Chapter 3: Indirect taxation in India – History, Problems and Reforms

1. After independence, India has taken the path of planned development under various five years plan in which tax policy has evolved as an important component of fiscal policy. It has placed a significant reliance upon setting up of public sector units in an effort to reduce the regional disparity and also to provide employment to the people. In particular, tax policy was the principal instrument for transferring private savings to public consumption and investment. Tax policy was also used to encourage savings and investment, reduce inequalities of income and wealth, foster balanced regional development, encourage small-scale industries on the assumption that they are employment intensive and influence volume and direction of economic activities in the country.

2. The evolution of tax policy within the framework of an industrialization strategy based on the public sector, heavy industry and import substitution has had several implications. The tax policy was directed to raise resources for the large and increasing requirements of public consumption and investment irrespective of the efficiency implications it entailed. In the objective of achieving a socialistic pattern of society, a system of licenses, quotas and restrictions, necessitated steeply regressive tax structure in both direct and indirect taxes. Further, with a view to achieve multiplicity of objectives, tax system was made very complicated leading to large-scale avoidance, evasion and disputes. There was a time when imports duty for around 400% and personal income-tax was as high as 97%!. This various types of indirect taxes existing at Centre and State levels are discussed herein below:

3. Central level taxes and its reforms:

(I) Central Excise duties.

(a) After independence, excise duties were levied on selected goods to raise revenue to meet the planned development. Significant revenue used to be collected from the tobacco and its products. Over the years, as the revenue requirement increased, the list of commodities subject to tax was expanded. In the initial years, for reasons of administrative convenience, the taxed commodities tended to be raw materials and intermediate goods rather than final consumer goods. As pressure to raise revenue increased, final consumer goods were included. In 1975–76 the tax was extended to all manufactured goods.

(b) In the past, the structure of excise duties was complex and highly distortionary. Some commodities were subject to specific duties and others to ad valorem taxes; on the later alone there were twenty-four different rates ranging from 2 to 100 percent. The tobacco and petroleum products were taxed at even higher rates. There was large number of ad hoc notifications giving complete exemptions or conditional exemption from payment of duties. Besides, there was different interpretation for the classification of the goods because of existence of multiplicity of rates. These all this gave rise to a large number of litigation on account of classification and valuation.

(c) Although the Indirect Tax Enquiry Report issued in 1977[17] provided a detailed analysis of the allocative and distributional consequences of union excise duties, its recommendations were not implemented for almost a decade. The rationalization recommendations included converting specific duties into ad valorem taxes, unifying rates, and introducing an input tax credit to convert

[17] Indirect Taxation Enquiry Committee Report(1977)

the cascading manufacturers' sales tax into a manufacturing-stage value-added tax (MANVAT). The report also suggested implementation of self removal procedure (SRP), whereby the manufacturer can remove the goods on payment of duty under the self-assessment system in respect of majority of goods except cigarettes, tyres and polyester.

(d) Concept of credit of duty was introduced for the first time in 1986 whereby MODVAT scheme allowed credit of duty paid in respect of certain inputs for making payment on the finished goods manufactured out of these certain inputs. After the liberalization of economy from 1991 onwards, the MODVAT the scheme was also amended many times to allow more inputs to be covered and it was only by 1996–97, that it covered a majority of commodities in the excise tariff and incorporated comprehensive credit.

(e) Though MODVAT scheme provided some relief to the industry yet the economy remained distorted because of existence of a large number of tax rates and many conditional/ end use exemptions notifications. There were a large number of sector specific or product specific or industry specific exemptions notifications. Different interpretations were given to different notifications leading to a large number of disputes going to tribunals and courts locking huge amount of revenue in these cases. Gross misuse of small-scale exemptions was also reported.

(f) Further reform of the excise duties came with the implementation of the recommendations of the Tax Reform Committee of Raja Chelliah[18]. The measures included gradual unification of rates and greater reliance on account-based administration. In 1999–2000, eleven tax rates were merged into three, with a handful of "luxury" items subject to an additional non-

rebatable tax (6 and 16 percent). The three rates were merged into a single rate in 2000–01 to be called a Central VAT (Cenvat), along with three special additional excises of 8, 16, and 24 percent for a few commodities. Further, the tax base was widened; some exemptions were replaced by a tax at 8 percent. Some simplification of the tax on the small-scale sector was also attempted. Small businesses could either take an exemption or pay tax at a concessional rate of 60 percent of tax due, with access to the tax credit mechanism. This option, however, was withdrawn from the budget of 2005–06. The Cenvat was further reduced to 14% from the budget of 2008-09.

II. Customs duties:

(a) In the initial years after the independence, the revenue from the Customs Duties was not significant due to import restrictions. The protectionism policies adopted by the governments to give boost to the local industry resulted in high and differentiated tariffs, with rates varying with the stage of production (lower rates on inputs and higher rates on finished goods) and income elasticity of demand (lower rates on necessities and higher rates on luxury items). This system of protectionism provided large premiums for inefficiency and caused unintended distortions in the allocation of resources. By the mid-1980s, the tariff rates were very high and the structure quite complex. The government's Long-Term Fiscal Policy (LTFP) presented in the Parliament in 1985–86 emphasized the need to reduce tariffs, apply fewer and more uniform rates, and reduce and eventually eliminate quantitative restrictions on imports. The reforms undertaken, however, were not comprehensive rationalization in the rates were attempted for specific industries such as capital goods, drug intermediates, and electronic goods. In fact, contrary to the LTFP recommendations, the tariffs were raised for revenue reasons, and the weighted average rate increased from 38 percent in 1980–81 to 87 percent in 1989–90. Thus, by 1990–91, the tariff structure

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[18] Tax Reform Committee Report(1991)

ranged from 0 to 400 percent[19]. More than 10 percent of imports were subject to tariffs of 120 percent or more. Wide-ranging exemptions, reflecting the influence of various special interest groups on tax policy, often granted outside the budgetary process.

(b) By now, the country's of the world started reducing import duties, removing import restrictions. In this era of globalizations, India also undertook reform process whereby tax laws were simplified and the rates were reduced to bring at the level existing in the neighboring countries. In 1991–92, peak duties were reduced on goods from above 150 percent in next four years to 50 percent, and then to 40 percent in 1997–98, 30 percent in 2002–03, 25 percent in 2003–04, 15 percent in 2005–06. Along with relaxation of quantitative restrictions on imports and exchange rate depreciation, the change in the tariffs constituted a major change in the foreign trade regime in the country.

© The number of major duty rates was reduced from twenty-two in 1990–91 to four in 2003–04. Of course, some items are outside these four rates, but 90 percent of the customs is collected from items under the four rates. At the same time, a special additional duty was imposed on goods imported into the country on the rationale that if the commodity was domestically produced and sold interstate, it would have attracted the tax rate of 4 percent. This duty was abolished in January 2004, only to be reintroduced in 2005–06. Thus, the direction of reforms was not always consistent, but overall the thrust has been to reduce the rates and reduce their dispersion. However, tariffs rates still vary with the stage of processing, and this practice has caused very high effective rates of protection on assembly of consumer durables and luxury consumption items.

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[19] Task Force Report on implementation of FRBM(2004)

III. Service tax:

(a) Till 1994, no service was taxed except for a few specified services assigned to the states such as the entertainment tax, passengers and goods tax, and electricity duty. The Constitution of India does not specifically provide for taxation powers to the Centre or the States. However, the service sector was growing significantly and its share in

the GDP was approaching about 50%. This omission violated the principle of neutrality in consumption as it discriminated against the goods component of consumption. Because services are relatively more income elastic, the tax system is rendered less progressive when these are not taxed. An even more important argument for taxing services is to enable a coordinated calibration of a consumption tax system on goods and services because services enter into goods production and vice versa.

(b) Although there was no specific authority to tax services, the Central government levied taxes under residuary powers contained in entry 97 of Union List of the Constitution on three services in 1994–95: insurance other than life insurance, stock brokerages, and telecommunications. The list was expanded in succeeding years and now includes more than 100 services had been brought under the service tax net. The initial 5 percent tax rate was increased to 8 percent in 2003–04 and to 10 percent in 2004–05. This was further harmonized with Cenvat in the budget of 2008-09. The Expert Group on Taxation of Services recommended extending the tax to all services, providing an input tax credit for both goods and services, and eventually integrating the services tax with the Cenvat. With these reforms, the tax system can effectively be called a manufacturing-stage VAT. The exceptions were to be two small lists one, a list of exempt services, and the other, a negative list of services, where the tax credit mechanism would not cover taxes paid on these services. The recommendation on the levy of general

taxation of services has not been implemented, and the tax continues to be levied on selective services. However, the recommendation pertaining to the extension of input tax credit for goods entering into services and vice versa has been implemented from 2004 onwards.

4. State - Level Taxes and Reforms

I. Sales tax:

(a) This was the most important tax collected by the State governments on the sales of goods to the consumers. Different states have been imposing sales tax at different rates depending upon their resource requirements. Majority of the states have multiplicity of rates, which was causing huge evasion of taxes as the administration of the same was also difficult because of large base. Further, various state governments have come out with different sales tax exemptions for setting up of units, companies, etc which were being misused. Since the value of the sales tax was to be determined after taking into consideration the landed cost at the dealer premises, the value included the tax paid on the manufacturing or import, and hence resulting in cascading effect of taxes. Tax reforms at the state level were not coordinated with those at the Center. While individual state governments tried to appoint Committees from time to time and reform their tax structures, no systematic attempt was made to streamline the reform process even after 1991 when market-oriented reforms were introduced. Most of the reform attempts were ad hoc and were guided by revenue needs rather than attempts to modernize the tax system. In some cases, even when systematic studies were done, the recommendations were rarely implemented. Increasing budget pressures and, in some cases, conditions imposed by multilateral lending agencies or the need to meet targets set by the medium-term fiscal reforms facility instituted by the eleventh Finance Commission helped to accelerate the pace of tax reforms in the states in the latter half of the 1990s.

(b) A systematic discussion on evolving a coordinated consumption tax system in the country was initiated in the "Report on Reform of Domestic Trade Taxes in India," prepared by the National Institute of Public Finance and Policy (NIPFP) in 1994. It has examined all models for consumption tax system for India and favored evolving an independent dual VAT at the central and state levels as the most practicable in the Indian context because it maintains a balance between sub national fiscal autonomy and the central government's fiscal capacity to undertake any desired interstate redistribution. Burgess and Stern had reached a similar conclusion in 1993[20]. Considerations of fiscal autonomy and demands on the central government to effect sizable interregional resource transfers as well as the political acceptability tilted the decision in favor of the dual VAT scheme as a medium-term goal. As a part of the dual VAT design, therefore, the NIPFP study group recommended that a separate destination-based, consumption-type, retail-stage VAT replace the existing state sales taxes.[21]

© The Government of India appointed a State Finance Ministers' Committee to make recommendations. The committee, which was subsequently transformed into the Empowered Committee of State Finance Ministers, recommended that the states adopt floor rates. The committee's recommendation that the VAT be implemented in 2003 was postponed repeatedly, until April 2005. Although characterized as adoption of VAT, the reform in April 2005 only extends the sales tax up to the retail stage with credit allowed for taxes paid on intrastate purchases used for all intrastate and interstate sales. The interstate sales tax, that is, the central sales tax, will continue in the same form, although a pending proposal would phase it out over a two-year period. In this sense, the reform is only a transitional measure to achieve the ultimate objective of having a

[20] Burgess Robin, Stephen Howes, Nicholas Stern (1994)

[21] Chelliah, P K Aggarwal, Mahesh C Purohit, R Kavita Rao(2001),

destination-based, retail-stage VAT.

(d) The salient features of the April 2005 reform are summarized here:

i) The tax is levied at two rates (except for bullion, specie, and precious metals, which are taxed at 1 percent). Basic necessities (about 75 items)are exempted. Most items of common consumption, inputs, and capital goods (about 275 items) are taxed at 4 percent, and all other items are taxed at 12.5 percent. Gasoline and diesel fuel (which contribute about 40 percent of the sales tax) are kept outside the VAT regime, and a floor rate of 20 percent is to be levied on them.

ii) The tax credit facility covers inputs and purchases as well as capital goods for both manufacturers and dealers. Credit for taxes paid on capital goods can be used over three years of sales.

iii) The tax credit mechanism operates fully only for intrastate sales. In interstate transactions, the exporting state is supposed to give an input tax credit for purchases made locally, against the collection of the central sales tax. The central sales tax credit in the importing state, or other mechanisms of zero-rating of interstate sales, will be introduced in two years, when the central sales tax in its present form will be phased out. In the meantime, an information system on interstate trade will be built up.

iv) The central government has agreed to compensate the states for any loss of revenue at rates of 100 percent in the first year, 75 percent in the second year, and 50 percent in the third year. The loss will be calculated by estimating the difference between the projected sales tax revenue using 2004–05 as the base and the actual revenue collected. The projected revenues will be estimated by applying the

average of the best three years' growth rates during the last five years.

v) Tax incentives given to new industries by different states could be continued so long as it does not break the VAT chain. Many states propose to convert tax holidays into deferment of the tax.

vi) All dealers with annual turnover above Rs. 500,000 are required to register for the VAT. However, the states may levy a simple turnover tax not exceeding 2 percent on those dealers with turnover up to Rs. 5 million. Such dealers, paying the turnover tax, do not have to keep detailed accounts of their transactions. But these small dealers will not be a part of the VAT chain, and no credit will be available for the taxes paid on purchases from these dealers. They may therefore voluntarily register as regular VAT dealers.

(e) The second reform pertained to abolition of sales tax-related incentives. In the past, all the States granted such incentives to new industries. These were given in one or the other form of exemption from tax on the purchase of inputs as well as on the sale of finished goods. Incentives were also granted in the form of sales tax loans and/or tax deferral. Various studies and committee reports had argued against such incentives. In terms of loss of revenue, all the States put together sacrificed about 25 percent of the sales tax base. In addition, the incentives took the form of tax competition (war) or harmful tax practices. Under a general consensus reached, State governments had stopped giving sales tax related incentives to new industrial units from 2000. The concessions already granted to the existing units were continued.

II. Central Sales Tax:

(a) CST is covered under the Central Sales Tax (CST) Act, 1956.

Under the CST Act, the tax is levied on the basis of 'origin' and collected by the exporting State. The consumers of the importing State bear its incidence. Such a system initially introduced in UBS 1956 to regulate inter-State trade and to provide equal tax treatment of tax on commodities entering into inter-State trade and on those locally produced. CST prescribes two different rates of tax: 4 percent on inter-State sales to registered dealers and 10 percent on sales to unregistered dealers

(b) High rate is charged from an unregistered dealer as the registered dealer pays State sales tax (GST) on its sales while no GST is charged on the sale of unregistered dealer. To curb evasion of GST (due to not levying of GST and levy of low rate of CST) there are certain documentation procedures that also go with it. First procedural requirement is to have a document called 'C Form issued by the officers of sales tax department in the Destination State. The C Form is required to be submitted to the officer of the State of 'origin' to enable a dealer to charge tax at the lower rate of 4 percent or less.

III Excise duty on sale of alcohol

This duty is collected by the state on sale of alcohol and constitutes a significant component of state taxation policy. There are several method of collection of this tax including auction of a particular area in the state to highest bidder or auctioning of the identified outlet to to the highest bidder.

IV: Tax on vehicles, entertainment tax, turnover tax, etc: These taxes are also collected by the state govt to supplement their tax revenue.

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