IMPEDIMENTS TO INTERNAL TRADE AND ALLOCATIVE DISTORTIONS IN INDIA

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NO.3 MAY, 1993

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1. Introduction

In spite of the impressive performance of the Indian economy throughout the eighties, the country slipped into an unprecedented economic crisis, when the oil prices virtually doubled following the middle-east war in August, 1990, international lenders tightened credit availability and refused to roll over the credit[1] and political instability created an atmosphere of uncertainity. This led to a serious rethinking on the efficacy of State dominated heavy industry based inward looking development strategy in bringing about rapid and sustainable economic progress. A series of measures such as attempt at fiscal correction, liberalisation of industrial and trade policy, exchange rate adjustment and public sector disinvestment intended to impart greater degree of openness and competition to Indian industry and trade were introduced since the middle of 1991.

Yet, several impediments to industry and trade have continued to persist for various reasons. First, apart from the varying effectiveness of the different reform measures, pattern of investment and its regional spread undertaken in the sheltered policy environment of the 'command' economy would continue to influence resource allocation in the short and medium term. Besides, the reform initiatives have not been uniformly effective. Second, reforms have been confined mostly to the Central government and the impediments at the State level have not received much attention. This is also because, the allocative implications of various State level controls, physical as well as financial, and distortions arising from the States' fiscal operations have not been properly analysed and understood.

In this paper, we make an attempt at identifying and analysing various regulatory policies having unintended distortionary effects on trade and industry. Particular emphasis is given to the tax policies of the State governments and local bodies which distort resource allocation, escalate production costs of Indian manufactures and cause inequitable resource flows. The paper is divided into five sections. In Section II, we present the broad preconditions

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1. In particular, the Bank of International Settlements stipulated more stringent conditions and deadlines.

required to achieve efficient resource allocation in a federal democratic polity. Section III summarises the various non-fiscal factors impeding and distorting trade and industry. Theadverse consequences of taxation policies of State and local governments, particularly the problems arising from the levy of sales tax, octroi and entry taxes are analysed in Section IV. The concluding remarks are given in Section V.

II. Competitive Federalism, Institutional Factors and Allocative Efficiency

Federalism is considered to provide a congenial environment for the efficient functioning of the market economy. The nation-wide market enables the production units to reap maximum economies of scale. The decentralised provision of public services helps to provide public services not only to correspond to the preferences of the people, but also enables the creation of infrastructure required to harness the resources in different regions. In addition, competition among the federating units could lead to innovation and efficient provision of public services (Oates, 1972, King, 1984).

a. Competetive Equality and Cost-benefit Appropriability: However, "Competitive federalism"[2] will lead to efficient allocation of resources only under certain preconditions. First, competition among the States, to be beneficial, calls for "Competitive equality". A necessary condition for equalising the Competitive strength of different regions (States) within a country is to enable them to provide equivalent levels of social and economic infrastructure at a given tax-price through Central transfers or through Centre's direct investments. This would ensure that larger/stronger units are not in a position to continually dominate, coerce or prevent the smaller/weaker units from making independent decisions, nor can they inflict disproportionate damage on them (Breton, 1987). The level and composition of public services and social and economic infrastructure actually provided by the States in a rational system would, however, depend upon marginal(social) productivity of public investment vis-a-vis marginal productivity of private sector activity. Second, it is also necessary that the costs and benefits of a State's decisions should be borne by its residents (appropriability of costs and benefits) in order to avoid unequal and unhealthy tax/benefit competition among the States.

b. Institutional Factors, Barriers to Mobility and Resource Allocation: Competitive equality and appropriability of costs and benefits by themselves may not result in efficient resource allocation. There should be equally conducive institutions and policies in different States. Institutions and policies determine the structure of incentives (Olson, 1982,

2. Federalism which introduces more competition both between and among different layers of government is called "competetive" federalism. Under a given set of preconditions, such a competition results in more efficient allocation of resources. For details, see, Breton, A, (1987).

1992). Allocation of resources in an environment of institutions and policies which do not provide incentives to the producer cannot be expected to promote the use of optimal factor use, the technology available or innovations.[3] Equally important precondition for competitiveness is the non-existence of impediments for free movement of factors or products. Removal of impediments to factor and product movements across the country helps to allocate resources in an efficient manner. The existing institutions itself may impart immobilities and such inflexibilities may not be uniform across the States. The policy framework, therefore, should attempt to do away with all hindrances to free trade and investments across regions. Of course, some regulations may be required for environmental reasons or to protect the consumers, but surely, this involves resource costs.

c. **Preconditions for Efficiency in Resource Allocation Summarised:** To summarise, competitiveness and efficiency in resource allocation in a large federal country like India presupposes efficient harnessing of the existing resources in various States. This calls for (i) creation of satisfactory levels of social and economic infrastructure and its spread across all the States, (ii) appropriability of costs and benefits of governmental decisions among the respective residents (iii) policies to evolve institutions to ensure accountability and incentives and (iv) removal of impediments - physical, financial as well as fiscal, to factor and product movements.

The issue of enabling the States to create satisfactory levels of social and economic infrastructure through federal transfer policy in India has been discussed at some length in the literature and therefore, need not be elaborated here. Nevertheless, it is necessary to mention that the general purpose transfers given on the recommendations of the Finance Commissions as well as by the Planning Commission have failed to offset the fiscal disadvantages in poorer States (Rao and Aggarwal, 1991). In such a situation, the competition among the States has worked to the disadvantage of poorer States and consequently, the lower standards of social and economic infrastructure in these States prevent efficient harnessing of resources even when these States are endowed with disproportionate resources, for, they can not attract private capital in required quantities. The economic disparity gets accentuated when the unequal competitiveness among the States results in inequitable spillover of the cost of public services wherein, the residents of poorer States bear a significant proportion of the cost of public services in richer States.

Why is there a 'Competitive inequality' to begin with? The uneven levels of investment in infrastructure to suit colonial interests during the pre-independent period and improper designing of intergovernmental transfers later, provide only a partial explanation. The exploitative relationships of the *zamindari* system of land tenure settled in these areas created an

3. An instance of such an environment is the Zamindari System of land tenure and ineffective implementation of land reforms. Similarly, an efficient administrative and legal environment to protect the property rights is an important necessary condition for economic growth.

institutional structure devoid of incentives. The inherent disincentives of the system continued even after the zamindari abolition due to insufficient and ineffective follow up of land reforms. These factors, coupled with inadequate investments in infrastructural facilities did not enable the development and penetration of markets and the institutions continued to be unfavourable to the efficient exploitation of the resources[4].

The uneven development and inefficient resource use arising from these factors are compounded by the effects of a plethora of controls and regulations. A brief discussion on the allocative impact of some of the important controls and regulations are discussed below.

III. Non-Fiscal Distortions to Industry and Trade

The State dominated, heavy industry based import substituting developmental strategy adopted in the country virtually eliminated both external and domestic competition[5]. There have been attempts at liberalising the industrial policy during the decade of the eighties and since July, 1991, the New Industrial Policy was announced wherein, licencing requirements were abolished for all except 18 industries, public sector reservation was restricted to eight industries, decision to disinvest public sector shares were taken, national renewal fund was established to initiate an exit policy and modernise the existing industrial units, Monopolies and Restrictive Trade Practices Act was amended to regulate monopolistic trade practices rather than putting impediments on their expansion of output, foreign investment and technology inflow was substantially liberalised and investment limit for small scale industries were enhanced to achieve better scale economies. Similarly, there have been reforms in trade and exchange rate policies to give outward orientation to the Indian manufactures.

The disincentive effects of years of controls and regulation, however, cannot be overcome in the short or even in the medium term. The production capacity and price formation in the economy is determined predominantly in the framework of regulation and controls that have prevailed in the past. Further, an important consequence of the regulatory regime has been the emergence of major distributional coalitions[6]. Given that the relaxation of regulatory regime tends to reduce their oligopolistic power and influence, it is in their interest to attempt to decelerate the pace of reform and/or to adjust to the new policy environment by finding other ways of acquiring oligopolistic influence. Therefore, it should not be surprising that in spite of attempts to impart competitive environment, a number of policy and bureaucratic impediments at the micro-level have continued to persist.

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4. For an interesting exposition of this, see Bhardwaj, Krishna (1990), and Prasad P.H. (1988)

5. For a well documented analysis of the overregulation of Indian industry and their adverse consequences on the economy, see, Marathe, Sharad, S (1987).

6. "Distributional Coalitions" is taken to mean narrow special interest groups having disproportionate organisational powers for collective action. It is in their self interest to engage in the distribution of existing incomes rather than work in production activity. For details on this, see, Olson (1982).

a. Inefficiencies from the Past Regulations: As already mentioned, in spite of significant relaxation in the policy environment since July, 1991, constraints placed by the regime of controls in the past on capacity, product mix, location, brand names and technology continue to distort the pattern of industrialisation and trade. The policy of reservation to small scale industry along with other fiscal and financial incentives not only hinders the possibilities of achieving economies of scale, particularly in a changing technological environment, but also impedes the growth of small units into medium and large scale enterprises.[7] The barrier to entry of private enterprises contained in the Industrial Policy Resolution of 1956, and non-availability of imports have placed the public sector in the role of a monopolist passing on the burden of inefficiency to the consumers of their products in terms of higher prices. The manufacturing processes employing inputs and capital goods purchased from these public sector enterprises cannot be expected to be competetive either. The adverse consequences of the high cost of rail transportation and inefficient communication system must also be mentioned in this context.

b. Economic and Social Infrastructure, its Spatial Distribution and Allocative Efficiency: We have, in the previous section discussed the role of economic and social infrastructure and its even spread in enhancing productivity in the economy. Both in terms of the overall provision of infrastructural facilities and its inter-regional distribution, the situation in the country is clearly unsatisfactory, which in itself is a major impediment for the efficient resource use.

It is very well recognised in the development economics literature that adequate supply of social overhead capital like transport, communication, power, urban infrastructure and skilled manpower is an important precondition for the entrepreneurs to make investments (Rosenstein - Rodan, 1943). However, in spite of four decades of planning, the level and quality of infrastructure provided is extremely inadequate and some of the infrastructural sectors like railways and power, have continued to pose binding constraints. The wagon shortages are too cammon and power-cuts all too frequent and extensive; the communication system continues to be inefficient and urban infrastructure too inadequate. There has hardly been any manpower planning to generate skilled manpower, worth the name. Surely, infrastructural sectors have continued to be a serious bottleneck in effectively utilising the existing production capacity.

Equally concerning has been the uneven spread of the available infrastructure. The backward States like Bihar, Orissa and Madhya Pradesh although are endowed with rich natural resources have not been able to adequately harness these resources due to the abysmally low and poorly maintained infrastructural facilities. These States are constrained by smaller tax bases and hence, lower revenue raising capacity as compared to their richer counterparts. At the

7. This may, nevertheless, be justified on other grounds like employment generation. However, it is yet to be conclusively shown that modern small scale enterprises are more labour intensive than the large scale enterprises. See, Banerjee Nirmala (1981).

same time, as already mentioned Central transfers have not been properly designed to offset their low fiscal capacities and therefore, their infrastructural levels have continue to be inadequate. This has not only constrained the efficient harnessing of the available resources in these States, but also "competetive inequality" and has worked to the disadvantage of these poorer States.

c. **Other Impediments**: Equally important inhibiting factor is that the reform process has not sufficiently encompassed certain sectors. There has been very little attempt at reforming the administrative, legal and judicial systems to make them adapt to changing conditions. Equally important is the lack of much progress at financial sector reforms. The pre-emption of a large proportion of household savings to meet public consumption and investment requirements by prescribing statutory liquidity ratio in the commercial banks[8] and rationing of credit to priority sectors likes agriculture, exports and the small scale enterprises at concessional rates of interest has enhanced the cost of credit to manufacturing enterprises (India, 1991 a). The subsidised credit given to the "priority" sectors in the absence of an adequate monitoring mechanism tends to create additional distortion and inequity.[9] Equally important are the inefficiencies arising from the explicit and implicit budgetary subsidies.[10] The effect of providing transportation subsidy to coal and steel through the freight equalisation scheme has not only denied the forward linkages in the poorer States where these resources are produced but also has led to locational distortions.

Impediments at the State level are even more glaring. Although each State has a package of incentives and has initiated various promotional measures, the multitude of clearances required and bureaucratic delays involved in starting an enterprise could very well be exasperating. Besides obtaining land, coping with zoning and land use regulations and getting water supply and electricity connection, the prospective entrepreneurs will have to obtain pollution clearance, arrange the needed finance, obtain clearances from the department of finance, planning, industry, environment, urban development, labour, etc. Even the procedures adopted to give the clearances in many cases are non-transparent and therefore, subject to arbitrariness and misuse. State governments also have a number of additional restrictions even on the creation of additional capacities.[11]

8. The ratio was brought down from 38 per cent to 30 per cent in the 1992-93 budget.

9. Subsidised loan given to the farmers, for example, are intended to protect the small farmers from the clutches of unscruplous money lenders. In the absence of a proper institutional framework and an adequate monitoring mechanism, this can lead to big landholders availing credit and in turn lending it to small holders at higher interest rates. Similarly, the governmental decision to waive farm loans though ostensibly to help the smaller farmers, helps the larger farmers disproportionately.

10. For a detailed analysis of explicit and implicit budgetary subsidies, see Mundle and Rao (1991).

11. The background note prepared by the Department of Industrial Development, Government of India (p.35) for the Conference of State Industry Ministers even laments on the restriction imposed on the export of granite by one State government.

Over and above these, the ineffective administration and enforcement of various regulations itself may be a source of inefficiency. While there exist a plethora of Acts and rules, the judicial interpretations have not always helped to protect property rights, and the bureaucracy has not ensured uniform application and enforcement of the existing laws, rules and procedures. Laxity in the enforcement of laws pertaining to trade marks, patents, selling of adulterated products etc., has not only been a source of disincentive, but also has resulted in allocating resources in unintended ways and promoted rent seeking activities (Rao, S.L., 1988).

Another major source of distortion is the minimum wage legislation and its non-uniform application in different States. Fixation of minimum wages at levels much higher than the average labour productivity would not only result in lower employment but also causes significant substitution of capital to labour. Similarly, payments to organised sector labour at rates higher than its average productivity results in either restricting production activities at less than optimal levels or cause factor use not corresponding to their endowments. It is necessary to mention here that although these legislations are intended to protect the weaker sections, given their vulnerability, they may end up in providing lower levels of employment and adversely affect the sections they are meant to protect.

IV. State-Local Taxes and Impediments to Trade and Industry[12]

A major achievement of post-independent India is the raising of the tax-GDP ratio from a mere 6.6 per cent in 1950-51 to about 17 per cent by the end of of the eighties.[13] What is however concerning is that the structure of taxes over the years has been employed mainly to meet the expediencies of large and growing consumption and investment resource requirements of the government and public sector and economic considerations, at best, have been secondary. In consequence, the share of commodity taxes has been large (80 per cent) and growing. Further, the Central government's attempt to raise resources from sources not shareable with the States has led to employing import duties as a revenue instrument rather than a protective device. Overlapping commodity taxation of inputs, outputs and capital goods by the Central, State and local governments alike has resulted not only in a highly cascading tax system, has altered relative prices in unintended ways and has rendered the achievement of equity extremely difficult. In addition, competition among the States to export the tax burden to the residents of other States and to attract business and industry into their own jurisdictions has resulted in the evolving of tax systems which can simply be characterised as 'archaic'. In this section, we do not discuss the economic and equity issues arising from the structure and operation of Central taxes, as this has been analysed in detail by the Tax Reform Committee[14]

12. This section relies heavily on the paper on *State-level Budgetary Reforms*, Rao, M.G. (1992).

13. This compares favourably with the 12 per cent which was average of the tax ratios in developing countries taken together, in the late eighties. See, Tanzi, (1990).

14. The Tax Reform Committee (India, 1991, 1992) has already submitted two reports to the Finance Minister, which has found the basis of reform exercises initiated in the 1992-93 budget.

and reform measures based thereon have already been initiated. In what follows, we confine our analysis to the inefficiencies arising from the levy of commodity taxes at the State and the local body levels.

a. **Structure of Sales Tax in India: Economic Issues:** In the evolution of the sales tax structures, raising of revenue seems has been the main objective and efficiency and equity considerations have been secondary. Here again, administrative considerations have received priority, sometimes to the detriment of economic efficiency. The general tendency of the States to move towards the first point tax, widespread taxation of inputs and capital goods, imposition of ad hoc turnover tax and surcharge on sales tax, and persistence with multiple rate categories are only some instances of this.

b. **The First Point taxation: Economic ill-effects Versus Administrative Advantages:** Almost all the States realise bulk of their revenues from the tax at the first point of sale. In the absence of set off provisions, the first point tax, in effect, becomes a multistage levy, for, it falls on successive stages of processing of and transactions in goods. Like the Union excise duties, the manufacturers' sales tax distorts consumption pattern and resource allocation by imposing a lower burden of tax on commodities having high value added at the wholesale and the retail levels. As typically, post-manufacturing value added is low for items of common consumption and high for luxury goods, the first point sales tax tends to encourage the consumption of luxury goods (Lim, 1980). Pre-retail sales tax may even affect the method of doing business, as there is an incentive to pass on as much of the activity beyond the point of tax as possible. This also causes cascading wherein, the price to the consumer increases by an amount larger than the tax imposed. In a situation of imperfect competition characterised by mark-up pricing, the larger the percentage of value added between the point of impact of the tax and final retail price, the higher would be the extent of mark-up. The extent of distortion of pre-retail sales tax can bring about thus, depends upon value added subsequent to the point of tax and the degree of market imperfection.

c. **Taxation of Inputs and Problem of Cascading:** When sales taxes are levied on inputs as well as outputs, in addition to excise duties which again fall on both inputs and outputs, virtually two independent systems of sales tax at the manufacturing stage come into operation. The resulting cascading caused by the tax and the mark-up on excise duty gets compounded with similar sales tax falling on the same products. The data collected by the Indirect Taxation Enquiry Committee (India, 1977) for the major States indicate that in 1974-75, over one-third of sales tax revenue was collected from inputs and capital goods.

Cascading has harmful effects on the economy for several reasons. First, an increase in the consumer price by more than the tax element creates an additional dead-weight loss. Second, this adversely affects the competetiveness of Indian manufactures because, it is difficult to arrange a duty draw-back on input taxes for the exported goods. Besides, designing the appropriate tax structure becomes extremely difficult as effective rates of taxation on final products cannot be easily estimated. More importantly, cascading changes relative prices of commodities in unintended ways, as tax rates on inputs are not uniform and input costs in the total value (or the ratio of value added to total value) differ among commodities.

d. **Complicated Tax Structures:** An important factor complicating the tax structure is the multiplicity of tax rates. The number of sales tax rates in the States vary from 6 in Orissa to as many as 17 in Bihar and Gujarat. The practice of giving end-use relief increases the rate differentials even more. Levying of across the board turnover tax, additional sales tax or a surcharge on sales tax have introduced further complications. Further, although by and large, the attempt by the States is to levy tax at the first point of sale, some of the States also have double point and multipoint taxes. These complications surely have enhanced administration and compliance costs.

e. **Inter-State Differentials in Tax Rates: Some Implications:** A serious phenomenon observed in a federal set up is the inter-State differences in tax rates. Variations in effective tax rates among the States mainly arise from the differences in nominal tax rates and patterns of tax incentives for industrialisation though, this may also be partly attributable to the differences in exemptions and standards of administration and enforcement of the tax.

(i) Inter-State Differences in Nominal Tax Rates: Table 1 presents the comparative structure of nominal tax rates among different States on selected commodities. It may be seen from the table that both the point of levy and the rates of tax vary widely differ among the States. This may be partly attributed to varying notions of equity. We can also clearly discern some rate differences to inter-State tax competition. Generally, the food surplus States levy higher rates of tax on cereals and pulses. Given that the demand for food imports is inelastic, the levy of higher tax rates on these items could clearly be a way of exporting the tax burden to the residents of importing States. In respect of commodities having higher income elasticity, the attempt is to reduce the tax rates to enhance revenue by attracting trade.

(ii) Sales Tax Incentives for Industrialisation: Another factor causing effective rate differentiation among the States is the variety of sales tax incentives for manufacturers. The incentives usually take the form of lower tax rates on inputs, tax holidays or interest-free loans of the collected tax. In some States limits are placed on the amount of incentives whereas in others it is open-ended. Again, the incentives may be across the board or selective to certain specified industries. Differentiation is also made depending on whether a manufacturing unit is located in a backward area or a more developed region within a State.

As the output-linked incentives reduce the cost of capital and thereby help to build excess capacity, particularly in industries having a low capital-output ratio. A study of incentives in Madhya Pradesh showed that, while the increase in investment or its dispersal to backward areas due to sales tax incentives could not be considered significant, the exchequer had to forgo a significant amount, about 7 to 10 per cent of tax revenue collected by the State during 1981-84 (Tulasidhar and Rao, 1986). Further, when all the States compete, they may merely be able to maintain their relative shares in capital investment. Therefore, such tax expenditures are expensive, particularly to the poorer States; they may have to forgo a substantial amount of tax revenue with no more tangible gain than being able to maintain the same level of investment.

(iii). Rate Differences and Trade Diversion: An important economic consequence of tax rate differential is the uneconomic trade diversion. Diversion of trade from States where tax rates are higher to those where the rates are lower can occur so long as the cost of transporting the goods is lower than the tax differential. Trade diversion can take place in respect of those commodities where the price differential among the States is due largely to tax differentials and not to imperfections in the market. Diversion on a large scale takes place mainly in the case of high value-low volume manufactured commodities.[15] Trade diversion not only affects the revenues of the States but can distort the tax structure itself. Sometimes, tax rates levied even on commodities having a very high income elasticity (such as motor cars) are lower than less income elastic commodities due to the fear of trade diversion (see, Table 1).

A more serious adverse consequence of tax rate differences is resource misallocation. Large differences in tax rates, *ceteris paribus*, may lead to migration of capital from high tax rate to low tax rate regions. This could not only result in allocating resources among States contrary to their resource endowments, but also may involve avoidable transportation of raw materials and finished products. The extent of allocative distortions, however, would depend upon the responsiveness of capital migration to tax rate differences.

f. Issues Arising from Taxation of Inter-State Trade: *(i) Central Sales tax (CST) and inter-State exportation of tax burden:* One of the most obnoxious features of the Indian sales tax system is the taxation of inter-State trade. Although, initially, the Central Sales Tax (CST) was levied at the rate of only one per cent, over the years, the rate has been raised in stages to four percent. This has created as many tariff zones within the country as there are States in the Indian Union.

Besides being a source of hindrance to the free flow of trade across State borders, the CST has become an important instrument of perverse resource transfers from less developed to the relatively more developed States. Export of taxable goods from industrially more advanced States to backward States exceeds their imports. This may be seen from the

15. For example, the low rate of tax on bus and truck chassis in Silvasa (3 per cent) in the Union Territory of Diu is said to affect the trade even in as distant a State as Uttar Pradesh. Similarly, the lower effective rates of tax prevalent in Delhi are believed to be a significant source of diverting trade from the States of Madhya Pradesh, Uttar Pradesh and Rajasthan.

information on CST collections in major States presented in Table 2. The seven more developed States with a population of 41 per cent, though account for 45 per cent of household consumption collected as much as 74 per cent of the CST in 1987-88. In fact, almost 57 per cent of collections were accounted for by the five developed States of Maharashtra, Gujarat, Punjab, Haryana and Tamil Nadu. On the contrary, Uttar Pradesh, Bihar, Orissa and Rajasthan with a population share of 38 per cent and consumption share of 34 per cent collected just about 14 per cent of revenue from CST. This gives a broad idea of the extent of tax burden exportation from the richer to the poorer regions of the country. It is also seen that over time this form of perverse transfer has shown increases. The share of seven developed States in total CST collection increased from 72 per cent in 1977-78 to 74 per cent in 1987-88. In fact, in 1975-76, these States had even a lower share of 69 per cent. It is also seen that the proportions of CST collected by some of the poorer States like Orissa and Rajasthan have been declining over the years.

(ii) *Taxation of Consignment Transfers*: When Central sales tax was increased to four per cent, it became profitable for the manufacturers to open stock depots and warehouses in various States, sell their products from these 'branches' and thus camouflage inter-State sale as consignment transfers. The amendment of the Constitution (46th Amendment) to plug this loophole in response to the States' demand empowered the Centre to levy a tax on consignments in the course of inter-State trade. However, the tax is yet not been brought into operation.

While there can not be any excuse for tax evasion, it must be noted that taxation of consignments like the tax on inter-State trade itself alters relative prices, promotes concentration and encourages vertical integration, apart from segregating the economy into different tariff zones. There is also the problem of exempting genuine transfers by the manufacturers.

The exportation of the tax burden to the residents of other States goes against the principle of 'appropriability' and places larger burden on the residents of backward States. When inputs are also subjected to taxation, as the proportion of finished goods in total exports of more advanced States is larger, the effective rate of tax on their exports to other States would be higher. At the same time, this cannot be considered a legitimate source of revenue, for, to the extent that CST and consignment tax is paid, the "tax room" for other State taxation is reduced (India, 1992).

(iii). *Octroi and Entry Tax:* Another major hindrance to the inter-regional trade and commerce is the tax on the entry of goods into a local area for consumption, use or sale. Presently, among the major States Gujarat, Haryana, Maharashtra, Orissa and Rajasthan levy octroi. Karnataka and Madhya Pradesh have abolished this levy, but in lieu of it, Entry Tax is levied.

Octroi has been variously described as 'obnoxious' 'vexatious', 'wasteful' and 'distorting'. Some of the important disadvantages of the levy are the production loss arising from hindrance to smooth traffic flow, rampant corruption and harassment to taxpayers, perfunctory assessment of the tax based on trust rather than on actual books of accounts, efficiency loss resulting from the collection of revenue predominantly on inputs and capital goods, multiple taxation of same goods in different urban local bodies and exportation of the cost of urban development to rural areas.

However, collections from octroi form a predominant proportion of the urban local body revenues in the States where the tax is levied. In fact, the standards of urban local services in the States where octroi is not levied has been found to be significantly lower and the gap between the desired level of expenditures and resources available with the local bodies has been much larger.[16] What is more, this is a liquid source of revenue to the local bodies. Due to the difficulty in finding a suitable alternative, the tax has continued to be levied in spite of its shortcomings.

Karnataka and Madhya Pradesh have replaced octroi with 'Entry tax'. In principle, this is also a tax on the entry of goods, but as it is account based, the hindrances, delays and harassment arising from the checkposts and physical verification can be avoided if the administration is backed by adequate information system. However, the proceeds of entry tax have been found to be inadequate to completely offset the loss of revenue from octroi and given the States' reluctance to make larger devolution, this has had an adverse effect on urban infrastructure in these States. It must also be noted that entry tax, like octroi is a tax on the entry of goods and hence has similar economic effects. In some cases, this has tended to shift the production and distribution centres to outside municipal limits necessitating needless movement of consumers to these distribution centres. More serious issue however is that, in many cases, as the metropolitan areas are centres of entrepot trade, the goods necessarily have to pass through these centres. In such cases, the additional protection accorded to manufacturing units located within the urban areas due to the levy of Octroi or Entry tax exerts a strong gravitational pull into these areas with all attendant evils of congestion, overscrowding, slums, social degradation and environmental pollution.

The search for new avenues of resource mobilisation driven by the increasing need to finance ever expanding expenditure requirements of the States have led them to levy highly distoring taxes. In particular, mention must be made of the recent trend in the States of levying taxes on the entry of all commercial vehicles into their jurisdictions (Path Kar). This tax, like in the case of Octroi and Entry tax causes significant resource distortion due to the delays caused by the checkposts as well as the inefficiences arising from the additional tariff barriers.

16. The Rural Urban Relationship Committee (1963) estimated the expenditure needs of the urban local bodies. Employing these norms the gaps between desired expenditures and existing revenues of the municipal bodies was estimated. For details, see Rao, Pradhan and Bohra (1985).

Similarly, the levy of market fees and cesses on the sale of agricultural commodities in organised markets, levied in a number of States causes significant inefficiences by discouraging trading in organised markets and altering relative prices of commodities in unintended ways. Though not yet important in terms this contribution to the exchequer, the inefficiences caused by these taxes could be considerable.

V. Concluding Remarks

The increasing requirements of resource mobilisation and the attempts to allocate resources as determined by the developmental plans have necessitated the adoption of several physical, financial and fiscal regulations. These not only have led to oligopolistic tendencies by restricting both internal and external competition, but also given rise to powerful rent-seeking groups having a vested interest in continuing the regime in one form or another.

Economic reform initiatives under the Structural Adjustment Programme have hitherto focussed on the obvious factors inhibiting external and internal competition, particularly those arising from the Central government policies. There are equally serious physical and fiscal impediments arising from the State level policies causing significant welfare losses. We have tried to identify some of these factors and attempted to analyse the nature of their distortions and inequity. It is necessary to emphasise that State level reform measures to remove the major impediments are extremely important in any attempt at imparting competetiveness to Indian industry.

Many of the physical controls, though well intentioned have outlived their utility and therefore, need to be reviewed. More importantly, creation of nation-wide market in the federation helps in the efficient functioning of the economy. Provision of an administrative and judicial framework ensures proper functioning of the market and designing the intergovernmental transfers to enable the fiscally disadvantaged States to provide comparable standards of social and economic infrastructure is an essential precondition for the efficient resource allocation. Similarly, it is very important to emphasise that the method of raising revenues is as important if not more, as the amount of resources raised. The same amount of revenue can be raised through well organised and less distorting tax systems having a broader base, lower rate, less of rate differentials and avoiding input taxation. Introduction of destination principle Value Added Tax with proper border tax adjustments made, holds immense promise. At the same time, there is no place for the tax on inter-State trade, nor would any purpose be served by the States competing to give large tax incentives to industry. It is also necessary to harmonise the Union excise duty with the States' sales taxes. The Tax Reform Committee has made a package of recommendations to reform Central sales tax and abolish octroi, which should be considered.

In the ultimate analysis, the reform measures taken and their effectiveness will depend upon political feasibility. As the reforms, to be effective have to reduce the power of distributional coalitions, the process cannot be easy or smooth. It would, therefore, be ambitious to expect significant improvements in efficiency within a short period. Therefore, the expansion of the exports in the short and medium term would have to be achieved by promoting thrust areas where the country already has a comparative advantage rather than waiting for the general competetiveness to improve.

Table 1

Sales Tax Rates on Selected Commodities as on March, 1991

(per cent)

Commodities	Andhra Pradesh	Bihar	Gujarat	Haryana	Karna taka	Kerala	Madhya Pradesh	Maha-rashtra	Orissa	Punjab	Rajas-than	Tamil Nadu	Uttar Pradesh	West Bengal
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)	(15)
1. Cereals	4	4	E	4	2	4	2	E	4	4	4	E	4	1
2. Pulses	4	4	E	4	2	4	3	E	4	4	4	4	4	1
3. Hydrogenated vegetable oil	6	9	10	8	5(c)	6(c)	12	8	4	8	8	5	8	8
4. Other edible oils	4	2	4	6	4/3(c)	6(c)	3	4	2	8	6	E	5	8
5. Kerosene	4	6	3	3	4	4	3	4	E	8	10	4	8	5
6. Cooking gas	10	9	14	14	15(c)	15(c)	16	4	5	8	10	8	8	15
7. Cosmetics	10	12	12	10	15	15	16	15	16	8	12	12	12	15
8. Medicines	5	7	8	8	10	10	3	4/12	4	4	6	6	6	4
9. Stainless steel utensils	6(a)	8	6	3	7(a)	10	8	12	12	10	15	5	12	8/11
10. Wooden furnitures	5	12	12	8	8(c)	10(c)	14	8	16	10	12	8	12	8
11. Steel furnitures	10	13	12	10	15(c)	10(c)	14	15	16	10	15	8	12	15
12. Refrigerator/ air-conditioner	10	16	12	10	15	15	16	15	12/16	10	12	15	12	11/15
13. Domestic electrical appliances	10	12	15	10	12+3(b)	10	12	15	12	10	12	12/8	12	8/11/15
14. Motor cars	4	9	12	8/10	6	4	10	15	8	10	6	5	10	6
15. All kinds of machinery	6	9	6	8	13	8	12	10	16	10	10	10	5	8
16. Fertilizers	3	6	4	R	3	2	3	E	2	E	6	3/5	5	4
17. Cement	9	11	12	12	15(c)	10	12	10	12	7	16	12	10	8
18. Motor spirit	18	9	20	8	20	20	16	12	12	E	18	18	E	10
19. High speed diesel	12	14	18	E	20	20	18	10	16	E	16	16	E	12
20. General rate	6(a)	8(c)	8+4(b)	8	7(a)	5(a)	8	10	12	7	10	8	8(c)	8(a)

Note: (a) Multi-point levy
(b) Double point levy
(c) Single stage last-point
(d) E - Exempted
All other commodities are subject to first point single stage levy.

Source: Sales Tax System in India: A Profile, NIPFP, 1991.

Table 2

Shares of Population, Consumption and Central Sales Tax Collection in Major States

	Per cent of Population		Per cent of Total Consumption		Per cent of Central Sales Tax Collection	
	1977-78	1987-88	1977-78	1987-88	1977-78	1987-88
	(1)	(2)	(3)	(4)	(5)	(6)
I. More Developed States						
Maharashtra	9.8	9.9	11.6	11.5	23.8	22.8
Gujarat	5.3	5.3	5.6	5.6	10.7	11.4
Punjab	2.6	2.6	4.1	3.7	5.7	5.2
Haryana	2.0	2.1	2.5	2.6	5.8	7.1
Karnataka	5.8	5.7	5.5	5.6	6.4	7.0
Tamil Nadu	7.7	7.3	7.3	7.6	9.2	10.6
West Bengal	8.6	8.6	7.9	8.6	10.4	9.6
Total I	41.8	41.4	44.6	45.1	72.1	73.7
II. Less Developed States						
Andhra Pradesh	8.4	8.4	8.4	8.5	3.6	2.7
Bihar	10.9	11.0	8.9	8.9	5.0	7.9
Kerala	4.0	3.8	4.1	4.8	2.4	2.5
Madhya Pradesh	8.1	8.3	7.2	7.6	6.0	7.3
Orissa	4.2	4.0	3.1	3.2	3.6	0.4
Rajasthan	5.2	5.5	7.4	5.9	3.1	1.2
Uttar Pradesh	17.3	17.5	16.2	16.0	4.1	4.3
Total II	58.2	58.6	55.4	54.9	27.9	26.3
Total: All Major States	100.0	100.0	100.0	100.0	100.0	100.0

Source: 1. NSS Consumption Expenditure Survey, 32nd and 42nd Round.
2. Population projection from Registrar General (adjusted pro-rata to conform to financial years)
3. Budget Documents/Finance Accounts

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