CHAPTER VI
TAX REFORM MEASURES SINCE 1953-54 AND ITS FUTURE

Introduction

The analysis so far has highlighted certain features of the form of commodity taxation, its weakness and other cascading effects leading it to be termed as distortionary tax. Since 1953-54, with the publication of Report of Taxation Enquiry Committee, till now switching over to VAT, attempts are being made to reform domestic trade taxes.

As a result different study teams, committees and commissions were set up. The present Chapter is an attempt to review them. Also, the impact of VAT, imposed in the State of Haryana, is also examined.

Need for Reforms of Commodity Taxes

The commodity taxes have continued to play an important role in the Indian tax system and they will continue to play such a role in future because direct taxes have a limited coverage on account of lower incomes. So, the commodity taxes were considered to be a better source of revenue for both Centre and States and less burdensome for the taxpayers also. However, commodity taxes in India were in urgent need of reform. “The reason simply is that the system that is operating at present is antiquated, complex – according to knowledgeable experts the most complex in the world and injurious to the economy in many ways.”(Bagchi, 1994)

While designing the tax policy it was assigned many objectives but its macro aspects were generally ignored. When the incidence of individual taxes were analysed certain problems were ignored like taxation of the same base by various taxes (such as Union excise duty, State excise duty, sales tax, octroi and entry tax) causing cascading and pyramiding of the taxes. The adverse affects were the plethora of rates on relative prices, progressive taxes on income and property and inequality in distribution of income. More importantly, administrative aspects of the tax policy were not given due consideration. We have already discussed in detail these deficiencies in the commodity taxes in the last few chapters.
The Evolution

Reforms in the commodity taxes had arisen due to above-mentioned reasons. Also the decade of the 1980s witnessed sweeping reform of tax systems across the world and in India a beginning was made in 1986 with the introduction of MODVAT. Fairness, efficiency and simplicity have been the guiding aims of the reform. An additional motivation particularly in the developing countries was the need for raising government revenues to reduce budgetary deficits, which had increased drastically in the wake of the oil shocks in the seventies and the economic crisis that many countries had to cope with in the early eighties. The crisis that affected the Indian economy in 1991 necessitated the need to carry out some radical reform of the tax system, which was delayed for a long time. However, the current phase of tax reforms in India is linked to the ongoing structural reforms of 1991 related to liberalization of the economy. Reforms in the trade and industrial policies requires additional reforms in the tax system so that it did not act as a constraint on the growth of domestic industries or their competitiveness in the world markets.

Various committees have been formed from time to time to analyse the tax system and the problems associated with it and suggested measures to reform the system. Apart from the major report on the tax system brought out in the fifties by the John Mathai Commission (1953-54), the Report of the Indirect Taxation Enquiry Committee ITEC (1978) was the first comprehensive and illuminating report on indirect taxes, which paved the way for an integrated commodity tax system in the country. It recommended a Manufacturers Value Added Tax (MANVAT) for replacing the then existing union excise duties. This report in the words of John F. Due is “one of the most exhaustive studies of indirect taxation ever made in any country.”

In addition to the ITEC Report a large number of studies by the scholars and other reports of different committees have contributed since independence, especially during the last two decades towards reforms in the tax system. Reports of the Tax Reforms Committee (1991, 1992 and 1993) sets the way for the reforms undertaken in the last decade. In the words of Bird (1993), it offers a “clear and sound guidance as to what can should be done.”
Pre-requisites of Tax Reforms

It has long been established that the tax system is complex and has adverse effects on efficiency and neutrality. It has also created a parallel economy. Tax reforms were initiated taking into account the criteria of neutrality, efficiency and equity. It also ensures fiscal autonomy of all the layers of governments. To achieve this, following are the main pre-requisites of reform measures: -

(a) Broad-based and destination based tax

The tax system should be broad-based including all goods and services with a uniform rate of tax. The tax should fall on consumption and not on production of goods. This means that goods and services should be taxed in the State where they are consumed and not where they are produced. This results in free movement of goods and services.

(b) Harmonised rates

The complex tax regime should be replaced by a few tax rates across the States. In this regard, the reforms should harmonise the base for both excises and sales tax, as the rates of all the taxes are applied at the same base. This harmonized tax system should be efficiently implemented by more or less uniform administrative procedures.

(c) Fiscal autonomy of the Centre and the States

Proposed tax reforms should take into account the significance of consumption taxes in the finances of the Centre and the States and so they should continue to enjoy fiscal autonomy. Also, inter-State tax competition should be stopped.

(d) Promotion of a National market

In a federal economy, there should be a common national market and not a fragmented one. There should be free flow of goods and services among the States. This norm of national sales tax should be applied to international trade also.

Adoption of a Value Added Tax as a Reform Measure

As mentioned in the Chapter III, VAT is the most desirable method to combat adverse inefficiencies in the commodity tax system. In its ideal form, VAT is a multi-stage tax levied on all stages of production and distribution of a commodity. It is collected in installments on the basis of value added at each stage of production and
distribution. Since an input is taxed only once, VAT avoids the cascading effects, which is the chief demerit of a generalized system of excise or sales taxation. Value added tax discourages vertical integration of industries to the advantage of small-scale sector. Since the cumulative effect of input taxation is absent under VAT, the impact of this tax on cost of production is limited to the amount of tax itself. By not allowing unnecessary cost escalation, VAT promotes competitiveness among domestic industries in the world market and thus generates favorable effects on exports.

However, the operation of VAT has certain limitations in a developing country like India. Firstly, VAT is a comprehensive levy covering almost all production. It is different from excise duties, which are in many cases selective in nature. Also, VAT like sales tax is essentially levied on *ad valorem* basis and does not admit of physical production as a criterion for tax liability assessment. In India, excise duties were imposed on *ad valorem*, specific, and *ad valorem*-cum-specific basis or even in the form of a compounded levy.

In principle VAT should be impose at a uniform rate or at the most 2 or 3 rates at all stages of production and distribution so that tax credit claims could be made easily. However, in India though Central excise rates have converged to a single rate, sales tax is imposed at a variety of rates on different commodities by the State Governments. The higher the number of rates, the more complicated the operation of VAT becomes. Value added tax tends to be regressive in view of uniformity or limited number of rates. One way to ensure progressivity under VAT is to impose special excise duties on a select band of final commodities (luxuries) without extending the advantage of tax credit. At the other end, zero-rating or exemption may be applied in the case of necessities.

Value added tax is more suitable under a unitary form of government, i.e. under a single tax authority for commodity taxation. In a federation, where different tiers of government enjoy commodity taxation powers, VAT would be difficult to operate due to problems of overlapping and lack of co-ordination. VAT can be advantageous only if it replaces both CenVAT and State VAT. It is unlikely that the States would agree to surrender their power to levy sales tax, particularly in view of its dominant and growing importance in States’ revenues.

Lastly, a comprehensive VAT requires an elaborate system of book keeping, involving numerous computations at each level of production. It calls for additional
and efficient administrative efforts to check and crosscheck the paper work done by the taxpayers. Apparently, both collection and compliance costs have a tendency to increase. The problem of administration was more serious in India where accounting practices were less developed, partly due to low literacy rate. It is much simpler for firms to file returns of gross turnover than the value added returns, which require, accounts of taxes paid on inputs. This problem was further compounded because of the prevalence of small-scale producers and sellers. These conditions deprive VAT of its theoretical advantage of automatic crosschecking to discourage evasion. Lack of proper recording of transactions and the unmanageable number of small taxpayers engages the administration in a futile exercise of hide and seek. This problem can partly be solved by extending the VAT system only to the wholesale stage and by exempting sectors dominated by small-scale production. For further simplification, VAT may be restricted to the manufacturing stage as is the case in India at present. Exclusion of retail and wholesale stages has significantly reduced the burden on administration without, at the same time, interfering in the working of the tax because they come at the end of the production chain.

Now, in this section a study is done to examine the various Committees formulated by the Central government since the planning process started, and their recommendations, which paved the way for the adoption of VAT.

Reform Measures Recommended by Various Committees

The Planning period started in 1950’s and since then various committees have been formed, time and again, which gave various recommendations to solve tax problems and some of them are accepted also. A beginning was made when the first Committee was formulated under the chairmanship of John Matthai titled Report of the Taxation Enquiry Commission (1953-54). The Commission was instituted to make “a comprehensive enquiry into the system of taxation in this country”.

The Report, however, exhibits the following broad features: Indirect taxes can be used as a means of progressive taxation, although in a limited manner. There is a scope for widening the base for taxation. According to the Commission, sales tax faces a number of problems including collusive evasion by the consumer and trader, lack of uniform rates, problem of co-ordination of tax between different States due to large-scale evasion and difficulties of law and administration. Another problem relates to wide disparities in the exempted “essential” goods of different States and in
a few instances, the power of imposing a sales tax ceiling on "essential" goods has been exercised by the Union with respect to commodities on which it continues itself to levy relatively high duties of customs and excises.

The Commission had put forward various recommendations to solve the discrepancies arising out of the tax system. The Commission however said that the sales tax should specifically be a source of revenue for the States, levied and administered by them. The Union governments' intervention is allowed only in case of inter-State sales and specific intra-State sale as, for example, when raw material produced in a State is sold to a manufacturer in that State and the finished goods in turn figures significantly in inter-State trade. The Union’s power of levy and control should be so exercised that there was no avoidable duplication and there was incentive for co-ordination between the States. Subject to this, each State should be free to evolve the system of sales tax best suited to its conditions. It also recommended the levy of a tax on inter-State sales subject to a ceiling of 1%, which the States would administer and also retain the revenue.

The next effort towards reform of the system of commodity taxation in India was taken in 1965 when the Fourth Finance Commission (under the chairmanship of Dr. P.V Rajamannar) was given a term of reference by the Government of India to measure the combined incidence of the Union excise duties and State sales taxes and the effect of their incidence on production, consumption or export of the commodities taxed, examine the possibility of determining the proportion that the combined money burden of union excise duties and sales taxes bore to the sale price of each commodity. The Fourth Finance Commission found it difficult to carry on this study due to different reasons.

Even if the Commission were able to determine the proportion that the money burden of the two taxes bore to the total price of a commodity, it was not easy to assess the effect that money burden had on production, consumption or export of a commodity while the factor of taxation had a bearing on the price of a commodity. For this, they have to undertake detailed cost analysis of each excisable item.

Taking into account these observations, the Fourth Finance Commission examined the manner in which better coordination between Union excise duties and sales taxes levied by the States could be brought about. This coordination could be achieved through a system of ceilings on sales tax along with a financial sanction in
the form of cut in States’ share of excises in case a State exceeded the ceilings, but the States had expressed strong views on it.

According to the States, the sales tax constitute a major portion of their revenue and any restriction on sales tax would affect their capacity to raise resources and inhibit the growth of industry and trade within their respective areas. Certain States had also commented that excise duties on commodities imposed a higher money burden than sales taxes and so ceilings should be placed on excise duties. The proper coordinated tax policy could be achieved not by a financial sanction but through regular exchange of views between the Centre and the States on problems of taxation and finding a solution to them.

Since adequate data for determining the combined incidence of the two taxes and their economic effects were not available, the Commission could not recommend any scheme of ceilings on the sales tax rates of any of the excisable commodities and there was no need of suggesting a formula for adjustments in the share of the States out of excise duties.

With changing circumstances new problems arise in the tax system and there was a need to review the existing tax system. However, there was increasing dissatisfaction with the indirect tax system. Accordingly, in July 1976, the Government of India appointed the Indirect Taxation Enquiry Committee under the chairmanship of LK Jha, Governor of Jammu and Kashmir (to review the existing structure of indirect tax system). The Committee had very wide terms of reference, which included the following: -

a) Review of the existing structure of indirect taxes of the Centre, State and local bodies;

b) To examine the role of indirect taxes in promoting economic use of scarce resources;

c) To analyse the structure and level of excise duties, their impact on prices, incidence on various expenditure groups and the scope for widening the tax base and increasing the elasticity of the system;

d) To examine the appropriability of Value Added Tax (VAT) in the field of indirect taxation and if found feasible, to suggest the appropriate stage to which it should be extended – manufacturers, wholesalers or retailers.
c) To examine, feasibility of concessions in indirect taxes to particular industries, keeping in view the administrative and revenue aspects etc;

f) To consider the interaction and proper balance between indirect and direct taxes in the tax structure while examining the role of indirect taxation in mobilizing resources.

According to the Committee, the existing complex system of indirect taxes is the result of a more or less uncoordinated growth of major individual indirect taxes levied independently by the Centre, State and local authorities. There is lack of uniformity and abundance of diversity regarding rates, coverage, procedures etc. in indirect taxation especially in the sphere of State taxes like sales tax, octroi and the like. Also there is an overlapping of excise and sales taxation over a number of products. The committee also found that the existing indirect taxation does not have an adequate built-in-elasticity because each year the tax rates have to be revised upwards and coverage increased to meet revenue requirements.

The taxes also suffer from a cost-cascading effect and results in inefficiencies in the tax system, like vertical integration, lower exports and also it becomes difficult to have an assured progressive and effective tax policy.

Recommendations of the Committee

The Committee was in view of initiating reforms, which ensures a sufficient availability of resources of the government and develop an efficient, result oriented, equitable system of taxation. The recommendations of the Committee were in the nature of both short term and long term measures, though they necessarily overlapped in certain areas.

In the field of excise duties the committee recommended rationalisation of duty on final goods, abolition of input taxes, criterion of granting concessions and simplification of procedures for collection and assessment of excise duties. In the case of sales tax, the committee suggested that the State governments should gradually move over to a single point tax at the last stage (Para 8.16). It was also suggested that inter-State sales tax be reduced to 1% from 4%, sale of inputs to registered manufacturers be tax free etc. For details see Annexure. However, the government accepted some of these recommendations.
The above recommendations were made without taking into account the need and significance of long-term reforms. According to the Committee, a combined tax effort should be initiated to minimize the problem of cascading and overlapping of Excise and Sales taxes. It is in this context that the committee proposed the option of VAT system at the manufacturing level (MANVAT). “It would be prudent to make a start with 3 or 4 industries which produce final products.... Such a pilot project would enable Tax Administration to test out procedures and study the reaction of the tax payers” (Para 10.18).

According to the Committee administratively, MANVAT is not much difficult to operate and problems will be minimum, since dealings are with big manufacturers and number of taxpayers will be small. The committee recommended that the tax credit version of MANVAT should be adopted. In pursuance of the proposal made in the Long Term Fiscal Policy Statement (December 1985) to extend the Proforma Credit scheme which observed that, “The basic approach will be to move towards an extension of the present system of proforma credit to all excisable commodities with the exception of a few like petroleum, tobacco, and textile products. This programme would amount to a modified system of VAT or MODVAT for short”. The Government introduced a modified system of value added tax or MODVAT in the budget for 1986-87. The scheme became operational with effect from March 1, 1986. MODVAT ushered in a new era in the system of excise taxation as it permitted instant credit to manufacturers on the duty paid on bought out inputs and intermediates and thereby affected the rising incidence of the cascade effect of excise and countervailing duties on the final products. In the budget 1987-88, MODVAT was extended to most excisable commodities. The underlying objective of MODVAT was to minimize the cascade effect and at the same time achieve revenue neutrality. To avoid a fall in revenue following MODVAT, the rates had been suitably adjusted upwards in 1986-87 budget and more rates were adjusted and raised in 1987-88.

Although the committee had made far-reaching recommendations but the nature of the problem it was analyzing, it could not recommend an overhauling of the entire system without suggesting that the authorities should gather experience about the new system. To this end, therefore, its recommendations fall into short term and long-term proposals. Furthermore, it was facing a difficult issue in the form of merger
of sales tax with union excise duties. The solution involved the will and aspirations of the States, their past experiences with the Centre and various economic and political questions. The committee decided in favour of retention of sales tax by the States for the time being. However, it recommended a long-term switch towards VAT system right through indirect taxation at both the Centre and State levels together with the abolition of octroi at the State level.

Under the New Economic Policy (NEP) 1991, the Government of India had realized that restructuring of the complicated tax structure was required for the transformation of the economy. Accordingly, the Tax Reforms Committee under the chairmanship of Prof. Raja J. Chelliah was appointed in 1991. The broad terms of reference of the committee were to examine and make recommendations on: -

(a) ways of improving the elasticity of tax revenues, both direct and indirect, and increasing the share of direct taxes as a proportion of total tax revenues and of GDP;
(b) making the tax system fairer and broad-based with necessary rate adjustments, particularly with regard to commodity taxation and personal taxation;
(c) simplification and rationalization of the structure of excise duties for better tax compliance and administration.
(d) the scope of extending the MODVAT scheme etc.

According to the Committee, the Structural Adjustment Programme initiated by several countries includes tax reform as an important part but comprehensive tax reform has gained mass momentum. According to the committee, to the extent the MODVAT operates, the union excise does not cause distortions in the producers’ choice of inputs. The exporters were greatly benefited, because all inputs were relieved of excise and/or countervailing excise on imports. Cascading continues when excise taxes fall on machinery, accessories, fitting tools, office equipment and vehicles. However, in other countries, capital goods have been treated like other inputs to concentrate the tax on consumption and to encourage saving.

The Committee had listed various problems faced by the commodity tax system and these were similar to what other committees had pointed out i.e exemptions to small sector under the excise system, the cascading effect of CST, biasedness of the inter-State sales tax etc.
Also the system of tax administration in respect of both direct and indirect
taxes required much improvement. Record keeping was in bad shape and new
methods of detecting evasion were not being developed. Unscrupulous taxpayers
who indulged in large-scale tax evasion continued to do so with impunity either
because there was little chance of detection or because they had made suitable
arrangements with the tax officers.

Reform Measures

The committee had planned out a number of reform measures with regard to
“the criterion of a sound tax structure i.e. equity, economic efficiency and
administrative tax.” The constant refrain of this report was that the tax system should
be broad-based, simple and should have moderate rates.

(a) The first major reform should be to convert the existing MODVAT into a full-
fledged VAT system at the Central level. For this it is necessary to simplify
the excise-cum-MODVAT system, expand its base, removal of most
exemptions, and increase its income and price elasticity.

(b) The committee also recommended the replacement of specific duties by ad-
valorem rates not only for introducing full-fledged VAT at the manufacturing
level, but also for enhanced elasticity of revenue with respect to the national
income and buoyancy in revenue on account of increase in prices.

(c) For broadening the tax base and lowering of rates, services must be brought
under taxation. The service tax must be part of VAT in course of time and
should be levied at the Central level. A cascading type services tax should be
avoided at all costs.

(d) There must be selective excises on specified products- mainly commodities of
luxury or non-essential consumption and goods whose use must be
discouraged for purposes of conservation and/or protection of the
environment. To make the VAT system simple and easily administrable, it
should be levied at two or three rates, say, at 10, 15 or 20 per cent. The
selective excise duties on non-essential consumption could be levied at 30, 40
or 50 percent. This means that maximum rate on a commodity would not
exceed 50 percent with a few exceptions like cigarettes.
(e) It would be ideal if there were one comprehensive VAT and limited exemptions replacing the present system of Central excise, the State sales tax and other indirect taxes except the State levy on alcoholic liquor and the State entertainment tax. The proceeds of the tax could be shared between the Centre and the States.

(f) Any reform of tax structure had to be accompanied by a reform of tax administration, if complete benefits were to be derived from the tax reforms.

(g) The imposition of the consignment tax as demanded by the States, taken together with the existing CST, both being levied at a maximum rate of 4% would lead to inefficient allocation of resources and subsequent loss of welfare of the backward or less industrialized States and not enabling the States to raise more revenues. This was because a tax at 4% of the value of inter-State sales, together with a consignment tax, in addition to the tax embedded in the costs through the taxation of inputs in the producing States, acted as a strong barrier to inter-regional trade within the borders of the country and fragments the common market. Such fragmentation goes contrary to the attempts being made to integrate the Indian economy with the world economy.

Yet another important and comprehensive report in the direction of reform of indirect taxes especially State sales tax and Central excises, was by Dr. Amaresh Bagchi, titled “Reform of Domestic Trade Taxes in India”, 1994. According to the Report, the need for reforms of domestic indirect taxes i.e. Central excises and State sales tax arised due to various factors: -

a) The system presently operational was complex, in the sense of, laws and procedures, structure and violates canons of taxation- equity, efficiency and neutrality.

b) The decade of 1980’s saw commendable changes in the tax systems across the world reflecting the importance of the taxes in the growth and development of the economy.

c) Also the need arises, in the developing countries for the governments to enhance their revenue generating capacities to cover deficit budgets arising due to oil shocks in seventies and economic crisis of early eighties.
The crisis that shocks the economy in 1991 and the structural adjustment programme thus initiated required the reforms of the tax system, which were even otherwise long overdue.

The Chelliah Committee (TRC, 1991) recommended measures for direct taxes and comprehensive reform of domestic indirect taxes was yet to be undertaken.

According to the Report, the operation of both these taxes had given rise to problems and inefficiencies that cost the economy dearly in many ways: Loss of output, growth and welfare; inefficiency and high cost in industry and trade; impediments to the free flow of trade within the country and growth of the common market that the Indian Union offers; inter-jurisdictional conflicts; and high costs of compliance and enforcement.

The costs enumerated above arised essentially due to the following reasons or shortcomings in the present tax structure. These were: -

a) Heavy reliance on taxes at the manufacturer\first seller level;
b) Exclusion of services from the tax base;
c) Taxation of inputs and capital goods;
d) High level and multiplicity of rates with too many exemptions and concessions;
e) Taxation of inter-State sale and lack of harmony in States’ sales tax systems; and
f) Complex laws and archaic administration.

Some of these were common to both excises and sales tax while some were peculiar to either one or the other.

Reform Measures

According to the committee, the primary objectives of domestic trade tax reform had to be to impart neutrality and transparency to the tax system, to minimize the scope for distortion, harassment and abuse. The following were the main prerequisites of reform measures: -
(a) Economic efficiency and neutrality: - This implies that taxes should apply equally to as broad a base as possible including all goods and services. They should extend beyond the first point of sale and go as close as possible to consumers. Also, taxes on production inputs including plant and equipments should be removed. Internal neutrality requires the taxes do not affect the free flow of goods and services within the Indian common market. This requires that goods and services should be taxed in the State where they are consumed and not where they are produced.

(b) Equity: - Consumption taxes (excises and sales taxes) are regressive and regressivity is reduced through differentiation in tax rates and exemptions. So the system that has emerged is complex and irrational. Equity is served better if the tax is applied to as broad a base, and at a few rates, taking into account both social policy and administrative considerations.

(c) Simplification and harmonization: - International experience shows that simpler tax laws not only lower costs of compliance and administration, but also contribute to the revenue potential and fairness of the tax system. When the tax is applied to a broad base, at fewer rates, the tax laws would be much simpler, the costs of compliance and administration much lower and evasion more difficult.

Inter-State and Centre-State harmonization of tax laws and administrative procedures could also make a significant contribution to the objective of simplification.

(d) Fiscal autonomy of the Centre and the States: - When a certain degree of harmonization among taxes imposed by different governments is essential for simplification and effective enforcement, consolidation of all taxes into a single levy administered by only one level of government, to be shared among the Centre and the States, is neither politically feasible nor desirable. This implies curtailment of the tax powers of one or the other level of government. Given the significance of consumption taxes in the finances of the Centre and the State, it was desirable that they continue to enjoy fiscal autonomy with respect to the broad design features and overall revenue contribution of these taxes.
Strengthening of revenue base: Reform initiatives should not impair the overall revenues of the Centre and the States. Governments need revenues to provide public resources, to redirect resources to areas of social and economic priorities and to reduce inequalities in the distribution of income and wealth. So there revenue bases need to be strengthened in order for them to maintain and improve the quality of the basic public services and infrastructure.

According to this Report some of the inefficiencies of the present system could be removed through provincial reforms or harmonization of rates among the States. But a long-term reform in the form of a VAT could help to stabilize the economy and free from the clutches of complex and outdated system of taxation.

To reform the sales tax towards a simple, neutral and productive system of indirect taxation, the essential measures included in the Report were:

a) Replace sales tax by VAT by moving over to a multistage system of sales taxation with rebate for tax on all purchases with only minimal exceptions.

b) Allow input tax credits for all production inputs, including raw materials and parts, production machinery, equipment etc., consumables and goods for resale.

c) Inter-state harmonization and rationalisation of tax rates. The structure of tax rates should be replaced by two or three rates within specified bands, applicable in all States and Union Territories.

d) Remove the exemptions and concessions except for a basic threshold limit and items like unprocessed food, concession like tax holiday should also be withdrawn.

e) Zero rate exports out of the country and also inter-State sales and consignment transfers to registered dealers with suitable safeguards against misuse.

f) Tax inter-State sales to non-registered persons as local sales.

g) Modernize tax administration, computerize operations and the information and simplify form and procedures.

h) Extend the tax base to include all goods sold or based with minimal exceptions, and services, which are integral to the sale of goods. The base
should also include services, which are predominantly of a consumption nature and can be taxed conveniently by the States.

**Union Excises**

TRC, 1991 had made wide-ranging recommendations for the restructuring of the Central excises taking into consideration the various problems in excise taxation. However, the Report of Domestic Trade Taxes in India proposed on alternate set of measures with TRC recommendations in the background. “The main components of the proposals were:

a) Technical improvements in the method of valuation for more effective taxation at manufacturer level.

b) Extension and generalization of MODVAT to transform central excises into a manufactures value added tax (MANVAT) as envisaged by the Indirect Taxation Enquiry Committee of 1976-77.

c) Rate rationalization on the lines, suggested by TRC (1991).

d) Provision of full and immediate credit for tax on inputs including equipment for exclusive use in taxable manufacturing.

e) Broadening the base of excises by withdrawal of exemptions and extension to selected services.

f) Cessation of tax-rental agreement between the Centre and the States in regard to levy of sales tax on textiles, tobacco and sugar.

In the recent past, another Committee which had given some worth mentioning recommendations in the field of indirect taxation was the **Report on the task force on Indirect Taxes, 2002 by Vijay Kelkar**. Some of the reform measures suggested by this committee were:

i) The Kelkar Committee has recommended that “through suitable legislative changes, the levy of central excise should be progressively based upon value addition to be applied only to the processing stage (of manufactured goods) which ensuring that the other areas of value addition not relating to the processing activity (such as Sales tax) was not entered into and possibility of double taxation was avoided.” In the Budget 2003, this recommendation was not accepted by the Government.
ii) The Kelkar Committee had expressed its concern over the amended Section 2(f) of the Central Excise Act, 1944 which empowered the Executive to rule upon what is manufacture and once it is clarified, the Executive would be in a position to demand the duty from the tax payer on all production and clearances made over the past one year, which would be a heavy burden. So the Committee had advised the Government that this provision should not be used regularly and it should also be amended.

The assessment of excise taxes was based on the Retail Sale Price [Maximum Retail Price (MRP)] where when the goods were sold in large quantities for actual industrial use, certain relaxations were given. Manufacturers take undue advantage of these relaxations by taking the goods from the factory in bulk and get it re-packed outside. So the Committee had recommended that wherever MRP based levy be applied on an item, the act of repacking, re-labeling and putting the item into unit container for retail sale might be deemed to be amounting to ‘Manufacture’. However, the Budget 2003 had again not accepted these recommendations.

iii) Multiple rates of commodity taxes had long been considered a weakness of the indirect tax system in India. The Kelkar Committee, following the principle of replacing multitudes of levies by one rate namely, CenVAT, suggested the following duty rate:

- 0 % - for life saving drugs, security equipments, food items etc.
- 6 % - for processed food products and matches.
- 14% - standard rate for all items.
- 20% - for motor vehicles, air conditioners and aerated water. Higher rate for tobacco products and pan masala.

Tea was to be exempted as coffee was exempted. Cement would continue to have a fixed rate.

The Budget 2003, however, had created a three-tier excise duty structure namely 8%, 16% and 24% in place of four tiers- 4%, 8%, 16% and 32%.

A very good simplification had been suggested for the textile sector. Uniform duty of 16% (later 14%) had been suggested on fibers and yarn. For all fabrics it was 12%. All but 15 exemptions were to be abolished. Uniformity was to be brought about
by bringing all duties to the standard rate of 16% and in 2004-05 to 14%. But extending the CenVAT to weavers would create serious difficulties due to a large number of them being in the small sector. Although a very good scheme, but it was not implemented in the following budget.

iv) Prior to the introduction of MODVAT in 1986, there were provisions in the Central Excises and Salt Rules, 1944, under which certain inputs were exempted from taxation to minimize the cumulative effect of excise levies. Thus, Rule 56-A of the said Rules, introduced in 1962, allowed the manufactures of certain notified finished excisable goods to bring excise paid components (for example compressors for refrigerators) to take credit for the said duty in the Proforma Credit Account to get adjustment of duty on the final excisable good. Then with recommendation of the ITEC, 1978, the Proforma Credit Scheme was extended and MODVAT was introduced in 1986.

According to the Kelkar Committee Report, the CenVAT credit was allowed in respect of inputs, which were brought into a factory for use for the manufacture of the final products. In contrast, the CenVAT credit was allowed in respect of capital goods used in the factory of the manufacturer. This distinction between inputs and capital goods caused disputes and litigation. So, the Committee recommended that the CenVAT Credit Rules, 2002 should be amended to abolish the distinction between capital goods and inputs and allow credit on all inputs brought into the factory (except those in the exemption list, such as office furniture, motor vehicles, MS, HSD, etc.) and on the capital goods.

However, the government in the Budget 2003 had not accepted these recommendations. In contrast, with regard to the capital goods industry, the Budget had given certain negative features, which had adversely affected the sector.

v) The Kelkar committee report recommended the abolition of multiplicity of exemptions and also said that if any help was at all merited it could be given by a transparent budgetary grant. Instead of accepting this suggestion, a number of location-based exemptions had been increased in this budget.

vi) With regard to the service tax, the Kelkar Committee had suggested a comprehensive service tax where all services should be declared taxable and there could be an exemption list. But this does not seem to be a feasible option since there
were so many services about which the definitions were not clearly demarcated. Even
the Kelkar Committee was not clear about ‘what is a service’. However, in the budget
2003, service tax had been raised from 5% to 8%. Ten new services had been brought
under the purview of service tax. Also the facility of credit of service tax on input
services had been extended across all services even if the input and the final services
fall under different headings in the tariff structure.

Vat in Haryana

Now let’s briefly analyse the situation prevalent in the State of Haryana where
VAT had already been imposed at a time when no other State was ready to take the
initiative. In 2003, Haryana replaced the Haryana General Sales Tax Act (HGST) by
the Haryana ValueAdded Tax Act. VAT in Haryana is special for more than one
reason. The first is that this was an experiment, for Haryana went ahead with VAT
when all other States hesitated for different reasons. Secondly, this was an attempt
after the failed experiment of Maharashtra in the recent past, and if it does not
succeed, the whole programme for the rest of India due in April 2005, would receive a
severe jolt. Lastly, VAT was implemented in Haryana without the bill having received
the president’s assent.

The design of VAT in Haryana had been on the same lines as that for the rest
of India. All dealers had been given 11-digit tax identification numbers, just as was
being planned in the rest of India. The first two digits indicate the name of the State,
and the second two, the charge of the department. The next four are the identification
numbers of the dealer, one digit for the tax law and the last two for the correctional
code.

The rate structure consisted of three main rates of 4%, 8 %and 12%. Apart
from that there were exemptions at zero rate (85 items are included such as
vegetables, sugar cane, bajra, maize fresh fruits etc.) 1% for articles including jewelry
made of gold, silver and other precious metals and stones and 20% for liquor, aviation
turbine fuel and petrol. The number of items included at different rates were: at 4 %
44 items were included like paddy, pesticide raw wool, safety matches etc., 8% tax
was only for tyres and tubes. A rate of 12% was levied on all other items such as
refrigerators, cooking appliances, cars, cooked food etc. With the rates being 4%, 8 %
and 12%, it became very easy to merge with the rates of 4 % and 12.5 % for the rest
of India when VAT came on April 1, 2005. As there was only one item namely, tyres
and tubes under 8% VAT, it would fall under 12.5% category. And all items under the 12% category would obviously went to the 12.5% one. This extra 0.5% would give some revenue buoyancy to Haryana. Input credit had been allowed for capital goods also. But it had been restricted to capital goods used in the manufacture of taxable goods for sale only.

The treatment of interstate trade was on the same pattern as the proposal for the rest of India. This means that input credit would not be given to the goods coming from other States but intrastate input credit would be allowed. No input credit would be available in the case of branch transfer of consignment sale or for any CST paid for interstate trade. The system of sale assessment had been introduced so that dealers could write down their own assessment, pay the VAT and submit the return to the sales tax office. The system that had been adopted for the calculation of VAT was on the basis of the invoice method. Under the invoice system, the dealer could take tax credit for all taxes paid for the input, which had been purchased, and debit this amount from the total amount of VAT to be paid. The balance amount could be deposited as the next sum of VAT that was to be paid in a month. The same method was followed under the CenVAT procedure. An audit team had also been set up.

Revenue growth was the most important aspect by which to judge the success of VAT in Haryana. VAT had given the State 43 per cent additional revenue in 2004-05. The State’s revenue had gone upto Rs 4,778 crore in 2004-05 from Rs 3,346 crore in the 2003-04. The number of taxpayers had increased from 6,417 before VAT to 8,504 after, which itself was an indication of the broadening of the tax base. The increase in revenue could be seen from the following Table 6.1.

According to Associated Chambers of Commerce and Management (ASSOCHAM), certain revelations were made by the Haryana Finance Minister, Mr. Birendra Singh while having interactions with senior members of the Chamber.

Mr. Singh said that the Haryana experience should be emulated by those States that were resisting VAT’s implementation, an ASSOCHAM release stated. “Our experience has been that ever since Haryana adopted VAT, not only its tax collections have gone up but also the retail prices of essential commodities like grains, pulses, fruits and vegetables, electrical appliances, consumer goods have remained stable compared to those that prevailed in States like Delhi, Punjab and the like during 2004-05.”
Comparing the growth of the State’s economy with that of the national economy after the State adopted VAT, Mr. Singh said, “while the growth rate of the nation’s economy in 2003-04 was 8.4%, in 2004-05 it is estimated at 6.9%. In comparison the GSDP of Haryana recorded a growth of 8.6% in 2003-04, which is almost the same as the national average but the growth rate in the manufacturing sector at 7.5% was higher than the national average at 6.6%. In 2004-05, the State economy is estimated to record a growth of 8.5%, which is about 2% higher than the estimate for the national average.”

Table 6.1: Total Tax Revenue in Haryana: Selected years (in %)

<table>
<thead>
<tr>
<th>Total tax collection/year</th>
<th>2002-03</th>
<th>2003-04</th>
<th>2004-05</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Revenue</td>
<td>86.6</td>
<td>182.48</td>
<td>202.06</td>
</tr>
<tr>
<td>Tax Revenue</td>
<td>63.1</td>
<td>131.4</td>
<td>151.6</td>
</tr>
<tr>
<td>State’s own tax revenue</td>
<td>55.5</td>
<td>111.8</td>
<td>125.4</td>
</tr>
<tr>
<td>1) Taxes on income</td>
<td>NA</td>
<td>1</td>
<td>1.3</td>
</tr>
<tr>
<td>2) Taxes on property</td>
<td>5.5</td>
<td>9.5</td>
<td>10.7</td>
</tr>
<tr>
<td>3) Taxes on commodities &amp; services</td>
<td>50.1</td>
<td>101.2</td>
<td>113.4</td>
</tr>
<tr>
<td>a) Sales tax</td>
<td>33.4</td>
<td>71.7</td>
<td>81</td>
</tr>
</tbody>
</table>

Source: wikipedia.org

Goods and Services Tax (GST): The Future of Tax Reform

The Goods and services tax is a value added tax that exists in a number of countries. Some of these countries are Australia, Canada, New Zealand, Singapore and Sri Lanka. Firstly, an analysis is done on the structure of GST in these countries and examine to what extent they are successful. Then, the progress made in the context of GST in Indian economy is analysed.

Goods and services tax in Australia

In Australia the GST was introduced by the Howard government on 1 July 2000, replacing the previous federal wholesale tax system and designed to phase out the various State and territory taxes such as stamp duty and land value tax. It is levied at the rate of 10% on most goods and services sold in the country.

Economic and Social effects of GST

When GST was introduced in Australia many critics have argued that it was similar to a regressive tax, which had a more pronounced effect on lower income
earners, meaning that the tax consumes a higher proportion of their income, compared to those earning large incomes. However, these claims were somewhat mitigated due to the corresponding reductions in personal income taxes, State stamp duties, federal wholesale tax and some fuel taxes that were implemented when the GST was introduced. Thus, according to the Federal Treasurer of Australia, Peter Costello, people were effectively paying no extra tax.

The preceding months before the GST became active saw a spike in consumption as consumers rushed to purchase goods that they perceived would be substantially more expensive with the GST. Once the tax came into effect however, there was plummeting consumer consumption and economic growth, that by the first quarter of 2001, the Australian economy plunged into negative growth for the first time in more than 10 years. The government was further criticized by small business owners on the grounds that administrative costs and red-tape had soared as businesses had to submit Business Activity Statements regularly to the Australian Taxation office, in addition to having to pay one eleventh of revenue for GST purposes.

A Study commissioned by the Curtin University of Technology, Sydney in 2000, argued that the introduction of the GST would negatively impact the real estate market as it would add upto 8% to the cost of new homes and reduce demand by about 12%.

These claims might had been accurate during the early GST period, however the real estate market returned to unprecedented boom between 2002-04 where property prices and demand increased dramatically, particularly in Sydney and Melbourne. During the period 2004-06 Perth has also witnessed a sharp climb in real estate prices and demand.

Tourist Refund Scheme

The removal of import duties, as part of GST, had led to a change in discounts available when duty free shopping and the process for claiming tax savings. Previously, goods could be purchased from suppliers offering duty free pricing upon presentation of a current passport and airline tickets. The goods would then remain sealed until the passenger had passed through the customs area to an airport.

Following the introduction of the GST, a receipt for goods with a combined total over AUD$300 was eligible for a referral of any GST paid upon exiting the
country with refunds claimed at a TRS (Tourist Refund Scheme) counter at the airport. The advantage of this arrangement was that goods purchased up to a month prior to departure might be freely used within Australia prior departure as long as they were carried in hand luggage and presented when making a refund chain. This obviously does not extend to consumable goods such as food & beverages.

Goods and services tax in Canada

The Canadian GST (French: Taxe sur les produits et services, TPS) is a multi-level value added tax introduced in Canada on Jan 1, 1991, by P.M Brian Munro and F.M Michael Wilson. The introduction of the GST in Canada was, however, very controversial.

Structure

The tax is a 6% charge (previously 7% before July 1, 2006), on the sale of all goods and services, except certain essentials such as groceries, residential rent, and medical services, and services such as financial services. The tax is levied on each sale. Businesses that purchase goods and services as inputs can claim “input tax credits” (i.e., they deduct from the amount of GST they have collected the amount of GST that they have paid). This avoids “cascading” (i.e., the application of the GST on the same good or service several times as it passes from business to business on its way to the final consumer). In this way, the tax is effectively borne by the final consumer. Unfortunately, criminals have defrauded this system by claiming GST input credits for non-existent sales by a fictional company. Exported goods are exempt, while individuals with low incomes can receive a GST rebate with their income tax.

In 1997, the provinces of Nova Scotia, New Brunswick and Newfoundland and Labrador and the government of Canada merged their respective sales taxes into the Harmonised Sales Tax (HST). In these provinces, the HST rate is 14% (previously 15% before July 1, 2006). HST is administered by the federal government with revenues divided among participating governments according to a formula. All other provinces continue to impose a separate sales tax at the retail level only, with the exception of Alberta, which does not have a provincial sales tax. In PEI and Quebec, the provincial taxes include the GST in their base. The three territories of Canada (Yukon, Northwest Territories and Nunavat) do not have territorial sales taxes. The
government of Quebec administers both the federal GST and the provincial Quebec Sales Tax (QST). It is the only province to administer the federal tax.

Certain services have the tax added in such a way that the total cost is rounded to the nearest multiple of cents, due to limitations in the collection mechanism; for e.g payphone calls are taxed so that the cost is a multiple of 5 cents; calls payable at 35 cents or less are not charged GST as the tax is under 2.5 cents.

Untaxed items

The tax is a 6% charge on all goods and services except certain items that are either “exempt” or “zero-rated”.

a) For tax-free i.e “zero-rated” sales, GST is not charged by vendors. However, they are still able to recover any GST paid on purchases used in making tax-free good or service. This effectively removes all tax from these goods and services

b) Tax-free items include basic groceries, prescription drugs and medical devices. Exports are also zero-rated.

c) For tax-exempt sales, vendors do not charge tax on their sales. By the same token, however, they are not entitled to credits for the GST paid on inputs bought for the purposes of making the exempt good or service. Tax-exempt items include residential rents, health and dental care, educational services, day-care services, legal aid services and financial services.

Implications of GST

The high profile and public resentment of the GST led to a partial tax revolt on the part of Canadians. Surveys, anecdotal evidence and econometric analysis by economists all suggest that there was a substantial increase in the size of the underground economy in Canada as a result of the introduction of the GST.

The political ramifications of the GST were severe. The Progressive Conservative government of Mulroney became one of the least popular in Canadian history. It lost the 1993 election to Liberal Party under the leadership of Jean Chretian.

During the election campaign, Chretian promised to repeal the GST and replace it with a different tax. Instead of repeal, the Chretian government attempted to
restructure the tax and merge it with the provincial sales taxes in each province. They intended to call it the Blended Sales Tax, but when its opponents derisively called it the “B.S Tax,” they changed the name to Harmonised Sales Tax before its introduction. Only 3 provinces agreed to go along with this plan. However, Nova Scotia, New Brunswick and Newfoundland and Labrador now have the 14% HST instead of separate GST and PST. The decision not to abolish or replace the GST caused great controversy, both within the party and without.

Current Situation

Fiscally, the GST has accounted for 15% to 17% of total federal tax revenues each year since 1999. This is slightly greater than the annual amount of the Canada Health and Social Transfer itself.

Many also argue that a switch towards heavier consumption taxes on the European model has helped the Canadian economy become more efficient and competitive with lower-priced goods for the international market. However, the effects of the GST in this realm are quite modest, and are regularly swamped by large changes in the exchange rate. It can also be claimed that the transparent nature of the GST has kept Canadians actually aware of their taxation. This has led to a major change in political culture so that deficit financing is no longer considered an option by the federal and provincial governments.

The GST once again became an issue, as the Conservative Party of Canada reduced the tax by 1% (to 6%) on July 1, 2006 as part of an election promise and to reduce it by another 1%. But it could not be implemented due to weak majority in the Parliament.

Tax-free shopping for visitors

Currently, visitors to Canada may request a tax refund when they leave Canada by filling out a form at a Canadian airport or some duty free stores at border crossings. The visitor must send in original receipts with a stamp by Canadian Customs. Cheques are mailed to the visitor within a few weeks. Recently the government has announced plans to eliminate this refund programme.

Goods and Services Tax in New Zealand

GST is a value added tax introduced in New Zealand on October 1, 1986 at 10%, but later increased to 12.5% on June 30, 1989. End users pay this tax on all liable
goods and services directly, in that it was included in the purchase price of goods and services.

GST registered organizations only pay GST on the difference between GST liable sales and GST liable supplies (i.e. pay GST on the difference between what they sell and what they buy: income less expenditure). This is accomplished by reconciling GST received (through sales) and GST paid (through purchases) at regular periods (typically every 2 months with some qualifying companies opting for 1 month or 6 month periods), then either paying the difference to Inland Revenue Department (IRD) if the GST collected on sales is higher, or receiving a refund from IRD if the GST paid on purchases is higher. Unlike most similar taxation regimes, there are few exemptions—all types of food are taxed at the same rate; for example, exceptions that are present include rents collected on residential rental properties, donations and financial services. Businesses exporting goods and services from New Zealand are entitled to “zero-rate” their products effectively, they charge GST at zero percent. This permits the business to claim back the input GST but the eventual, non-New Zealand based consumer does not pay the tax (businesses that produce GST-exempt supplies are not able to claim back input GST).

Because businesses claim back their input GST, the GST inclusive price is usually irrelevant for business purchasing decisions. Consequently, wholesalers often state prices exclusive of GST, but must collect the full, GST-inclusive price when they make the sale and account to the IRD for the GST so collected.

The headline price must always be GST-inclusive in advertising and stores. The only exceptions are for businesses, which claim a mainly wholesale client-base. Otherwise, displaying a prominent GST-exclusive price (i.e. larger and more obvious than the GST-inclusive price) is illegal.

Goods and Services Tax in Singapore

GST was introduced in Singapore on April 1, 1994 at 3% but later increased to 4% on January 1, 2003 and 5% on January 1, 2004. It is slated to rise to 7% on July 1, 2007.

Singapore’s GST is a broad-based consumption tax levied on import of goods, as well as nearly all supplies of goods and services. The only exemptions are for the
sales and leases of residential properties and most financial services. Export of goods and international services are Zero-rated.

Objectives

The GST was introduced as part of a larger tax restructuring exercise, to enable Singapore to shift its reliance from direct taxes to indirect taxes. The GST also enabled Singapore to sustain a lower income tax rate.

The government argues that with an ageing population, Singapore’s income tax base was expected to decline. With a broad-based GST, the taxation burden will be more evenly spread among the population. Thus, the GST was introduced as part of a larger exercise to put in place a tax structure to see the country into the future.

A value added tax like GST also has several features that make it attractive. Being a tax on consumption, and not on income, the tax system inherently encourages savings and investments instead of consumption. The tax also has a self-policing mechanism that discourages evasion, unlike in a retail sales tax system or an income tax system where it would be relatively easier to scheme to evade taxes.

Proposed GST increase to 7%

More details of the GST increase will be announced on 15 February 2007, which is “Budget Day”. Prime Minister and Finance Minister Lee Hsein Loong added that Second Finance Minister Tharman Shanmugaratnam would deliver the Budget speech. The 2% increment came as surprise to many Singaporeans, which was followed shortly after the 2006 general elections.

Goods and Services Tax in Sri-Lanka

One of the most controversial issues in Sri-Lanka today, the HST Act was made effective only on April 1, 1998. The intent of the law was to enact a system of comprehensive value added taxation in line with the U.K value added tax.

Towards this end, the Act imposes a GST on supply of all goods, and rendering of all services, except those listed in the Schedule. At the same time, tax provides for relief on account of GST paid by the taxpayer. Thus the tax is only on value added. (http://en.wikipedia.org)

The study of the experience of some of the developed countries like Australia, Canada, following the GST in their respective countries, reveals the success of this
comprehensive goods and services tax. It gives a boost to the countries like India, who are on the path of adopting GST in their countries.

**Goods and Services Tax in India**

In India, the Goods and services tax is a part of the proposed reforms that centers on evolving an efficient and harmonized consumption tax system. The Kelkar Task Force Committee recommended the introduction of goods and services tax, as it would simplify the tax structure. Presently, there are parallel systems of indirect taxation at the Central and State levels. Each of the systems needs to be reformed to eventually harmonise them.

In the Union Budget for the year 2006-07, Finance Minister has proposed that India should move towards national level Goods and Services Tax that should be shared between the Centre and the States. He has proposed to set April 1, 2010 as the date for introducing GST.

Kelkar (2006) has expressed joy and hope that “it will help India achieve economies of scale by becoming a common market and help India score in the global market for labour intensive manufacturing”. According to Kelkar, first of all an EC for GST implementation should be set up and since, GST involves both Centre and States it should be chaired by the Finance Minister.

However, Kelkar (2006), Rao (2006), and Srivastava (2007) have given different views about how to harmonise the taxes but these views are similar to certain extent also. According to them, by early 90’s much has already been achieved on the way to reform the commodity tax system. But still a lot has to be done to complete the process of evolving an efficient and a harmonized consumption tax system in the country. According to Rao, such a coordinated indirect tax reform in an environment where the states give much importance to their autonomy is not quite easy.

**Reform at the Central Level**

According to Rao, although a considerable progress has been made by converging widely varying tax rates and extending input tax credit to convert excise duties into a CenVAT. Though on paper full tax credit is supposed to be given for the prior taxes paid on both goods and services, in terms of actual operation, much remains to be done. Besides, to transform this into a manufacturing stage VAT on goods and services requires considerable reforms.
To transform CenVAT into MANVAT requires further simplification and convergence of excise duties, which, inter alia, also requires conversion of specific duties into ad valorem, with the exception of a few items such as cigarettes.

It is also important to broaden the base of the tax. Almost 40% of the revenue from excise duties is collected from petroleum products alone and this concentration, particularly on a predominantly intermediate good creates severe distortions. It is also necessary to get rid of area-based exemptions and exemptions to small-scale industries and rationalize concessions on exports.

A necessary reform is the extension of the scope of service taxation to all services and its merger with CenVAT, VAT on goods and services should apply to all services with a small exemption list and a narrow negative list.

Once the service tax is made general, it may be merged with CenVAT to have a common exemption limit and tax rate. After broadening the base by removing exemptions to small-scale industries and area-based exemptions and general taxation of services, the revenue-neutral rate of tax could be worked out.

A rate of 12-13% at the manufacturing stage would be equivalent to about 10% retail VAT.

Reform at the State level

As far as the State taxes are concerned, the replacement of cascading and narrow based sales taxes with VAT is the most important tax reform in independent India. The major gain from the tax has been to simplify the tax system considerably.

However, there is need to further simplify and rationalize the system. This includes restricting the number of items in the 4% category to basic necessities, and shifting the “inputs”, currently taxed at 4%, to the general tax rate.

In fact, the general rate itself could be reduced to 10% from the prevailing rate of 12.5%. In any case, taxes on all inputs will be credited under VAT and taxing the so-called “inputs” at a lower rate only reduces tax compliance.

The real gains from the reform will accrue only when the tax is extended to all the States and tax credit is extended to inter-state transactions. This definitely requires an effort to be made by all the States to take up this reform process.
It is important to finalise the methodology of relieving taxes on interstate transactions to make the tax system destination-based and build the information system to administer the levy. According to Kelkar, the Tax Information Network (TIN) system, built by NSDL, is the right foundation for implementing the GST. TIN already reaches 600,000 establishments, and these are exactly the establishments, which need to be plugged into the GST. Hence, the IT development work should be initiated at NSDL now, so that it can be ready by April 2007.

The method of zero-rating transactions at the point of interstate sale requires considerable preparation, particularly computerization to ensure that the items eventually zero-rated by the exporting State pay the tax in the importing State.

According to Srivastava, the final reform of the CST lies in its abolition. The tax is levied by the Centre but collected by the State governments who are allowed to retain the revenue proceeds. It was introduced at the nominal rate of 1%.

Under pressure from the State governments, the CST rate was progressively increased to 4%. Overtime, the CST has become an important source of revenue for some States that are known to be 'producing' States, it is paid by the citizens of the consuming States. As such, the CST has been a vehicle of tax-exportation violating the principle that the tax should accrue to the jurisdiction where the final consumption takes place. The total revenue under the CST is estimated to be Rs 19,345 crore in 2006-07 as per the Budget estimates. Some of the major States such as Maharashtra, Gujarat, Karnataka, Tamil Nadu, Haryana and Andhra Pradesh have a comparatively high share in this revenue. Considering Rs 20,000 crore as the potential revenue under CST for the current year, a decline of 1% point in the CST rate would involve a loss of about Rs 5000 crore and the individual annual losses for the States could range from about Rs 170 crore for West Bengal to Rs 550 crore for Maharashtra. Part of the loss would be made up by increase in the tax base.

In addition, the State governments are likely to be allowed to levy State VAT at the rate of 4% on inputs. This would be comparable to the countervailing duty that the center levies on imports.

According to Rao, the power to levy VAT on sugar, textiles and tobacco products should be given to the States. But, the levy on tobacco products should be
only at the general rate and sumptuary powers of the levy will continue with the Centre.

However, both agree that it is necessary to give the power to levy service taxation to States as part of the compensation.

Rao, has suggested two methods of sharing the service tax powers. One is to give the States concurrent powers to levy the tax. The other is to share only the services of regional spread with the States, but this would neither bring in substantial revenues to the States nor enable proper levy of the GST at the State level.

Then the individual States should be merged into the TIN, one by one, at an administrative level while keeping the State VAT distinct from the Central GST.

Once there are separate Central and State-VAT systems, the next step is to work on the harmonised GST at the Centre and a piggybacking levy by the States. Given the prevailing rate structures, on average both could levy the tax at 10%. This will allow complete input tax relief and reduce the compliance cost considerably. But to achieve the “grand bargain”, the States have to agree and this can be done only when their fiscal autonomy is ensured.

All including the Chambers welcomes the news of introducing GST in the country. According to the Federation of Indian Chambers of Commerce and Industry (FICCI), integration of goods and services taxation would “provide India a world class tax system even while improving tax collections and ending the long standing distortions of differential treatments of manufacturing and service sector.”(Hindu Business line, 2004)

This will ensure the abolition of taxes such as octroi, Central sales tax, State level sales tax, entry tax, stamp duty, telecom license fees, turnover tax, tax on consumption or sale of electricity, taxes on transportation of goods and services, and eliminate the cascading effects of multiple layers of taxation, it added.

According to the Associated Chambers of Commerce and Industry of India (ASSOCHAM), introduction of GST would significantly reduce the overall tax burden and would bring down the “cost of compliance”. All these proposed recommendations would lead to improved intra-state trade, which will benefit the common market agenda, it added. But ASSOCHAM “cautioned” on how the
government would intend to encourage investment in infrastructure, if the concerned tax exemptions are done away with.

According to the PHD Chamber of Commerce and Industry (PHDCCI), exemptions “should be phased out in a manner that the impact on the sector could be minimized and effective tax burden does not go up.” India has not reached at a stage where we should do away with the exemptions relating to Section 80L and Standard Deduction, it added.

Summary and Conclusions

The review so far can be summarized in the following way. Commodity taxes (excises/CenVAT and sales/StateVAT) form the mainstay of revenue generations in the Indian economy and since these taxes are beset with several problems it has necessitated for tax reforms.

A beginning in the direction of reforming commodity tax structure was made by the 1953-54 report, which had for the first time, listed some of the discrepancies present in the indirect tax structure, especially sales tax structure. To remove these discrepancies, certain suggestions were made by the committee and even the later committees also recommended various measures, continuing the reform process.

Another noteworthy effort in this direction was the Indirect Taxation enquiry Committee Report 1978, which had proposed the option of VAT system at the manufacturing level (MANVAT) and it culminated to MODVAT in 1986. However MODVAT was transform into CenVAT in the Budget 2000-01.

Yet, another important and comprehensive report was the Reform of domestic Trade Taxes, 1994 that actually paved the way for the adoption of VAT in the country. In the meantime, deliberations as to how VAT can be implemented was started in 1995 with the setting of Empowered Committee. Their effort had materialized in the form of StateVAT at the State level replacing sales tax (2005).

The imposition of VAT in Haryana (2003) shows a positive impact on the finances of the State. The VAT has given the State 43% additional revenue in 2004-05. In comparison with the growth rate of the national economy, which was 8.4% in 2003-04, Haryana recorded a growth of 8.6% in the same year. In 2004-05, the State economy is expected to grow at the rate of 8.5%, which is 2% higher than of national average of 6.6%.
Than the Kelkar Task Force, 2002 had suggested to achieve VAT in its full form and recommended merging of CenVAT and StateVAT into a single National VAT / GST, as prevalent in most of the federal countries. As seen in the text, various countries like Australia, Canada, New Zealand, Singapore and Sri Lanka successfully implemented GST. Experiences of these countries should be carefully examined and then efforts should be undertaken to implement GST in India. In this direction also, Chidambaram has announced in the Budget 2006, the adoption of GST by 2010. However, certain queries have emerged as to which model is going to be accepted. These queries are left for the future studies to be undertaken in this field.

1 This tax credit version has many advantages such as the possible relief for certain goods, a relief on the basis of use of labour intensive techniques, or the need to tax value added at stages before the manufacturing stage if it is not possible to apply MANVAT for some reasons. Rule 56-A of the excise tax system already provides a method similar to the tax credit one. Extension of this rule was recommended as the first step towards adoption of MANVAT.