# FISCAL OVERLAPPING, CONCURRENCY AND COMPETITION IN INDIAN FEDERALISM*

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## Abstract

In this paper we provide an overview and analysis of problems with, and reform efforts aimed at the different layers of the tax system in India. Overlapping in the commodity tax systems of the three levels of government in India has made the tax system non-transparent, and rendered the pursuit of the objectives of tax policy difficult. The incidence of taxes on commodities remains unknown and multiple taxation of commodities by different levels of government creates broad wedges between producer and consumer prices. Tax sharing arrangements between the center and states have created incentive problems for tax collection. At the state level, tax competition without appropriate constraints or coordination imposed by the center has led to a multitude of tax rates, "races to the bottom", inter-state tax exportation, and inter-state trade barriers. Reform efforts and proposals have focused both on improving the current system and on more comprehensive overhauls. In our analysis, we demonstrate the importance of examining the redistributive impacts across states of suggested major reassignments of tax powers. These must be carefully understood, in addition to impacts across the center and the states as a whole. We provide specific suggestions concerning the reform of state-level trade and consumption taxes in India, and for steps to follow in introducing a broad-based VAT in India.

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Overlapping fiscal powers and functions are features seen in all multilevel governmental systems. This is because fiscal overlapping is an inevitable consequence of intergovernmental competition. Although the efficient delivery of public services is, to a large extent, determined by the distribution of tax and expenditure powers, the assignment system itself is an outcome of intergovernmental (vertical) and inter-jurisdictional (horizontal) competition. Therefore, even under the most judicious and efficient assignment system, fiscal overlapping is unavoidable.

Nor is vertical and horizontal overlapping in tax and expenditure powers necessarily undesirable. Like competition between different firms in an industry, "entrepreneurial" competition between different levels of government and between different jurisdictions within the same level of government can enhance efficiency in the delivery of public services. As discussed in Rao and Singh (1998), comparative advantage in raising revenues and delivering public services will determine the equilibrium assignment. A constitutional assignment at variance with the competitive advantage poses a constraint on efficient delivery of public services and the establishment of comparative advantage in delivering services by different governmental units requires the exercise of concurrent powers.

However, not all competition is socially beneficial and often, it can be wasteful. An important precondition for benign intergovernmental competition, however, is that there should be a mechanism to resolve competitive instability. In order to bring about stability in competition, it is necessary to formulate rules to prevent predatory pricing of public services, exportation of tax burdens to non-residents, spillovers of negative externalities across jurisdictions, erection of trade barriers, and a "race to the bottom" to attract trade and investment into a jurisdiction at the cost of others. Competitive stability can not be achieved through cooperation, which only suppresses competition. What is needed is the establishment of an effective mechanism to monitor the competition[1]. This implies that no governmental unit should be in a position to exploit others and if it does, there should be an effective mechanism to counter it. Exploitation can be minimized when there is "competitive equality" or equality of the power of the competing entities. It is also important to see that no jurisdiction is able to "free-ride" on others or provide public services to its residents by passing on the burden of financing them to non-residents.

Thus, concurrency and competition, under certain circumstances can be unstable resulting in exploitation and disharmony and consequently, inefficiency and inequity in the delivery of public services[2.] In order to ensure that the competition is beneficent, it is important to

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1 For details, see, Breton (1996) pp.240-262.

2 According to Oates (1972, p.145), fiscal disharmony enhances excess burden and yields undesirable pattern of incidence.

understand the sources of instability. The objective of this paper is to analyze for the case of Indian federalism the sources of disharmony and instability in the delivery of public services and in raising revenues to finance them vertically between different levels of government and horizontally between different jurisdictions, and to suggest ways to resolve the disharmony and restore stability to intergovernmental competition.

The plan of the paper is as follows. In section I, we discuss some of the key issues that arise in considering vertical fiscal disharmony, in terms of overlapping or conflicting authority of different levels of government. In section II, we consider the specific problem of vertical tax overlapping, across center and states in India in more detail. The major issues include tax assignment conflicts and problems with tax sharing arrangements. Section III looks at the problems of horizontal tax disharmony, across the states themselves, including divergences in rates, inter-state tax-exportation, and internal barriers to trade. Sections IV and V examine different measures taken and proposals being considered for reform of trade and consumption taxes, including issues concerning the introduction of a value added tax (VAT) system for India. Section VI is a summary conclusion.

## I Vertical Fiscal Disharmony: Major Issues

In all governmental systems, no matter how carefully the assignments are worked out disharmony in the functioning of vertical intergovernmental units is inevitable. This is because, constitutional assignments are determined not by economic considerations alone, but also by a number of historical, political and cultural factors besides. Besides, even when economic factors are considered, this has been driven by the eagerness to forge cooperation and suppress competition rather than by activating stable intergovernmental competition[3]. In some cases, measures to have harmonized systems to appease industry and businesses, result in suppression of intergovernmental competition altogether. Such an harmonized tax system has a cost in terms of less efficient delivery of public services[4]. Finally, in a hierarchically ordered governmental system, unless there are constitutional safeguards and effective monitoring mechanisms, higher level governments can suppress competition among subordinate governments by appropriating the powers to themselves through various means.

In the Indian context, vertical disharmony between the center and the states in fiscal and regulatory functions arises for a variety of reasons. To some extent, this conflict has its source in the centripetal bias implicit in the constitutional arrangement itself, but the more important cause has to be found in the overlapping and interdependent nature of fiscal operations. Formally, there is a large area of common functions included in the concurrent list in which the center can constrain and influence the states' functioning, and the states' actions can in turn influence the central provision of goods and services.

Even when the center and states undertake the functions exclusively assigned to them, overlapping can not be avoided. The execution of stabilization and distribution functions by the

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3 The center taking over tax powers to avoid disharmony in sub-national tax systems or persuading sub-national governments to have uniformity in their tax systems are cases in point.

4 The Australian system of assignment is a case in point.

center can be nullified by the state governments operating in opposite directions[5]. Besides, the instruments of fiscal policy employed in the course of executing stabilization and redistribution functions have their impact on states' budgets. For instance, expansionary fiscal operations financed by large deficits can create an inflationary environment. In addition, if ever-expanding expenditures on wages and salaries, interest payments, subsidies and other transfers crowd out capital and maintenance expenditures. Crowding out of expenditures on social and physical infrastructures can cause supply bottlenecks to create a stagflationary situation (Rao and Sen, 1993, 1994). This constrains the ability of the states to raise revenues and at the same time inflates their expenditures, forcing them to cut down their own spending on social and economic infrastructures.

In a system where many prices are determined by administrative fiat rather than by market forces, and where the public sector controls a significant proportion of production and distribution activities, effectiveness in the delivery of public services at each level of government will be affected by policy changes at other levels. Thus changes in administered prices or, conversely, their rigidities at the center affect the ability to provide public services at state and local governments and vice versa. Policies on interest rates and lending to the states affects the states' ability to finance infrastructure and debt servicing.

An important way in which the central policies affect the state and *vice versa* is through the "diffusion" process. A successful (or populist) measure in one level of government or jurisdiction can get diffused into the policy arsenal of another (Breton, 1996, p. 235-37). A classic case of this diffusion mechanism in India is seen in the pressure for revising the pay scales of the state government employees as a consequence of the center's implementation of pay revisions. The extension of social security measures and a mid-day meal scheme to school-going children at the central level, which was initially implemented in some states, illustrates diffusion in the other direction.

The policies and programs of the state governments affect efficiency in the delivery of public services by the center, just as central policies affect states' public service delivery. The perception that the states are unable to competently discharge the functions assigned to them has led the central government to bring a number of subjects which were initially in the state list into the concurrent list and influence states' expenditure decisions by using states as agencies executing centrally designed and financed programs, and through shared-cost programs. The expansion of central government in several activities like population control and family planning, forests, education, trade, and commerce and agriculture illustrates this phenomenon. These items were originally placed in the state list but were brought into the concurrent list through constitutional amendments. Similarly, the central government has significantly expanded its involvement in agriculture, rural development, education and health sectors though these were originally conceived as subjects legitimately belonging to the states (Gulati and George, 1985).

The central "intrusion" in allocational decisions on subjects falling in the state list has also taken the form of introducing several "central sector" and "centrally sponsored" schemes.

5 The "fiscal perversity" hypothesis of Hansen and Perloff (1944) suggests that the fiscal activities of the state and local governments would accentuate rather than dampen fluctuations in the level of economic activity.

Through the central sector schemes, the central government spends the moneys using the states essentially as spending agencies. The centrally sponsored schemes are in the nature of shared cost programs or specific purpose transfer schemes wherein the center influences states' allocation on the aided functions by making matching contributions. There were as many as 262 centrally sponsored schemes a decade ago, accounting for about 10 per cent of states' expenditures. The share of these schemes in states' expenditures has increased steadily to about 15 per cent in 1995-96, though the number of schemes have declined to 179[6].

Another area of overlapping jurisdictions is in borrowing. With revenue receipts unable to meet growing current expenditure commitments, the states have been increasingly utilizing borrowed funds to meet current budgetary deficits. Besides, low financial returns from past investments have not helped to improve buoyancy in revenues. Alignment of the interest rates on states' borrowing with market interest rates in recent years only compounded states' difficulties in debt-servicing and necessitated periodic rescheduling and write off of states' borrowings which, in effect, meant transferring the burden from the state taxpayers to the national taxpayers. This periodic adjustment in states' borrowings itself has had its adverse effects on fiscal management of the states.

Vertical tax overlapping too has serious allocative implications. First, there are problems arising from the uncoordinated levy of consumption taxes at central, state and local levels. Levy of taxes on the same base by different levels of government also raises the question of efficient means to pursue macroeconomic policies and the method of coordinating their tasks so that action by one level of government does not nullify that of the other. Further, it is also suggested that sharing of certain taxes adversely affects incentives for the collecting government, causing distortions in the structure of indirect taxes. We consider vertical tax overlapping next, in more detail.

## II Vertical Tax Overlapping in India

The constitutional assignment of taxes in India follows the principle of separation. However, the interdependence of tax bases makes it impossible to separate the tax bases of the center and the states in a *de facto* sense. This has not helped to evolve a coordinated development of domestic trade taxes. According to the constitutional assignment, the central government can levy taxes only at the manufacturing stage while the states can levy sales taxes. Although attempts have been made to reduce the ills effects by crediting the tax paid on inputs in the case of excise duties and concessional taxation of inputs in the case of sales taxes, the approach is unsystematic, procedures involved in availing them cumbersome and the scope of these concessions limited (NIPFP, 1994). Besides, as the base of the domestic consumption tax is narrow (because excise duties are levied at the production stage, sales taxes are predominantly at the first point of sale and services are not included in the tax base) and this requires higher tax rates for the same amount of revenue.

Overlapping in the commodity tax systems of the three levels of government in India has

6 The Planning Commission has proposed to transfer 115 of these schemes to the states in the near future

created serious vertical disharmony. The levy of union excise duties by the center, sales taxes by the states and octroi or entry tax by local bodies has made the tax system non-transparent and rendered the pursuit of the objectives of tax policy difficult. In such a tax system, the incidence of taxes on commodities remains unknown and multiple taxation of commodities by different levels of government creates a broader wedge between producer and consumer prices. This is particularly true as the center levies the tax at the manufacturing stage and the states levy the sales taxes predominantly at the first point of sale - on the excise duty-paid value. In respect of commodities which have a high price elasticity of demand, the levy of commodity taxes at high rates by higher levels of government leaves very little tax room for lower levels of government. The problem is further compounded by cascading due to the levy of sales taxes at the first point of sale, taxation of inputs and capital goods. Given that sales taxes also have anti-protective effect, it would be difficult even to hazard a guess on the effect of such a tax system on the effective rate of protection on various commodities. While, in the past, producers sheltered from both foreign and domestic competition could pass on the burden to consumers, this may not be sustainable as the import of consumer goods is liberalized.

Another problem of assignment is the adverse incentives on the center's tax effort created by the tax sharing arrangements. As mentioned earlier, the constitution provides for center's sharing of the proceeds from personal income tax and union excise duty with the states. The distribution between the center and the states and the shares of individual states are determined by the Finance Commission appointed by the President of India every five years.

The states have, by and large, preferred tax sharing to grants, because tax shares fixed in percentage terms have an inherent buoyancy and therefore, to a large extent, are hedged against inflation. In contrast, unless indexed, the grants recommended once in five years can significantly erode in value at the end of the recommendation period, particularly when the inflation rate is high. Partly in deference to the states' wishes and partly in response to the widespread criticism of the "gap-filling" approach adopted by them, successive Finance Commissions increased the states' shares of income tax and excise duty. The eighth and the ninth Finance Commissions covering the last ten years recommended that 85 per cent of net collections of personal income tax and 45 per cent of union excise duty should be transferred to the states and the Tenth Commission increased the states' percentage share of income tax and excise duty further to 87.5 and 47.5 respectively.

It has been suggested that the increase in the states' shares of devolved taxes has considerably reduced center's incentive to raise more revenues from these taxes, and this has impacted in distorting the tax structure (Burgess and Stern, 1993). Thus, customs duty which ought to have been primarily used as a protective instrument has been used mainly as a revenue instrument. In the event, its share in total central tax revenue increased from 16 per cent in 1970-71 to 36 per cent in 1990-91 and declined marginally thereafter to 32 per cent in 1996-97 (Table 1). It is also seen that the share of personal income tax in the center's tax revenue declined from 15 per cent in 1970-71 to less than 10 per cent in 1990-91 and gradually increased thereafter to 13.7 per cent in 1996-97. The tax sharing arrangement has also led to the preference for increasing administered prices of public monopolies instead of revising union excise duties by the center. This can create serious resource distortions by altering relative prices and effective protection rates of different commodities in unintended ways.

The changes in the composition of central taxes provide some evidence, albeit casual, of the disincentives and distortions caused by tax sharing arrangements. However, this can only be a hypothesis which needs to be rigorously tested to arrive at definite conclusions. However, whether or not the devolution system has in fact distorted the tax system in India, its perverse incentive to the center is unmistakable. Therefore, the tenth Finance Commission recommended an alternative scheme of devolution by pooling revenue all central taxes and giving a fixed share to the states and the government is in the process of implementing this recommendation.

**Table 1**

**Tax Revenue of the Central Government by Sources**

| Tax | 1970-71 | 1980-81 | 1990-91 | 1991-92 | 1992-93 | 1993-94 | 1994-95 | 1995-96 (R.E) |
|---|---|---|---|---|---|---|---|---|
| Percentage of Tax Revenue to Total Tax Revenue | | | | | | | | |
| Direct Taxes | 27.0 | 23.0 | 19.0 | 22.6 | 24.1 | 26.5 | 29.0 | 29.3 |
| Personal Income Tax | 15.0 | 11.0 | 9.3 | 10.0 | 10.6 | 12.0 | 13.0 | 13.7 |
| Corporation Tax | 12.0 | 10.0 | 9.3 | 11.7 | 11.9 | 13.3 | 15.0 | 14.7 |
| Others | n | 2.0 | 1.4 | 0.9 | 1.6 | 1.2 | 1.0 | 0.9 |
| Indirect Taxes | 73.0 | 77.0 | 81.0 | 77.4 | 75.9 | 73.5 | 71.0 | 70.7 |
| Customs | 16.0 | 26.0 | 35.9 | 33.0 | 31.9 | 29.3 | 29.0 | 32.0 |
| Excise | 55.0 | 49.0 | 42.6 | 41.7 | 41.3 | 41.9 | 40.5 | 37.2 |
| Others | 2.0 | 2.0 | 2.5 | 2.7 | 2.7 | 2.3 | 1.5 | 1.5 |
| Total | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |
| Percentage of Tax revenue to Gross Domestic Product (market prices) | | | | | | | | |
| Direct Taxes | 2.3 | 2.2 | 2.0 | 2.5 | 2.6 | 2.5 | 2.8 | 3.0 |
| Personal Income Tax | 1.2 | 1.1 | 1.0 | 1.1 | 1.1 | 1.1 | 1.3 | 1.4 |
| Corporation Tax | 1.0 | 1.0 | 1.0 | 1.3 | 1.3 | 1.3 | 1.5 | 1.5 |
| Others | 0.1 | 0.1 | n | 0.1 | 0.2 | 0.1 | n | 0.1 |
| Indirect Taxes | 6.1 | 7.5 | 8.7 | 8.5 | 8.1 | 6.9 | 6.9 | 7.2 |
| Customs | 1.5 | 2.5 | 3.9 | 3.6 | 3.4 | 2.8 | 2.8 | 3.3 |
| Excise | 4.5 | 4.8 | 4.6 | 4.6 | 4.4 | 4.0 | 4.0 | 3.8 |
| Others | 0.1 | 0.2 | 0.2 | 0.3 | 0.3 | 0.1 | 0.1 | 0.1 |
| Total | 7.4 | 9.7 | 10.8 | 10.9 | 9.4 | 9.8 | 9.8 | 10.2 |

R.E- Revised Estimates; B.E- Budget Estimates
n= negligible.

While the new arrangement is definitely better than the prevailing system, the problem of disincentives is not entirely eliminated. The center can retain only 71 per cent of the taxes collected by it. While the new arrangement does not change the incentives in favor of any particular tax, the center still has the incentive to raise non-tax revenues as against tax revenues, and raise administered prices of public monopolies instead of raising excise duties.

## III Inter-State Tax Disharmony in India

In this section, we analyze the salient features of the states' tax systems in India and identify the sources of instability in states' tax systems causing inter-state tax disharmony. The analysis shows that instability and disharmony in the states' tax systems are mainly caused by "beggar-thy neighbor" policies followed by the states to attract trade and industry, "free-rider" behavior by levying "origin" based consumption taxes and exporting the tax burden and erection of trade barriers through fiscal instruments. The analysis helps to highlight inefficiencies and inequities caused by the strategic behavior of the states.

### IIIa State taxes in India - salient features

States play an important role in raising tax revenues in Indian federalism and therefore, structure and operation of their tax systems have a significant impact on economic efficiency and equity. Together, states raise almost 35 per cent of total tax revenues. As a ratio of the SDP, revenue from state taxes increased steadily from about 6 per cent in the mid-1970s to almost 8.5 per cent in the 1990-91 and thereafter, declined marginally to 8 per cent in 1994-95 (Table 2). Even though the ability of the states to finance expenditures from their own taxes has shown a steady erosion over the years, they still finance over 40 per cent of their current expenditures. It is also seen that there are wide inter-state variations in the level of taxes raised, and in the ability and effort in raising revenues to finance expenditures and these variations have increased steadily over time as indicated by the rising coefficient of variation (standard deviation divided by mean).

**Table 2**

**Importance of States' Tax Revenue**

| Year | Share of states' Own Tax Revenue in state Domestic Product (SDP) | | Share of states' Tax Revenue in states' Current Expenditure | |
|---|---|---|---|---|
| | Mean | Coefficient of variation | Mean | Coefficient of variation |
| 1975-76 | 6.3 | 19.7 | 53.5 | 20.8 |
| 1980-81 | 6.9 | 23.5 | 47.9 | 25.9 |
| 1985-86 | 8.2 | 26.8 | 47.8 | 24.6 |
| 1990-91 | 8.5 | 26.9 | 45.3 | 27.7 |
| 1993-94 | 8.0 | 30.4 | 41.6 | 30.6 |

**Note** Estimates relate to 14 major states and they constitute 93 per cent of total population. The hill states of the north-east and the small state of Goa are not included in the analysis.

**Sources:** 1. Budget documents of the state governments
2. Central Statistical Organisation, Ministry of Planning, Government of India

As in the case of the central government, political economy considerations have dominated the evolution of state tax systems. The importance of landed interests has constrained the states from raise direct taxes on land and agricultural incomes and this has resulted in the

predominance of indirect taxes. The revenue from indirect taxes has shown a steady increase from about 85 per cent of states' tax revenues in the 1950s to almost 97 per cent in 1994-95 (Table 3 and Figure 1), with the sales tax alone contributing almost 53 per cent to total tax revenues. The pattern is broadly similar across states with the share of sales tax varying from 44 per cent in Punjab to over 70 per cent in Bihar. The other major state taxes are state excise duties on alcoholic beverages (15 per cent) and stamp duties and registration fees (8.5 per cent).

Given that revenue from sales taxes predominates in the states' fiscal operations, the structure and operation of sales taxes have an important bearing on allocative efficiency and equity in the economy. Inter-state competition in levying consumption taxes introduces additional issues having implications not only on allocative efficiency and equity but on the very stability of the competition itself.

Whether inter-state competition in taxation leads to inefficient resource allocation or it is a beneficent force is a controversial issue. Break (1967, pp.23-24) almost three decades ago argued, "....Active tax competition.....tends to produce either a generally low level of state-local tax effort or a state-local tax structure with strong regressive features." More recently, Rivlin (1992) has argued for the replacement of state taxes with tax sharing arrangements to avoid disruptive inter-state competition. In contrast, Oates and Schwab (1988) show in a formal model of inter-jurisdictional competition in which states provide two public goods - one local consumption good and another public input which enhances the productivity of capital-and finance the public goods through benefit taxes, there is a Pareto efficient outcome. However, if the states are constrained to deviate from the basic assumptions of the model and levy non-benefit taxes, particularly taxes on capital, state taxes can be a source of allocative distortions. Another critical assumption is, like in the case of atomistic competition, that states are assumed to be

**Table 3**

**Composition of State Taxes**

| Taxes | 1975-76 | 1980-81 | 1985-86 | 1990-91 | 1994-95 |
|---|---|---|---|---|---|
| A. Direct Taxes on Land and Incomes | 8.0 | 4.1 | 4.3 | 4.1 | 3.2 |
| B. Indirect Taxes, of which: | 92.0 | 95.9 | 95.7 | 95.9 | 96.8 |
| B.1. Sales Tax | 51.0 | 55.5 | 55.3 | 54.7 | 52.6 |
| B.1.Stamp duties and Registration fees | 6.1 | 6.4 | 5.9 | 6.9 | 8.5 |
| state Excise Duty | 12.4 | 12.6 | 14.2 | 15.9 | 14.0 |
| Others | 34.9 | 21.8 | 19.6 | 18.4 | 21.7 |
| Total state taxes | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |

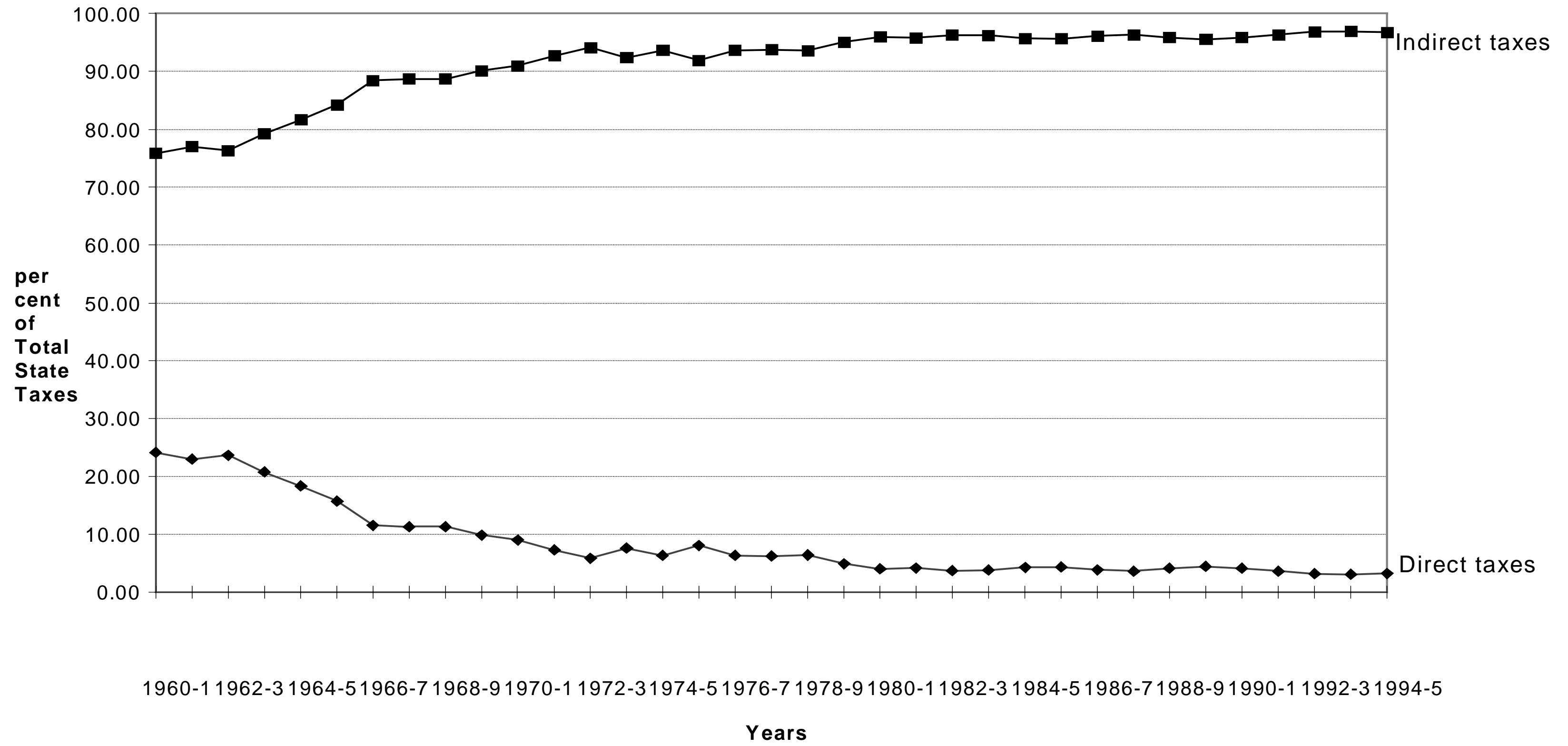
Figure 1
Share of Direct and Indirect Taxes in States' Tax Revenue
100.00
90.00
80.00
70.00
60.00
50.00
40.00
30.00
20.00
10.00
0.00
per cent of Total State Taxes
Indirect taxes
Direct taxes
1960-1 1962-3 1964-5 1966-7 1968-9 1970-1 1972-3 1974-5 1976-7 1978-9 1980-1 1982-3 1984-5 1986-7 1988-9 1990-1 1992-3 1994-5
Years

"small", essentially "price-takers. Finally, as in standard neo-classical models, Oates and Schwab assume benevolent decision making. If, the elected state officials have their own objective function, contrary to that of the citizens, the tax system could be distorted. Thus, it would seem that inter-state tax competition may produce beneficial results only when there is an effective monitoring mechanism to ensure that competition is stable (Breton, 1996).

The analysis of inter-state competition in India shows that there are indeed sources of instability which can result in distortions and inequity. Specifically, Indian experience shows that inter-state competition can result in serious inefficiency in the state tax systems. This can result from the competition causing (i) divergence in tax rates, an irrational tax system and tax competition leading to trade diversion; (ii) attempts at "free-riding" resulting in significant inter-state tax exportation; and (iii) erection of trade barriers. These issues are next analyzed in more detail[7].

### (i) Divergence in sales tax rates and tax competition

A major consequence of sales tax competition is the minute differentiation in tax rates. Although originally, differentiation was introduced for equity or efficiency (lower tax rates on inputs and capital goods) reasons, inter-state competition has contributed to this outcome in no small measure. Attempts to divert trade have led to reductions in tax rates on commodities with high price elasticities of demand and increase in rates on price inelastic commodities which are predominantly exported out of a state. Thus, there are quite a few instances where motor cars and consumer electronics are taxed at the same or lower rates than foodgrains and edible oils controverting the very objective of equity for which rate differentiation was introduced in the first place.[8]

The anomalies in the sales tax systems and contribution of inter-state competition to its irrationality have been brought out clearly in the NIPFP (1994) study. Foodgrains, for example, are exempt in approximately half the number of states and taxed at 4 per cent in others - particularly the food surplus states[9]. Edible oil is taxed at 1.5 per cent in Maharashtra and 9 per cent in Bihar. Bicycles are taxed at 2 per cent in Andhra Pradesh, but at 8 per cent in Haryana and Madhya Pradesh. Such competition naturally led to significant inter-state rate differences, besides leading to the evolution of irrational rate structures. In 1994-95, the rate of tax on motor cars was the same as that on bicycles in Kerala and Rajasthan, but was lower in Gujarat, Punjab and Uttar Pradesh. Medicines are taxed at rates higher than on motor cars in 8 out of 14 major states. Competition to attract trade in electronic goods has led to significant reductions in the rates of tax on these goods - often much lower than on items usually considered as necessities[10].

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7 For detailed analysis of the sales tax systems in different states and its adverse efficiency and equity consequences, see, NIPFP (1994).

[8]In Punjab, for example, the tax rate on motor cars is 3.5 per cent whereas foodgrains are taxed at 4 per cent and edible oils at 8 per cent. Of course, the equity objective in the design of tax rates itself has been taken account of on the basis of judgments about the income elasticity of demand for various commodities without considering the general equilibrium effects of such a tax design.

[9]The states can not levy inter-state sales tax higher than the local tax rate. Therefore, foodgrain surplus states have to levy a local tax at 4 per cent, if they wish to levy inter-state sales tax at the maximum permissible rate.

[10]For detailed analysis of irrational rate differences, see, NIPFP (1994, 1995).

This kind of competition has also been a source of inter-state differences in effective tax rates(tax revenue divided by the tax base). First, as mentioned above, there are significant inter-state differences in the list of exempted commodities and nominal tax rates. Second, there are notable inter-state differences in sales tax systems. Administrative considerations and attempts to conceal the tax burden (fiscal illusion) has led to levy of the tax at the first point of sale (this is also more acceptable to traders), and in some cases at multiple stages of sale transactions. In addition, for revenue reasons, most states levy an additional sales tax or a surcharge on sales tax over and above the general rates on sales tax for dealers above a specified turnover limit. Third, there are significant differences in the standards of tax administration and enforcement across states. Another source of variation in effective rates of tax is the inter-state competition in providing sales tax concessions to attract new investments. These have not only narrowed the tax base, but also have caused minute rate differentiation and distorted the relative prices across both commodities and regions[11].

**(ii) "Free-riding" and inter-state tax exportation**

Another worrisome consequence of competition is the attempts by the states to pass the tax burden to non-residents. As already mentioned, the states levy predominantly origin based sales taxes at the first point of sale. They also levy taxes on raw materials, intermediate inputs, and capital goods. In addition, inter-state sale is also taxed subject to the ceiling rate of 4 per cent[12]. In an economy where there is only a limited internal and external competition the tax is fully shifted forward, input taxes cascade on to inter-state sales tax and consequently, effective tax rate on inter-state sales would be much higher than the four per cent nominally levied. When the exports of more developed states are larger than their imports, and the proportion of final goods in their exports too is higher as in the Indian case (Rao and Sen, 1996), the residents of poorer states end up paying taxes on larger volumes of imports and at higher effective tax rates.

The extent of inequitable inter-state resource transfers due to the prevailing tax system comes out clearly when we compare the actual share of each state in sales tax collections with the share that would accrue when the tax is levied according to the destination principle. To arrive at an estimate of tax collections under the destination-type consumption tax, we have quantified the tax base consisting of the total value of consumption in each of the states consisting of household consumption and the state government's purchase of goods and services[13].

The estimates shown in table 4 bring out the difference in the sales tax shares of the states from their consumption shares. When the effective tax rates (ETR) are uniform across states, sales tax collections under the destination based consumption tax would be lower by 9.4 per cent of total sales tax collections in high income states, and by 6.4 per cent in middle income states, but higher by 16.8 per cent in the low income states. On an average, the destination based tax

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[11]For analysis of cost and efficacy of sales tax incentives, see Tulasidhar and Rao (1986).

[12]The ceiling rate is applicable only when the transaction takes place between the registered dealers. If the sale is from a registered dealer, in the exporting state to a non-registered dealer in the importing state the ceiling rate applicable is 10 per cent.

[13]This still leaves out central government consumption of goods in various states. As the bulk of this accrues in the Union Territory of Delhi, the non-inclusion of this would not significantly affect the relative shares. In any case, information on the state-wise purchase of goods by the Central government is not available.

would have reduced the tax revenue of the high and middle income states by about 22 per cent and would have increased the collection of low income states by a similar amount if the entire difference in effective tax rates is attributed to inter-state tax exportation. (Inter-state tax exportation based on alternative assumptions are presented in the table). Of the seven above average income states, all except Punjab and West Bengal were net tax exporters and among low income states, except Kerala, all were net tax importers. Under the assumption that the difference in effective tax rates is entirely due to inter-state tax exportation, the extent of exportation as a percentage of their actual tax collections was the highest in Tamil Nadu (about 34 per cent); in contrast, the residents of Rajasthan paid almost 18 per cent of the taxes to other states.

One possible reason for the variations in states' actual tax shares from consumption shares is the differences in the effective tax rates. If the effective tax rates in poorer states are lower than those in the richer states, it is possible that tax shares of the poorer states would be lower than their consumption shares. However, the variations in the actual tax shares seen in column 7 of Table 4 are possible even when there is no inter-state tax exportation only if there are large and unrealistic variations in effective tax rates from about 4 per cent in Bihar and Rajasthan to 16.8 per cent in Tamil Nadu (column 8). Thus, even if effective tax rates among the states vary to some extent, the evidence indicates the existence of tax exportation from the richer to the poorer states.[14] Notably, these estimates are only approximations, but nevertheless, they bring out the inequitable nature of inter-state resource flows due to tax exportation.

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[14]This is given by the elasticity of effective tax (t) rates with respect to per capita incomes (y) which is estimated by the regression equation, $\log t = -5.9124+0.973 \log y$. The elasticity of 0.97 while close to unity is actually an overestimate as we are really trying to estimate the elasticity of ETR with respect to home consumption, while the t here is based on tax collection inclusive of tax exportation and on home consumption alone. Thus, the figures for t are themselves overestimates.

## Table 4

### Inter-State Tax Exportation - 1993-94

| | Household Consump-tion | State Govt Consump-tion of Goods | Total Consumpti on | Per Cent of Total Consump-tion | Sales Tax Collections | Per cent of Total Sales Tax | Effective Tax Rate | Difference Between Consump-tion Shares and tax Shares | Per Capita Tax Exported at 25% of difference Rs. | Per Capita Tax Exported at 50% of Difference | Per Capita Tax Exported at 100% of Difference |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 | 11 | 12 |
| Gujarat | 18470.1 | 475.2 | 18945.4 | 5.8 | 2771.0 | 9.9 | 14.6 | 4.2 | 6.8 | 13.7 | 27.3 |
| Haryana | 8562.4 | 208.6 | 8770.9 | 2.7 | 768.5 | 2.8 | 8.8 | 0.1 | 0.4 | 0.7 | 1.4 |
| Maharashtra | 37775.3 | 770.7 | 38546.0 | 11.7 | 4740.8 | 17.0 | 12.3 | 5.3 | 4.4 | 8.9 | 17.7 |
| Punjab | 11617.6 | 295.7 | 11913.3 | 3.6 | 961.2 | 3.4 | 8.1 | -0.2 | -0.6 | -1.2 | -2.4 |
| **High Income States** | **76425.4** | **1750.2** | **78175.6** | **23.8** | **9241.5** | **33.2** | **11.8** | **9.4** | **4.0** | **8.0** | **15.9** |
| Andhra Pradesh | 27198.2 | 687.1 | 27885.3 | 8.5 | 2323.9 | 8.3 | 8.3 | -0.1 | -0.1 | -0.3 | -0.6 |
| Karnataka | 17876.8 | 175.7 | 18052.5 | 5.5 | 2277.9 | 8.2 | 12.6 | 2.7 | 4.0 | 8.1 | 16.1 |
| Kerala | 15161.4 | 310.3 | 15471.7 | 4.7 | 1533.2 | 5.5 | 9.9 | 0.8 | 1.9 | 3.7 | 7.4 |
| Tamil Nadu | 18380.8 | 706.2 | 19087.0 | 5.8 | 3210.0 | 11.5 | 16.8 | 5.7 | 8.6 | 17.2 | 34.4 |
| West Bengal | 29138.0 | 837.3 | 29975.3 | 9.1 | 1813.1 | 6.5 | 6.0 | -2.6 | -2.5 | -5.1 | -10.1 |
| **Middle Income States** | **107755.2** | **2716.6** | **110471.8** | **33.6** | **11158.1** | **40.0** | **10.1** | **6.4** | **1.7** | **3.4** | **6.8** |
| Bihar | 26044.3 | 322.1 | 26366.4 | 8.0 | 1137.5 | 4.1 | 4.3 | -3.9 | -3.0 | -6.1 | -12.1 |
| Madhya Pradesh | 24634.9 | 587.6 | 25222.5 | 7.7 | 1214.1 | 4.4 | 4.8 | -3.3 | -3.3 | -6.6 | -13.2 |
| Orissa | 9754.6 | 309.6 | 10064.2 | 3.1 | 514.3 | 1.8 | 5.1 | -1.2 | -2.6 | -5.2 | -10.4 |
| Rajasthan | 24630.2 | 330.0 | 24960.2 | 7.6 | 1058.1 | 3.8 | 4.2 | -3.8 | -4.7 | -9.3 | -18.7 |
| Uttar Pradesh | 52705.7 | 645.2 | 53350.8 | 16.2 | 3552.6 | 12.7 | 6.7 | -3.5 | -1.7 | -3.3 | -6.7 |
| **Low Income States** | **137769.7** | **2194.5** | **139964.2** | **42.6** | **7476.6** | **26.8** | **5.3** | **-15.8** | **-2.8** | **-5.5** | **-11.1** |
| **All Major States** | **321950.3** | **6661.2** | **328611.6** | **100.0** | **27876.2** | **100.0** | **8.5** | **0.0** | **0.0** | **0.0** | **0.0** |

### (iii) Sub-national tax system and impediments to internal trade

A major advantage of a federal system over independent or separate entities is the availability of a larger common market. The common market enables the producers to reap scale economies and achieve cost-efficient production of goods and services. However, this is possible only when there are no impediments to free trade and movement of factors of production and goods and services throughout the federation and inter-state competition works towards trade creation rather than diversion. When a certain minimum level of social and economic infrastructure is provided across the federation free mobility of capital and labor tends to equalize marginal productivities in different regions resulting in an efficient allocation of resources. Inter-jurisdictional competition among different states in providing varying public expenditure-tax mixes to attract capital could provide a conducive environment for innovations. Thus, fiscal federalism helps not only in ensuring efficient utilization of resources (operating on the production possibilities frontier) but also in technological progress (shift in the frontiers) to result in higher economic growth as compared to a balkanized economy.

On the other hand, impediments to free trade and movement of factors and products can seriously misallocate resources. Each state would be interested in preventing the outflow of capital from and inflow of labor to its jurisdiction, but such self-interest of regions would not be in the interest of the country as a whole. Similarly, there would be attempts to regulate the free movement of commodities across the states or local bodies. In a scarcity hit economy, regulatory impediments are placed to prevent speculation and profiteering and to ensure fair distribution of the commodity across regions and persons at a reasonable price (rationing). Though this has adverse effects on resource allocation in the long-run, it could be justified in the short-run as a measure to manage the fair distribution of the scarce commodity. The restrictions on the movement of foodgrains until the country attained surplus in foodgrain production is a case in point. However, when a jurisdiction erects fiscal or non-fiscal barriers to provide local protectionism, it could have serious distortionary effects on resource allocation.

Local protectionism results from attempts by the states either to protect local trade and industry or to export the burden of providing public services to the non-residents. This could take the form of placing restrictions either on the exports out of a state or imports into a state. The restrictions may be placed on either the inputs or the outputs and this could take the form of fiscal impediment or physical restrictions. The restriction can be placed on inter-state movements or on intra-state movements.

There are several non-fiscal impediments, often informal and non-transparent, imposed by different state governments as well. Most state governments have knowledge of the local language as a precondition for state government employment. Preference given to the products of the enterprises of the state government in its purchase policy even when there is a price disadvantage is not uncommon. Some north-eastern state governments even stipulate that non-residents cannot conduct trade and commerce in the state unless they have a local partner with them. Some states restrict the inter-state sale of raw materials to ensure that the value addition takes place inside the state. Restrictions on the inter-state sale of oilseeds in Gujarat, raw cashew nuts in Kerala and monopoly procurement of cotton in Maharashtra fall into this category. Regulation against the closure of financially unviable firms also acts as an impediment. Some states also stipulate that enterprises can get concessions and incentives only if they employ local

personnel. The industrial policy of Karnataka, for example, stipulates that 80 per cent of additional employment opportunities created by the industry should accrue to the local people. Similarly, in Kerala government and state's public enterprises give price preferences of 15 per cent on the purchases made from the small scale units and 10 per cent on the purchases made from the medium and large scale industries located in the state.

The non-fiscal impediments mentioned above, are of lesser consequence than the fiscal impediments on inter-state and intra-state trade. The two most important fiscal impediments are the levy of (i) tax on inter-state trade in goods, and (ii) "octroi" or tax on the entry of goods into a local area for consumption use or sale. Until recently, the states having large deposits of coal such as Bihar, Madhya Pradesh, Orissa and West Bengal used to impose a cess on the center's royalty rate at very high rates. However, this had to be abolished after the Supreme Court disallowed it. The exact extent of adverse economic consequences of all these levies, though unclear, are significant and hence, deserve discussion in greater detail.

### IIIb. Taxation of Inter-state Trade: Major Issues

More serious allocative distortions of the inter-state sales tax arise from the state level protectionism it offers to economic activity. The inter-state sales tax is a tax on the exports of one state into another, and as such has all the allocative implications of an export duty. The erection of checkposts and physical verification of goods transported across state borders is only a small part of the efficiency loss. More important efficiency and equity consequences lie in the export tariffs from one state to another.

Another major hindrance to the inter-regional trade and commerce is octroi - the tax on the entry of goods into a local area for consumption, use or sale. While the inter-state sales tax is on the inter-state export of goods, octroi is analogous to an import duty. Presently, among the major states, Gujarat, Haryana, Maharashtra, and Orissa levy octroi. Karnataka and Madhya Pradesh have abolished this levy, but in lieu of it, a state Entry Tax is levied. West Bengal also levies an entry tax on the goods entering into the Calcutta metropolitan area. Rajasthan has abolished this levy only recently (July, 1998).

Octroi has been characterized as 'obnoxious' 'vexatious' 'wasteful' and 'distorting'. The important disadvantages of the levy are, 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 the same goods in different urban local bodies and exportation of the cost of urban development to rural areas.

However, collection from octroi forms 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 have 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[15]. It is also 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 a state 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 checkpoints and physical verification can be avoided if the administration is backed by an 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 a greater devolution of tax powers, this has had an adverse effect on urban services in these states. It must also be noted that the entry tax, like octroi, is a tax on the entry of goods and has similar economic effects. In some cases, this has tended to shift the production and distribution centers to outside municipal limits necessitating needless movement of consumers to these distribution centers. A more serious issue, however, is that in many cases, as the metropolitan areas are centers of entrepot trade, goods necessarily have to pass through them. 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 the attendant evils of congestion, overcrowding, slums, social degradation and environmental pollution.

The search for new avenues of resource mobilization to finance ever increasing expenditure requirements of the states has led them to levy highly distorting 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, as in the case of octroi and entry tax, causes significant distortions in allocation. Similarly, the levy of market (*mandi*) fees and cesses on the sale of agricultural commodities in organized markets, levied in a number of states causes inefficiencies by discouraging trading in organized markets and altering the relative prices of commodities in unintended ways. Though these taxes are not yet important in terms of contribution to the exchequer, the inefficiencies caused by them could be considerable.

The above analysis shows that inter-state fiscal competition in the Indian context has not led to welfare gains. This also implies that the central government has not effectively carried out the function of monitoring inter-state competition both in terms of formulating the rules of competition and in implementing them. Rather than preventing unhealthy competition, there are instances where the center has actively prompted the states to create unstable competition. The most glaring instance is the "race to the bottom" indulged by the Union Territories, whose policies are decided by the Union Home Ministry. The low rates of tax on motor vehicles in the Union Territories of Daman and Diu and Chandigarh have not only distorted the sales tax systems in the neighboring states, but also have caused a number of states to raise additional barriers through the levy of an entry tax on the vehicles registered outside the state.

Similarly, the center has not made attempts to mitigate inter-state exportation of the tax bases. As already pointed out, inter-state sales tax has not only been a source of inefficiency but also an important conduit for inequitable resource transfers. Although originally introduced at a maximum rate of 1 per cent to safeguard against the evasion of local sales tax by showing it as an

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15 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).

inter-state sale, the tax in course of time became an important instrument of resource mobilization and was raised in stages to 4 per cent. As traders avoided and evaded the tax through consignment transfers, under pressure from the Planning Commission and the states for raising more resources the center introduced the 46th amendment to the Constitution wherein "sale" was redefined to include consignment transfers. Thus, rather than preventing inter-state tax exportation, the center has actually helped the process[16]. Of course, legislation enabling the states to levy the tax is yet to be passed and the reluctance of the Union Finance Ministry and some of the poorer states has slowed down the implementation of the tax.

Equally important is the failure of the central government in ensuring a customs union in the federation free from impediments. Interestingly, Article 301 in the Constitution recognizes the virtue of a common market when it states, "Subject to other provisions of this part, trade, commerce and intercourse throughout the territory of India shall be free". However, to meet exigencies, Article 302 empowers the Parliament to "….impose such restrictions on the freedom of trade, commerce and intercourse between one state and another or within any part of the territory of India as may be required in *public interest*"(emphasis added). The creation of various fiscal and non fiscal trade barriers and the creation of tariff zones within the country does not seem to be in the *public interest* or to improve overall economic welfare of the country.

## IV A Coordinated Tax System for India: Measures Taken and Challenges Ahead

### IVa. Instability in Competition: Failure of Monitoring

The analysis of intergovernmental competition in India points towards serious vertical and horizontal disharmony in the tax systems. Vertical disharmony arises when the state and local commodity tax systems are superimposed on that of the center. The levy of cascading type state sales taxes at the first point of sale, the tax on inter-state sale of goods and the tax on the entry of goods into the local body jurisdictions in addition to the excise duties levied by the center has made the tax system non transparent, distortionary and inequitable. As stated in the NIPFP (1994, p.1) report, ".... the system that is operating at present is antiquated, complex ….and injurious to the economy in many ways. It follows no rational pattern, ....and violates all time-honored canons of taxation - certainty, neutrality and equity". In addition to uncoordinated domestic trade taxes, it is believed that disincentives due to the tax sharing arrangement has also contributed to the uncoordinated levy of domestic trade taxes in India.

The above discussion shows that there are several serious sources of horizontal tax disharmony as well. Inter-state competition have led to minute differentiation in the structure of tax rates. The strategic actions of the states also has led to significant "free-riding" in terms of inter-state tax exportation, predatory pricing of goods and services, erection of trade barriers and under-pricing of capital by varying degrees through fiscal and financial incentives. In an economy where the spread of production structure and infrastructure facilities are largely the consequence of history, the ability (power) of different states to play this strategic game is not equal, the competition may not improve economic welfare.

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16 Rather than going into the merit of the tax, even the Sarkaria Commission (India, 1988, pp. 292-3) indicted the center for not passing the legislation to enable the states to levy tax on consignment transfers.

Attempts have been made to reform taxes separately at the level of the center and states, but co-ordinated development of the central and state tax systems has not received much attention. At the central level, simplification and rationalization of the tax system has been attempted on the lines recommended by the tax reform committee (India, 1992, 1993). In the case of commodity taxes, the major initiatives were in terms of a switchover from specific rates to *ad valorem* rates, a reduction in the number of tax rates, and extension of coverage under MODVAT credit[17]. Measures have also been taken to expand the base of indirect taxation by selectively taxing a number of services such as telephones, general insurance, stock broking, goods transportation by road, custom house, steamer, and clearing and forwarding agencies, air travel agencies, car rental agencies and tour operators, out-door catering and pandal (tent) contractors and mandap keepers, and manpower recruitment agencies[18]. Further, to restore incentives, the center has recently passed a bill in the Parliament for an alternative scheme of devolution wherein 29 per cent of total central taxes will be devolved to the states instead of the sharing of income tax and excise duties prevailing at present.

Not all these reforms are in the direction of developing a coordinated system of domestic trade taxes. In particular, the center's levy on selected services, even when the states have a comparative advantage in levying taxes on some of the services is a retrograde step. The appropriate measure should be to amend the constitution to allow the states to levy sales taxes on services as well so that they are enabled to transform their cascading type sales taxes into a consumption type value added tax (VAT).

### IVb. Reform in Domestic Trade Taxes: Recommendations of the NIPFP Study Team.

Although in terms of actual implementation not much has been achieved, a number of proposals have been made to enable the coordinated development of domestic trade taxes in India. The study team on the reform of domestic trade taxes after a comprehensive analysis discussed three alternatives namely (i) an exclusive Central VAT, (ii) an exclusive state VAT and (iii) a dual VAT concurrently levied by both the center and the states (NIPFP, 1994). An exclusive central VAT, though desirable from the point of view of efficient development of the tax system was rejected because it would enormously enhance the fiscal dependence of the states. Such a solution would not be politically acceptable to the states as well.

An exclusive state VAT, on the other hand would strengthen the Wicksellian connection between revenue and expenditure decisions at the state level and improve their fiscal management. However, both the study team and Burgess, Howes and Stern (1993) consider this to be a feasible solution only in the long term. In the short term, it is suggested that such a reform would impair the center's ability to undertake redistribution. In fact, Burgess, Howes and Stern (1993) show that an exclusive state VAT would result in the five poorest states losing up to

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17 Following the recommendation of the Jha Committee report (India, 1978), the facility of crediting the tax on inputs against the tax on outs was extending to convert the excise duty into a Modified value Added tax at the manufacturing stage (MODVAT). The facility was initially extended to a few commodities in the 1984-85 budget, but later, over the years coverage under the scheme was extended.

18 This list has been further expanded in 1998-99 budget to include architects, interior decorators, management consultant, chartered accountants, company secretaries, private security services, real estate agents and consultants, market research agencies, underwriting agencies and mechanized slaughter houses.

40 per cent of their budgets and the nine richest major states gaining by the same extent. According to them, this would “not only be next to impossible to achieve politically, it would also be undesirable”. Therefore, the study team recommended that a dual VAT to be concurrently levied by the center and the states within the existing Constitutional framework. Under this scheme, the Central excise will be converted into a manufacturing VAT by widening the base to include all goods produced, imported and a few select services. Full input tax credit will be given and the structure will be simplified to have not more than three rates. states, on the other hand, will be required to broaden the tax base by minimizing exemptions and including services, transform the tax into a multi-stage levy with rebate given for the tax on purchases, allow credit of taxes on all inputs and capital goods, and zero-rate taxes on exports and inter-state sales.

### IVc. Redesigning the Tax System: An Alternative Proposal

Joshi and Little (1996), have suggested an alternative assignment proposal which in their view will not only eliminate disincentives of tax sharing, but also achieve a simple, efficient and coordinated development of the taxes levied by the center and the states. In their scheme, there should be no tax sharing. The center would retain the personal income tax levied on non-agricultural incomes entirely and would withdraw from broad-based excise taxation. The Central excises would only be on ‘demerit’ and ‘luxury’ goods such as alcohol, tobacco, petrol and diesel fuels, and motor cars. The states, on the other hand, would have the right to levy a broad-based VAT at a single rate chosen by them[19],but falling within a band of 3 percentage points negotiated and agreed to among the states themselves.

While both Burgess, Howes and Stern (1993) and the NIPFP study team (1994) have suggested that an exclusive state VAT would impair the center’s ability to undertake inter-state equalization, Joshi and Little assert that the arrangement will leave sufficient revenue to fill its redistributive role. According to their plan presented in table 5.5, the change in the arrangement would result in (i) an increase in the ratio of direct taxes from 2.86 per cent of GDP to 4 per cent, the yield of the corporation tax increasing from the present level of 1.34 per cent to 2.00 per cent and personal income tax increasing from 1.52 to 2 per cent; (ii) revenue from customs duty would decline from 2.86 per cent of GDP (currently 3.3 per cent) to 1.5 per cent. With liberalization, the import-GDP ratio is expected to rise from the present level of 10 per cent to 15 per cent of GDP and at 10 per cent effective tax on imports the tax - GDP ratio would be 1.5 per cent; and (iii) revenue from domestic indirect taxes would increase marginally from the present level of 9.76 per cent to about 10 per cent of GDP, and the increase would come about mainly with the introduction of a VAT. According to them, this arrangement, would preserve the fiscal autonomy of the states, permit inter-state redistribution achieved by the sharing of taxes, maintain the desirable qualities of the VAT, and would be administratively efficient by discouraging leakage and corruption. As is shown in Table 5.5, in the redesigned system, the center would have to give 2.19 per cent of GDP as grants to the states which is only marginally higher than the 2.12 per cent prevailing at present

The Joshi and Little proposal, however, does not consider the inter-state redistributive implications of substituting the tax devolution scheme with tax assignment. In fact, the

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19 Joshi and Little (p.100), argue that the NIPFP (1994) erred in suggesting a low rate (4-5 per cent), a standard rate (12-14 per cent) and a high rate (20 per cent or more).

replacement of a progressive tax sharing scheme with the proposed assignment provides more benefits to richer states[20]. When the progressive distribution of the share of income tax and union excise duties is replaced by the states' levy of VAT which accrues to them according to the size of their tax bases, significant redistribution is bound to occur.

In the Joshi-Little proposal, the center collects less revenue as a percentage of GDP from customs (1.36 points), excises (0.40 point), and has to give marginally higher grants (0.07 point). This is made up through retaining personal income tax and higher collections of corporate taxes. The states, on the other hand, lose their share of excises (1.84 points) and income tax (1 point), and the state excise duty (0.83 point), but gain from the right to levy the VAT (3.28 points). The remainder is made up through better collection from the agricultural income tax (0.24 point), other taxes (0.07 point) and higher grants from the center (0.07 point). In broad terms, distributional implications arise from the difference in the progressivity between tax devolution and tax collections under the changed system of assignment. The tax devolution is done by the Finance Commissions on the basis of a progressive formula with high weights assigned to the inverse of per capita SDP and the distance from the highest per capita SDP, whereas the collection of uniform rate destination based state VAT will follow the distribution of their consumption[21].

The redistributive implications of the Joshi-Little proposal worked out by us for 1993-94 are presented in Table 6. The distribution of taxes for the year shown in columns 2 and 3 is covered under the award of the Ninth Finance Commission. The states' losses of income tax shares (1 per cent of GDP) and union excise duties (1.84 per cent of GDP) are shown in column 4 and 5 and aggregated in column 6. The ability of each state to collect additional revenue from the state VAT after netting for the loss from the foregone state excise duty to the center (2.45 per cent) is shown in column 6. These have been estimated by distributing the additional VAT collections in proportion to the distribution of NSS household consumption data (42nd round) plus state government consumption[22]. The distribution is shown in column 7.

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20 Chelliah, Rao and Sen (1992) show greater negative correlation for the shared taxes with per capita state Domestic Product than for grants.

21 When the unprocessed food items are exempt, the ratio of tax collections will vary from the ratio of consumption, depending on the variations in the exempted proportion. This, however, is ignored here.

22 The 42nd round NSS household consumption pertains to 1987-88. Government consumption, too, was taken for the same year to generate the distribution of total consumption across the states for 1987-88. The additional state VAT (2.45 per cent of GDP) was distributed in proportion to the proportion of consumption. The implicit assumption is that the pattern of consumption across the states in 1993-94 is the same as in 1987-88.

**Table 5: Tax Revenue as a Percentage of GDP and its Center-State Distribution - 1993-94**

| Taxes | Combined center and states | Before Sharing | | After Sharing | | After Reforms | | |
|---|---|---|---|---|---|---|---|---|
| | | center | states | center | states | Combined | center | states |
| Total Tax Revenue | 15.51 | 9.76 | 5.75 | 6.93 | 8.58 | 15.51 | 7.00 | 8.51 |
| Direct Taxes | 2.86 | 2.70 | 0.16 | 1.71 | 1.15 | 4.00 | 3.60 | 0.40 |
| Personal Income Tax | 1.52 | 1.36 | 0.16 | 0.37 | 1.15 | 2.00 | 1.60 | 0.40 |
| Corporation tax | 1.34 | 1.34 | 0.00 | 1.34 | 0.00 | 2.00 | 2.00 | 0.00 |
| Customs | 2.86 | 2.86 | 0.00 | 2.86 | 0.00 | 1.50 | 1.50 | 0.00 |
| Domestic Indirect Taxes | 9.76 | 4.20 | 5.59 | 2.36 | 7.43 | 10.01 | 1.90 | 8.11 |
| Union Excise Duties | 4.04 | 4.04 | 0.00 | 2.20 | 1.84 | 1.80 | 1.80 | 0.00 |
| state Excise Duties | 0.86 | 0.03 | 0.83 | 0.03 | 0.83 | 0.00 | 0.00 | 0.00 |
| Sales Tax/VAT | 3.51 | 0.09 | 3.43 | 0.09 | 3.43 | 6.71 | 0.00 | 6.71 |
| Other Indirect Taxes | 1.37 | 0.05 | 1.33 | 0.05 | 1.33 | 1.50 | 0.10 | 1.40 |
| Grants | | | | -2.12 | 2.12 | | -2.19 | 2.19 |
| Total with Grants | | | | 4.81 | 10.7 | | 4.81 | 10.70 |

**Note:** * Revised Estimates.
**Source:** Joshi and Little (1996) p.108.

**Table 6: Redistributive Implications of Joshi-Little Proposal - 1993-94**

| | | | | | | | Rs. Crore |
|---|---|---|---|---|---|---|---|
| States | Share in excise duty (%) | Share in income tax (%) | Excise - Prevailing system | Income tax - Prevailing system | Total tax devolution - Prevailing system | state VAT - after reform | Difference |
| 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 |
| Gujarat | 3.18 | 4.55 | 469.14 | 360.82 | 829.97 | 1057.04 | 227.07 |
| Haryana | 1.10 | 1.24 | 161.98 | 98.65 | 260.63 | 512.05 | 251.41 |
| Karnataka | 4.10 | 4.93 | 604.89 | 390.64 | 995.53 | 1059.56 | 64.03 |
| Maharashtra | 5.19 | 8.19 | 764.22 | 649.56 | 1413.78 | 2195.10 | 781.32 |
| Punjab | 1.36 | 1.71 | 200.75 | 135.29 | 336.03 | 708.14 | 372.10 |
| Tamil Nadu | 6.38 | 7.93 | 940.20 | 628.94 | 1569.15 | 1470.62 | -98.53 |
| West Bengal | 6.60 | 7.98 | 972.77 | 632.51 | 1605.29 | 1647.71 | 42.42 |
| **Sub-total - A** | **27.91** | **36.52** | **4113.95** | **2896.43** | **7010.38** | **8595.14** | **1584.76** |
| Andhra Pradesh | 7.17 | 8.21 | 1056.79 | 650.91 | 1707.70 | 1628.59 | -79.11 |
| Bihar | 11.03 | 12.42 | 1625.42 | 984.77 | 2610.19 | 1700.61 | -909.58 |
| Kerala | 3.09 | 3.73 | 454.99 | 295.72 | 750.71 | 909.40 | 158.69 |
| Madhya Pradesh | 7.22 | 8.19 | 1064.75 | 649.09 | 1713.83 | 1473.02 | -240.81 |
| Orissa | 5.36 | 4.33 | 789.72 | 343.06 | 1132.78 | 619.53 | -513.25 |
| Rajasthan | 5.52 | 4.84 | 814.18 | 383.51 | 1197.69 | 1143.00 | -54.69 |
| Uttar Pradesh | 15.64 | 16.79 | 2304.88 | 1331.25 | 3636.13 | 3091.40 | -544.73 |
| **Sub-total** | **5.03** | **58.49** | **8110.72** | **4638.31** | **12749.02** | **10565.54** | **-2183.48** |
| Assam | 0.81 | 2.63 | 561.56 | 208.64 | 770.20 | 481.28 | -288.92 |
| Arunachal Pradesh | 0.90 | 0.07 | 132.21 | 5.79 | 138.0 | 26.39 | -111.60 |
| Goa | 0.52 | 0.11 | 77.08 | 8.72 | 85.81 | 58.37 | -27.44 |
| Himachal Pradesh | 1.94 | 0.60 | 286.38 | 47.18 | 333.56 | 134.56 | -199.01 |
| Jammu& Kashmir | 3.55 | 0.70 | 522.94 | 55.11 | 578.05 | 135.43 | -442.62 |
| Manipur | 1.17 | 0.17 | 173.04 | 13.56 | 186.60 | 39.96 | -146.64 |
| Meghalaya | 0.89 | 0.21 | 131.32 | 16.49 | 147.82 | 40.93 | -106.89 |
| Mizoram | 1.11 | 0.07 | 163.46 | 5.79 | 169.24 | 19.24 | -150.00 |
| Nagaland | 1.35 | 0.10 | 198.68 | 7.61 | 206.30 | 31.42 | -174.87 |
| Sikkim | 0.26 | 0.03 | 38.32 | 2.38 | 40.70 | 10.34 | -30.36 |
| Tripura | 1.56 | 0.30 | 229.34 | 24.03 | 253.37 | 47.39 | -205.98 |
| **Sub-total** | **17.06** | **4.99** | **1875.68** | **177.95** | **2053.64** | **1025.32** | **-1028.32** |
| **All states** | **100** | **100** | **14100.35** | **7712.69** | **21813.04** | **20186.00** | **-1627.04** |

Our analysis shows that both states with less than average per capita SDP and special category states are significant losers if the Joshi-Little proposal is implemented, and their loss amounts to about Rs. 3500 Crore (0.45 per cent of GDP). At the same time, the better off states gain by about Rs. 1700 Crore. Further, if and when the tax is extended to services in addition to goods (as should be the case), revenue productivity of the tax system could improve which would bring disproportionate benefits to richer states not only because of their higher tax base but also due to the ability to invest in and organize proper information systems and improved administrative practices. It should also be noted that additional revenue from the state VAT (2.45 per cent of GDP) does not completely offset the loss of revenue from foregone tax devolution (2.83 per cent). The difference has to be made up through the additional collection of agricultural income tax ( 0.24 per cent) and other taxes (0.07 per cent) which too will be distributed in favor of high income states.

It would thus seem that apart from the political difficulties in adopting a radical solution like the adoption of exclusive state VAT in the short or even the medium term period, the arrangement places the additional burden of targeting the grants even more sharply to ensure even the present degree of progressivity. As mentioned earlier, in any case, the Government of India, has accepted the recommendation of the Tenth Finance Commission and is taking measures to amend the Constitution to enable the devolution of 29 per cent of Central tax revenue to states for the next 15 years.

## V Reform of State Consumption Taxes - Progress and Challenges

### Va. Reform of Domestic Trade Taxes in India: Major Issues

As pointed out earlier, the discussions on desirable directions of reforms in sales taxes have indicated the need to transform the prevailing state sales tax systems into a consumption type value added tax (VAT) to be levied by the states. Towards forging a consensus on the reform of state sales tax systems, the Union Finance Ministry appointed a Committee of states' Finance Ministers from 10 state governments to work out measures and their sequencing to achieve a rational and a coordinated structure of sales taxation in the states.

In keeping with its terms of reference, the Finance Ministers' Committee laid down steps to transform the prevailing state sales tax systems into a consumption type VAT at the retail stage. In the first stage, rationalization in tax rates is to be attempted that would bring about a certain measure of harmony in the tax systems while preserving the states' flexibility and autonomy. The Committee, by general agreement fixed four floor rates, namely, 0, 4, 8 and 12 per cent for general commodities and two special floor rates of 1 and 20 per cent on a few high value and conspicuous items classified on the basis of the prevailing rate structures in the states. In the second stage, that is by April 1997, the sales tax incentives for industrialization should be done away with. Policies in this sphere in the past have led to a 'race to the bottom' with the states competing with one another to provide in some cases, 'open ended' and 'comprehensive' tax incentives (Tulasidhar and Rao, 1986). In the third stage, provision should be made for relieving the tax paid on inputs and capital goods. This should be followed by further rate rationalization, and reduction and eventual elimination of the tax on inter-state sales.

A number of states have already taken steps to simplify and rationalize their sales tax systems broadly in keeping with the spirit of the state Finance Ministers' Committee recommendations and others have been deliberating on the feasible measures to be taken towards levying the VAT in the near future. states like Andhra Pradesh, Kerala, Rajasthan and West Bengal have attempted to introduce the VAT principle by extending the sales tax to stages beyond the first point of sale in respect of selected consumer goods and a number of states are considering reform on similar lines. Maharashtra, on the other hand, has introduced a tax on resale of goods with a set off on the tax already paid for all dealers with a turnover of more than Rs. 50 lakh and intends to extend the coverage to dealers with smaller turnover over the years.

It must however be, conceded that the experience of the states that have already taken the initiative, is not encouraging. For example, in Andhra Pradesh, the first point sales tax was converted into a VAT for 19 commodities but the move was strongly resisted by traders because of the vagueness in the laws and procedures in respect of the definition of a "retailer", the threshold limit, the conditions for claiming the set-off on the purchases, and so on. In Tamil Nadu, the introduction of VAT in respect of services has been challenged in the High Court by "Sundaram Finances". Some states like Karnataka have taken steps to simplify the rate structure into 4 rates, but have allowed the surcharge and additional turnover tax to continue. By and large, fear of losing revenue has made the states reluctant companions in fiscal reform.

It is also important to note that fixing floor rates by the Finance Ministers' Committee, although intended to prevent the "race to the bottom", could support a state cartel. Therefore, it needs to be assured that the measure is intended only to be transitory - to minimize the "free-riding" effects of inter-state tax competition, and eventually leading to further rate rationalization[23]. Even so, it must be noted that the states may find rationalization difficult, if the Union Territories continue to undercut their tax rates as in the past. The Union Home Ministry is not a party to the agreement reached in the states' Finance Ministers' Committee, nor have they been involved in further discussions on rationalization. As the present government at the center represents the interest of a number of regional parties, it is eminently placed to ensure conformity by the Union Territories in any measure of rationalization and should so act in order to minimize the harmful effects of intergovernmental competition. Unless the tax systems of the Union Territories are brought in line with those of the states, any hope of evolving a coordinated and efficient consumption tax structure in the country will be belied.

The reform measures taken so far cannot be characterized as the adoption of the VAT. They can, at best, be called the initial steps towards achieving the VAT. Firstly, the principle of VAT is applied only at the post-manufacturing stage on the distribution and trade margins, and the cascading effects of taxes levied on inputs and capital goods up to the manufacturing stage persist, though some states have evolved mechanisms to give significant relief. Secondly, the states have been selective in their coverage, ether in terms of commodities or the turnover limit. Such reforms, instead of simplifying the tax system, may contribute to its complexity and thereby generate hostility from traders towards VAT. Thirdly, the tax is confined only to goods, and services continue to be outside the purview of the levy. The extension of the tax to services would require the amendment of the Constitution. A number of services enter into the production of goods and *vice versa* and

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23 Further reduction in the number of rates, minimizing exemptions etc.

therefore, if the dual VAT system has to be implemented, both the center and the states should have concurrent powers to tax services to enable them to relieve input taxes. Fourthly, no mechanism has so far been developed to relieve the tax included in the commodities sold on inter-state trade. Finally, as a proper VAT is not in vogue, it has not been possible to calculate the refunds on that is (zero-rate) the exports.

As regards expansion of the tax base and application of the VAT principle, reforms hitherto undertaken by the states can be classified into alternative categories. Some states have attempted to extend the principle of VAT *selectively* on specified finished consumer goods. Others have extended the principle to *all* finished goods up to the wholesale stage identified by specified turnover base. The introduction of the VAT principle on *specified commodities* can create considerable inconvenience to traders and tax payers, for dealers now have to maintain separate accounts on the sale of commodities subject to the VAT principle and on those that are not. The selective extension of the coverage to specified commodities at post-manufacturing/ import stages may also create lobbying and special interest groups to keep themselves out of the additional coverage. It seems more appropriate to confine the VAT principle initially to the manufacturing and wholesale stages and then to extend it to subsequent stages of transaction, with the gaining of experience in administering the tax and improvement in the information system.

### Vb. The Experience of Thailand in Introducing the VAT

In introducing the VAT, much can be gained from the experience of other countries successful in implementing the tax. Particularly, in undertaking the initial reform measures, the experiences of developing countries such as Thailand has much to offer. This is because, Thailand, like India, has a large number of small dealers. Before the introduction of the VAT in January 1992, Thailand also levied a cascading type "Business tax" on the producers, importers and dealers in various services at as many as 21 rate categories. This was replaced by the VAT at a single rate (with very few exemptions on unprocessed food items, farm inputs and educational and health services) on all dealers having a turnover of more than 600,000 Baht. Even though the revenue neutral rate was estimated at 10 per cent, the tax was levied at a lower rate of 7 per cent to ensure easy acceptability and better compliance.[24]

There are some notable lessons from the experience of Thailand in introducing the VAT. First, the tax was introduced after thorough preparation for almost five years. The government appointed as many as eleven working groups to work out the details, evolve the necessary legal framework, build the information system and computerization, cater to the educational and training needs of the tax payers and tax officials and to coordinate the various working groups to ensure a smooth transition. In this task, international advisers and consultants also played a very important role.[25] The preparation also created confidence in the policy makers and showed them that even with a low tax rate, the targeted revenues could be realized. The reforms resulted in the simplicity, lower tax rate, a properly worked out scheme of tax relief on inputs and capital goods and most important, provisions to refund the tax to the exporters within a month.

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24 For details, see NIPFP (1995), Appendix

25 This was also true of Indonesia where the team led by Malcolm Gillis of Harvard University not only provided the blueprint for the introduction of VAT, but also took a lead role in providing training to the tax officials.

Second, a policy environment was created to switch over from the cascading type tax with 21 tax rates to a single-rate consumption-type VAT. Of course, in India inter-state tax competition makes it more difficult to make such a radical change in one stroke, but significant rate reduction and rationalization is within the realm of feasibility as states like Karnataka have found when they reduced the number of tax rates.

The most important feature of the reforms in Thailand, however, is the system of simplified tax assessment introduced for small dealers. The tax is applicable to all dealers with a turnover of more than 600,000 Baht. However, all dealers up to 1.2 Million Baht may opt for a simplified system of assessment by simply paying the tax at 1.5 per cent of their turnover. Those above this limit are required to pay the tax at 7 per cent with set off provided for the tax already paid. The smaller dealers who pay the simplified tax are not a part of the 'ring', and the tax paid by them can not be set off. If, however, they intend to be a part of the 'ring', they could voluntarily register and opt for regular assessment. As most dealers below 1.2 million baht are retailers, there is little cascading from the tax. This principle can easily be incorporated in the reforms in the sales tax systems in India.

### Vc. Transition Towards the VAT : Suggested Measures

In the interest of minimizing cascading effects and relative price distortions, and improving revenue productivity of the tax system, there is general agreement that the prevailing sales tax system should be transformed into a consumption type VAT. It is, therefore, important that the reforms in the sales tax systems undertaken by the states should facilitate a smooth switchover to VAT. It is also important to create a vested interest for such a reform. Given the complexity of the prevailing system and the large number of players involved in the game, this can only be reached in stages with well backed up research and preparation. However, it is necessary to lay down the various stages and evolve a definite time table to be followed by all the states and Union Territories to ensure that the reforms are in the indicated direction and progress in achieving the goal is broadly uniform.

The first step in the introduction of the VAT is to rationalize the existing tax rates on the lines suggested by the state Finance Ministers' Committee, and extend the tax beyond the first point by setting off the tax paid at the previous stage. Rate rationalization into four floor rates should be done taking account of all supplementary levies such as the surcharge on sales tax and turnover tax. It is important that rationalization exercise should involve the Union Territories as well.

The next stage of reform involves the extension of the sales tax on services and this calls for the amendment of the Constitution. Neutrality or non-discrimination in taxation requires that services should also be taxed. As both the center and the states will be levying the VAT, there is no reason why the taxation of services should be an exclusive prerogative of the center. It would be ideal to give concurrent powers to the states to levy tax on services. Of course, some merit goods like social services may be kept out of the purview of taxation.

In the third stage, all forms of tax relief and incentives for industrialization should be eliminated as these are not found to increase overall investment in the economy, but merely reduce the marginal productivity of capital. Simultaneously, the states can introduce the system of

providing tax credits on all inputs and capital goods to manufacturers. This is a more neutral and better form of incentive than the various types of incentives provided by the states. However, as the central sales tax will still be used, the principle can be extended to purchases within the state, which, from the national viewpoint is not entirely desirable as it can result in inter-state tax spillovers. However, as a transitional step, this may be the next best solution.

The fourth stage of reform involves further rate rationalization to levy one or at the most, two rates. The rates levied should be revenue neutral and should take into account the expanded tax base. This should also help to demonstrate the advantages of the VAT to tax payers. The emphasis should be on long term revenue productivity from better tax compliance and the experience, particularly of Thailand shows that even when the tax rate is lower than the revenue neutral rate, better compliance may result in enhanced revenues from not only the VAT but also income taxes.

The choice of the tax rate should also help to reduce administrative and compliance costs. One method that can easily be adopted to minimize hardship to dealers and reduce the burden on tax officials is to have a simplified tax levied at the rate of 2 per cent (or lower) on the turnover of all dealers with, say less than Rs. 10 lakh and the regular VAT on the remaining. At present, the tax on their turnover is in the range of 1.5 to 2 per cent and even in Karnataka where in addition to the regular sales tax, a turnover tax and a surcharge on sales tax is levied, the average rate works out to about 2.5 per cent. The tax paid by the dealers paying the simplified tax however, will not be deductible as they will not form a part of the ring. If, however, any of the dealers in this category want to be a part of the ring they could opt to voluntarily register and pay the tax at regular rates. This would reduce the compliance cost for the small dealers of having to keep detailed accounts and at the same time dealers falling below Rs. 10 lakh are in any case likely to be retailers and therefore, cascading resulting from levying the tax on their turnover will be minimal. In Karnataka for example, dealers below Rs. 10 lakh turnover constitute 77 per cent of the total and they account for only about 6 per cent of the taxable turnover and the tax paid (Table 7).

Simultaneously, the Central sales tax should be abolished, the input relief extended to all inputs and capital goods, whether bought from within or outside the state. This would also require the creation of a clearing house mechanism to relieve the tax on inter-state sales to ensure that the tax collected by the exporting state is returned to the state where the final sale tax place. It is necessary to recognize that a full-fledged VAT can not be achieved unless the inter-state sales tax is significantly brought down and eventually, all such sales are either zero rated or set off.

Abolition of the inter-state sales tax will be the most contentious issue in the introduction of a VAT. Due to the fear of losing revenues, the states have not been able to come to agreement on the issue of abolishing or even reducing the inter-state sales tax. Of course, the political leadership in a number of states did not hesitate lose large amounts of revenues for populist reasons such as introducing prohibition or to initiating a number of subsidies and transfers. But, it is unlikely that they will be easily persuaded by the need to reform the tax system by abolishing the inter-state sales tax unless a compensatory mechanism is introduced, although, the revenue from the tax constitutes just about 17 per cent of the sales tax revenue. The center could work out a scheme to persuade the states to give up the inter-state sales tax in return for giving them the power to tax services. After all, if the economy is fully liberalized and import of consumer goods allowed at low tariffs rates, the states would lose a considerable amount of business if they persist with the inter-state sales tax,

because import may become cheaper than purchasing from other states. If necessary, the center may also provide compensation to cover a certain percentage (say 50 per cent) of the revenue from inter-state sales tax in each state for a specified period (say, three years) until the reforms are firmly in place and revenue productivity of the tax system shows significant improvement. The compensation may be based on the latest years' revenue from inter-state sales tax or the average of the last two/ three years. As it is, the introduction of the VAT, backed by a proper information system is likely to enhance the revenue productivity of personal income and corporate taxes significantly and as the amount of compensation involved is within the realm of feasibility, the center can certainly do so in the interest of efficiency.

**Table 7. Distribution of Sales Turnover and Tax Paid by Range of Turnover Illustration From Karnataka state(1994-95)**

| Range of Turnover (Rs. Lakh) | Number of dealers | Gross Turnover (Rs. Crore) | Taxable Turnover (Rs. Crore) | General Sales Tax Paid* (Rs. Crore) | Percentage of Tax Paid to Gross Turnover |
|---|---|---|---|---|---|
| <10 | 171224<br>(76.7) | 4553.6<br>(6.6) | 1414.6<br>(5.9) | 115.1<br>(5.6) | 2.5 |
| <50 | 205882<br>(92.2) | 12627.7<br>(18.2) | 4398.5<br>(18.2) | 298.9<br>(14.6) | 2.4 |
| >50 | 17351<br>(7.8) | 56717.5<br>(71.8) | 19746.0<br>(81.8) | 1744.7<br>(85.4) | 3.1 |
| Total | 223233<br>(100.0) | 69345.2<br>(100.0) | 24144.5<br>(100.0) | 2043.6<br>(100.0) | 2.9 |

* Includes turnover tax also.
Figures in brackets represent percentage to totals.
**Source:** A Profile - Commercial Taxes Department, Government of Karnataka, 1996.

It is important that the detailed steps involved are discussed carefully by the center and the states, and that a detailed time table is drawn up indicating by which time all the parties concerned will undertake the needed reform measures. Once broad measures are agreed upon and the time table drawn up, it is necessary to appoint a number of working groups by the states to work out the structural, legal, operational, and transitional details, the development of the required information system, computerization of the returns and the creation of the clearing house mechanism. This will ensure a certain measure of uniformity and harmony in the evolution of the VAT and also adherence to a time bound plan of removing the inefficiencies and distortions that bedevil the sales tax systems at present.

Even when the states' sales tax systems are reformed on the lines suggested above, the

consumption taxes will still suffer from the inefficiencies of local levies like octroi, entry tax, market fees and *path kar* (tax on the entry of vehicles registered in other states). These check post based taxes should not have a place in a modern fiscal system. The solution lies in charging user fees on many of the services rendered by local governments and reforming the property tax to restore its legitimate role in local government finances.

## VI Conclusions

In this paper, we have provided an overview and analysis of problems with and reform efforts aimed at the different layers of the tax system in India. We noted that overlapping in the commodity tax systems of the three levels of government in India has made the tax system non-transparent, and rendered the pursuit of the objectives of tax policy difficult. The incidence of taxes on commodities remains unknown and multiple taxation of commodities by different levels of government creates broad wedges between producer and consumer prices. Tax sharing arrangements between the center and states have created incentive problems for tax collection. At the state level, tax competition without appropriate constraints or coordination imposed by the center has led to a multitude of tax rates, “races to the bottom”, inter-state tax exportation, and inter-state trade barriers.

Reform efforts and proposals have focused both on improving the current system and on more comprehensive overhauls. We have pointed out the importance of examining the redistributive impacts across states of major reassignments of tax powers as suggested by some. These must be carefully understood, in addition to impacts across the center and the states as a whole. We have provided specific suggestions concerning the reform of state-level trade and consumption taxes in India, and for steps to follow in introducing a broad-based VAT in India.

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