I. Introduction

Background

The issue of "level playing-field" has been a topic of considerable attention in recent times. In the Union Budget Speech for 1998-99, the Finance Minister stated that, "I am persuaded about a clear disability that our commodity taxation inflicts on the indigenous goods *vis-à-vis* the imported goods. While the former are subjected to sales tax and other local taxes and levies, the import sector escapes them by their very nature. In order to provide a level playing-field to the domestic industry, I propose to impose an additional non-modvatable levy of 8 per cent which is approximately equal to the burden of local taxes on domestic producers." The proposed duty, ultimately fixed at 4 per cent, led to considerable debate. Furthermore, in the Budget 1999-2000, the Finance Minister has said: "Mr. Speaker, Sir, conceptually, I am averse to *zero* customs duty, since our domestic industry generally merits some minimal protection. I have reviewed the entire list of such commodities and to begin with I am proposing the imposition of 5 per cent rate of duty for some of these commodities. In order to mitigate the impact of the incidence of 5 per cent rate of duty on such items which have previously enjoyed exemption, I propose to exempt this category from the existing 4 per cent special additional duty."

Whether customs duty should be as low as *zero*, or whether domestic industry "merits some minimal protection" and how much that "minimal protection" should be are matters of debate. But, it is universally agreed that high customs duties have an anti-export bias, encourage inefficiencies and do not spur domestic industry to become world-class. Introduced in India originally for the purpose of protecting the nascent domestic industry, customs duties progressively came to be used as an important instrument of building an impregnable protective wall as well as raising revenue. The duties were supplemented by quantitative restrictions on imports. Starting with an average rate of only 7.5 per cent after World War I, customs tariffs continued to go up steadily, with the peak rate reaching as high as 300 per cent by the end of the 1980s. The rates were also widely dispersed among various commodities. Reduction of these

duties from very high levels and dismantling of quantitative restrictions to remove the distortions inherent in a highly protective regime has been an important component of the liberalisation programme launched since 1991-92. The peak rate of customs duty (CD) was brought down from 200 per cent in 1991 to 40 per cent in 1997-98, with a considerable narrowing of their spread. One of the crucial motivations behind the import liberalisation strategy has been the establishment of an appropriate degree of competitive equality between domestic and foreign producers so that protection to domestic producers does not go beyond a reasonable level.

The analysis of competitiveness of domestic versus international producers purely in terms of CD is valid only when the other duties paid by the two sets of producers are the same. In India, a highly complex domestic trade tax structure makes such an assumption highly dubious. Some of the imports escape certain domestic trade taxes while they apply to domestic purchases. Limitations suffered by domestic producers *vis-à-vis* their foreign counterparts, owing to asymmetric application of domestic trade taxes, may be more than neutralised by high customs tariffs.

The justification for positive discrimination in favour of domestic producers – often in terms of handicaps such as relatively high costs of power, transportation bottlenecks, higher interest rates and other financing costs – is controversial. But, there is no justification for reverse discrimination in favour of foreign producers, and when import tariffs are brought down to reasonable levels, the issue of competitive equality in the presence of distortionary domestic trade taxes requires a closer scrutiny. The aim of this study is to conduct such a scrutiny.

Scope of the study

To study the effect of domestic trade taxes, it is important to take account of the multiplicity of taxes levied at various levels of government and their rates on one hand, and specific exemptions and concessions, on the other. General exemptions and concessions are appropriately accounted for. End-use exemptions and concessions are accounted for, wherever feasible. Given the variation in the rates of general sales tax, surcharge, turnover tax and concessions across states, it was necessary to be selective in the coverage of states in the study. The study is focused on Maharashtra with

Mumbai, the most important port in India located in the state.[1] Also, only the major domestic trade taxes have been taken into account, with other taxes such as electricity duty, passengers and goods tax are not included in the scope of the study. The study is based on the tax structure relating to the year 1998-99. Some preliminary observations are made, wherever feasible, with reference to the changes introduced through the Union budget 1999-2000.

Basic approach

Two approaches have been followed to estimate the net tax advantage or disadvantage to the domestic producers from domestic trade taxes. The first basic approach is to estimate contribution of these taxes to the effective rates of protection (ERPs) of different commodities. The calculation of ERP for a commodity takes into account the tax on not only the output of the commodity, but also the inputs. The calculation requires information on the input-output matrix in the economy. The contribution of each domestic trade tax can thus, be estimated by estimating the ERPs for different commodities under selected tax regimes (R_i). For example, ERP under the regime, say R_1, of CD only, gives the degree of protection provided to different commodities through CD. ERP under a different regime, say R_2, of customs duties together with union excise duties (UED), can be taken as the degree of protection provided by these two taxes together. Therefore, the difference between the ERPs under R_2 and under R_1 can be taken as the effect of UED on protection to a particular industry. Estimation of ERP is attempted for 60 broad groups of commodities for which the input-output matrix is available.[2] In each commodity group, tax rates vary across commodities. Thus, an estimate for a commodity group gives the average ERP for the commodities included in the group.

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[1] Among Maharashtra, Tamil Nadu and West Bengal – the three states with Mumbai, Chennai and Calcutta as gateways to imports -- Maharashtra is the only State where an octroi is levied.

[2] The actual burden of taxes depends on the exact procedure followed in procuring inputs and disposal of output. Thus, ERP may differ across firms within an industry. This firm-wise variation, however, can only be revealed through case studies, which is beyond the scope of the present study.

A broad group of commodities may have a positive ERP. Yet, within the group, some commodities may suffer a negative degree of protection with this negative protection being more than overweighed by the positive protection to others within the group. Furthermore, within a broad group, tax treatment of specific commodities can vary widely. To get a sharper picture of the net effect of domestic trade taxes, it is necessary to focus on specific commodities rather than broad groups. Lack of information on input-output coefficients at specific commodity level does not allow calculation of ERPs at such a level of disaggregation. Nevertheless, the calculation of composite duty rates for import of a particular commodity and the corresponding domestic product can give a first approximation to the extent of tax advantage or disadvantage that domestic producers of that commodity have relative to their foreign counterparts. Calculation of composite duty rates for all commodities is not only a tedious task, but also somewhat, unnecessary. If the CD rate is relatively high, in spite of domestic trade taxes, domestic producers are likely to have a tax advantage over their foreign counterparts. The commodities subject to low CD can be expected to have a relatively high probability of a tax disadvantage for domestic producers *vis-à-vis* their foreign counterparts. Therefore, in the second approach, the composite duty rates have been calculated for selected commodities and compared across domestic and foreign suppliers.

Plan of the study

Salient features of the structures of domestic trade taxes are discussed in chapter 2. The methodology for estimating effective rates of protection and composite duty rates is outlined in chapter 3. Results are presented and discussed in chapter 4. Main findings and recommendations are given in chapter 5. Some details are contained in the Annexures.