CHAPTER-V

INDIRECT STATE TAXES WITH SPECIAL FOCUS ON SALES TAXES

Introduction

As we have already discussed in Chapter I that indirect/commodity taxes play a crucial role in revenue generation at both Central and State levels. At the Central level, union excise duties as a commodity tax has emerged as a major source of revenue and was the subject matter of Chapter IV. Now, in this Chapter the case of State government’s indirect taxes; the significance, trends and issues in Sales tax are examined.

The study also takes into account the difficulties faced by the States in implementing sales tax. In response to these problems, the governments at both the levels, undertook various efforts. A brief outline is done of these measures that resulted in implementing State VAT.

Another important problem confronted by all the States was the interstate tax or central sales tax (CST) that created severe impediments to internal trade and market segmentation, inequitable resource transfers with richer States collecting significant amount of taxes from the consumers in poorer States. The process of phasing out CST was also discussed.

In this Chapter, another important aspect of the commodity tax system that is discussed is services tax.

Meaning of Sales Tax

Sales tax (commercial or trade tax) is the most intricate and controversial aspect of the Indian tax system. It is the most important among the taxes raised by the States in India and hence it has an important place in the fiscal structure of the Indian States.

Sales tax is normally an ad-valorem levy imposed on the seller with reference to the transactions or sale. On the basis of the stage of collection, sales tax is classified into (a) multi-point sales tax and (b) single-point sales tax.
(a) **Multi-point Sales Tax**

As a multi-point levy, sales tax may be applied at two or more stages of production and distribution and is same as a turnover tax applicable at each transaction of purchase and sale. Multi-stage sales tax is politically advantageous since a given amount of revenue can be raised at a lower rate of transaction, which also reduces the temptation for tax evasion.

The main disadvantage of multi-point sales tax is its encouragement to vertical integration of production and distribution processes. Producers of finished products prefer to produce their own materials and components, and this tendency harms the interest of independent suppliers, particularly small ones. Thus, multi-point sales tax discriminates against non-integrated firms. Furthermore, it discriminates against those goods and their consumers, which have to pass through numerous transactions.

(b) **Single-point Sales Tax**

A single-point sales tax applies to one stage, either at the manufacturing or the wholesale, or the retail level. At the manufacturing level, sales tax applies to the sale by manufacturer of finished product and is similar to excise duty. At the wholesaler level, the tax applies to the last wholesale transaction i.e. purchase by retailer. The retail sales tax applies to the final sale that means sale to the consumer.

The main advantage of single-point sales tax is that it discourages vertical integration and promotes horizontal integration. As regards the stage of its imposition, the retail stage is considered the most satisfactory due to the following reasons: -

i) Sales tax at the retail stage is collected when final sale to the consumer takes place. Thus, it avoids the cascading or pyramiding effect of a tax.

ii) A given revenue can be realized by applying a lower tax rate at the retail stage as compared to other stages because the margins of all middlemen are included at the final stage of sale, meaning thereby the enlargement of the tax base at the retail stage.

iii) The desired change in the ratio of tax to consumer expenditure can be achieved more effectively in case of retail-stage sales tax. This will be difficult at other stages because the margins of dealers on various goods, besides being applied to the tax component of the purchase prices, may differ significantly.
iv) Sales tax at the retail stage can be shown separately from the price and thus made known to the consumer, increasing tax consciousness among the taxpayers.

v) Expected changes in the rates of retail sales tax do not lead to changes in inventory position of the firms. Anticipated changes in the rates of sales tax at 'other stages' may influence inventory decisions of the firms causing dislocation in trade cycles.

However, retail stage sales tax has its own problems, the main being the large number of taxpayers in the form of small shopkeepers and scattered retail outlets. In developing countries, the problem of tax administration is more acute in view of widespread illiteracy, lack of monetisation, and poor accounting practices. From an administrative point of view, this form of taxation is costlier and cumbersome, offering ample scope for tax evasion and corruption.

Sales tax at manufacturing or wholesale stage is administratively preferable because the number of taxpayers is small and readily identifiable. However, the problem of cascading will emerge. So there exists a tradeoff between economic rationale and administrative efficiency. The relative weightage to competing objectives depends on political judgment and the economic circumstances under which the sales tax system has to operate.

**Origin of Sales Tax in India**

The origin of Indian sales tax can be traced back to Kautilya's *Arthasastra*. Though it ceased to be in existence after the 18th century, the revival of sales tax in its present form in India should be attributed to the Government of India Act of 1935 when India was under the British rule. Though Maharashtra (erstwhile Bombay Presidency) was the first province to impose, within a very limited urban and suburban area, a selective tax on the sales of tobacco in 1938, Tamil Nadu was the first State in India to levy a general sales tax (GST) in 1939 through a multi-point turnover tax primarily to make up for the loss in revenue arising as a result of prohibition. The tax was levied on almost all commodities excepting agricultural and horticultural commodities sold by the producers. In the footsteps of Tamil Nadu, several other States soon followed and adopted a general sales tax during and after the Second World War. Like for example, 5 States adopted this form of levy in the

The Constitution of 1950 that closely followed the main features of the Government of India Act, 1935, clearly divided all the tax powers between the Union and the States. Period following the adoption of the Constitution and upto 1955 was a transitory phase for sales taxation. It was with the Supreme Court judgment in 1955 and through the resultant Constitutional amendment in 1956 that the power of the States to impose sales tax was clearly demarcated. The right to tax on sales within State (intra State sale) was exclusively assigned to the States and taxation of inter State sale was within the purview of the Centre. This was done through the Sixth Constitutional Amendment Act that introduced Entry 92 A in the List I of the Seventh Schedule. This authorized Parliament to levy tax on the sale or purchase of goods (other than newspapers) in the course of inter-State trade. As a result, the Central Sales tax Act, 1956 was enacted.

Consequently, the States levy no sales tax on the transactions not within the boundaries of the State concerned. Instead a Central Sales Tax (CST) is levied on sale or purchase of goods in the course of inter-State trade and commerce. The power to levy CST and revenue from this tax is, however, assigned to the State occasioning the movement of goods from one State to another (i.e., the exporting State).

**Fiscal Significance of Sales Tax**

Tax revenue is vital to every planned economic development. As we have seen earlier also, in percentage terms the share of States’ tax revenue in their total revenue has increased substantially; whereas it was 51% in 1970-71, 57% in 1990-91 and it increased to 69% in 2003-04 (Table 5.1).

The States’ total tax revenue comes from three broad groups of taxes i.e (i) taxes on income (ii) on property and capital transactions and (iii) on commodities and services. However, the changes in States’ tax revenue have not been in the same direction in all the taxes. Taxes on incomes have been an insignificant source of revenue in State finances. The Table 5.2 depicts that while their share was 0.92 % of States’ own tax revenue in 1970-71, it increased to 2.08 % in 1990-91 and in 2003-04 it was 1.5%. The share of taxes on property which includes stamp duty, registration fee and urban immovable property tax has, increased from 9.02% in 1990-91 to 10.45% in 2001-02 and further to 12.53 % in 2003-04.
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<tr>
<td>A+B Revenue from States' own taxes</td>
<td>15.46</td>
<td>35.73</td>
<td>66.65</td>
<td>145.97</td>
<td>301.45</td>
<td>640.35</td>
<td>1167.17</td>
<td>1274.75</td>
<td>1403.72</td>
<td>1628.06</td>
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<td>A. Direct taxes</td>
<td>1.4</td>
<td>2.88</td>
<td>2.71</td>
<td>6.32</td>
<td>12.3</td>
<td>22.13</td>
<td>34.57</td>
<td>39.11</td>
<td>40.02</td>
<td>45.67</td>
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<td></td>
<td>9.06%</td>
<td>8.06%</td>
<td>4.07%</td>
<td>4.33%</td>
<td>4.08%</td>
<td>3.46%</td>
<td>2.96%</td>
<td>3.07%</td>
<td>2.85%</td>
<td>2.81%</td>
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<td>B. Indirect taxes of which</td>
<td>14.06</td>
<td>32.85</td>
<td>63.94</td>
<td>139.65</td>
<td>289.15</td>
<td>618.22</td>
<td>1132.6</td>
<td>1235.64</td>
<td>1363.7</td>
<td>1588.39</td>
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<td>90.94%</td>
<td>91.94%</td>
<td>95.93%</td>
<td>95.67%</td>
<td>95.92%</td>
<td>96.54%</td>
<td>97.04%</td>
<td>96.93%</td>
<td>97.15%</td>
<td>97.56%</td>
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<tr>
<td>General Sales tax</td>
<td>7.12</td>
<td>18.21</td>
<td>36.98</td>
<td>80.71</td>
<td>164.76</td>
<td>338.26</td>
<td>683.86</td>
<td>713.79</td>
<td>794.25</td>
<td>1126.46</td>
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<td></td>
<td>50.64</td>
<td>55.43</td>
<td>57.84</td>
<td>57.79</td>
<td>56.98</td>
<td>54.72</td>
<td>60.38</td>
<td>57.77</td>
<td>58.24</td>
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Source: Reserve Bank of India Bulletin (Various issues)
<table>
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<tr>
<th>Year</th>
<th>State's own tax revenue</th>
<th>Taxes on income</th>
<th>Taxes on Property</th>
<th>Taxes on commodities and services</th>
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</thead>
<tbody>
<tr>
<td>1970-71</td>
<td>15.28</td>
<td>0.14 (0.92)</td>
<td>2.39 (15.64)</td>
<td>12.75 (83.44)</td>
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<tr>
<td>1975-76</td>
<td>35.46</td>
<td>0.46 (1.3)</td>
<td>4.56 (12.88)</td>
<td>30.44 (85.8)</td>
</tr>
<tr>
<td>1980-81</td>
<td>66.16</td>
<td>1.08 (1.6)</td>
<td>5.76 (8.7)</td>
<td>59.31 (89.65)</td>
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<tr>
<td>1985-86</td>
<td>145.51</td>
<td>2.72 (1.87)</td>
<td>12.12 (8.3)</td>
<td>130.67 (89.8)</td>
</tr>
<tr>
<td>1990-91</td>
<td>303.84</td>
<td>6.34 (2.08)</td>
<td>27.42 (9.02)</td>
<td>269.7 (88.76)</td>
</tr>
<tr>
<td>1995-96</td>
<td>638.65</td>
<td>8.35 (1.3)</td>
<td>72.75 (11.4)</td>
<td>557.5 (87.3)</td>
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<tr>
<td>2000-01</td>
<td>1179.81</td>
<td>19.7 (1.67)</td>
<td>111.87 (9.5)</td>
<td>1048.24 (88.85)</td>
</tr>
<tr>
<td>2001-02</td>
<td>1330.79</td>
<td>22.67 (1.7)</td>
<td>139.08 (10.45)</td>
<td>1166.8 (87.68)</td>
</tr>
<tr>
<td>2002-03</td>
<td>1421.4</td>
<td>21.63 (1.52)</td>
<td>154.2 (10.85)</td>
<td>1243.6 (87.63)</td>
</tr>
<tr>
<td>2003-04</td>
<td>1628.06</td>
<td>24.43 (1.5)</td>
<td>203.96 (12.53)</td>
<td>1628.3</td>
</tr>
</tbody>
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Source: Reserve Bank of India Bulletin (Various issues)
Taxes on commodities and services have come to occupy a prominent place. The yield from these taxes rose from Rs. 269.7 b in 1990-91 to Rs 1048.24 b in 2000-01 (Table 5.2). The share of these taxes in States' own tax revenue however declined marginally from 88.8% in 1990-91 to 87.7% in 2000-01. However taxes on commodities and services further include basic taxes in accordance with their importance: Sales tax, State excise, motor vehicle tax, electricity duty, passenger and goods tax and entertainment tax.

Since Independence, sales tax has grown considerably in depth and coverage, and forms the mainstay of States’ own tax revenue. As shown in the Table 5.2, in 1970-71, the relative share of sales tax in States own tax revenue was Rs. 7 billion out of a total tax collection of Rs. 15.5 b. The share of sales tax has increased to 18.2 b in 1975-76, 37 b in 1980-81, 165 b in 1990-91, 684 b in 2000-01 and 1126.5 b in 2003-04.

Additional Resource Mobilization

The higher growth of sales tax has partly been due to the efforts of the States to mobilize additional resources for the planned economic development of the country. As and when the States were asked by the Planning Commission to raise further resources, efforts have been made to mobilize additional resources through sales tax either by increasing the tax rate or by changing the coverage of the tax. During last years substantial revenue has been raised through additional tax measures relating to sales tax. In contrast, there were no significant discretionary changes relating to the other taxes excepting State excise.

Revenue Productivity- Buoyancy of Sales Tax

In terms of raising revenue, the sales tax has been quite successful. The higher growth rate of the sales tax could be attributed to its buoyancy or its responsiveness to the tax base (i.e normal automatic growth in revenue due to the growth in the base). This could be estimated through relationship:

\[ \log y = \log a + b \log x \]

Where \( y \) is tax revenue and \( x \) is state income. The relationship shows the percentage change in revenue in respect to a percentage change in State income. The estimates of the responsiveness of sales tax calculated show that the tax has always been highly responsive to increase in its base (Table 5.3). During the decadal periods...
1970-80, the buoyancy rate was 1.54, in 1980-90; 1.11, in 1990-2000; 1.02 which implies that sales tax has been a buoyant source of revenue for the government. But the buoyancy rate was less in 1999-2000 as compared to other decadal periods and it shows that during this period sales tax was a non-buoyant source of income.

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<tbody>
<tr>
<td>Buoyancy</td>
<td>1.54</td>
<td>1.11</td>
<td>1.02</td>
<td>1.52</td>
<td>1.07</td>
<td>1.15</td>
</tr>
<tr>
<td>Growth Rate</td>
<td>19.13</td>
<td>15.74</td>
<td>15.26</td>
<td>14.59</td>
<td>15.32</td>
<td>16.23</td>
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The buoyancy is also calculated for the overall period of 1970-2004 (1.15) and the period 1981-2004 (1.07). This shows that the depressing decadal period of 1990-2000 has affected the overall buoyancy of 1981-04 and so it's comparatively less.

Similarly, growth rate is rising in the particular period when buoyancy is also increasing and vice-versa. But the two noticeable periods (as in excises) are 1990-00 and 2000-04, where, although buoyancy rate has increased from 1.02 to 1.52 but the growth rate has in fact, declined from 15.3% to 14.6% respectively. It implies that the growth rate of sales tax has been much faster than the growth rate of GDP implying that sales tax has always been highly responsive to increase in its base.

**Structure of Sales Tax**

The structure of sales tax that has evolved over the years was complex and faulty. Since the sales tax were levied by the States in diverse forms, they vary in structure – the points of levy and the rates – as well as administrative procedures, though some common features do exist.

a) **Point of Levy**

Initially, the systems of sales taxation in India took two main forms – the Madras (or multipoint) system and the Bengal (retail taxation) system. Most of the States levy tax on just one of the sales from among the series of transactions taking place between the manufacturer and the retailer. This was known as a single-point tax. The States levying a single-point tax adopt either the first-point tax or the last-point tax. When the tax was levied on the last registered dealer who sells commodities either to the consumer or to the unregistered dealer, it was called the last-point tax.
In addition, some of the States under pressure to raise more and more revenue have resorted to levies in the form of surcharges (SC), on the one hand and additional sales tax/turnover tax (TOT) on the other hand. The surcharges were in operation in a majority of the bigger States, the base in some being the amount of general sales tax and in some, the total of both general sales tax and TOT payable. The TOT, which was levied at all stages of transaction of a commodity, was a multipoint tax. It was levied on gross turnover of dealers with sales in excess of the exemption threshold, and this applied to intermediate dealers even in States where the general sales tax was largely leviable at only one point.

b) Rate Structure

Rates of sales tax in Indian States had been so designed that the taxable commodities were treated differently according to their nature (i.e. necessities, comforts and luxuries). In general, “necessities” were either exempted or taxed at a very low rate of 1% to 4% to help the poor strata of society. “Comforts” were taxed at an average rate of 10% to 12%; and “luxuries” were taxed at a high rate of 15% to 20%. This arrangement helped in providing not only social justice and equity but also promotion of trade and industry within the State. It also provided progressivity to the sales tax system in the country.

c) Exemptions

In general, most of the States provided exemptions on different articles and for a number of reasons. Like exemptions for necessities were granted to reduce the regressivity of the tax on equity grounds. These included commodities like basic food products sold in unprocessed form, books and maps (including student exercise books) and bicycles. Only those non-food commodities, which form an important part of the budgets of the lower income groups, were exempted from the tax. Like firewood and charcoal, hand-made low priced footwear, orthopaedic footwear, glass bangles, non-ornamented ivory bangles, kumkum and low priced (upto Rs.50.00) manglasutra.

Exemptions were also provided as an incentive to industry in the form of deferment of sales tax, sales tax holidays, repayment of term loans from sales tax collected etc. Such incentives were provided to new industrial units located in some
specific area, small scale enterprises and the total amount of sales tax foregone was according to the fixed capital investment made by these enterprises.

In many of the States exemptions were given for some specific organizations and institutions like military canteens, public hospitals and so on.

Services were also exempted from sales tax as per Constitution, which empowered States to impose “taxes on sale or purchase of goods” and services were not included in this clause. However, exceptions were for electricity, transportation, entertainment, and professions (in the recent budget it is proposed to include the services of doctors and lawyers also in the tax net)

Other exemptions included when two statutory authorities levy tax on the same commodities, one of the authority exempted the goods and share the revenue with the levying authority. For instance, Centre levied additional excise duty in lieu of sales tax on commodities like textiles, sugar and tobacco and revenue was shared by the States as per the recommendations of various Finance Commissions.

Also, there were certain exemptions that were granted on grounds of administrative ease. This was due to the fact that a badly administered tax adversely affected the morale of the honest taxpayers. Thus, exemption was granted to most of the perishable agricultural and dairy products.

d) Taxation of Inputs

Sales tax was generally levied on the sale or purchase of all commodities including raw materials, inputs and capital goods except for some exempted commodities. Inputs were bought by the manufacturers at different rates depending upon the input treatment of the State concerned. This treatment under sales tax laws in different States could be classified into three categories.

Firstly, total exemptions on inputs were allowed in some of the States/territories like Delhi, Himachal Pradesh, Jammu & Kashmir and Punjab. This, however exemption was (except J&K and Delhi) only for raw materials used in the manufacture of taxable gods sold within the States. If the goods were transferred to other State, no exemption was available on these manufacturing inputs.

Secondly, in many States concession was provided on inputs but the type and extent of a concession differed from State to State. Finally, in Assam State no concession was provided on inputs used for manufacturing purposes. However, small
scale manufacturing units (whose total fixed capital investment does not exceed Rs.6.5 lakh) registered as small-scale industrial units with the Director of Industries were allowed to set off or drawback by way of refund of taxes paid on raw materials after assessment.

e) Taxation of Inter-State Sales

The States levy tax not only on sale and purchase of goods within their territories but also on inter-State sales. To deal with inter-State sales, Central Sales Tax (CST) Act was enacted in 1956. The Constitution empowers the Centre to levy tax on inter-state sales but the States were also authorized to levy CST on sales in their territories. Earlier, 1% was the rate of tax and this had been raised to 4%. In case of sales to an unregistered dealer 10% or the rate applicable on local sales including additional sales tax and surcharge, whichever was higher was levied. However, an amendment was passed to levy sales tax on consignment.

After analyzing the structure of the sales tax as described above we can easily conclude that there existed large scale variations in the tax rates and the problem of multiplicity of rates. Different tax rates were levied on different types of commodities like necessities, comforts and luxuries. Also, exemptions were granted not only on necessary commodities but to specific institutions and certain services also. The treatment of inputs also differed from one State to another. Even inter-State sales created complexities and ill effects in the sales tax structure of the States.

Problems confronted by the Sales Tax Structure

The above description of the earlier structure of sales tax in Indian States exhibited the following weaknesses in the system:

i) Complex Structure

The Indian sales tax structure was considered to be one of the most complex structures around the world. The various laws, rules and procedures lay down for their enforcement made the structure even more complex.

ii) Lack of Uniformity in Tax Rates

The rate structure as presented above shows that there were large variations in tax rates among different States. These variations exist in almost all the commodities. Certain basic food articles like cereals, pulses which were necessary for human
existences were exempted in some of the States while in other States were subject to
tax at a low rate. Articles such as toilet articles and cosmetics were also taxed
differently and they were generally taxed at a higher rate. However, some uniformity
existed in the taxation of luxury goods whose rates vary from 10%–16% and they
were levied at the first point. Although some uniform floor rates had been introduced
to curb rate war but variations do exist in the rates of a large number of commodities
leading to complexities and inefficiencies in the system.

iii) Bad Effects of First-Point sales Tax

Most of the States applied sales tax at the first point of sale, which falls either
on the manufacturers or on importers from other States or from abroad. States prefer
first point sales taxation since they were easy to administer. But sales tax levied at
first point suffered from many weaknesses also:

a) The base of the first-point tax was lower than the last-point tax so the rates
were set at a higher level to derive same amount of revenue. The high rates
than resulted in increased cost of holding inventories and so higher interest
payments causing cascading and avoidance of tax on the part of consumers
and business firms.

b) Taxes on input led to changes in relative factor prices, which affected the
production process and created related inefficiencies.

c) In case of first point tax or manufacturers’ sales tax, commodities which had
larger value added at the wholesaler\ retail level had an advantage of lower tax
over those commodities whose value added was substantial at the earlier
stages. The consumer durables had low value added and it was high for luxury
goods, so the first point tax encourages the consumption of luxury goods.
Also, it allocated scarce resources for the production of non-essential items.

d) The first point also resulted in vertical integration of firms to avoid tax and
affected the growth of ancillary industries.

The sales tax system caused adverse pyramiding effect on the industry. Even if
the sellers had set the sale price of goods with a profit margin, the absolute size of
mark-up for profits increased due to taxes levied in the initial stages. The government
however, collected only a smaller fraction of the income collected through taxes.
Sales Tax Reforms

According to the Study Team on the Reform of Domestic Trade Taxes in India, “Domestic trade taxes in India are in need of urgent reform. The system that is operating at present is archaic, irrational and complex – according to knowledgeable experts, the most complex in the world.” It was envisaged that for accelerating growth and for evolving an efficient tax system, steps should be taken to transform the prevailing sales tax system in the States into a destination based consumption type, retail stage value added tax (VAT). Introduction of State VAT is the most significant tax reform measure at State level. The State VAT has replaced the earlier State Sales Tax system.

The process of reforms in the State level Sales tax system began with the Conference of the State Finance Ministers held on May 27, 1994, at the instance of the Union Ministry of Finance. In November 1999, the then Union Finance Minister convened a conference of Chief Ministers of States/ UTs, in which it was decided to simplify the prevailing tax system in the States by introduction of VAT. On the recommendation of the Chief Ministers, the Empowered Committee (EC) consisting of finance ministers from nine States was also constituted on 17th July 2000 to monitor the process of introduction of VAT.

This decision was reiterated during the subsequent meetings held in June 2000 and July 2001. The consensus arrived at to introduce VAT from April 1, 2003 but could not be adhered to as States were not fully prepared both in terms of legislative requirements as well as administrative infrastructure required for the purpose. Only one State i.e. Haryana adopted VAT on the same principles as approved by the EC.

However, at the meeting of the EC (Convenor: Dr. Asim Dasgupta) held on June 11, 2004, it was agreed to implement State level VAT from April 1, 2005. This decision had been further reaffirmed in subsequent meetings of the Empowered Committee held on Sep. 23, 2004 and Nov. 2, 2004. Accordingly, VAT has been introduced by 30 States/UTs. Two UTs, namely, Andaman and Nicobar Islands and Lakshwadeep do not have Sales tax/VAT. The remaining three States/UTs, namely, Uttar Pradesh, Tamil Nadu and Pondicherry didn’t introduce the VAT. Out of them, Tamil Nadu had announced their decision to implement VAT from Jan. 1, 2007.
Recently, even Uttar Pradesh has decided to shift to VAT, with a change in
government in the State.

The proposed VAT is a multi-point destination based system of taxation, with
tax being levied on value addition at each stage of transaction in the production/
distribution chain. The EC has, through its deliberations over the years, finalized the
design of VAT adopted by the States, which seeks to retain the essential features of
VAT, while at the same time providing a measure of flexibility to the States to enable
them to meet their local requirements. Some other salient features of the VAT design
are as follows: -

a) The rates of VAT on various commodities shall be uniform for all the States/
UTs. There are 2 basic rates of 4% and 12.5%, besides an exempt category
and a special rate of 1% for a few selected items. The items of basic
necessities have been put in the 0% or the exempted schedule. Gold, silver and
precious stones have been put in the 1% schedule. The 4% rate applies to other
essential items and industrial inputs. The 12.5% rate is residual rate of VAT
applicable to commodities not covered by other schedules.

There is also a category with 20% floor rate of tax, but the commodities listed
in this schedule will not be Vatable. This category covers items like motor
spirit (including ATF), liquor etc. It is also pertinent to mention here that
States have been given the flexibility to select 10 items each as "goods of local
importance", which can be put in the 0% or the exempted schedule. This
would make the tax system simple and uniform and prevent unhealthy tax
competition among the States.

b) Provision has been made for allowing "Input Tax Credit (ITC)", which is the
basic feature of VAT. However, since the VAT being implemented is intra-
State VAT only and does not cover inter-State sale transactions, the ITC will
not be available on inter-State purchases. The provision of input tax credit
would help in preventing cascading effect of tax.

c) There are provisions to make the system more business-friendly. For instance,
there is provision for self-assessment by the dealers. Similarly, there is
provision of a threshold limit for registration of dealers in terms of annual
turnover of Rs. 5 lakhs (i.e. dealers with lower turnover are not required to
obtain registration under VAT). There is also provision for composition of tax liability up to annual turnover limit of Rs. 50 lacs. The provision of self-assessment by dealers would reduce harassment.

d) Exports will be zero-rated, i.e no tax will be charged on exports and at the same time, credit will be given for all taxes on inputs/purchases, related to such exports. The zero-rating of exports would increase the competitiveness of Indian exports.

e) There is provision for eliminating the multiplicity of taxes. In fact, all the State taxes on purchase or sale of goods (excluding entry tax in lieu of octroi) are required to be subsumed in VAT or made Vatable.

f) Regarding the industrial incentives, the States have been allowed to continue with the existing incentives, without breaking the VAT chain. However, no fresh sales tax/VAT based incentives are permitted.

Role of Central Government

Since State sales tax / VAT is a State subject, the central government is playing the role of a facilitator for successful implementation of VAT. Some of the steps taken in this regard are as follows:

a) The Central government convened Conferences of State Chief Ministers and Finance Ministers, constituted an EC to facilitate and generate deliberations and decisions on tax reform at State level. The necessary technical expertise required for this purpose was also made available through National Institute of Public Finance and Policy (NIPFP) or otherwise.

b) The Central government also got a Model VAT Bill prepared and made it available to the States, to help them in preparation of their VAT bills.

c) One of the concerns expressed by States in adopting VAT relates to the possible loss of revenue in the initial years. To remove these apprehensions of States and to provide a measure of comfort, the Central government agreed to compensate the estimated loss on the basis of an agreed formula, on account of the introduction of VAT, to the extent of 100% of the loss in the first year, 75% of the loss in the second year and 50% in the third year of introduction of VAT.
d) The Central government has also been providing technical and financial support to the EC as well as the States for VAT computerization and for VAT related publicity.

**Encouraging Experience**

Before the implementation of VAT on 1st April 2004, apprehensions were there in the minds of both business community and State governments as well as sale tax/commercial tax department officials. However, the central government had endeavoured to mitigate there apprehensions. The experience of implementation of VAT has been very encouraging so far. The new system has been received well by the business community as well as the general public and the transition to the new system has been quite smooth. The EC has been constantly reviewing the position and resolving various issues that arise from time to time. The trend of revenue collection in VAT implementing States is also encouraging. During 2005-06, the tax revenue of the VAT implementing States showed an increase of around 13.8% over tax revenue of 2004-05, which is higher than the Compound Annual Growth Rate (CAGR) of sales tax revenues of these States for last 5 years (upto 2004-05). During April-June, 2006, the tax revenue of VAT implementing States has shown an increase of about 27.1% over the corresponding period of last year, which is quite remarkable and indicates that the VAT system has started stabilising and yielding the desired results.

The total amount released to the States on account of VAT compensation during 2005-06 was Rs. 2,471.27 crore. The expenditure is likely to be higher during 2006-07, since a number of VAT compensation claims relating to the year 2005-06 have been filed by the States in 2006-07 only. As of now, only 8 States out of 30 VAT implementing States/ UTs have been claiming VAT compensation (http: Indlawnews.com).

**Reform in Central Sales Tax**

The interstate sales tax or CST was introduced at a rate of 1% on registered dealers, as a mechanism to trace inter-State sale. In subsequent years, it was used as a revenue measure and the ceiling rate on inter-State sale to registered dealers was increased in stages to 4%. But, the dealers had misused the tax by pretending inter-State sale as consignment transfer and selling the commodity within the State.
While CST had been used as an instrument for raising revenue and more importantly, a vehicle for exporting the tax burden to non-residents, the original objective of developing a mechanism to trace inter-State transaction had remained unfulfilled. The States had also erected border check posts which had created a serious impediment to inter-State trade leading to trade diversion. The levy of CST not only created distortions but also led to adverse inter-regional equity implications. In a mark up pricing situation, the taxes are shifted forward and the consumers in poorer States pay taxes to richer producing States (Rao 2003).

To overcome the problem of CST in the States and to promote economic activity in their respective jurisdictions, different economists advocate phasing out of CST in a planned manner. The phasing out of CST should, however, be calibrated carefully since the share of CST in State’s sales tax revenue was increasing consistently. Moreover, zero rating of the CST would have reduced the revenues of the States and created budgetary difficulties in the short term, so the need arised to provide compensation to most of the States.

In Jan. 2007, Chidambaram has announced a gradual phase-out programme of CST by 2010-11. CST phase out would start from April 1, 2007 on the basis of full compensation package to State. As part of a compensation package for revenue loss because of CST cut, States are likely to get the entire revenue from tax on 33 services that are currently being levied by the Centre. Chidambaram said an agreement has also been reached to make legislative changes, if required, to start the phase out and compensate the States. The CST is expected to generate more than Rs 25,000 crore in the next fiscal and if the tax is reduced by one per cent as planned out, States are likely to lose about Rs 6,250 crore.

**Taxation of Services in India**

Sales tax in India was confined almost exclusively to goods; services were exempt subject to a few exceptions contained in the State List of the Constitution. The exceptions, which the States had the power to tax, were electricity, transportation, entertainment and professional services. There is no such power under the Union List but under the provisions of the residuary entry of the Constitution the Union government has the power to tax services like on foreign travel, hotel expenditure, telephone, stockbrokers, non-life insurance, advertising, couriering, radio paging and a host of other services.
'Services' constitute a very heterogeneous spectrum of economic activities. Over a period of time, the definition of 'service' has also undergone change. Service sector now occupies the centre stage of the economy, so much so that in the contemporary world, development of the service sector has become synonymous with the advancement of the economy. The share of the services sector in the real Gross Domestic Product (GDP) in India has surpassed that of agriculture and industry at a relatively faster pace, as compared to other industrialised nations.

Service tax is a tax levied on service providers in India, except the State of Jammu and Kashmir. The tax is levied on service providers who have an annual revenue of more than 8 lakhs, which encourages smaller service providers. (http://en.wikipedia.org)

Taxes on services were imposed for the first time in 1994 at a rate of 5% on three services only i.e Telephone, stockbroker, and general insurance. Many new services were added in every Budget and the number has reached to around 96. Details of services are provided in the Annexure A.5.1.

Considering the increasing workload due to the expanding coverage of service tax, it has been decided to centralise all the work and entrust the same to a separate unit supervised by a very senior official. Accordingly, the office of Director General (Service Tax) has been formed in the year 1997. It is headed by the Director General (Service Tax).

Presently there are 65 Central Excise Commissionerates and 6 Service tax Commissionerates within the jurisdiction of 23 Central Excise Zones. The 6 Service Tax Commissionerates have been established in Mumbai, Delhi, Kolkata, Chennai, Ahmedabad & Bangalore.

Central Board of Excise and Customs(CBEC)

The responsibility of collecting the tax lies with the Central Board of Excise and Customs(CBEC). Central Board of Excise and Customs (CBEC) is a part of the Department of Revenue under the Ministry of Finance, Government of India. It deals with the tasks of formulation of policy concerning levy and collection of Customs and Central Excise duties, prevention of smuggling and administration of matters relating to Customs, Central Excise and Narcotics to the extent under CBEC's purview. The Board is the administrative authority for its subordinate organizations, including
Custom Houses, Central Excise Commissionerates and the Central Revenues Control Laboratory.

**Constitutional & legal provisions behind levy of service tax in India**

To enable parliament to formulate by law principles for determining the modalities of levying the Service Tax by the Central Government and collection of the proceeds thereof by the Central government and the State, the amendment vide constitution (95th amendment) Act, 2003 has been made. Consequently, new article 268 A has been inserted for Service Tax levy by Union government collected and appropriated by the Union government, and amendment of seventh schedule to the Constitution, in list I-Union list after entry 92B, entry 92C has been inserted for taxes on services as well as in article 270 of the constitution the clause (1) article 268A has been included.

**Analysis of Service Tax**

The Service tax collections have shown a steady rise since its inception in 1994. The tax collections have grown manifolds since 1994-95 i.e Rs. 410 crores in 1994-95 to Rs. 14196 crores in 2004-05.

Service tax revenue collection target for the year 2004-05 was fixed at Rs. 14150 crores, but the actual service tax revenue collection stands at Rs. 14196.19 crores. It indicates a growth of 79.93% against the actual realization Rs. 7889.97 crores during the last financial year 2003-04.

There is a substantial growth in the assessee base from 403856 numbers in 2003-04 to 7,74,988 numbers in 2004-05. It indicates a growth of almost 91%, which is significantly robust ever after 1994-95 in comparison with 74% growth rate of previous year. The revenue and assessee statistics from the year 1994-95 to 2004-05 is as shown in the Table-5.4 below
Table 5.4: Growth in Revenue and Assesses of service tax

<table>
<thead>
<tr>
<th>Financial Year</th>
<th>Revenue Rs. Crores</th>
<th>% Growth</th>
<th>No. of Services taxed</th>
<th>No. of Assessees</th>
<th>% Growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>1994-95</td>
<td>410</td>
<td>Base Year</td>
<td>3</td>
<td>3943</td>
<td>Base Year</td>
</tr>
<tr>
<td>1995-96</td>
<td>846</td>
<td>101</td>
<td>3</td>
<td>4866</td>
<td>19</td>
</tr>
<tr>
<td>1996-97</td>
<td>1022</td>
<td>24</td>
<td>6</td>
<td>13982</td>
<td>187</td>
</tr>
<tr>
<td>1997-98</td>
<td>1515</td>
<td>49</td>
<td>18</td>
<td>45991</td>
<td>228</td>
</tr>
<tr>
<td>1998-99</td>
<td>1787</td>
<td>18</td>
<td>30</td>
<td>107479</td>
<td>133</td>
</tr>
<tr>
<td>1999-00</td>
<td>2072</td>
<td>16</td>
<td>27</td>
<td>115495</td>
<td>7.45</td>
</tr>
<tr>
<td>2000-01</td>
<td>2540</td>
<td>23</td>
<td>26</td>
<td>122326</td>
<td>5.91</td>
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<tr>
<td>2001-02</td>
<td>3305</td>
<td>26</td>
<td>41</td>
<td>187577</td>
<td>53</td>
</tr>
<tr>
<td>2002-03</td>
<td>4125</td>
<td>25</td>
<td>51</td>
<td>232048</td>
<td>24</td>
</tr>
<tr>
<td>2003-04</td>
<td>7890</td>
<td>91</td>
<td>58</td>
<td>403856</td>
<td>74</td>
</tr>
<tr>
<td>2004-05</td>
<td>14196</td>
<td>79.93</td>
<td>71</td>
<td>774988</td>
<td>91</td>
</tr>
</tbody>
</table>

Source: wikipedia.org

Future Proposals

The Finance Minister Mr. P. Chidambaram in his Budget speech 2006, has indicated the government’s intent of merging all taxes like Service Tax, CenVAT and StateVAT into a common Goods and Service Tax by the year 2010. To achieve this objective, the rate of Central excise and service tax will be progressively altered and brought to a common rate.

Summary and Conclusion

In the foregoing analysis, an overview is done of the system of State sales tax. Modern sales tax system has its origin with imposition of general sales tax in the State of Tamil Nadu at a modest rate on multi-point basis. Since then all other States also started levying this tax.

Sales tax is normally an ad-valorem levy imposed and collected from the seller with reference to the transactions or sale at the single point stage or at the multi-point stage. The sales tax system till switching over to VAT, was partly origin-based and partly destination-based. It’s importance as a buoyant revenue source for the States has increased by leaps and bounds.
The buoyancy and growth rate estimated for the States in the period between 1970-2004 and the decadal periods from 1970's show some interesting results. The buoyancy and growth rate were quite high (more than 1) in all decades except 1999-2000 when sales tax was a non-buoyant source.

Another feature that is noticeable in the estimates of buoyancy and growth rate is that except the two periods 1990-2000 and 2000-04, in all other periods buoyancy and growth rate are moving/changing in the same direction. In these two periods when the buoyancy rate was increasing from 1.02 to 1.52, the growth rate in fact reduced from 15.3% to 14.6%. This shows that during these two periods growth in sales tax revenue was comparatively more with regard to GDP growth. Moreover, it can also be concluded that out of the two commodity taxes; excises and sales tax, sales tax were a more buoyant source of revenue.

Predominantly, first point sales tax was imposed by many of the States, rendering the tax base narrow. Multiplicity of rates and surcharges, turnover taxes and entry taxes loaded on to them made the systems complex and opaque. Moreover, the levy of central sales taxes (CST) created severe impediments to internal trade and market segmentation, inequitable resource transfers with richer States collecting significant amount of taxes from the consumers in poorer States.

Various studies were done, since the Study Team on Domestic Trade Taxes submitted its report and the steps envisaged by these committees were to transform the prevailing sales tax system in the States into a destination based consumption type, retail stage VAT. The EC of State Finance Ministers was formulated and in 1999 decided to implement VAT in place of sales tax. Though deliberations were carried on by the EC but a consensus couldn’t be reached with the States and it’s only in the year 2005 almost all the States agreed to introduce State VAT.

The experience of implementation of VAT has been very encouraging so far. During 2005-06, the tax revenue of the VAT implementing States showed an increase of around 13.8% over tax revenue of 2004-05. During April-June, 2006, the tax revenue of VAT implementing States has shown an increase of about 27.1% over the corresponding period of last year, which is quite remarkable and indicates that the VAT system has started stabilising and yielding the desired results.
Another area of concern was the phasing of CST in a planned manner and to compensate the States for the loss of revenue as a result of phasing out. Chidambaram announced the gradual phasing out of CST from April 1, 2007 with a compensation package for the States.

In this Chapter, another important aspect of the commodity tax system is considered i.e services tax. Beginning with just three services taxed in the year 1994, the ambit of service tax has widened substantially, in terms of coverage of services and revenue generated by them. A comprehensive Goods and Services tax (GST), however requires the CenVAT/ services tax to be integrated with the State VAT’s introduced in 19 States and 2 UTs on April, 2005 in place of earlier sales taxes.

The last point tax is akin to a retail sales tax in the literature on public finance. In the Indian context, the sale is taxable only when made by the last registered dealer to a non-registered dealer or to a consumer.