

Research Notes

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Sales Tax Efforts of the States - Comment on Jose Sebastian's Study

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Sebastian's study (1992) raises some methodological issues involved in the measurement of relative sales tax potential and efforts of States. However, apparently he fails to take note of some of the recent advances made in this respect, for instance, the Ninth Finance Commission (1988) and Sarma (1991). This note aims to bring out the limitations of Sebastian's study. In brief, the view that consumption expenditure is a better proxy for the sales tax base than State Domestic Product (SDP) is not entirely acceptable in view of the more serious limitations of the estimates of the total consumption expenditure. The note also disapproves the author's reliance on only the Representative Tax System (RTS) approach for judging the relative tax efforts of States disregarding the well-developed and more comprehensive regression approaches.

To begin with, Sebastian rejects the use of SDP as a proxy base of sales tax on two counts: Firstly, that SDP may not adequately capture the inter-state differences in sales tax potential arising from the variables such as income (expenditure) distribution, propensity to consume, urbanization and monetization. Secondly, as SDP is usually measured on income-origin principle, that it can not capture the increase in tax potential arising from the remittances made by the people, working in other States and countries to the home States.

These two limitations are no doubt valid and well-known. But the alternative proxy base in terms of consumption expenditure is also not without problems. First, a substantial portion of the consumption expenditure in any State lies outside the purview of households and is not covered by NSS. Second, it is not uncommon that a part of the burden of the sales taxes levied by a State is borne by the consumers of other States, and therefore, the tax base is not confined to the State's borders only. Third, it is well-known that consumption expenditure of the higher income groups is not adequately covered by the NSS samples. Sebastian's assumption that the underestimation, if any, of rich income groups will be of more or less the same magnitude in all the State and hence will not pose any serious problem, is not tenable in view of the glaring differences in the income inequalities across the States.

Next, Sebastian follows only the representative tax system approach for measuring the relative tax effort of States. Under the RTS method, potential tax revenue for each of the taxes in a State are estimated by multiplying the respective tax bases in that State with all - State average effective tax rates. The