CHAPTER-III

THEORETICAL ASPECTS OF
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3.1 Introduction:

In India, sales tax was initially adopted in 1939 to substitute the transit duties and the state excise duties. Generally, the substitution has turned out to be very lucrative for the Indian States. The growth rate of the yield of sales taxes in the States has been very high as compared to any other State tax. Also, it has been a buoyant tax. In almost all the States, the sales tax has proved to be very elastic. In addition, the States have depended upon this tax for discretionary tax measures whenever the Planning Commission had expected them to mobilise additional finance for the purpose of the Five Year Plans. Thus, Sales tax has come to occupy a very important place in the fiscal structure of the States. As Due observed, a tax which essentially crept in by the backdoor in periods of crisis, and was apologetically justified by Governments as a temporary measure has gained a high degree of respectability. In this Chapter, some of the theoretical aspects of sales taxation, i.e., the concept of sales tax, its various forms, and the economic effects of sales tax are discussed. The differences between the taxes, namely, consumption and expenditure taxes, direct and indirect taxes are reviewed. Finally, some aspects of tax overlapping, tax co-ordination, incidence of sales tax, sales tax and black money, points of levy and cascading and pyramiding effects are discussed.
3.2 Concept of Sales Tax:

Sales tax is essentially a tax on business transactions and thus it differs from an excise duty in certain aspect. Its significance in India is that it has provided a relatively elastic and productive independent source of revenue to the States. Sales tax can be general or selective. What is known as the General Sales Tax in India is, in fact, a selective sales tax, as many commodity transactions are not covered under it. From operational point of view, sales tax may be either single point or multipoint. In India, both single point and multi point sales taxes have been levied in different States. Sales tax is collected from all registered trading concerns that invariably shift its burden to consumers. In India, the practice of charging the amount of sales tax from buyers is a sufficient evidence of the fact that its incidence is wholly on consumers. The sales tax has been levied practically on all tangible commodities; immovable property and services have not been covered under it. Tax rates are not uniform in all States. They are generally higher in States where sales tax is at single point. Further, luxury articles have been taxed rather heavily. Jacoby defines it as "The common factor in all these outwardly diverse taxes is the economic property that the amount of tax payable is obtained by a constant rate applied to the volume or value of commodities and services transferred or exchanged." The basis of the tax is the volume and value of sales of physical commodities and of services rendered by commercial enterprises, profession etc., but not services rendered by workers to their employers.
3.3 Importance of Sales Taxation:

The sales tax family includes a wide variety of taxes with bases ranging in scope from selective to broad multiple. The general meaning of the concept of sales taxation is obvious. But a precise definition which draws a clear line of demarcation between levies known as sales taxes and closely related taxes such as purchase, excise, octroi, customs etc., is more difficult than might appear at first. It has been defined by Buchler as "A tax imposed upon the sales of numerous commodities and the use of personal services at uniform rates"\(^8\). However, his inclusion of words "use of personal services" has brought user taxes directly into the scope of sales taxation. It has been defined by Plank as "A tax upon the sale or exchange of goods or services which is proportioned to the value or quantity of the things transferred"\(^9\). This definition does not clearly differentiate sales tax from other levies. For example, we find that while the base of the tax should be gross sales, several of the laws in American States specify gross receipts.

The most satisfactory definition of sales tax is given by John F. Due. He defines "A sales tax is a levy imposed upon the sales, or elements incidental to the sales, such as receipts from them of all or a wide range of commodities"\(^10\). It may be levied on all transactions through which commodities pass or upon one or a small number of stages only. The basis of the tax is the volume of sales of physical commodities and of services rendered by commercial enterprises, profession, etc. (But not services rendered by workers to their employers)
Many a time sales tax is misinterpreted and mistaken to taxes like purchase tax, excise duty, octroi etc. Therefore, it is necessary to make a distinction between sales tax, purchase tax and excise duty.

The sales and purchase taxes are taxes on the sale and purchases of goods. The former is a tax on a sale whereas the latter is a tax on the purchase. In other words, sale and purchase are merely different ways of looking at the same transaction. Every act of sale is also an act of purchase as well. When the tax is levied on an act of sale cum purchase and collected from the seller, it may be called sales tax and when the state collects it from the buyer a purchase tax. In this connection, it is important to note that the dealer may enter the picture either as seller or buyer, whereas the non-dealer (consumer) enters only as a buyer.

The main differences between a sales tax and an excise tax are (i) a sales tax has a wide coverage in the sense that exemptions from it are very few, whereas excise tax is selective and confined to few commodities in most of the cases; (ii) a sales tax is a levy imposed on the sale of a commodity in the process of production to distribution, whereas an excise tax is essentially a tax imposed on the production of a commodity, and collected at the factory; (iii) in a federal form of government, a sales tax is generally imposed by the states while major excise duties are levied by the centre; and (iv) both sales and excise taxes drive a wedge between price and factor payments, but they differ as to the base. The former is assessed on gross receipts and is a function of price. The latter is assessed on the unit of output and constitutes a constant addition to variable costs.
3.4 Types of Sales Taxation:

Sales tax is a tax on all sales of tangible goods at the retailing, wholesale trading or manufacturing stage with the exceptions noted in the taxing laws. When the tax is assessed on the turnover of sales of a dealer, it is called sales tax. If the tax is assessed on the turnover of purchase of the dealer and ignores whether he has sold what he had purchased, it is called purchase tax. The several types of sales tax are as follows:

1. Selective sales tax or general sales tax.
2. Turnover tax or gross receipts tax.

Exemptions:

Various exemptions are granted from the following points of view

1. From the administrative point of view, exemptions are made on account of the inconvenience of assessing and examining the accounts of small traders, or dealers located in distinct places or interior villages.

2. Exemptions of articles of common consumption or articles used mainly by the poor are made so as to make the tax less regressive in character.

3. Sometimes articles which are exported are exempted in order to promote exports of the country.

4. Exemptions are also given to promote certain economic, social and other activities.
3.5 Classification of Sales Taxation:

Since the publication of Haig and Shoup the sales tax in the American States in 1934, there has been a tendency to classify the different forms of sales tax into four groups. (a) Retail sales tax, (b) general sales tax, (c) gross receipts tax and (d) gross income tax. This classification is not satisfactory as it includes gross income tax which, in fact lacks an essential feature of sales tax, viz., the direct shifting to the purchaser. This classification is even misleading because it concentrates attention on rather minor points of difference among the different forms of sales tax and diverts attention from their basic similarities. Somewhat similar classification has been given by A.G. Buchler. It runs as follows:

1. A tax upon sales in general:
   (a) Imposed upon sales of commodities and services, as in Germany and many other countries.
   (b) Imposed upon sales of commodities only, as in Puerto Rico.

2. A tax upon producer's sales:
   (a) Imposed at uniform rates, as in Canada
   (b) Imposed at adjusted rates, as in Austria.

3. A tax upon commodity sales at wholesale stage, as in Italy.

4. A classified sales tax, as in Virginia.

5. A tax upon sales at retail stage, as in Kentucky.

6. A hybrid tax which combines taxes upon sales of goods and services and special taxes on producers' sales as in France.
This classification simply lists different forms of sales tax and is a categorization of the basis of levying sales. A better attempt in this regard is that of C.V. Oster who classifies American sales taxes.\textsuperscript{16}

3.5.1 According to Scope:

(a) Selective sales taxes and
(b) General sales taxes.

If specific commodities or services are singled out to be taxed at specific rates, the tax is called selective sales tax. A general sales tax refers to a common rate applied to a defined class of commodities or services such as tangible personal property sold at retail. Either specific or ad valorem rates are feasible with a general sales tax. The distinction is often a matter of degree. Perhaps the real distinction is that a selective sales tax programme can treat commodities differentially, while a general sales tax applies uniformly to all taxable commodities.

3.5.2 Legal Basis:

On this basis, a sales tax statute may impose the tax legally.

(a) On the seller, or
(b) On the buyer.

As has already been stated sales and purchases are the two aspects of the same transaction. When the tax is imposed on the sales, it is termed as sales tax and when it is imposed on purchases, it is called purchase tax.
3.5.3 Turnover:

Another classification along these lines has been developed by the National Industrial Conference Board as 17

(a) Multiple turnover tax; and
(b) Single turnover tax.

Multiple turnover taxes are imposed more than once in the production and distribution process whereas single turnover taxes are levied only once.

3.5.4 Coverage

The study of Haig and Shoup 18 brings out a different type of classification based on American State Sales Taxes. This relates to: (a) retail sales tax, (b) general sales tax, (c) gross receipts tax and (d) gross income tax.

(a) Retail sales tax is imposed upon the sales of tangible personal property at retail or for consumption.

(b) General sales tax includes, besides levies specified under- (i) wholesaling, extractive, and manufacturing industries;

(c) Gross receipts tax includes, besides items specified under (a) and (b), personal and professional services;

(d) Gross income tax includes, besides all the above three types, receipt from non-business activities as wages and salaries.
This scheme of classification enables us to eliminate overlapping. It makes the significant distinction between selective and general sales taxes and makes it clear that the general sales tax may be a single point levy or a multi-point levy.

Following Herber the imposition of sales taxes may be placed at various stages of economic activity. Among the alternative points of placement are the (a) natural resource extraction (mining), (b) manufacturing, (c) whole sale and (d) retail levels of trade. If the tax is placed at only one of these transaction points, it is referred to as single stage sales tax. A tax which is imposed at two or more stages of economic activity is known as a multi-stage or multiple sales taxes. A tax imposed on an economic good at the manufacturing level is referred to as manufacturer's sales tax. A tax levied on a commodity when it is sold by a wholesaler to a retailer is called a whole sale sales tax, while one levied on the final sales of the commodity to its ultimate purchaser is known as a retail sales tax.

Multi-stage sales taxes are best represented by turnover and value added taxes. Turnover tax is imposed on the gross monetary value of a product at each stage of the production process. The value added tax is also applied at multiple stages of business activity, but it differs from the turn over tax in that the tax base at each level includes only net value added at each stage of production.
In addition to the above, the sales tax can also be differentiated in terms of their tax bases, which are either narrow or broad in scope. A sales tax applied to one or a few economic goods is considered to be narrow based, while one levied on a wide range of goods is considered to be broad based. A sales tax base can be further classified in terms of either value (advalorem) or physical quantity (specific). If the tax base is defined in terms of the monetary value of the purchased item or items, the tax is said to be advalorem; on the other hand if the tax base is defined in terms of the number of units of the commodity purchased, the tax is termed as specific tax.

It is not possible, however, to choose one form of sales tax that would be suitable commonly to all countries that are at different stages of development. A choice must be made in each case, under a policy prescription, paying attention to factors, such as amount of revenue needed, trade structure, extent of record keeping in the business community, administrative capability of the revenue department, standard of voluntary compliance among the tax payers, and previous experience with other taxes on domestic consumption.

3.6 Economic Effects of Sales Tax:

Economic effects have been so important that they have been making economists change the status of the tax. The economic effects of sales taxes may be more subtle and far reaching in character. Even if the economic forces and other shifting devices enable the sellers to shift the tax to the
consumers, the sellers also suffer in the process. They cannot escape the effects of the tax as manifested in the declining sales, reduction of the effectiveness of competition and integration of industry involved painful adjustments. The problem that a general sale gives rise is the question of avoiding integration and yet helps in the reduction of an unduly large number of middlemen between the producer and the consumer. Also, the regressive nature of the sales tax and the effects of the tax on the business community imposes intricate administrative problems in such matters as defining transactions, avoidance of integration, exemptions, collection and other complexities.

3.6.1 Sales Tax and Allocation of Resources:

It is necessary to highlight some of the features of the sales tax systems in the country which have important consequences on resource allocation and equity. First, a common feature of the sales tax system in India is its complicated structures. Besides a list of exempted goods, there exist a large number of rate categories in each of the States, in some States numbering as many as nineteen. Second, with different lists of exemptions, differential nominal rate structures, differing incentive schemes for manufacturers, and varying standards of administration and enforcement of the tax, the effective tax rates are widely different among the States. This has, besides causing trade diversion and resource misallocation, effected significant tax exportation and the inequitable transfer of financial resources from richer to
poorer States. Third, the taxation of inter-State sales at as high a rate as four per cent, has created, in effect several tariff zones within the country and has greatly reduced the advantage of fiscal federalism.

3.6.2 Sales Tax and Income Distribution:

Sales tax is regressive in character, if it is imposed on those commodities which are purchased by the poorer sections of the community. Thus in such a case, it may enlarge the inequalities in the distribution of income and wealth. However, in order to remove the drawback, if it is imposed on a selective basis and only on luxury goods, it may not remain a productive source of revenue. It is the fundamental weakness of the sales tax that it is not related to the tax paying capacity of the consumer. The rich and the poor pay it alike at the same rate. Moreover, it does not make allowance for domestic circumstances and thus, it tends to fall more heavily, as between tax payers of equal income, on those who have a large number of dependents. It is not possible to make the sales tax progressive as between different tax payers of unequal income.

It should be noted that the increase in production and better distribution of wealth is the sine-quo-non of economic welfare. Hence, the efforts should be made to impose sales tax in such a way so that it may not retard the productive capacity of the country and various exemptions should be provided in the tax structure so as to remove its regressive character.
3.6.3 Sales Tax as an Anti Inflationary Device:

Sales tax has been advocated as a means of controlling inflation, especially during and after the Second World War\textsuperscript{24}. In view of the greater average propensity to consume among lower income groups, a regressive sales tax may have somewhat greater inflationary effects from a progressive income tax yielding the same amount of revenue. In other words, sales tax is more likely to tax the amount that would have been spent than a progressive income tax which tends to tax the amount which has been saved.

However, the degree of progression may have only a limited effect on the anti-inflationary power of a tax if consumption is a linear function of income. In other words, if the marginal propensity to consume is fairly constant over considerable ranges of income, alternative taxes with varying degrees of progression, but with identical yields, will reduce consumption outlays by approximately the same amounts\textsuperscript{25}. Nevertheless, a regressive sales tax would tend to be more anti-inflationary than a progressive income tax because the spending-savings ratios of many low income families are such that current savings cannot be reduced materially. The opportunities to escape the threatened reduction in real consumption by dissaving or borrowing are not as readily available to low income families as they are to higher income families.

In appraising the anti-inflationary effects of alternative taxes, it is important to consider the extent to which they may affect the supply of labour.
and output in an adverse manner. In general, sales tax would appear to exert smaller influence on the decision to work than a progressive income tax, because the former tax allows the individual greater discretion over the use of his income. He can avoid the tax by saving, which in itself would be anti-inflationary.

The anti-inflationary advantages of the sales tax over income tax may be only temporary. The crucial-assumption is that sales tax will not affect output in an adverse manner, because it permits individuals to save their incomes. Even if this assumption were granted, it should be noted that increased savings are always a potential source of future inflation\textsuperscript{26}.

3.6.4 Arguments against Sales Taxes:

It has been argued by the representatives of trade and industry as well as others that sales tax should be abolished as a separate entity and appropriate enhancements in the excise levies should be made; the proceeds of which could be earmarked for the States. In support of this view, it has been argued that if a number of separate authorities independently levy a tax on some products, there can be no rationalisation of the tax structure\textsuperscript{27}.

Again, in support of the imposition of Central levy and abolition of sales tax, it has been argued that when a single authority levies all the taxes on a particular product, it can take into account all relevant considerations such as the burden on the consumer as well as impact on production and investment in the industry\textsuperscript{28}. In case of such a Central levy, it would be easy to give rebate when export takes place. Besides, there would be considerable saving in the cost of collection.
The diversion of trade as well as of production centres from one State to another, with differential rates of sales tax lead to, would be eliminated in case of such a Central levy. Finally, the harassment caused by the requirements to comply with the laws, procedures and forms of different States which make life difficult for small traders as well as manufacturers who buy their raw materials and components from different States and also sell their products in different States will be removed.

Apart from the overall tendency to place a relatively heavy burden on persons in the lower income groups, the tax tends to penalise people who are compelled to spend higher percentages of their incomes to attain a given standard of living. Thus, the tax tends to impose a greater burden on larger families than on smaller families with the same income since the former must spend a higher percentage of income to attain a given living standard. In fact, a large family has less tax paying ability than a smaller one and hence the burden of sales tax will be heavier on the former than on the latter. At the very best, sales tax is a relatively crude method of distributing burden among different classes of people although admittedly it does place a more equitable burden than the income tax on persons spending large amounts from accumulate wealth and on those able to escape the income tax.

3.6.5 Sales Tax and Income Hypotheses:

The Government exerts greater influence on total spending and hence on output, through its expenditure and tax policies. It alters total spending
directly by varying its own spending, or indirectly by raising or lowering taxes. If expenditures are increased or taxes lowered, the spending of higher incomes by the recipients requires additional output which generates additional income and spending and the cycle repeats itself. The cumulative increase in Gross National Product (GNP) is therefore, a multiple of initial increase in Government expenditures or reduction in taxes. Correspondingly, reductions in expenditure or increases in taxes reduce GNP by a multiple of the initial action.

It is believed that consumption depends on income that is expected to be received regularly and is not much affected by temporary or transitory changes in income. On this hypothesis, temporary tax changes would have relatively little impact on consumption. However, this is a minority view. Most economists believe that a temporary income tax change would have a strong effect on consumption, although they agree that it would be less powerful than a permanent tax change.

Counter-cyclical tax changes are often assumed to be most effective if they are confined to the lower income classes. This view presupposes that poor people spend proportionately more out of any additional income they may receive than the rich. There is no evidence, however, to confirm or deny this assumption. Policy purposes is probably satisfactory to assume that this incremental consumption rate is fairly high throughout most of the income distribution. This would suggest that, if the distribution of the tax burden is considered equitable by the large majority of tax payers, tax rates
can be moved up and down uniformly for counter-cyclical purposes by a simple formula such as an equal percentage change for all tax payers. Tax rate changes are sometimes criticized on the ground that they are too small to exert a significant economic effect.

In the recent discussions on sales tax, a new set of issues is emerging. Until recently, debate followed a predictable pattern. The sales tax is relatively favourable to saving and investment and to industrial location in one's State. The permanent income hypothesis had the most dramatic impact on sales tax analysis.

Friedman points out those families consume not on the basis of their current incomes but on the basis of their expectations of their long-term resource positions. In other words, their consumption is based on their normal or 'permanent' income, which roughly, is expected average income over a period of several years, discounted. Friedman contends that if one could take a sufficiently long period of receipt and consumption-defining consumption to include only the use value of durables, the consumption-income ratio would be the same for all levels of income.

Absolute and relative income hypothesis imply that consumption taxes will be regressive, while the permanent hypothesis challenges this idea and conditions to think of such taxes as proprotional levies with respect to 'income' properly conceived.
3.7 Sales and Excise Taxes:

Indirect taxes on expenditure at present provide a large amount of tax revenue in most developing countries. Given the prevalence and revenue importance of sales taxes in the developing countries, it is surprising that there is so little literature on the economic effects of such taxes in these countries. Sales and excise taxes often have considerable effect on the rate of capital formation and on the balance of payments, and their rate and exemption structures are also significant determinants of prices and of the composition of final demand. The three authors differ on several points; some of their differences are related to the particular countries described, whereas others are apparently more basic.

The experience of the States shows very marked increase in the use of commodity taxes since 1930. This increase has occurred along two lines; new excise taxation of specific commodities—principally, liquor, cigarettes, petroleum products and the imposition of retail sales taxes. Repeal of the Prohibition act is of course the principal cause of the rise in liquor tax revenues. The regulation of traffic in alcoholic liquors devolves principally upon the States and it is not surprising to find taxation accompanying the imposition of regulation.

Excise taxes on specific commodities, which are especially important as revenue producers to countries in the earliest phases of developing their tax system are not given adequate treatment in the literature. Almost all countries
levy heavy sumptuary taxes on such commodities as liquor and tobacco because these taxes offer the Government an opportunity to collect substantial revenue while allegedly defending the public interest. The regressive nature of most sumptuary taxes, which fall heavily on the 'undeserving' poor (or at least on those included within the monetary sector of the economy), does less to deter their heavy use than the porwnril competition, of smuggling and illicit production. Unfortunately, for Government revenues, consumption of sumptuary items annually does not keep pace with increasing incomes, so taxes on these items tend to become continually less important as development proceeds. For consumption taxation to keep pace with development, excise taxes would have to be extended to cover such items as gasoline and durable consumer goods, and at some point, more general sales taxes would almost certainly have to be levied.

3.7.1 Tax Overlapping:

In the realm of commodity taxation, excises on production and customs were assigned to the Centre and taxes on sale, purchase and movement of goods to the States. While there is no overlapping of tax powers in the sense that no one technically or legally distinguishable tax has been assigned to more than one level of Government, assignment has not been so contrived as to prevent or minimise the overlapping of implicit bases of taxation. Effective overlapping arises by the use of the same base by more than one level of Government. Thus the excises levied by the Centre, and the sales tax levied by the States overlap to a considerable extent, since they both fall on
the products of the industrial sector. The octroi by the local bodies overlap with both excises and sales taxes, since, in practice, wherever it exists, it falls on both industrial and agricultural products.

It is possible that the Constitution makers had not envisaged that such extensive overlapping would develop, since excise taxation was conceived of at that time to be selective in its coverage. However, using its power under entry, 84 in the Seventh schedule to the Constitution to levy duties of excise on tobacco and other goods manufactured or produced in India, the Central Government on sugar, mill made textiles and tobacco. The logical culmination of this process was the introduction in 1975-76 of a general levy on all manufactured goods\textsuperscript{43}.

Additional duties of excise in lieu of sales tax are levied and collected by the Central Government of sugar, mill made textiles and tobacco. The entire proceeds, other than the proceeds attributable to Union territories are distributed among the States. This levy was the result of the unanimous agreement reached, in the National Development Council in December 1956\textsuperscript{44} by which the States agreed to refrain from exercising their power to levy sales tax on sugar, mill made textiles and tobacco in lieu of a share in additional excise duties to be levied by the Centre. Having regard to the background on which these duties came to be levied, the Commission felt the net proceeds should be distributed on the basis of consumption of the relevant commodities in each State. Therefore, in the interests of minimising tax overlapping, greater co-ordination between the Central and State governments are essential.
3.7.2 Tax Co-ordination

The problem of inter-State co-ordination of the sales taxes is demanding serious attention. Inter-State differences in definition of sales taxes, collection schedules and lack of co-ordination in the sphere of inter-state commerce hinder free flow of goods and factors of production between different States, discourage the prevalence of a national outlook, create unjustified handicaps for business having inter-State trade, and encourage the undesirable survey of political forces over economic forces\textsuperscript{45}. It should, however, be remembered that "co-ordination is a useful thing to bring about the most effective taxation with the least burden, but it does not always work out that way, and co-ordination is not an end in itself. There are situations where co-ordination should go by the board in favour of something else more primary"\textsuperscript{46}. It would follow the national objectives of the overall tax policy and should be in consonance, in essential respects, with the structures prevailing in the neighbouring States.

3.8 Incidence of Sales Tax:

Sales taxation gives rise to two categories of problems viz., problems of equity and problems of administration, although it is the problems of equity that give force and urgency to the problems of adequate, efficient and just administration\textsuperscript{47}. Yet it is convenient to treat them separately.

To consider the problems of equity is to analyse the incidence and effects of the sales tax on consumers, producers and businessmen. As regards
incidence, the final result depends on the elasticities of demand and supply
and on whether tax is shifted to the consumers in the long run and that in the short run; it may be shifted only in part or not at all. "It requires a considerable period of time for production to become adjusted to the tax and sellers may be unable to reduce output immediately and this shifts the tax. Capital and labour investment may be such or highly immobile making shifting impossible or possible only in the long run. The frequent changes in the rates and scope of the tax also render forecasts of future business costs uncertain, and it may be impossible to add the full tax to costs."48"

The effects of sales taxes are made subtle and far reaching in character. For, even if economic forces and mandatory shifting devices enable the sellers to shift the tax to the consumers, they do not escape the effects of the tax in the shape of declining sales, reduction of the effectiveness of competition and integration of industry involving much exertion and painful readjustments. To avoid the discrimination in favor of integrated business concerns under a multi-point sales tax, Germany at one time attempted to apply the turnover tax to even the exchanges made between the branches or divisions of an integrated industry but this proved to be more interesting than helpful49. The problem that a general sales tax raises is how to avoid integration and yet help in the reduction of an unduly large number of middlemen between the producer and the consumer.

If the general sales tax is not shifted, it becomes a tax on gross receipts which do not indicate correctly the profitability of a business as no allowance
is made for varying conditions of expenses, indebtedness and investments. It becomes extremely inequitable as between various classes of business and even as between different individuals in the same class, the extent of the burden depending largely on the rapidity of the turnover.

Generally speaking, a sales tax is shifted forward from the seller to the buyer by increasing the selling price. But what portion of the tax is shifted depends on the elasticity of demand and supply. If demand is inelastic, the tax could be entirely shifted. On the other hand, if demand is elastic, the tax cannot be shifted and the incidence is on the seller. In practice, however, the incidence of the tax tends to be distributed between the seller and the buyer. Other things being equal, the more elastic the demand, the greater will be the proportion of the incidence on the seller.

The extent to which the sales tax can be shifted depends also on institutional factors. For instance, if the tax is imposed in Tamil Nadu and it is not difficult to buy the taxed commodity outside the taxed area, say in Bombay, it will be relatively difficult to shift the tax on to the consumers. Shifting might also be difficult if there are untaxed substitutes for the commodities in question.

The shiftability or otherwise of a tax also depends on the size of the tax in relation to its price. For instance, if there is a customary price for a commodity, any attempt on the part of seller to shift a newly imposed tax might reduce sales and so the seller might decide to bear the tax himself.
Finally, it may be noted that the possibility of shifting the sales tax will vary in different phases of a business cycle, shifting from the dealer to the consumer being relatively easier in a period of boom than in a depression. In India, the sales tax was developed during the war and post war period, when there was a seller's market. The tax was, therefore, generally shifted even in the case of luxury articles. It has pyramiding effects in a period of rising prices. Under normal condition, however, the tax on luxuries and fashionable articles, whose demand is elastic, tends to rest with the dealers or may even be shifted backwards to the manufacturers51.

3.9 Points of Levy:

An important problem in the sales tax structure relates to the points of levy. Although different States adopt varying systems of sales taxation, they have shown a tendency over the years to switch over to the first-point of levy. Notwithstanding the type of tax structure followed by a State, revenue derived from the first-point tax in most of the States has been growing every year52.

The choice in favour of the first-point levy has been made largely on considerations of administrative expediency. As is well known, this form of tax is easiest to administer. It is possible to collect the major part of revenue from a small number of dealers who are mainly manufacturers and importers. In this system, the task of surveillance is quite manageable and the small dealers would be left relatively free. Thus, the small dealers are completely freed of possible harassment by tax authorities.
However, economic considerations are equally important and must be given due weight. From the economic point of view, the first point tax suffers from many shortcomings. First, cascading takes place under the first-point tax because normally complete set-off is not given in respect of inputs used in manufacture. In addition, the increased cost of holding inventories leads to higher interest payments and additional cascading. Second, taxes on inputs lead to changes in relative factor prices and can produce inefficiency in the technique of production and related inefficiencies and waste. Third, since the proportions of value-added at later stages and at earlier stages of production differ from commodity to commodity, the first-point tax is based against those commodities which have larger value-added at the earlier stages of production. In particular, there is an unintended bias in favour of commodities such as consumer durables in whose case the proportion of value-added is substantial at the retail stage. Fourth, the first-point tax has a lower taxable base than the last point tax and hence it has to be levied at a higher rate for deriving the same amount of revenue. Finally, the first-point tax pushes functions beyond tax point and promotes vertical integration of firms, and therefore, militates against the objective of promoting ancillary industries.

In view of the above mentioned adverse economic effects, one cannot argue for the first-point tax solely on grounds of administrative convenience. In addition, even on administrative counts it has been found that among some of the commodities administered through the first-point levy, tax evasion
takes place on a large scale. For this purpose, various methods are adopted by the dealers. These methods are reported as bill-trading in Tamil Nadu, Sales through hawala dealers in Maharashtra and evasion of tax through bogus dealers is seen in almost all the States.

As against the first-point tax, the last-point tax is the most desirable form of levy from the economic point of view. However, administratively it is not preferred because, it is said, the tax department would have to deal with large number of dealers under such a system. This apprehension does not seem to be well founded. Whereas, it could be correct to say that the first-point tax has the advantage of collecting a greater part of tax from a smaller number of dealers, it is not correct to say that the task of checking and the workload of assessment will be much less voluminous in the case of first-point tax than with the last-point tax. It is well known that under either system, all dealers with turnover above the stipulated exemption limit are required to submit returns which in turn will have to be checked. In fact, saving of workload under the first point tax is quite exaggerated.

According to the Report of the NIPFP, "What is required is a form of double multi-point taxation which, while enabling the Government to capture value added in the course of trade would not suffer from the familiar demerits of cascading, promoting vertical integration, etc., that are associated with traditional multipoint tax such a system will have to embody the principle of value added taxation. Ideally, the existing systems could be transformed into a State value-added tax under which all registered dealers would be able to
pay tax, each one's liability being computed as the tax payable on his sales minus the tax paid on the relevant purchases".

The introduction of such a system of value added would be an ideal solution. To begin with, however, an attempt could be made to levy this type of tax only on a few commodities. Once a State tax administrative machinery has gained experience in administering it, the tax could be gradually extended to other commodities.

The single point and multipoint taxes differ in conception and design. The single point system is "incidence controlled". It ensures that no more than the specific amount of the tax is added to the price. This object is attained by collecting the tax at only one point in the chain of sales or purchases through which a commodity passes before it reaches the consumer. The reason why the total tax on the goods is restricted to a predetermined amount is that the tax is generally levied at relatively high rates. The same consideration also leads to a large number of exemptions. The multipoint tax is not "incidence controlled" in either structure or purpose. The rates are low and the exemptions few.

The double point tax is levied at the point of entry and exists of a commodity in the chain of transactions from the producer to the consumer. The incidence of the total tax is split up between the two points. The double point tax could be levied either on purchases or sales of a dealer. This system is also, "incidence controlled", to a certain extent. If the tax is levied on the
basis of purchases, the tax element would be only slightly higher than the arithmetical sum of the two rates that have been charged at the two stages. This is the sense in which it is "incidence controlled". But the pyramiding effect would be high and the tax would not be, "incidence controlled", if the tax is levied on sale value at both the points.

3.9.1 Cascading and pyramiding effects of Sales Tax:

In their zeal to collect more tax revenue, tax authorities have imposed a number of new taxes. As a result, an indirect tax system, as it has emerged, is not an integrated system but just a position of a number of systems. Though the levies fall mostly on the very same products, their cumulative effects are not looked at or regulated by any single authority. While individually the systems do pay regard to progression as well as to economic factors, their cumulative effect does not adequately sub-serve these objectives.

Moreover, when taxes fall both on inputs and on the final product, such of these taxes as are levied on an advalorem basis fall not only on the value of the products but at each stage they fall on the taxes that may have been earlier levied on them. Alongside, there is an escalation of costs and profits at each stage. This is known as the phenomenon of cascading. The undesirable consequences which flow from the phenomenon are many, the most important of which are as follows:

(a) With widespread taxation of inputs by more than one authority, it is not possible to control the incidence of final products;
(b) The taxation of inputs tends to promote vertical integration, encouraging industries to produce more and more of the inputs needed by them rather than purchase them from ancillary industries, thus adversely affecting the growth of small industries;

(c) The general escalation of costs due to cascading, apart from the inequitable burden it places on different income groups within the country acts as a positive handicap in the efforts to increase exports because it reduces the competitiveness of Indian products in foreign markets;

(d) The use of indirect taxation as an economic tool gets blunted. Levying of tax on raw materials and intermediates imposed for revenue reasons affect producer's choice between different factors of production in unintended ways. This leads to uneconomic use of scarce resources and misdirection of investments contrary to national priorities.

When sales taxes are levied on inputs as well as outputs, in addition to excise duties which again fall on both inputs and outputs, virtually two independent systems of sales tax at manufacturing level come into operation. The resulting cascading caused by the tax and the mark up on tax produced by excise duty gets compounded with similar sales tax falling on the same products.

Cascading has harmful effects on the economy for several reasons. First, an increase in the consumer price by more than the tax element creates
an additional dead-weight loss. Second, this adversely affects the competitiveness on Indian manufacturing because it is not feasible to arrange a duty drawback of input taxes for the exported goods. Besides, designing the appropriate tax structure becomes extremely difficult as effective rates of taxation on final products cannot be easily estimated. More importantly, cascading changes relative prices of commodities in unintended ways, because:

(1) Rates of taxation of inputs are not uniform; and

(2) Input costs in the total value of a commodity (or the ratio of value added to total value) differ among commodities.

Thus, the price escalation is higher for commodities having higher material input costs, lower non-material input costs (including wages) and lower value added, while the relative prices of commodities having a high component of value added in general, and higher value added in wholesale and retail stage in particular are reduced because of cascading. As these commodities typically are non-essential items, their consumption is encouraged and more resources are allocated for the production of these commodities.

Imposition of the tax at all points of sale from the original producer or manufacturer down to the final consumer will produce a cumulative effect. The same commodity may be exchanged more than once and every time it is done so, the kind of tax is described as a turnover tax. In this case, it is
accompanied by what is characterised as pyramiding effect, meaning that not only the tax paid by the wholesaler or manufacturer and the middlemen but also the interest charges on the tax paid would raise the price of commodities. This objection to a multipoint general sales tax has been sought to be overcome in certain countries by the levy of a sales tax at only one point, either at the wholesale or retail operation.

The regressive character of the sales tax, the burden of a general sales tax or turnover tax places on business, the problem of pyramiding, and the effect of multi-point taxes on business integration impose a difficult task on the tax administrator and give rise to intricate problems of administration.

The intricacies of administration increase as the coverage of the tax increases. The simplicity and uncertainty of general sales tax vanish when numerous sales taxes at various rates are collected and general sales tax becomes a conglomerate of various different taxes on numeric services, production, imports, ordinary commodities etc.60

The fundamental problem of administration is that of the definition of a taxable transaction. This raises questions like the point at which the tax should be collected and the goods and services which should be exempted. The sales tax is easy to administer if it is levied at a stage in the manufacturing and distributive process where the transactions are concentrated in relatively few hands. But the earlier stage in production and distribution that the tax is collected, the greater is the possibility of its being
pyramided, and the greater is the difficulty of granting exemptions. Revenue considerations, however, necessitate the broadening of the base of the tax. Some countries impose taxes on producer's sales, some on wholesalers, some on retailers and some on all sales. Retail sales taxes have the advantages, the pyramiding is avoided, integrated organisations are not at a comparative advantage, the interest charges for carrying the tax are reduced to a minimum, and a low rate of tax can bring large revenues, but the difficulty is that the lack of proper business records of retailers may handicap the collection of tax. The sales tax has pyramiding effect in a period of rising prices in the case of luxury articles.

Conclusion:

Sales tax which is essentially a levy on business transactions can be either general or selective. Sales tax may be levied at a single point or at multiple points.

It is levied on several bases. If the levy is on sales, it is sales tax and if it is imposed on purchases, it is purchase tax. Sales tax is also levied according to slabs of turnover, and according to the legal basis. Sales tax affects resource allocation decisions, the degree of competition and integration of industries. The complex sales tax rates, bases, exemptions, deductions and incentives cause changes in relative prices which in turn cause diversion of trade and misallocation of resources. The inter-State differences in the sales tax rates and coverage lead to exportation of tax burden from the richer to the poorer States. This is particularly true of Central sales tax. Sales
tax collected from the commodities purchased by the poorer sections imposes regressive burden distribution and enlarge inequalities in the distribution of consumer expenditure, income and wealth.

Sales taxation has not found favour with those who advocate merger of sales taxes and excise duties. Some commodities are better levied by a single Government to control cascading and pyramiding. It is argued that a unified levy would prevent unnecessary diversion of trade and minimize problems relating to tax compliance.

The advocates of permanent income hypothesis believe that temporary tax changes would have relatively smaller impact on consumption. But, many economists disagree with this and argue that countercyclical tax changes are often assumed to be most effective if they are confined to the lower income classes. Absolute and relative income hypotheses imply that consumption taxes are regressive while the permanent income hypothesis disagrees with this view.

There is a considerable degree of tax overlapping between the Centre and the States. Very often the customs, Union excise taxes, sales taxes have a overlapping coverage in the sense that they are levied on the same base but at different stages and at different rates. The Octroi and toll taxes, imposed by certain States overlap with both excises and sales taxes. However, the scheme of additional excise duty in lieu of sales tax on sugar, tobacco and mill made textiles reduces the overlapping coverage at least partly.
The incidence of sales tax ultimately depends on the nature of the commodity, the relative elasticity of demand and supply and time required for adjustments in supply and demand. The expectation of future tax increases may create uncertainties about future cost which may result in either backward or forward shifting of sales tax. The shiftability of the tax depends on the size of the tax in relation to price and business and economic conditions. It is generally easier to shift a tax in a boom period than in depression. Sales taxes also promote black money. Generally, if the marginal sales tax rates are very high, it will act as an incentive to evade taxes which eventually results in black money. An important problem of sales tax structure relates to the point of levy. The choice in favour of the first point levy has been made largely on considerations of administrative expediency whereas the last point tax is not preferred administratively. The single point system is "incidence controlled" whereas the multipoint is "not incidence controlled". The double point tax is also "incidence controlled to a certain extent".

When taxes fall both on inputs and on the final product, those taxes levied on an 'advalorem' basis fall not only on the value of the products but at each stage they fall on the taxes that may have been earlier levied on them. Alongside there is an escalation of costs and profits at each stage. This is known as the phenomenon of cascading. Imposition of tax at all points of sale from the original producer or manufacturer down to the final consumer will produce a cumulative effect. The same commodity may be exchanged
more than once and every time if it is done so, the kind of tax is described as a turnover. In this case, it is accompanied by what is characterised as pyramiding effect, which means that not only the tax paid by the wholesaler or manufacturer and the middlemen but also the interest charges on the tax paid would raise the price of the commodities. The sales tax has a pyramiding effect in a period of rising prices and justify in the case of luxury articles.
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6 Retail Sales Taxes, Consumer Sales Taxes, Retailer's, Occupation Taxes, Gross Receipts Taxes and Gross Income Taxes.


16 Oster, Clinton, V., "State Retail Sales Taxation", Bureau of Business Research, The Ohio State University, Columbus, Ohio, 1961, pp.3-7.

17 “General Sales or Turn Over Taxation” (New York), National Industrial Conference Board, 1929, p.8.


20 Ibid., pp.230-231.


23 Ibid.,: 472.


29 Ibid, p.36.


31 Ibid., 300


34 Ibid.,: 285-290.


38 Ibid., p.41


46 Ibid.,: 788.


49 Ibid.,: 155.


55 The dealers called Hawala Dealers in Maharashtra and I Bogus dealers in other States are those non-existent dealers who get themselves registered with the tax department to make first-sale in the State and issue documents showing sale and collection of tax at the first-point. However, they simply disappear after continually issuing such documents for sometime. Only on cross verification it could be found that these dealers do not exist. But such cross-verification takes a long time, enabling such dealers to abet tax evasion for a sizeable consideration.


58 A recent study has attempted to estimate the effective tax rates. See Ahmed and Stern, Effective Taxes and Tax Reform in India (Discussion Paper No: 25) Coventry: University of Warwick, 1983).
By the same reasoning, it may be argued that the cascading resulting from the prevailing sales tax system tends to encourage labour intensive methods of production, for, while wage costs are not subject to the tax, capital goods are taxable. But it may be preferable to encourage adoption of labour intensive methods through other measures rather than through cascading.