CHAPTER II

THEORETICAL FRAME

WORK AND REVIEW

OF LITERATURE
Theoretical framework and review of literature is vital since it helps the researcher comprehend the concepts thoroughly, besides understanding the subject deeply. Literature survey also helps identifying the research gap in the particular field of study. In this chapter theoretical framework and review of literature is undertaken. The present study proceeded after reviewing the existing research work, reports, books, published data and the like.

2.1 Theoretical Framework

The New Economic Policy, Liberalisation, Privatisation and Globalisation (LPG) introduced by Narasimha Rao Government in the year 1991, heralded a new era in the economic history of India. Undoubtedly, the chief architect of the New Economic Policy (NEP) was Dr. Manmohan Singh, the then Finance Minister and the present Hon’ble Prime Minister (PM) of India. The success of NEP depends largely on the macro economic stability. To achieve this macro economic stability the Government of India introduced a series of structural adjustment programmes. “Obviously, macro economic stability aims at lowering inflation and monitoring internal balance (output, consumption and income)”.

1
2.2 Tax Reform

"Tax reform invariably forms a key component of structural adjustment programmes of developing countries. The most important reform to bring about economic reforms to overcome macro economic imbalances and remove impediments to growth. It is imperative to bring the tax system too in line with the basic thrust of the structural reforms, viz., enhancing efficiency in allocation and use of resources by promoting competition and avoiding needless interference with market forecast".

"The tax structure in India has become unduly complicated because of its numerous objectives. Raising revenue, equity considerations, promoting savings and investment, maximising employment, promote interregional equity (through differentiated tax concern across regions) etc., have made the tax system more complicated". In addition to this the tax base is narrow for both direct and indirect taxes. “In the case of personal income tax, the exclusion of tax on agricultural incomes, administrative difficulties of taxing the unorganised non-agricultural sector, provisions of exemptions and deductions for various purposes and difficulties the ‘hand-to-tax’ groups have rendered the tax base extremely narrow”. Similarly, generous deductions for depreciation and re-investment and contributions to a wide variety of social purposes has eroded the corporate tax base. “In the case of indirect taxes most of the services
are completely excluded from the tax base, even the retail general sales taxes have ceased to be either ‘general’ or ‘retail’, with the point of levy being shifted to the first stage of sale”.^5

Owing to extreme difficulties in tax administration, complicated tax structure with narrow base and highly distorting tax system have prompted the Government of India to bring about tax reform in the country as a part of structural adjustment programmes. However, any tax policy which aims at reformation should address two important issues in fiscal administration; i.e., (1) Equity and (2) Efficiency.

2.3 Equity

In formulating tax policy, the policy makers usually cannot avoid undertaking an evolution of equity and efficiency implications of alternative tax measures either explicitly or implicitly. Broadly speaking, equity means ‘fairness’. But any notion of fairness necessarily involves value judgment. “A full treatment of the ethical foundations of alternative notions of fairness is beyond the scope of the present study”.^6 Instead, the emphasis is placed on the operational significance rather than on philosophical aspects of equity considerations in formulating a tax policy.

2.4 Basic Concepts Of Equity

“Equity generally means fairness or justice in the distribution of burden of taxation”.^7 Equity involves two aspects i.e., ‘horizontal
equity' and 'vertical equity'. Horizontal equity is related to the like circumstances, which implies that those who are equally well-off from the economic point of view should pay equal amount of taxes, vertical equity is related to the unlike circumstances which imply that the people in dissimilar circumstances should be subjected to dissimilar treatment', i.e., the persons who are 'better off' should pay more as taxes than others. A perfect equity is maintained only if horizontal and vertical equities are well integrated in the tax structure. Any attempt to achieve vertical and horizontal equity simultaneously however, not at all an easy task and can lead to ludicrous results. For an equitable distribution of tax burden, the following 3 principles have been laid down by economists.

They are (1) cost of service principle, (2) benefit principle and (3) ability to pay principle.

1. **The cost of service principle**

This principle suggests that the cost incurred by the Government in providing public goods to satisfy social wants should be regarded as basis for taxation. Tax is payable as per the cost of public goods enjoyed by the citizens. This principle implies that every citizen should contribute in taxes the actual cost of public services by which he is benefited. This notion was present in medieval period when people used to pay for various services like justice, defence,
administration etc., rendered by the Government. However, this principle has no relevance in modern time.

2. Benefit Principle

The benefit principle suggests that the cost incurred by the government in providing social services or social goods should be borne by the citizens in accordance with the benefits enjoyed by them. This means those who get more benefits from public goods should pay more than others. Rousseau, Sismandi and others for instance, argued in favour of progressive (benefit) taxation, as a wealthy person benefits more from state protection than the poor. Adam Smith also advocated the benefit principle. According to him, "the subject of every state ought to contribute towards the support of the government as nearly as possible in proportion of their respective abilities that is in proportion to the revenue which they respectively enjoy under the protection of the state". 8

In the 19th century, however, most of the thinkers interpreted the functions of the state narrowly. As a result, the benefit theory came under their attack. For example, David Richard considered public expenditure a historical phenomenon and argued that "the very best of all plans of finance is to spend little". 9 However, the benefit principle was reformulated and revived by the writers towards the end of 19th century. Taxes were once again regarded as the price paid for public goods. For the efficient allocation of resources, it was
thus thought that the burden of tax should be determined in accordance with the benefit received. In the later part of the 19th century, Lindohl, Bowen and others gave a new twist to the benefit principle and popularised the concept. The main difference between the classical and the new school of benefit approach is that, while the former postulated taxation according to benefit as a standard of justice, while the latter interpreted the benefit principle as a condition of equilibrium.

However, the benefit principle has serious practical difficulties on account of a highly unrealistic assumption. Though the benefit approach theoretically and ideally sounds very well, taxes in actual practice cannot be levied on the basis of benefit. Nevertheless, a limited application of this principle in certain cases such as vehicle tax for financing improvements in roads is commendable.

3. The Ability to pay Principle of Equity in Taxation

"The ability to pay principle denies the possibility of imputing benefit shares to individuals. Hence a different principle must be substituted for the quid pro quo solution". According to Musgrave (1959) "the requirement that the distribution of tax payments should be 'just' is very old". It may be traced back to an essay of GUICCIARDINI, published in the first half of the sixteenth century; "a case for proportional taxation based on ability to pay was made towards the end of the same century by Bodin" since then, the
principle has been restated and amended by numerous writers of widely differing philosophical background.

"In modern taxation, the ability to pay principle advocates that every person should be taxed according to his ability-to-pay. It implies that broadest shoulders should bear the heaviest burden". That means persons with greater ability-to-pay should pay more, while those with little ability should be asked to pay less. The ability to pay principle thus, is based on the assumption that those who are placed in better economic condition should be made to contribute relatively more to the cause of public expenditure!

Though both the benefit principle and ability-to-pay principle advocate equity in taxation, there is a fundamental difference between the two concepts. The benefit principle demands that each individual should contribute in the form of tax as per the benefit derived from the public goods, thus suggesting quid pro quo exchange relationship between citizens and the state. While the ability-to-pay principle advocates equity by demanding that each individual should contribute compulsorily according to his ability to pay, without a quid pro quo benefit in return.

R.A. Musgrave (1959) describes ability to pay concept in terms of horizontal equity and vertical equity. “Taxation according to ability to pay calls for people with equal capacity to pay the same and for people with greater ability to pay more". The former is referred to as
horizontal equity and the latter as vertical equity. As far as the bases of the tax is concerned Musgrave has favoured consumption base rather than the income base. “The consumption tax approach gives the fair solution, since it places the same burden on people with equal potential consumption”.15

In this context, two approaches to the sacrifice principle are worth mentioning. They are: (1) Mills theory of equal sacrifice and (2) Edgeworth – Pigou’s theory of least aggregate sacrifice. The former deals with the objective of equity and distributive justice in taxation. The latter, however, confines itself to the welfare objective of public finance.

The equal sacrifice interpretation of ability principle was originally advocated by J.S. Mills. He held that just equity in taxation means equity in sacrifice. A just distribution of taxes would prevail when all contribute to the common good so as to incur equal sacrifice.

The ability to pay principle emphasises that in order to fulfill the equity must be endeavoured by treating all tax payers in a similar economic situation in equal manner, but simultaneously, vested equity should also be obtained by according discriminatory treatment to the tax payers under different economic circumstances. Equity in taxation thus, requires that the relative sacrifice of each tax payers must be the same.
2.5 Equal Sacrifice

The concept of equal sacrifice has been variously defined by the economists. According to Musgrave (1959), "Cohen-Stuart and Edgeworth have advocated three distinct concepts of equal sacrifice." These included equal absolute, equal proportional and equal marginal or least aggregate sacrifice. To illustrate these concepts Musgrave has made assumptions of interpersonal utility comparisons are possible and the tastes of individuals are identical in nature.

1. Equal Absolute Sacrifice

It implies that the total loss of utility (in giving up income) on account of tax should be equal for all tax payers. In otherwords, from each tax payer the same amount of total utility of income must be taxed. Symbolically thus:

\[ \{ u(y) - u(Y - T) \}_A = \{ u(Y) - u(Y - T) \}_B \]

where, \( Y \) = income, \( T \) = amount of tax, \( U \) = total utility (thus, \( u(y) \) = total utility obtained from income before tax; \( u(Y - T) \) = total utility obtained from disposable income after tax payment). The subscripts \( A \) and \( B \) refer to different individuals.

The concept of equal absolute sacrifice, thus suggests that different income groups are required to pay tax differently in such a way that the sacrifice by each individual is the same. The poor
should of course pay less tax and the rich should pay more, but the total sacrifice to both should be equal.

2. **Equal Proportional Sacrifice**

This principle suggests that the sacrifice or loss of income utility in tax payment should be proportional to the total income of each tax payer. Thus:

\[
\frac{\text{Sacrifice of } X}{\text{Total Income of } X} = \frac{\text{Sacrifice of } Y}{\text{Total Income of } Y} = \text{etc.}
\]

Symbolically,

\[
\frac{(u(y) - u(y-T))_A}{u(y)} = \frac{(u(Y) - u(Y-T))_B}{u(y)} = \text{etc.}
\]

According to the principle of proportional sacrifice, thus the direct tax burden on every tax payer should be proportional to the economic welfare which he derives from his welfare.

3. **Equal Marginal Principle**

This principle implies that the marginal utility of income sacrificed by all the tax payers should be the same. Thus, marginal sacrifice of A should be equal to the marginal sacrifice of B etc.

Symbolically,

\[
\frac{du(Y-T)}{d(Y-T)} |_A = \frac{du(Y-T)}{d(Y-T)} |_B = \text{etc.}
\]
Here, \( d \) stands for a marginal change or additional change.

Under this principle of equal marginal sacrifice, it is obvious that the person with a higher income will be expected to bear the most burden as the marginal utility of a higher income will be very low as compared to that of a low income. Thus, when the marginal sacrifice of each tax payer (poor or rich) is equalised; the total or collective sacrifice of all tax payers in the community as a whole will be minimum, than otherwise.

Thus, there are 3 possible concepts of equal sacrifice and the question arises which should be used. Musgrave (1959) states that Adam Smith in his writings furnished an indefinite answer, “contribute in proportion to their respective abilities, that is in proportion to the revenue which they respectively enjoy ....” From this statement we can infer two meanings : (1) all should contribute the same in proper relation to their income; (2) or it could be interpreted strictly to mean that all should surrender the same fraction of their income. The second interpretation however, seems to favour the principle of equal proportional sacrifice. Adam Smith however, categorically stressed the need for a progressive rather than a proportional rate schedule. On the other hand, J.S. Mills advocated equal sacrifice principle, but he did not explicitly define the concept.

“Even after three concepts were defined the problem could not be solved, by the later writer as they widely differed on the merits of
these concepts\textsuperscript{18}. Therefore, economists developed another concept known as the 'Least Aggregate Sacrifice'.

Sidwick, Edgeworth and Pigou, arguing on welfare grounds considered equal marginal sacrifice, the only proper rule not as a matter of equity, but because it met the welfare objective of least aggregate sacrifice.

2.6 Least Aggregate Sacrifice

Edgeworth, Canon, Pigou and Dolton developed another sacrifice theory called the minimum or least aggregate sacrifice theory, which proposes that the sacrifice imposed by way of taxes on the community as a whole should be the least. Edgeworth and Pigou, regarded minimum aggregate sacrifice as the superior principle of tax distribution not on the basis of equity, but on the criterion of welfare. According to Edgeworth, assuming a declining marginal income utility schedule, welfare is maximised by an equal distribution of income on the satisfaction of different wants; and at the same time, loss of welfare (due to sacrifice involved in parting with income in tax payment) should be minimised. Loss of general economic welfare is thus minimised when the taxes are imposed on the basis of equal marginal sacrifice. The least aggregate sacrifice theory is also called at the equi-marginal sacrifice theory, for it suggests that if the marginal sacrifice on each tax payer is equalised, the total sacrifice of the country as a whole is minimised.
Pigou regards, the least aggregate sacrifice principle of the 'ultimate principle of taxation'. He argues that minimum aggregate sacrifice is the essential prerequisite for achieving maximum aggregate welfare which in modern times has become the goal of welfare state. Pigou states that in order to secure least aggregate sacrifice, the allocation of taxes should be such that the marginal disutility of money expended in the tax payments is equal for all tax payers.

Pigou makes a distinction between the least aggregate sacrifice and the principle of equal sacrifice as advocated by Sidwick and Marshall. He contends that 'equal sacrifice among similar and similarly placed persons in an entirety different thing from equal sacrifice among all persons. The theory of equal sacrifice has a fundamental drawback that it cannot ensure equal net satisfaction to all individuals. The equal net satisfaction to all is ensured only if every one is so taxed that the marginal sacrifice is the same for all. Thus, Pigou suggests, a progressive tax structure. When the marginal income utility is very low in the case of rich and it is very high in case of poor people.

2.7 Limitations of the Subjective Approach

The subjective approach has several limitations. Firstly, sacrifice being a subjective phenomenon cannot be measured. Secondly, two persons having the same amount of income and other
liabilities may not involve the same amount of sacrifice in the payment of tax. Thus, it is very difficult to equalise the marginal sacrifice of all the tax payers. Thirdly, it involves interpersonal comparison of utility which is also difficult. Fourthly, it is very difficult to measure the declining rate of marginal utility of income. Thus, the progressive rates in taxation are arbitrarily fixed and cannot necessarily lead to equalisation of marginal sacrifice for all.

2.8 The Objective Approach Of Ability-To-Pay Principle-Faculty Theory

Realising the practical difficulties of subjective approach to sacrifice theory, Musgrave says that "Prof. Seligman has profounded an objective approach called "faculty theory of ability-to-pay".19

Contrary to the sacrifice approach or subjective approach, the faculty theory takes into account the money value of the taxable capacity of the tax payer instead of feelings and sufferings. Thus, faculty theory, unlike the sacrifice theory, is not based on the psychological feelings of a tax payer, but on his taxable capacity, measured in terms of his income, accumulated wealth and prosperity etc. Hence, faculty theory takes into account various external factors including the tax payers income and property, etc. which actually influence the tax paying ability of an individual. Moreover, a person's productive power depends largely on the economic structure of the society and the benefits that he enjoys in the society. Hence, faculty
theory gives a social flavour as against the individualistic approach of sacrifice theories.

However, faculty theory is also not free from criticisms. Firstly, this theory is criticised on the ground that it is regressive, as the tax burden falls more upon poor people. Secondly, the theory loses universal application. Third, it lacks in uniformity in assessment. And lastly it may provide an opportunity to dishonesty.

Since the objective approach also suffers from serious limitations, the method of measuring of tax paying ability of an individual still remains unanswered. In earlier days, in fact, property was an important source of taxation. In modern times, income is accepted as the fair index of measuring the ability to pay of an individual. In practice, in addition to the income property and similar considerations must also be taken into account, while determining the tax paying ability of an individual. It should also be noted that with regard to income, it is not only the amount which is important, but also the source, i.e., whether it is earned from personal services or from the ownership of property, should also be taken into account. Again, the size of the family, the regularity of income and the time duration while determining the tax paying ability of a person. Thus, it is obvious, that objective approach plays a supplementary role to subjective approach in achieving the objective of just distribution of burden of taxation.
To conclude, in view of the above facts, the ability theory is the most widely accepted principle for distributing the tax burden justly.

2.8 Efficiency

Having analysed tax equity we now turn our attention to the second requirement for a good tax structure, namely, the tax system should be efficient. Musgrave (1959) opines that “Tax administration should not be wasteful and compliance cost for the tax payer should not be unnecessarily large. Moreover, the ‘excess burden’ of taxation or its “dead weight loss” should be minimized”.20 “Most of the tax theories in recent years have been concerned more with the issue of efficiency and overall fairness rather than vertical equity”.21 There has been increasing recognition of the harm that an ‘inefficient tax’ system does to an economy. Thus, the proponents of ‘optional theory of taxation continued their efforts in search of equitable and, at the same time, efficient tax system’.

2.10 Defining Of Efficiency Loss

A tax except in the form of lumpsum tax (like pool tax, land tax and pool subsidy) reduces the consumers welfare in two ways: First directly through a transfer of resources from the consumer to the government, and secondly, indirectly through a rise in the consumer process (i.e., tax inclusive) of taxed commodities relative to those of non taxed goods. The former produces a (direct) income effect, while the latter gives risk to both an (indirect) income effect and a
substitution effect, in the standard manner following a relative price change. “The efficiency loss of a tax normally refers to the excess of the reduction in the consumers welfare above and beyond that which can be accounted for by income loss due to payment of the tax. For this reason, the efficiency loss is usually referred to as the ‘excess burden of the tax”. Therefore, this excess burden arises purely from the tax induced change in the relative prices of taxed and non-taxed commodities. It then follows that excess burden of a tax leads to welfare loss of the consumer.

2.11 Measurement of Efficiency Loss (Dupuit-Marshall – Harbinger – Measure)

The excess burden of a tax, in case of a single taxed commodity can be measured with the help of DMH model.

2.12 Dupuit – Marshall – Harbinger Measure

The DMH measure of a tax’s excess burden relies on the use of the concept of consumer’s surplus as a measure of the consumer’s net welfare, in consuming a commodity. In Fig. 2.1 DD’ is the consumer’s ordinary demand curve for commodity X₁. With X₀ being the quantity demanded at the initial price P₀ with no tax. The consumer surplus is then familiar area below the demand curve but above the price line, that is the area of the triangle DP₀B.
Consider now a new tax at the advalorem rate ‘t’ imposed on $X_1$, so that its consumer price rises to $P_1 = (1+t)P_0$, resulting in a decrease in the quantity demanded of $X$ from $X_0$ to $X_1$. Compared with the pretax situation consumer surplus has now declined by the area of the trapezoid $P_1ABP_0$. The area of the rectangle $P_1ACP_0$ represents, however, total tax payment. Hence, the excess burden of the tax is the area of the triangle $ABC$, which measures the excess of the reduction in consumer surplus above and beyond that due to the tax payment.

2.13 Supply Side Tax Policy

Supply side tax policy basically aims at overcoming the negative substitution effect of taxation. When the tax burden is heavy, work, saving and investment suffer and distortions in
resource allocation take place resulting in loss of efficiency. As defined by V.P. Gandhi (1967). "Supply-side economists stress minimizing the distortions that taxes in general, and high and progressive taxes, in particular inject into market decisions and believe that reforming the tax structures, in general and lowering the rates of taxes in particular, would encourage savings and production by allowing the economist incentives of a free market to work".23

The supply side economists focus on reform of income taxation and advocate to reduce the top marginal income tax rates. The argument is that when the top marginal income tax rates are reduced, the negative substitution effect will disappear and work effort, supply, savings and capital will all increase and the rate of growth of the economy gets accelerated. The most prominent exponent of this view is Arthur Laffer who advocated the famous "Laffer curve" that as the income tax rates are in the normal range and then reach a peak and thereafter further increase will take the rates to a prohibitive range resulting in a fall in revenue as shown in the diagram 2.2.

Graph 2.2
The Laffer Curve

![Graph 2.2: The Laffer Curve](image-url)
As shown in the diagram, tax revenue goes on increasing as the tax rate is raised up to $t_c$ and any increase in tax rate beyond $t_c$ will only result in lower revenue and at 100 percent tax rate, the revenue is zero, because at this rate incentive for production is destroyed and also nobody would be willing to pay tax at this rate. The maximum revenue that can be raised is $M$-Revenue at $t_c$ level of tax rate which may be taken at 50 percent. The curve is divided into two portions by the line $t_{cm}$. The portion below $t_{cm}$ is the normal range and the portion above $t_{cm}$ is the prohibitive range. The Laffer curve provided the basis for supply side tax policy and played a strong role in shaping the tax policy in many countries.

Even though the Laffer curve analysis is basically applied to reforms in income tax rates, its basic tenets can also be extended to the reforms of indirect taxes, with the aim of broadening tax bases and rationalising the rates to remove all tax related distortions. Tax reform in India after 1991 is on the lines of the basic version of supply side tax policy.

The idea that the tax burden should be kept low to stimulate development is not new. Sreekantarahydas (2000) draws attention to R.M. Bird, who recalls P.T. Bauer's advocacy of lower tax rates in contrast to Kaldor's advocacy of high tax rates in fifties. His description of the views of Kaldor and Bauer is worth quoting. “Tax more, said Kaldor; tax less, said Bauer. Increase public spending to
encourage development, said Kaldor; reduce public spending to encourage development, said Bouer. Tax the much especially heavily, said Kaldor; tax the rich if at all, with great care, said Bauer, who in this and other ways should perhaps be considered the modern father of supply side taxation in developing countries."\(^{24}\)

The tax reform in India after 1991 is clearly in response to the fiscal problems that appeared in the late eighties and aggravated by 1991. India faced with fiscal crisis and balance of payments crisis in 1991 it became inevitable to approach IMF for a large loan. As per the conditions put forth by the IMF, India had to adopt a stabilization and structural adjustment programme and fiscal correction involving reduction of fiscal deficit was an important component of this programme. It was in this context that tax reform was initiated in India after 1991 crisis.

With this theoretical background for tax reforms in India we shall move on to the next aspect, literature survey of this chapter.

2.14 Review of Literature

The present study proceeded after having gone into the theoretical framework reviewing the existing research work, reports, books, published data and the like. The details are depicted in the following Chart 2.1.
A. Review of Documentary Sources of Information

The documentary sources of information is classified as:

1. Studies abroad
2. Studies in India

B. Review of Non-Documentary Sources of Information

The internet through which E. journals constitute the source of informations to study the various aspects of services and services tax. This study was thought necessary to.

1. Studies Abroad

Several books of topical significance which include the tax in general and tax specific were to examine. In these books the objectives and findings of the authors were to examine.

2. Studies in India

The various domestic sources on the topic include:
a) Books, b) Reports, c) Leading dailies and d) Journals, were to examine the objectives of the various authors to find out the research gap on the present topic.

2.15 Studies Abroad – Tax-in-General

Tanzi Vito (1990) in his book deals with many issues of public finance, within a macro economic framework relevant to developing countries. At the same time, the book is based more on policy experiences than on theorizing. The author argues that the levels of tax revenue in developing countries depends on the impact of macro economic policies, the literature of which is entirely missing in the works of other fiscal economists. These macro economic aspects are grouped under three headings: 1. Statistical determinants which include, the level of per capita income, economic development, the degree of urbanisation, 2. Institutional or social determination – the quality of the tax investment, the honesty of tax payers, the degree of corruption, the income distribution etc., 3. Tax policy determinants – tax sources (for ex. a country uses or does not use value added tax), the number of taxes in the country’s tax system the level of tax rates etc. He concludes that, tax reform is likely to be most successful in raising revenue in a stable or improving macro economic environment, good tax reform cannot be made if the macro economic situation is not taken fully into account.
A) Tanzi Vito and Howellzee (2001)\textsuperscript{26} of the opinion that VAT has been adopted in most developing countries, it frequently suffers from being incomplete in one respect or another. They argue that many important sectors, most notably services and the wholesale and retail sectors have been left out of the VAT net, or the credit mechanism is excessively restrictive, especially when it comes to capital goods (that is there are denials or delays in providing proper credits for VAT on inputs). As these features allow a substantial degree of cascading effect which reduce the benefits from introducing VAT in the first place. Therefore they suggested that rectifying such limitations in the VAT design and administration should be given priority in developing countries.

B) Tanzi Vito and Howellzee are of the opinion that developing countries attempting to become fully integrated in the world economy will probably need a higher tax level, if they are to pursue a government role closer to that of industrial country, which an average enjoy twice the tax revenue. Developing countries, therefore have to reduce sharply their reliance on foreign trade taxes without at the same time creating economic distortions, especially in raising more revenue from personal income tax. They conclude that, to meet these challenges policy makers have to demonstrate the political will to implement the necessary tax reforms. Tax administration must be strengthened to accompany the needed policy changes.
Richard A. Musgrave (1987) seeks to analyse various problems of tax reforms of developing countries in his book. He analyses various problems like the burden of taxation, compliance costs, efficiency of the economy etc. He seeks to analyse the various alternative taxes, their structure, design, etc. According to Musgrave although, tax literature has traditionally featured a broad based income tax as the best form of taxation, recent writings has veered toward consumption tax of the preferred base. This literature stresses the dead weight loss or efficiency cost that arises because an income tax discriminates in favour of present consumption, whereas consumption tax is neutral in that respect. In addition it is argued that consumption tax is more favourable to saving and hence to economic growth. Therefore, he says that consumption offers an attractive tax base for taxation. He gives no reasons in favour of his argument. First developing countries are in urgent need of capital formation and saving is needed to sustain. Thus, taxation should draw on consumption rather than on saving. At the same time, the level of consumption for the large part of population is very low, leaving little or no 'surplus' that can be transferred to the budget. Second, the highly unequal distribution of income and the low rate of private sector saving, there exists however, a substantial surplus in the form of luxury consumption, at the upper end of the income scale. This sector of the population however, is also a source of private sector saving, whether as household savers or as share
holders in companies. Income taxation sufficiently progressive to absorb large part of surplus consumption, therefore, would also threaten most private sector saving, this problem being worse in cases where effective taxation of capital income is limited by what capital can earn abroad. The obvious answer therefore, is to focus directly on the taxation of consumption out of high incomes. He also argues that personal expenditure tax as suggested by Prof. Kaldors (1956) is not feasible for developing countries, which he attempted to apply in India. But the experiment proved a failure because the administration of such a tax requires accurate accounts for financial transactions. Therefore, he concludes that consumption tax provides the best tax base for developing countries.

Musgrave and Musgrave (1989) try to analyse and illustrate the various types of value added taxes in this book. For example, GNP type, income type and consumption type VAT is analysed by them. When the value added tax of the consumption type and retail sales tax has the same base, then the question of preference arises, they seek to differentiate between the two taxes, in favour of value added tax. According to them under the retail tax, the number of tax payers is less than under the value added tax, thereby facilitating administration provided that retailers can be reached effectively. In the United States tax system, this procedure is quite feasible, but in developing countries where retail establishments are small, it might not be. Further, they argue that under the value added tax exclusion
of capital goods can be accomplished more effectively than under the retail sales tax, where it is difficult to trace the use of items purchased from the retailer. Further, under the invoice method of collections the VAT has an element of self enforcement, which the retail sales tax lacks.

But in a federation they argue that it is difficult to integrate a federal VAT with retail taxes at the state level, therefore they conclude that a federal consumption tax should take the form of retail tax.

Ecker Raca (1970) proposes to arouse public concern for the fiscal problems that confront state and local governments and explore possible solutions to the problems. Raca opines that state sales taxes apply mainly to retail sales of tangible property including services in the sales tax if the base is quite common; and as has been noted, this tendency appears to be gaining momentum. The case for including services in the base of the sales tax is good. It makes the tax least regressive because expenditures for services tend to rise as incomes rise. It makes sales tax revenues more responsive to economic growth, because as people move up the income ladder their expenditures for services increase faster than for commodities. He further says that inclusion of services eases the compliance burden for those businesses which render services in conjunction with the sale of parts or other commodities.
He concludes by making a case for extending the sales tax also to professional services like accountants, architects, dentists, doctors, economists, consultants of various sorts etc.

Simon and Nobes (1978) seek to analyse in this book, the various issues concerning taxation, like the need for taxation, classification of taxes, effects of taxation on economic life etc. in England. According to them VAT should become a 'more broadly' based structure where by discriminating less between different types of goods and services, which was introduced in England in 1973. They argue that VAT has several advantages and disadvantages too. The most important advantages of VAT is that, it would reduce the mislocation of resources of selective sales taxes, it is neutral between all goods and services, it is neutral between vertically integrated companies and other exports are zero rated etc. The disadvantages are the VAT that covers only 55 percent of expenditures, innumerable collection points proved opportunities for tax evasion and overdue payment, it is estimated that 5 percent of the due revenue may be lost in this way.

They conclude by saying that introduction of VAT was the need to harmonise with EEC practice; such harmonization of indirect tax systems is called for by Article 99 of the Treaty of Rome. However, disadvantages can be mitigated by cross checking of invoices by the accountants, auditors and excise officers once every year.
Burgess and Stern (1993)\textsuperscript{31} in this paper seek to analyse theory and practice of taxation in developing countries, the tax structure, the role of the state and the macro economy. They also seek to draw lessons from Tax Reform in developing countries. They are of the opinion that tax GDP ratio in developing countries is merely 10 percentage points of GDP, below industrial countries where it is 30 to 35 per cent of GNP, with only a small amount of this revenue coming from non-tax sources. Further, they argue that in most countries the VAT extends through the retail stage and almost all category of goods can be taxed using VAT. Services which are of considerable importance can be taxed using the VAT, though this aspect may not have been given sufficient emphasis in developing countries.

They conclude that the reform of the tax system and the control of expenditure are at the heart of most structural adjustment problems. Indeed without fiscal stabilization structural adjustment will surely fail.

2.16 Studies Abroad – Tax-Specific

John Wholley and Deborah Fretz (1990)\textsuperscript{32} in their Monograph have discussed the economics of Goods and Service Tax (GST) which was to be implemented in Canada in 1991 in place of manufactures sales tax (MST). The authors investigate the operation, deficiencies and economic effects of the MST and also summarise previous
attempts to reform the federal sales tax. They put forward many of the arguments like inputs credit treatment, relative case of collecting taxes, tax base stability, tax treatment of services, the self policing factor, treatment of used goods etc. in favour of the federal GST. They also evaluate alternatives to GST involving changes in the sales tax, pay roll tax and personal income tax. Finally they draw several implications for Canada from other countries with value added tax.

They concluded by heralding the bold step taken by the Canadian Government with the objective of long-term deficit reduction and improvement of national economic performance through an efficient instrument like GST.

Gills, Shoup and P. Sicot (1990)\textsuperscript{3} tries to explore and evaluate various issues and principles relevant to developing countries from the IMF conference papers contributed by various experts. John A. Key and Evan H. Davis in their contributory article try to examine the problems that arise in imposing VAT on services. They also explore the methods of taxing services. To the question why should services be taxed? They have cited two important reasons for taxing services one is equity consideration and the second, is short term welfare effects. The exclusion of services from tax net leads to dead weight loss and have economic distortions according to them.

They conclude that the assertion that a value added tax provides a straight forward way of taxing services as well as goods is
much exaggerated. Most service activities pose problems under a value added tax, and many of these problems have been dealt within practice through adhoc procedures that could equally well have been used under other alternative tax regimes.

John F. Due (1979)\textsuperscript{34} in his study provides a more intensive analysis of issues regarding tax policies drawing heavily from the experience with the sales tax in both developed and developing countries. He argues that taxation of services is more satisfactory with a value added tax than with other forms of sales tax because of the tax credit feature. He expresses his reservation over taxing of financial services because a large portion of the receipts consists of 'interest' which often does not constitute value added is not subject to tax. Therefore, financial services should be exempted. To the question of the sale of second hand goods, he argues that, if their price reflects the tax originally paid on them, they should not be taxed again. Practically, even though it is not easy to include them in tax net and exemption encourages the converting of new goods into used ones for tax purposes.

He concludes that evidence strongly suggests that if a value added tax is used, universal coverage and uniformity of rate are highly important for satisfactory operations.

Lindholm (1976)\textsuperscript{35} in his volume tries to analyse the harmful effects of income tax or the graduated estate tax in America, on
efficiency employment and international competition. As a result, he suggests the desirability of a major new national tax source, a value added tax which might raise the revenue considerably. He argues that if service industry is exempted, it is unable to recover the VAT included in cost of supplies and capital goods purchased from the VAT collected from its customers as a portion of selling price because the industry itself does not pay VAT on its value added. Therefore, due to this kind of disadvantage he says, some service industries in Europe have actually requested they be included under VAT.

He concludes that some areas of economic activity do not fit readily into the strict economic concept of value added. The failure of nations using VAT to overcome some of the difficulties has been due to a reluctance to change certain established practice and violate certain taboo than to administrative or economic fundamentals. His remark is significant in the background of American failure to introduce VAT due to internal opposition.

Robin and Keen (2003) have asserted that financial services should be taxed as a part of a system of optional taxation for revenue raising purpose. In fact the tax system might also be used for corrective purposes to correct inefficiencies resulting from market failures. The authors opined that market failure is more vulnerable in financial markets because of asymmetric information in the market.
Satya Poddar (2003)\textsuperscript{37} in his article opines that the developing countries should introduce VAT on the models of experience of other countries which include taxes on financial services as a progressive source of revenue, as well as to avoid the distortions associated with an exemption of various financial services. According to him taxation of financial services is viewed as progressive because such financial services are connected closely with those with income and wealth. Thus, he concludes that progressive revenue objective dictates an application of VAT on wide ranging financial services. He also opines that compensatory taxes should be levied if exemption should be provided for various services for revenue purposes.

Joseph E. Payne (1991)\textsuperscript{38} in his article tries to analyse the implication for U.S. exporters, when the Canadian Government has replaced its Federal Sales Tax (FST) with a more broad based Goods and Services Tax (GST). The new tax is value added tax (VAT) similar to those found in most European countries when the GST went into effect on Jan. 1, 1991, the 7 percent tax was applied to most goods and services consumed in Canada. The tax is not applied to exports, since they are not destined for consumption in Canada. Since the GST is a VAT, manufacturer and businesses in the distribution chain pay tax only on the value they add to the product or service. Only the final consumer bears the full effect of the tax.
Joseph E. Payne says that U.S. exporter should have little difficulty in coping with the new Canadian GST. In fact, exporters of goods, previously subject to the FST may find demand increasing for many consumer products because the tax burden on those products was reduced from 13.5 to 7 percent on Jan. 1, 1991. In addition, due to the U.S. Canada Free Trade Agreement (CFTA), remaining Canadian import duties on U.S. products are reduced annually on Jan. 1. Under the tariff reduction programme, under the CFTA, remaining tariffs are being phased out with either 10 or 20 percent reductions every year until they disappear. This will further reduce the tax burden on U.S. exports to Canada and increase their price competitiveness.

Peter Hill (1999) in his article tries to analyse the economically relevant characteristics of goods and services that enable them to be distinguished from each other. Peter Hill in his article argues that the traditional dichotomy between goods and services should be replaced by a breakdown between tangible goods, intangible goods and services. This taxonomy not only clarifies the true nature of intangible products but highlights the fact that services are not intangibles. He opines that there are fast growing class of intangible products that have entities which are recorded and stored on media such as paper, film tapes or disks. Advances in computer, communication and audio visual technology have greatly enhanced the economic importance of these intangibles. On closer
analysis, it becomes clear that they have all the salient characteristics of goods and nothing in common with services. Intangible entities are the originals created by authors, composers, scientists, architects, engineers, designer, software writers, film studios, orchestra and so on. These originals are intangibles have no physical dimensions or spatial coordinates of their own and have to be recorded and stored on physical media such as paper, films, tapes or disks. They can be transmitted electronically. Like material objects, they are separate entities over which ownership rights may be established or traded and which may be of considerable economic value of their owners. Therefore, in the era of information technology the difference between goods and services are blurring. Thus, the distinction between goods and services is erroneous and unnecessary.

He concludes that good science always rests on sound classifications. The existing confusion between intangibles and services in economics cannot facilitate economic analysis in general nor the analysis of the role of information in the economy in particular.

T.P. Hill (1976)\(^4\) in this article tries to analyse the concept of a service and various ways by which services can be classified for purposes of economic analysis. According to Hill, 'a service is a change in the condition of an economic unit which results from the
activity of another economic unit'. Being a change overtime, its dimensions are quite different from those of a good, considered as a material object, so that goods and services belong to different logical categories. The ownership of a good can be transferred from one economic unit to another in an exchange transaction, whereas, no such exchange is possible for a service. A service is produced by one economic unit for another, but it is not exchanged between them. He criticises the idea that services are euphemeral and insubstantial because they are immortal goods is nothing but fallacious idea. He argues that the production of services often involves process of physical transformation which are exactly the same as those used to produce goods. He concludes that 'pure public services' should be distinguished from other services, as no satisfactory way has been devised to measure these services properly, and this is an area in which further theoretical and empirical research is required, given the size of resources consumed in their production.

The technical paper issued by the Ministry of Finance (1989), Government of Canada, criticises the Federal Sales Tax (FST), which has prevented economic growth and job creation in Canada by misallocating resources, lowering incentives to invest and impending the country's ability to compete internationally. It has become an increasingly unreliable and unpredictable source of federal revenue to fund programmes that are important to Canadians. Therefore, the Government of Canada proposes to introduce GST from 1991 with
the broad objectives to achieve i.e., to reduce fiscal deficit, to make Canadian economy more competitive in the world economy and finally to improve the fairness of the tax system and to increase the welfare of lower and modest income Canadians.

The benefits of the Canadian economy, from sales tax reform have extended across all regions and sectors. It has not only increased potential output, it has also contributed to improve productivity, competitiveness and positive impact on fiscal reforms. The introduction of GST at a 9 percent is estimated to yield about $24 billion in federal revenue, which is $5.5 billion more than the FST.

Studies in India : Taxation in General

K. Venkatagiri Gowda (1987)^2 in his study tries to explore how fiscal policy instruments are to be integrated with all other instruments of macro-economic policy in order to realise the desired results and underlines the complications of pursuing fiscal policy in isolation. This study highlights the importance of adopting a proper mix of policy and not tax policy as such in isolation. He argues that the VAT is levied in EEC countries, and the United States experts were debating whether to introduce a VAT system in order to reduce the balance of payments deficit and to lessen the burden of direct taxes. He also argues that the rates of VAT should be introduced in such a way that they are very low on essential goods and high on
luxury articles. He concludes that the VAT is as yet untried in any developing country, there is a need to carefully examine the viability and implications of the tax before it is introduced in India.

Ahmad and Stern (1991) in their study try to analyse the tax reform from basic economic principles. The objectives of the study are to develop guidelines for the design of tax policy, to show how the principles can structure systematic research into tax reform in terms of the consequences for households, producers and government and finally to combine the guidelines and applied research into a practical package for developing countries, especially for Pakistan. The authors argue that India and other developing countries should shift the balance of taxation within indirect taxes away from trade and towards domestic sources, in a manner such as VAT which avoids the taxation of inputs and to increase the role of direct taxes. They further argued that Pakistan is in an important respect better placed than other countries, such as India and Mexico, to introduce a VAT, in that it is less constrained by a vigorous federal structure. In India, this manifested itself of the problem of the allocation of sales taxation to the states, not the centre.

Nevertheless, they conclude, India and particularly Mexico have made strides in the direction of a VAT.

Chellaiah (1969) in his book seeks to study the role and nature of fiscal policy in an under developed country like India which
has adopted the mixed economic system of the institutional frame work within which to promote growth. He has also highlighted the major fiscal developments in India during the 1960s. He argues that there has been a shift in the fiscal policy from the short term stability to long term stability in the post Keynesian period. He argues that indirect taxes play a very important role in the finances of under developed countries. The greater part of the revenue should be raised through commodity taxation in such a way that high rates on luxuries and low rates on articles of common consumption are widely accepted rules. He concludes that if there is any regressivity in commodity taxation, it should be counter balanced by undertaking suitable investment policies by the Government.

Joshi and Little (1996), seek to analyse various aspects of economic reforms since 1991 in India like stabilization, taxation and trade, domestic and external finance, industry, agricultural sectors, poverty alleviation etc. The authors try to analyse various issues relating to fiscal policy and trade policy. They were of the opinion that central fiscal deficits need to be reduced by about 1.9 percent of GDP. This could be achieved by cutting the explicit central subsidy, increases in non tax revenue, by eliminating public enterprise losses, reduction in implicit subsidy to industries, transport and communications and greater economy in general governance by reducing excess employment and limiting rises in real pay, should yield large economics, permitting greater expenditure on social
services and investment in infrastructure. They also suggested that some reduction in states deficits is also required by reducing subsidies and by greater economy in administration.

Chellaiah (1996)\textsuperscript{46} tries to analyse various issues related to fiscal and financial sector reforms in India. He says that existing MODVAT should be converted into a full fledged VAT at the central level, covering first the manufacturing sector and then the greater part of the services sector. He concludes that as far as services are concerned there should be a clear demarcation between the centre and states in levying services tax on various services.

Jalan (1996)\textsuperscript{47} in his book tries to analyse various economic policy challenges before India in the years ahead, in the backdrop of global changes in technology and investment in the last decade. He opines that the change in the image and role of services has been brought about by unprecedented and unforeseen advances in computer and communication technology in the last two decades. An important aspect of the 'service revolution' is that geography and levels of industrialization are no longer the primary determinants of the location of facilities for production of services. As a result, the traditional role of developing country is also changing from mere recipients to import providers of long distance services. Service exports from developing countries are estimated to have reached $180 billion in 1994, a significant portion of which was from long
distance services. India too participated in this boom and exports of certain services (e.g., software) are expanding faster than the overall trade.

He concludes that some of the global developments provide immense opportunities to India for faster expansion. Knowledge based services, progress in information technology, structural shift in the pattern of demand in industrial countries in favour of services will provide more opportunities for India in providing services and service intensive goods.

Burgess and Stern (1993) in this discussion paper try to analyse the development and structure of tax revenues in India, since Independence. It describes the development of, and background to, the severe fiscal problems India now faces. An understanding of this problem is essential for the design of measures and reforms to overcome these problems. According to these authors government expenditures have consistently outstripped total government revenues in the period 1950-89 raising deficit makes the government to rely more on import duties and inflation tax as a means of deficit finance. They endorse the views of Chellaiah (1991-92), Buiter and Petel (1992) that consequence of the inability of tax revenues to finance raising deficits has been increasing resorts to debt financing. Therefore, they opine that further debt finance by borrowing does not seem viable in the medium term and monetary
expansion has proved inflationary. Tax reform, therefore, is necessary to increase revenue and fill the gap left by the reduced role of foreign trade taxes, together with expenditure reform, reduction in unproductive outlays on certain subsidies and public sector enterprises, appear as urgent priorities.

They conclude by stating that tax reforms should examine the implication for income distribution, acceptability of the states, as the reform process affects the state autonomy or revenue, tax reform should move from trade to domestic taxation, reduction in the role of state in production activities should be supplemented by increasing its activities in infrastructure development, education, health and social protection, which promote and enable the private sector to function well.

Ahmad and Stern (1991) analyse some international experience, primarily but not exclusively, keeping India in mind. The first was to identify lessons from other countries concerning possibilities and pitfalls in the reform of taxes in Pakistan. The second was to provide further and wider demonstration of the potential of the methods of marginal reform for the analysis of taxation in India. The authors argue that Pakistan lags behind other developing countries in the level and balance of its tax system. Its GDP tax ratio is still average for its income category and trade taxes will play an excessive role. This gives rise to taxation of inputs and
distortion of the price mechanism. The record of the other countries, including India, shows that it is indeed possible to shift the balance of taxation within indirect taxes away from trade and towards domestic sources, in a manner such as VAT which avoids the taxation on inputs. Further, they argue that Pakistan is in an important respect better placed than other countries, such as India and Mexico, to introduce VAT, in that it is less constrained by a rigorous federal structure. However, they conclude by remarking nevertheless India and particularly Mexico, have made major strides in the direction of a VAT.

Burgess and Stern (1993) analyse objectives, responsibilities, constraints of taxation for developed and less developed countries are essentially similar or sharply at variance that they are of the opinion that tax GDP ratio in developing countries is merely 10 percentage points of GDP, below industrial countries where it is 30 to 35 percent of GNP, with only a small amount of this coming from non-tax sources. They opine that, the reform of indirect taxation had been more successful than that of direct taxation. As administrative abilities grow and as the economy becomes more monetized with an increasing domestic base for taxation, domestic indirect taxation will reduce the importance of foreign trade taxation. Within domestic indirect taxation a movement to a system like the VAT, which is free from cascading and does not interfere with production efficiency, has become increasingly attractive and has been implemented in many
countries. They conclude that the lessons of theory and the experience of developing countries have much to offer to the developed countries.

STUDIES IN INDIA – TAX SPECIFIC

Tait A. Alan (1998) in his study tries to examine the single tax, looking at problems and options in theory and their different impacts, while keeping firmly in mind of practical implementation problems. The interests of both administration and tax payer are considered by him. At the same time, the problems of administering a VAT in Asia and Europe are similar, and yet they can be very different; but each region can learn from the other; and this study tries to illustrate problems and solutions by international experience. Tait tries to illustrate various problems confronting eight such various goods and services. These are construction, lending, financial services, services performed abroad, second hand goods, the trade of craftsmen, betting and rating.

He concludes that the construction industry should subject to the same treatment as other industries. The purchase of new business premises should, of course be liable to VAT of any other purchase of octroi goods, that should entail the buyer to claim full credit for tax paid against his current liability. On the other hand, sales of new properties that are not business premises.
Raja Chellaiah (1996) in his essays tries to identify two important major developments that contributed to the motivation and impetus for tax reform. The first is the realisation on the part of policy makers and tax administrators that the economic effects of taxation had to be given due consideration, for otherwise resource allocation would be distorted and economic growth would be adversely affected. The second factor which contributes for the tax reform is the new found awareness on the part of economists and tax designers, that the administrative implications and the possible behaviour response of tax administrators had to be kept in view while designing and recommending particularly tax structure. In this context he was of the opinion that the first major reform that should be carried out is to convert the existing Modvat into full fledged VAT at the central level, covering first the manufacturing sector, than the greater part of service sector should be covered by VAT.

He concluded that if tax reform is implemented as suggested by him would have created a broad based system, consisting of only a few major taxes without disturbing central-state financial relations. Not merely the economy but the entire tax paying communities will be greatly benefited. Further, he opines that it is possible with this structure to raise the ratio of direct to indirect taxes within 5 years time.

Purohit C. Mahesh (1993) seeks to analyse the various structure and governance of VAT in India. Further he seeks to
analyse the aspects related to harmonization of VAT in federal countries such as Canada, Brazil, India and also in European Union. He is of the opinion that the rationale of equity suggests that the taxes on services make the structure progressive, efficient and income elastic. He concludes that the tax on services must be levied under a system of full fledged value added tax only. He says that under this system, a tax credit is available when it is paid as business expenses. Hence there is no cascading of the tax. He also urges the central government to form an integrated and rationale VAT policy for all the taxes on commodities and services, both at the centre and states.

Hemlata Rao (2000) in her study seeks to analyse various issues relating to VAT in a comprehensive manner by consolidating the scattered plethora of literature available on VAT. The author is of the opinion that a good VAT should tax the broadest possible range of goods and services which are ultimately used for final consumption. She further states that if services are excluded from the tax net it leads to revenue loss, accentuates distributional impact and raises issues of horizontal and vertical equity. She also deals extensively with the various general problems while taxing services. She concludes that the comprehensive approach under which all services should be taxed and exempt those few well defined services.

Bagchi Amaresh, Goutham Ray, Purohit and Ranganathan (1993) the study team was constituted (1993) at the instance of
Ministry of Finance to examine the scope of extending service tax to more potential services. The terms of reference of the study were 1. To identify the services which have a potential source of revenue, 2. To examine whether the identified services may be brought under the purview of service tax, 3. To suggest the structural and administrative reforms to implement the tax, if levied and 4. to recommend appropriate measures while keeping in mind the constitutional provisions relating to taxation.

The study team was of the opinion that unless services are brought within the tax base, revenue growth from indirect taxes remain constrained and the objective of tax reforms would be difficult to achieve. It also opined that exclusion of services from tax base is undesirable from the angles of equity, efficiency and administrative ease. The team also held that since services are consumed by the rich, there is a positive relationship between income and proportion of expenditure on services, expenditure on services will increase as one moves up the expenditure level. Hence vertical equity suffers if services go untaxed. Therefore, the study team identified 18 services on a selective approach, such as construction and service contract, stock, real estate, customs agents and brokers, warehouses etc. and recoi. ended to bring those services under service tax net in 1995.

Srikantaradhya (2000)\textsuperscript{55} tries to analyse various issues of tax reforms in Indian economy. According to him the sales tax base is
narrow, since it is confined to mainly commodities. In fact the constitutional provision is to lay tax on sale or purchase of goods and thus services are excluded. But under specific provisions of the constitution, state governments have been levying tax on services like transport, entertainment, electricity, water tariff, catering etc. However, coverage of services is extremely limited and the opinion of the experts is that some major services can be brought under the sales tax net. He also opined that apart from motor vehicle tax on the transport sector, a tax on services provided by the transporters can be levied. Services provided by the private nursing homes, computer maintenance and consultant services, automobile repair and services can be brought under sales tax to achieve the objective of widening the tax base, which will serve the purpose of realising more revenue even with low rates of tax. He concludes that the possibility of bringing more services under the sales tax net without a constitutional amendment needs to be explored.

A) Gurumurti S. (2000) in his book compares the implementation and operation of the VAT among several countries of the world. According to him the Federal Constitution of Canada finally decided in 1989 to replace the MST with a VAT called, the Goods and Service Tax (GST). The GST was actually brought into force on Jan. 1, 1991. The GST is a multi stage sales tax operated on the invoice credit method collected at each stage of trade. It is a destination based tax levied at the rate of 7 percent on the
consumption of domestically produced goods and services, while goods and services exported to non-residents are not taxed. Further, exports as well as certain commodities like basic groceries, agricultural and fish products, drugs and medical devices were zero rated, while charities and non profit organisations, the MUSH sector namely, municipal services, universities, schools and hospitals were particularly zero rated in the sense that they were eligible to claim a rebate for a pattern of the tax paid on their inputs.

B) Further Gurumurti opines that introduction of the VAT as goods and services in Indonesia has been a major landmark in terms of improving the revenue. According to him the revenue from the VAT has increased at 25% per year and like in Thailand that has also contributed to better tax compliance of personal income tax and corporation income tax due to electronic tax administration. The high revenue buoyancy has led to the government to consider reduction of corporate tax and custom duties and gain a competitive edge in international market. Indonesia introduced VAT from April 1985, with 10 percent VAT. It was confined to the manufacturers level. Agricultural products were exempt. Services except construction were exempt. With effect from Jan. 1995, the coverage was further extended to small retailers. He concludes that all sellers of goods and services having a turn over of more than RP 240 million (US $1,20,000) per year were required to register and pay the tax. All essential services are exempt from tax.
Govinda Rao M. (2001) in his article attempts to analyse the issues involved in extending consumption taxes to the service sector. He opines that, although the share of services in GDP is over 50 percent, its contribution to tax revenue is not commensurate with it. Further, the prevailing taxes on services are overlapping and haphazard and are not conducive to the evolution of a coordinated value added tax at central and state levels. He also says that it is important to extend the tax also for reasons of revenue. He argues that for evolving a rational consumption tax system it is important to levy a general tax on services rather than continuing with the selective taxation prevailing at present.

He concludes by suggesting that at the central level by 2004-05 service tax should be merged with the MODVAT to evolve a manufacturing stage value added tax. In the case of states to evolve a destination based retail stage value added tax, it is necessary to give concurrent powers to tax all services subject to certain safeguards to ensure orderly development of the consumption tax system.

Shome (2002) in this book provides an analytical frame work within which fiscal deficit and economic growth are analysed. He also examines issues related to the introduction of value added tax (VAT) in Indian states and its importance in achieving a comprehensive and integrated tax base through a study of the background, experience and accompanying complexities. It also draws upon international experience from Asia, Africa, Latin America etc.
Shome argues that the services sector grows at a faster pace in both current and constant prices, whereas the ratio of agriculture and manufacturing sectors have shrunk in terms of current and constant prices, there is little alternative but for services to fill the gap in taxable base in order to barely maintain, leave alone increase, the overall tax-to-GDP ratio of central government. Further, he says that Brazil was one of the first countries to introduce a comprehensive VAT on both goods and services in the mid-1960s. Given its federal structure, in which the states have an important fiscal role, the VAT was primarily assigned to states, services under the VAT were also assigned mainly to the states. Municipalities were assigned selected services that typically catered to the local markets such as hotels and restaurants, laundry and dry cleaning. He says that, Brazil is a case in point from which India can draw important lessons in the area of service taxation.

He concludes that since the service sector is the largest and fastest growing sector, it is imperative to introduce service taxation in a comprehensive manner both at the centre as well as at the state level.

A) Bagchi Amaresh (1994) in this article tries to analyse the trends in growth of revenue, appraises the tax structure, before and after reforms and tries to draw the attention to the results of tax reform in some developing countries and the likely Indian scenario in
the next few years. Bagchi opines that, one of the deficiencies of the domestic trade taxes is the exclusion of services. If the buoyancy of the revenue from consumption taxes is to improve and the distortions removed, services have to be brought under taxation more generally. He thinks that revenue neutrality cannot be achieved with the reforms that have taken place so far until the progress is made in introducing a harmonised comprehensive tax on consumption of goods and services. He concludes that our tax system cannot deliver things without a comprehensive tax on domestic consumption like the VAT.

B) Bagchi (2004) in this article seeks to analyse whether the evolution of the structure of taxation of services is on the right track and tries to analyse the important issues in service taxation. Bagchi argues that, since services account for more than 50% share in the countrys' GDP, whereas the primary and the secondary sectors contribute the rest. The contribution of service sector to the government exchequer, has however, been far from commensurate, which contributes merely 0.5 percent, there is an urgent need to get the sector contribute more to the exchequer. He also opines that services should be brought under tax net from efficiency and equity point of view to avoid distortionary effect. He cited the recommendations of the Rao Committee which had envisaged a scientific scheme of dual VAT, whereby the tax is levied both by the centre and the states. He concludes by saying that the way must be
explored to levy service tax on a comprehensive base and integrate both CENVAT and the state VATs as and when they came to replace the state taxes.

The Planning Commission set up the Advisory Group in July (2000)\textsuperscript{61} to study tax policy and tax administration issues and make appropriate recommendations at different levels of government with the purpose of generating adequate resources for the Tenth five year plan (2002-03 to 2006-07).

One of the terms of references (TR) made to the Advisory Group enjoin or prescribe separate and explicit treatment of control and state level taxes. The Advisory Group recommended two separate jurisdiction for central duties and state duties to have an integrated comprehensive VAT. It recommended to frame appropriate rules and regulations to enact VAT legislation well before April 1, 2002. It opposed the introduction of VAT by individual states in isolation, rather they should act in unison on the issue (pp. 553). An important recommendation of the Advisory Group is with the taxation of services. States should be allowed to tax services whose consumption is of an intrastate nature. After initial introduction, services could be incorporated into the VAT. The tax on services should be fully integrated with the VAT, on goods, both in its design and administration, with an appropriate mechanism to setoff service input tax against goods output tax and vice versa (pp. 555).
Therefore, a destination based invoice credit method dual VAT - one at the central level and another at the state level comprising both goods and services could be envisaged by the end of the Tenth Plan.

The most important aspect of the recommendation of the Advisory Group is the assignment of the powers to tax services to states must be viewed as adequate compensation for revenue losses on account of abolition of the central sales tax.

It was Tax Reform Committee on Indirect Taxes under the chairmanship of Raja J. Chellaiah (1992-93)\textsuperscript{62} for the first time recommended to introduce services tax on a selective basis (Annexure 1). An important recommendation of the committee was to rationalise the indirect taxes of the central level and gradually move towards VAT comprising commodities and services. However, though there was no specific entry in the Constitution to authorise levy of service tax, the central government has imposed such tax in terms of residuary entry no. 97, in the Union list. It is stated in the constitution that in the absence of specific entry, unless the subject of taxation is covered under the state list, or there is a prohibition against such levy, the parliament by virtue of residuary entry is empowered to any fiscal levy. Accordingly Sections 64 to 96 of the Finance Act, 1994, as amended from time to time, provide the legal basis for the levy and collection of service tax in India. Thus, service tax was introduced in India, for the first time in 1994-95.
The committee envisages that the union excise on commodities gets gradually transformed into a value added tax at the manufacturing level, the services tax will get woven into that system and therefore, tax could be levied also on services that enter into the productive processes. The committee favoured advalorem duties to specific duties on commodity taxation, particularly under MODVAT regime. The committee recommended to levy service tax initially on the following services:

1) Advertising services
2) Services of stock broker
3) Services of automobile insurance
4) Service of insurance of residential property, personal effect and jewelleries and
5) Residential telephone services.

The committee recommended to levy tax on the value of the service transaction.

Report of Task Force on indirect taxes (Chairman Vijay Kelkar) (2002)\(^6\) one of the terms of references (TR) made to the Task Force was how to rationalise the indirect tax system and procedures on par with the standard international practices and thus encourage compliance and reduce transaction cost by taking advantage of information technology.
Value Added Tax (VAT) is unanimously acknowledged to be a major reform in the indirect taxation system. By adopting VAT the country would soon be joining the majority of the countries and hopes to derive the advantages thereof, by proposed implementation of state VAT from 1st April 2003 (but actually state VAT was introduced from 1st April 2005 (Chap IV).

The task force recommended the introduction of comprehensive service tax covering all possible services and leaving out only a few services by including them in a negative list. It also recommended to extend credit scheme to service sector by enhancing the present 5% rate to 14%. It also recommended the limit of exemption of services upto Rs. 10 lakhs in a financial year. The task force recommended to enact a separate service tax legislation to administer the tax (at present service tax is levied through the provision of Finance Act 1994 and Service Tax Rules). It is also recommend that services should be classified on the basis of WTO classification (Annexure 1). The task force recommended to provide for dispute redressal legislation for quick settlement of disputes. Lastly S.T. should be implemented as a E. tax to facilitate voluntary compliance and reduce, cost and improve tax administration. To utilise IT technology for online filing of tax return.

Report of Task Force on implementation of the Fiscal Responsibility and Budget Management Act (FRBM Act, 2003)\(^6^4\) has
highlighted the prevalence of low tax rates for the growing services sector which have adversely affected the tax base. This has generated a bias in favour of higher tax rate on manufacturing sector and on high import duties in order to maintain the tax GDP ratio. The report further states that the poor tempt to consume necessities with little value addition. The rich spend on larger transaction after income, on services. Therefore, a symmetric tax framework covering the service sector is desirable from the view point of both horizontal and vertical equity.

**Research Gap**

The study of literature, both in India and abroad, clearly reveals that most of the studies on service tax are general in nature. They are in tune with tax reforms as a part of structural adjustment programmes undertaken by several countries of the world, which have rigorously pursuing liberalization, privatisation and globalisation policy. No study has been undertaken in nitty and grity to explain the importance of service tax to mobilize additional resources hand to increase tax GDP ratio and eliminating fiscal deficit of the government, on the other hand to broaden the tax base, to infuse efficiency in the allocation of resources, so that distortions in economic activities are eliminated by relieving commodities sector by excessive burden of taxation.

An extensive literature survey not only emphasizes the need for introducing service tax in general on the grounds of equity, efficiency
and welfare consideration. They also demonstrated that service tax has been aligned with VAT. In otherwords, service tax has been integrated with commodity taxes or VAT in almost all countries of the world.

Therefore, the present study is undertaken to know the importance of service tax in increasing tax GDP ratio and eliminating fiscal deficit on the other hand. It also intends to analyse buoyancy of service tax in Indian tax system and infusion of commodity taxation with service tax to introduce a broad based goods and service tax (GST) in the country.

**Notes and References :**


4. ibid., p. 15.

5. ibid., p. 15.

6. A classic treatment of various aspects of equity is available in Musgrave (1959).


11. ibid., pp. 7-73.

12. ibid., pp. 7-73.


15. ibid., p. 225.


17. ibid., p. 96-97

18. Cohen Stuart argued in favour of equal proportional sacrifice, Sidwick and Marshal favoured equal absolute sacrifice, Edgeworth and Pigou arguing on welfare grounds considered equal marginal sacrifice the only proper rule, not as a matter of equity, but because it met the welfare of the objective of least aggregate sacrifice.


20. ibid., pp. 227-228.

22. The excess burden of a tax is also commonly known as the dead weight loss of a tax.


