to large-scale evasion.
- vi) a) It certainly is an advantage to traders that taxation falls only at the stage of production.

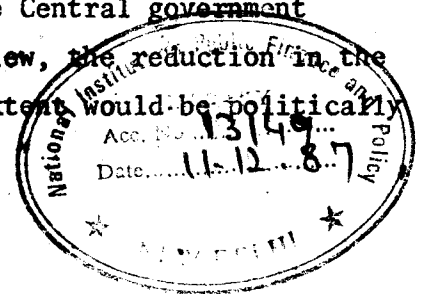
But purely from the economic point of view, i.e., in terms of the impact on the economy, it is the tax at the last or retail stage, or a tax covering all stages but without cascading, such as the value added tax, that is to be preferred most. A tax on gross value, or a specific duty, at the stage of production leads to cascading not only at the different stages of manufacturing but also at the post-manufacturing stages of wholesale and retail sales.

- b) Confining taxation to the production stage would mean discrimination in favour of those commodities in respect of which a larger proportion of value is added at later stages. If such a discrimination is to be minimized, in the context of a single production tax, the rates of tax on different commodities would have to be finely differentiated according to proportions of value added at the manufacturing stage. In practice, such a fine differentiation would not be possible as it would lead to a plethora of rates. Since durable consumer goods and leisure goods are sold along with certain services in order to attract and satisfy the consumers, they normally have a higher proportion of value added at the post-manufacturing stages. (Charges for installation, warranty service, etc., are usually included in the retail price.) Thus, there arises some discrimination under the production tax in favour of the more well-to-do who are the main consumers of such products.

- vii) To avoid such discrimination, it is of course possible to correspondingly raise the rate of tax on these goods at the manufacturing stage. But then there would be attempts at enlarging value added at subsequent stages. For example, assembling of some products could be shifted to the retail stages. Some of the components also could be fitted in at the time of final sale. There would be in addition an incentive to under-state the ex-factory price and correspondingly increase the price at the wholesale level if the manufacturing firm itself has an interest in the wholesale or retail outlets. In such cases, the Excise Department can proceed to make assessment on the basis of the price at the retail or wholesale level, but then the existence of a less-than-arm's-length transaction has to be proved in each case. There are already many disputes in regard to value.
- viii) The ideal form of indirect taxation would be one on consumption. A tax levied at the manufacturing stage leaves out value added at subsequent stages, and hence cannot be considered a satisfactory form of tax, if the intention is to place burdens on individuals in proportion to their consumption. Moreover, a tax at the production stage, unless it is accompanied by a system of set off for taxes paid on inputs, would suffer from many of the ills of a cascading type manufacturers' sales tax.

5. Centrally Administered Value Added Tax

Whether or not the tax powers of the States should be curtailed is, in the ultimate analysis, a political question to be decided by the representatives of the people. What is involved is the balancing of the economic merits of a unified tax system against the loss of welfare represented by the reduction in the financial autonomy of the States. One thing is clear, however, it is pointless to whittle down the fiscal powers of the State to push through a proposal, namely, the merger of the sales tax with the present excises, which has so many significant economic weaknesses. However, if one were to consider the replacement of both excises and sales taxes by a centrally administered value added tax, the economic advantages could be so overwhelming that a real political choice would exist. In this connection, one must consider the extent of erosion in the States' taxing powers that would be caused by the abolition of sales tax. Table 1 presents the share of the revenues raised by, and accruing to, the States in the tax revenues and the total revenues of the Centre and the States. It is seen that the share of the taxes raised by the States has fallen from 35.5 per cent in 1970-71 to 32.0 per cent in 1978-79. The share seems to have stabilised around the level of 32 per cent since 1970-71. The point to note is that since sales taxes contribute slightly more than 50 per cent of the total taxes raised by the States, their abolition would reduce the share of the taxes raised by the States in total tax revenue to something like 16 per cent only. There would thus be a virtual centralisation of tax collection with the share of the Central government going upto as high as 84 per cent. In my view, the reduction in the taxing powers of the States to this great extent would be politically undesirable.



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TABLE 1

Relative Shares of the Centre and the States in Tax and Total Revenues - Selected Years

	(Per cent of the total)								
	1950-51	1955-56	1960-61	1965-66	1970-71	1975-76	1976-77	1977-78	1978-79 (R.E.)
<u>Revenues</u>									
Revenues raised by the Centre	64.55	63.20	66.31	70.53	67.48	68.21	67.22	67.07	68.02
Revenues raised by the States	35.15	36.80	33.69	29.47	32.52	31.79	32.78	32.93	31.98
Revenues accruing to the Centre	56.97	53.60	54.07	61.08	51.58	53.87	53.57	53.40	54.76
Revenues accruing to the States	43.03	46.40	45.93	38.92	48.42	46.13	46.43	46.60	45.24
<u>Other Revenues</u>									
Revenues raised by the Centre	61.89	59.49	65.90	70.60	69.45	65.39	64.06	64.83	65.00
Revenues raised by the States	33.11	40.51	34.10	29.40	30.55	34.61	35.94	35.17	35.00
Revenues accruing to the Centre	55.84	52.31	56.57	63.14	56.56	46.35	44.49	44.45	42.68
Revenues accruing to the States	44.16	47.69	43.43	36.86	43.44	53.65	55.51	55.45	57.32

Source: Computations made by the National Institute of Public Finance and Policy.

1. Government of India, Ministry of Finance, Indian Economic Statistics, Part II, September 1976 and Vol. 1, September 1975.

2. Reserve Bank of India Bulletins.

If India were a unitary State, the ideal form of indirect taxation would undoubtedly be a single value added tax reaching down at least to the semi-wholesale stage. A value added tax is, in the ultimate analysis, consumption tax and from the economic point of view has the same merits as a retail sales tax falling directly on the consumer. However, if we wish to preserve undisturbed the existing distribution of tax powers as between the Centre and the States, one could consider an approximation to this ideal as the most suitable structure of indirect taxation in the country. A desirable, practicable, and politically acceptable solution would be to keep the excises and the sales taxes separate and to convert the sales tax into a consumption tax while the excise tax system may be rationalised along the lines suggested by the Jha Committee. It may be recalled that the recommendation of this Committee was to convert the existing excise tax system into a value added tax at the manufacturing stage. The sales tax could play a complementary role to such a reformed excise insofar as it could cover value added in the post-manufacturing stages. In other words, in course of time, we could have two tax systems complementary to each other and both embodying the principles of value added.

6. Lines of Reform of Sales Tax

It is against the above background that the lines of reform of the existing sales taxes should be discussed. As regards the structure, the objective should be to give to the States an instrument to enable them to tax mainly the consumption of their respective residents without harming the national economy through distorting relative prices and the allocation of resources and

through raising costs of production. From the administrative point of view, the aim should be to spare the small dealers, reduce harassment and tone up the functioning of the tax department to increase revenues at the existing or lower rates, while minimising inconvenience to the assesseees. For lack of space, we shall deal only with the major aspects.

a. Structure and point of levy

We have seen that most of the States rely predominantly on the first-point levy. Administrators prefer it claiming that it is the easiest to administer on the ground that it leaves out the large majority of small dealers. In point of fact, however, even under the first-point levy, all resellers having a turnover above the exemption level as well as most, if not all, manufacturers and importers irrespective of their turnover (in most of the States) have to get themselves registered, file returns and get themselves assessed. Actually, the number of dealers to be checked and to be kept under surveillance would remain the same under both the first and the last-point levies. But it is true that the number of people from whom tax is to be collected would be much smaller under the first-point levy than under the last-point one. It may also be true that under the former, the returns of the majority of resellers would not be scrutinised carefully. The resellers themselves seem to be happy to pass on the botheration of paying the tax to the manufacturers and "importers" of goods into the State. From the point of view of equity, there seems to be no justification for exempting large resellers with turnover running into lakhs and crores of rupees, while even the meanest manufacturer and the tiniest importer is to be kept within

the tax net. In any case the predominant reliance on the first-point levy brings in its train checkpoints and import permits leading to harassment and corruption. The decision to move towards the first-point levy can only be regarded as a short-sighted move leading to a cul-de-sac. It tends to favour in an unjustified manner a relatively unproductive sector, trade, at the expense of a relatively productive sector, manufacturing.

There is also no economic justification for not taxing value added including profits at stages subsequent to manufacture. The last-point levy has the great advantage that it covers value added at all stages and can be so levied as not to impinge on production processes and choices of producers, where non-neutrality is not intended. However, if we rely predominantly on this levy, we would be exposing revenue to great risk for the reason that tax payments would be concentrated at the last stage inducing evasion. Administratively it would be difficult to check evasion at this stage because of the ease with which bogus registered dealers are created sales to whom are then claimed to be tax exempt.

What we need, therefore, is a form of sales tax which would combine to the best extent possible the merits of the first- and the last-point levies, while avoiding their weaknesses. Such a compromise is found in the value added tax, which is nothing other than a multi-point turnover tax with a set-off being provided at each stage for the tax paid at the immediately preceding stage. The existing systems of sales tax could be gradually converted into a form of value added tax.

For this purpose we may start with a first-point levy on most commodities and combine it with a provision for set-off for taxes paid on inputs by manufacturers. That would make the system entirely rational within the manufacturing sector. While cascading and distortion in relative factor prices would be avoided, revenue would be safeguarded. Additional burden can be spread over post-manufacturing stages. To begin with, a tax at the last-point (i.e., at the stage of sale by a registered dealer to a non-registered entity) could be introduced on a selected number of commodities with a provision that the tax paid at the first-point could be set-off against the last-point tax, both being levied at the same rate. A provision of a similar kind was once in existence in the erstwhile State of Bombay. In order that the last-point tax may not cause trouble to the small dealers, the exemption level could be raised, as argued below.

If the States argue that they do not have the capacity to administer a rational system of sales tax and refuse to take note of the substantial harm caused to the economy by the provisions of the present irrational system with its predominant reliance on a cascading type of first-point levy, then, in the long run, there will be no alternative but to merge the State sales tax into a rationally designed Central levy. Indeed, since there already exists a tax on production in the form of Union excise duty, if an additional tax is to be levied, it must serve the purpose of a consumption tax. There is no strong case for having a second tax at the point of manufacture or, at one remove, at the point of import into a State. (The tax at the stage of import is also generally paid by the manufacturer himself who moves his goods from his factory in one State to his warehouses in the other States.)

Instead of tackling the problem in a comprehensive manner through the rationalisation of the sales tax structure, a suggestion is sometimes made to short-circuit the problem by extending the list of goods subject to additional excise duty. According to the proponents of this scheme, the objective is to bring about uniformity in tax burden in respect of some important commodities in addition to the three goods already removed from the sphere of sales tax. From the discussion of the demerits of the prevailing sales tax systems and of the harmful effects flowing from the cascading type of excise duties, it would be clear that replacing the sales tax on a few commodities by an additional excise duty would amount to nothing more than tinkering with the problem and would in no substantial measure lead to rationalisation. If, on the other hand, a sufficiently large number of goods are to be brought under the additional excise duty scheme, then the objections we have raised against the merger proposal would hold. (Incidentally, adding to the list of additional excise duty goods would raise problems regarding the relative levels of basic and additional duties and the basis of the distribution among the States of the proceeds of the latter. A State would be well within its rights to insist that its share must approximate to what it would have collected, if the sales tax on the concerned commodity had not been abolished.) If the Central government really wishes to bring about a greater degree of rationality in the indirect tax system in the country and to prevent the States from levying taxes in such a manner as to cause harm to the national economy, it should, without making an attempt to increase its own tax powers at the expense of the States, persuade or cajole them to eliminate the elements of economic irrationality in their systems which tend to harm the national welfare, and at the same time assist

them in improving tax administration. If the recalcitrance of a few States should stand in the way, the Constitution could be amended to the minimum extent possible to ensure that the sales taxes do not vitiate productive processes. What is specially important to note in relation to the rationalisation of the sales tax structure is that the freedom of the States to tax inputs as they think fit does harm to the national economy, and enables one State to export its taxes to the other States. If the sales tax is to survive, the States must be prepared to reform it to make it economically more acceptable and each State should tax mainly the consumption of its residents.

b. Rate structure

There is a multiplicity ^{of} sales tax rates. Such multiplicity is not only unnecessary but also causes complications and often leads to diversion of trade. While some degree of progression is necessary, it is to be remembered that the main purpose of the sales tax is to depress consumption and to raise revenues for the States. In fact, the multiplication of rates seems to have come about through ad hoc changes made from time to time as part of the efforts at additional resource mobilisation. There should be only four or five rates of sales tax - 15 per cent on luxuries; a general rate of 8 per cent; 4 per cent on declared goods, other raw materials and machinery; and 2 per cent on necessities which are not exempted.

c. Exemption level

As pointed out earlier, given the steep increase in the price level that has taken place during the last 20 years or so,

the general exemption level is found to be too low. No significant loss of revenue would occur if the existing exemption levels for resellers are raised to Rs 1 lakh or 1.5 lakh. Simultaneously the exemption level prescribed for importers and manufacturers could also be raised at least to Rs 50,000.

d. Administration

As pointed out earlier, the administration of sales taxes in many of the States leaves much to be desired. The procedures of enforcement, the various forms prescribed, submission of returns, limitation of time for completion of assessments, appellate procedures - all of these have to be examined and reforms effected. To mention a few major shortcomings, one finds that in almost all the States quarterly returns and in some cases even monthly returns have to be submitted wherein details of sale and purchase of commodities grouped according to rate categories have to be given, while the assessment is done on an annual basis. At the time of assessment, the figures in the quarterly or monthly returns are added up. Since much time elapses between the month and year of submission of returns and the year of assessment, the quarterly returns serve no useful purpose but only cast an additional burden on the assesseees. While quarterly payment could legitimately be asked for, even the income tax law does not require submission of quarterly returns. Short quarterly declaration and a single annual returns should suffice.

In some of the States, assessments relating to a given year are not completed until after several years. This means that assesseees are forced to maintain records of transactions for

many years, particularly where the law does not provide a time limit. Where the law does provide that assessment proceedings should begin before the expiry of a certain period, the sales tax authorities make a mere motion of starting the assessment proceedings by issuing a notice and then postpone the real work of assessment. In one of the States, where assessments are pending for more than six or seven years, it is found that in practice 98 per cent of the revenue is derived only from admitted tax. In other words, the dilatory assessment proceedings completed years after the events have taken place at considerable expense on to the department and the taxpayers adds only about 2 per cent to collections!

There are too many forms and some of them are being security-printed unnecessarily. For example, there is no need for a declaration form under the first-point levy, when the purchase invoice, which is accepted, can be endorsed in the manner required. It is well known that sales tax offices not too infrequently run out of stock of several forms; even when forms are available it is not always easy for the small dealers to obtain these forms. Among the forms, the one that creates the most trouble and inconvenience is the permit which is to be obtained in some of the States before a dealer can import goods into the State from other States. Sales tax authorities would have to find some means other than this permit for monitoring the flow of goods.

Above all, if only the States would reverse the trend towards the first-point levy and take steps to spread the burden of taxation over the different stages, they would be able to get rid of the checkpoints. This is a matter on which the Centre should take a firm stand. Any impediment in the form of a check-

post or otherwise to the free flow of goods within the country must be declared ultra vires of the constitution. The sales tax becomes due only when a sale takes place, and hence the detention of trucks at the border and levying a penalty along with tax on the spot because of the complaint that proper documents are not being carried, should surely be considered an unwarranted extension of the taxing power of the government.

Instead of relying on such drastic methods for the enforcement of their sales taxes, the States should be encouraged to improve the quality of the tax administration. As of now, it is fair to say that in most of the States the taxation department is among the most neglected departments. What is required for a better enforcement of the tax are better training for the staff, a better information system, more research, greater attention to survey to detect dealers with taxable turnover and the strengthening of the administration at the top including a reasonably long tenure for the Commissioner of Commercial taxes.

7. Conclusion

The prevailing systems of sales tax and their administration stand in need of considerable modification and improvement. It would be a counsel of despair, however, to suggest that the sales tax cannot be mended and therefore should be ended. The important criterion of preserving intact our federal structure and the need to maintain undisturbed the fiscal autonomy of the State, would suggest that the right approach would be to try first to convert the sales tax into a nationally acceptable instrument which, while raising revenue for the States, would form a useful and necessary

complement to Central taxation. If in the long run the States prove themselves incapable of administering a rationally designed sales tax, one could consider the replacement of the excise and the sales taxes by a Centrally administered value added tax. But it would be premature to think of such a solution when the excise tax system itself has not been reformed. The proposal to merge the sales tax with the present system of excises, in any case, should be rejected. Trade and industry would learn to live with the sales tax and would eventually come to appreciate its merits if the States should take steps to remove the elements of irrationality and make serious attempts to improve the administration. The task of reform can begin now without waiting for the Centre to take the first step.