1. Introduction

OCTROI, the tax on the entry of goods into a local area for consumption, use or sale therein, which forms the most important source of revenue for the urban local bodies in Gujarat, has been variously characterised as obnoxious, vexatious, wasteful and distorting. The tax falls as much on raw materials, intermediate goods and machinery as on final consumer goods. This causes cascading, multiple taxation and distortions in the cost structure. As the taxation of inputs affects the incidence on final goods in unintended ways, satisfying the norm of equity is rendered more difficult. The holding up of goods traffic at the octroi checkposts results in an additional production loss apart from the excess burden resulting from the changes in relative prices generally caused by selective commodity taxation. Even though substantial improvements in reducing the impediments to the smooth flow of goods traffic as claimed by the Municipal Corporations has been achieved, production losses resulting from hindrances to goods traffic is a striking feature in the case of Municipalities, particularly the smaller ones. Besides, assessment of the tax can only be perfunctory, on the basis of trust, as it is not possible to unload all the goods vehicles and check them before making the assessment,

Almost all the Commissions and Committees, that dealt with the issue of local finances, albeit some of them only remotely, were unanimous in equivocally recommending the abolition of the tax. But, in spite of the awareness of the desirability to abolish octroi, the levy continues to occupy a prominent place in the urban local finances in Gujarat. Moreover, the importance of octroi in the total revenues of Municipal Corporations and Municipalities in the State has shown a marked increase during the last decade. The yield from octroi which formed 40.4 per cent of total revenues in 1970-71 increased to 46.3 per cent in 1979-80, thus recording an increase of almost six percentage points.

The reason for the continuance of octroi, in spite of the general awareness of its undesirable effects, has to be found in the inability to find equally lucrative alternative sources of finance. The unilateral abolition of octroi without a viable alternative source of finance would only cripple the already unhealthy finances of the urban local bodies. As it is, the Zakaria Committee (1963) estimated that the local bodies' own revenues were sufficient to finance only about three-fourth of their expenditure needs in Gujarat. Similar estimates for a more recent year are not available, but given the fast-growing expenditure responsibilities of the urban local bodies, their fiscal situation, if anything, could only be worse.

It is therefore very important to find a viable alternative to octroi. The proposed alternative should not merely generate adequate revenue but also should not suffer from the various shortcomings of octroi, should not impinge on the financial autonomy of the local bodies and should not cause administrative complexities and harassment to the assessees.

The Gujarat Taxation Enquiry Commission went into the question of replacement of octroi with a more desirable alternative levy in detail. After carefully considering the various alternatives, the Commission came to the conclusion that replacement of octroi with an entry tax to be levied and collected by the State government would be the best solution. The entry tax is to be levied on all goods subject to sales tax, including the declared goods and goods subject to additional excise duties. The levy, like octroi, would have high rate and income elasticity and would not have the undesirable economic effects of octroi. The uniformity in the tax rates and administration, it is expected, would avoid the production distortions present when octroi is levied at different rates in different urban areas, an anomaly which alters the relative prices between different Municipal areas within the State. Further, the alternative would entail fewer horizontal inequalities and would render the rationalisation of the rate structure easier. The absence of hindrances to the smooth flow of goods traffic would prevent the production losses otherwise caused in a contrary situation. Besides being expected to reduce the cost of tax collection drastically, it could be designed to give set-off to essential inputs and also does not pose any insurmountable administrative problems. As in the Municipal Corporations in general, the growth of octroi would have been higher than what the compensation could provide for, the Commission felt that the Corporations could be allowed to levy a surcharge on the entry tax in respect of all taxable goods other than declared goods, essential inputs and machinery.

The Terms of Reference

However, the replacement of octroi with entry tax on scientific lines should be preceded by an indepth study estimating the proposed tax base, its likely buoyancy and designing a rational rate structure. With this in view, the Government of Gujarat entrusted a study to the National Institute of Public Finance and Policy with the following terms of reference:

(i) to estimate the elasticity of octroi in the past;

(ii) to quantify the potential tax base of the entry tax on the basis of trends and using other methods that may be appropriate; and

(iii) to determine the exact rate structure of the entry tax on various commodities such that revenue from the tax would adequately compensate the revenue loss arising from the abolition of octroi, keeping in view the economic effects of the tax.

The study is presented in three chapters. In Chapter 2, we analyse the structure of octroi and estimate the growth of revenue from octroi collected by the different Municipal Corporations and Municipalities in Gujarat. Chapter 3 sets out the principles of tax design in the context of urban local bodies, estimates the tax base of entry tax, suggests a suitable rate structure of entry tax that could be adopted in Gujarat and projects the rate of growth of the proposed tax.