



**REPORT
OF THE
INDIRECT TAXATION
ENQUIRY COMMITTEE**

**PART I
OCTOBER, 1977**

**MINISTRY OF FINANCE
(DEPARTMENT OF REVENUE)
GOVERNMENT OF INDIA**

**DEPARTMENT OF REVENUE
INDIRECT TAXATION ENQUIRY COMMITTEE**

Shri H. M. Patel,
Finance Minister of India,
NEW DELHI.

Sir,

We, the Members of the Indirect Taxation Enquiry Committee, submit herewith Part I of our report.

The reason why we are submitting Part I of our report in advance of the finalisation of the rest of our report is that we gather that Government are anxious to have our recommendations in their hands as early as possible so that they can be examined and considered well before the time when budget proposals begin to take shape. We have accordingly, in Part I of our report, outlined our main conclusions and recommendations and the reasons behind them.

Part II of our report, apart from being a more detailed presentation of the recommendations in Part I along with the facts and figures on which they are based, will set out the results of the various studies involving a good deal of research which we initiated and also examine the impact of indirect taxation on a select number of important industries. Further, since we found that a wide range of the problems and difficulties presented to us by trade and industry as well as by departmental representatives were basically procedural in nature, we have preferred to deal with them at some length in Part II of our report though there is a brief reference to procedural reform in Part I. We shall submit Part II of our report well within the extended term of life of the Committee.

It is our hope that our report will be of some help to Government in bringing about the kind of reform in indirect tax system of the country which was their aim in asking us to undertake this task.

Yours faithfully,

Sgd/-
(L. K. Jha)
Chairman

Sgd/-
(G. B. Newalkar)
Member

Sgd/-
(J. Sen Gupta)
Member

Sgd/-
(K. Narasimhan)
Member-Secretary

Sgd/-
(Raja J. Chelliah)
Member

Sgd/-
(M. V. Arunachalam)
Member

Sgd/-
(S. S. Marathe)
Member

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P R E F A C E

In pursuance of the Finance Minister's Budget speech of 1976, announcing the decision to appoint a Committee to review the existing structure of indirect tax system, the Indirect Taxation Enquiry Committee was set up under the Government of India Resolution F. No. 331/3/76-TRU, dated the 19th July, 1976. The initial composition of the Committee was as under :-

CHAIRMAN

Shri L.K. Jha, Governor, Jammu & Kashmir.

MEMBERS

1. Shri M.V. Arunachalam, President, Federation of Indian Chambers of Commerce and Industry.
2. Dr. Raja J. Chelliah, Director, National Institute of Public Finance & Policy.
3. Shri J. Sen Gupta, President, Bengal Chamber of Commerce.
4. Shri G.B. Newalkar, Managing Director, Maharashtra Mineral Corporation Ltd.
5. Dr. Manmohan Singh, Chief Economic Adviser to the Government of India.
6. Shri K. Narasimhan, Member (Tariff), Central Board of Excise & Customs.

In September, 1976, Shri S.S. Marathe, former Chairman, Bureau of Industrial Costs and Prices and now Secretary, Industrial Development, replaced Dr. Manmohan Singh, as a Member and Shri K. Narasimhan was appointed as Member-Secretary of the Committee.

2. The Committee was assigned the following terms of reference:
 - (i) To review the existing structure of indirect taxes - Central, State and Local - in all its aspects.
 - (ii) To examine the role of indirect taxation in promoting economic use of scarce resources.
 - (iii) To examine the structure and levels of excise duties, the impact of these duties on prices and costs, the cumulative effect of such duties, their incidence on various expenditure groups, the scope for widening the tax base and increasing the elasticity of the system.
 - (iv) To examine the feasibility of adopting some form of Value Added Tax in the field of indirect taxation where appropriate and, if found feasible, to suggest the appropriate stage to which it should be extended having regard to Indian conditions, i.e. whether the stage of coverage should be manufacturers, wholesalers or retailers.

(1)

- (v) To examine whether and how far it would be advisable to assist any particular industry or particular sectors of an industry by grant of concessions in indirect taxes; in doing so, the Committee will doubtless take into account all the normal canons of taxation, and the balance of administrative convenience. In those cases where these devices are found to be advisable, to suggest norms for the same.
- (vi) To examine the structure and levels of import duties from the point of view of import trade control, protection to indigenous industry and pricing of ~~indigenous products~~ and suggest changes, if necessary.
- (vii) To advise the Government on the steps to be taken to implement the recommendations made, including changes in the administrative and organisational set up.
- (viii) To suggest changes, if any required, in the Constitution and in the related taxation statutes, for the implementation of the changes suggested in the tax structure and having regard to the revenue needs of both the Centre and the States.
- (ix) To consider the interaction and the proper balance between indirect and direct taxes in the tax structure while examining the role of indirect taxation in mobilising resources.
- (x) To make any other recommendations germane to the enquiry.

3. Soon after the setting up of the Committee, a questionnaire was issued to elicit the views of Associations and organisations of all-India status representing trade, industry, labour and co-operative interests. Letters were also addressed to Central Ministers, Deputy Chairman of the Planning Commission, State Chief Ministers, eminent economists, public men, academicians and officers of the departments of Excise and Customs, seeking their suggestions on the kind of changes and re-orientation needed in the indirect tax structure. The questionnaire was also given wide publicity through the press. The Committee held meetings at various centres and received suggestions and representations from a wide cross section of people, including representatives of trade, industry and labour, eminent men, senior officials of the Central Government (in various Ministries as well as the departments of excise and customs) as also some State Governments. In addition, the Committee initiated research in a number of fields relevant to its enquiry. The most important of these, pertaining to the incidence of indirect taxes - the way they impinge upon different expenditure groups - could not be completed until October, 1977. In consequence, at the request of the Committee Government agreed to extend its life till the end of 1977.

4. In response to an informal request from the Ministry of Finance, the Committee submitted an Interim Report in April, 1977. In it the Committee attempted to set out its general line of thinking, as a result of the meetings and discussions it had had, even though none of the studies the Committee had initiated had been completed. It was the Committee's hope that the line of reasoning set out in the Interim Report might be of some use to Government when the occasion came to consider changes in tax rates at budget time and also that the Committee would have the benefit of the reactions of those who had access to the Interim Report.

(iii)

5. The Committee has now completed its work. Its findings, conclusions and recommendations are set out in this Report. Part I of the Report outlines in a condensed form the main conclusions and recommendations of the Committee. Part II makes a full and detailed presentation of the Committee's comments on the indirect tax system, of the results of the research studies instituted by it and of its recommendations on the reform of the indirect tax system.

1. THE TASK

1.1 The terms of reference assigned to us are wide ranging and the issues involved are complex. The task before the Committee is to suggest measures which would build a more enduring system in the field of indirect taxation. In doing so we have to recognise the important contribution that indirect taxes make to Central and States' revenues.

1.2 The share of indirect taxes in the total tax revenue of the Centre and the States has been steadily rising over the last two decades. Currently, it accounts for nearly 80 per cent of the total tax revenue as indicated in the table below :-

T A B L E

THE RELATIVE IMPORTANCE OF DIRECT AND INDIRECT TAXES IN THE INDIAN TAX SYSTEM, 1976-77 (BUDGET)

Category	Percentage of contribution to total tax revenue
1. Indirect Taxes, of which ...	79.7
(a) Union Excise ...	34.8
(b) Customs ...	12.8
(c) Sales Tax ...	18.7
(d) Other Indirect Taxes ...	13.4
2. Direct Taxes, of which ...	20.3
(a) Income tax ...	8.1
(b) Corporation tax ...	8.7
(c) Other Direct Taxes ...	3.5
3. All Taxes ...	100.0

The share of indirect taxes in the total tax revenue is not only much higher than that of industrialised countries - about 45 per cent on the average - but it is also appreciably higher than the average share for most developing countries.

1.3 The reasons for much greater reliance on indirect taxes in a developing country like India are well known. In an advanced economy with a high per capita income and a production structure characterised by relatively large business undertakings, the Government is able to derive the major part of its tax revenue through the direct taxation of individuals and businesses. On the other hand, in a developing economy characterised by low personal incomes and preponderance of small producers and traders, the collection of small amounts of direct tax from a multitude of low income earners presents insuperable difficulties. Therefore, it is only through indirect taxation that the vast majority of the population can be made to contribute to revenues.

1.4 The need for additional revenues has been rising steadily from year to year and from plan to plan, to provide the resources necessary for public sector investment and to meet the growing cost of general administration including defence, by imposing such restraints on current consumption as are necessary to divert real resources.

1.5 It is not possible for the Committee to express any views on a priori grounds regarding the level of indirect taxation as a whole. How heavy the burden of taxation should be, calls for a judgment - which is partly political - about the sacrifices which the people could be called upon to make and, partly economic - based on considerations relating to savings, consumption and capital formation, as well as the relative roles of private and public investment in the country's economic development. This judgment can only be exercised by Government.

1.6 What we, as a Committee, can and intend to do, in accordance with our terms of reference, is to discuss the structural aspects of indirect taxation. We are proceeding on the assumption that any changes we propose should ensure an adequate and rising flow of resources to Government and pave the way for an integrated indirect tax system in the country which is more efficient, more equitable and better oriented to further the objectives of planned development.

2. SOUNDNESS OF INDIRECT TAX SYSTEM IMPORTANT CRITERIA

2.1 The prime objective of a tax system should obviously be to provide sufficient revenues. A sound tax system should also satisfy the following criteria. First of all, it should have an adequate measure of built-in elasticity with reference to national income, so that as the national income rises, the revenues also go up at least proportionately, if not, at a higher rate. Secondly, from the social angle, the tax burden should be progressive, so that it impinges more heavily on those who are better off than on those who are poor. Thirdly, since indirect taxation has an impact on production, employment and investment as well as relative costs and prices, it should not be so much as to militate against national priorities and efficient use of economic resources. Fourthly, the procedures for the levy and collection of taxes must be such as to ensure that there is the minimum of cost, harassment and occasions for litigation.

2.2 From the revenue angle, one of the weaknesses of the existing structure of indirect taxation is that it does not have an adequate built-in elasticity. Each year the tax rates need to be revised upwards on a variety of items in order that the revenue requirements may be met. When circumstances warrant an increase in the tax burden on the community, an upward revision of tax rates cannot be avoided. But when there is no intention to raise the tax burden and what is desired is merely that the same percentage of national income should accrue to the exchequer, a sound tax structure should be capable of ensuring that as income rise, as production increases and consumption goes up, the same rates of tax should result in a proportionate rise in revenues. Indeed, if the tax system had an income elasticity of greater than unity, the percentage increase in revenue would automatically be higher than the percentage increase in national income. The need to make an upward revision of tax rates on particular products each year would then be reduced and the tax structure would acquire greater stability and would also become enduring.

2.3 In determining the rates of tax applicable to different products, Government - both at the Centre and the States - have been attaching the utmost importance to minimising the burden on lower income groups while having a heavier imposition on those who are better off. However, the compulsions of mobilising adequate resources and the overwhelming preponderance of low income groups in the community have made it inevitable that quite a number of the basic necessities of the common man should be taxed. The effort nevertheless has been and must be to tax articles of mass consumption at relatively low rates so as to ensure an adequate measure of progression. The studies we have had made indicate that this laudable effort has been successful upto a point. We examine later the ways in which a greater measure of progression can be imparted to the structure of indirect taxation to make it more equitable.

2.4 In trying to promote social justice through indirect taxation, it is not enough to consider merely the burden that the tax imposes on the consumption of the lower income groups. The tax system could also help to raise the income levels of the poor by generating additional employment. Products which have a high potential for additional employment could well be taxed at relatively lower rates even if they are consumed by relatively higher income groups. In the interest of social justice, attention should be paid not only to the impact of taxes on expenditure but also on income, not only on consumption but also on production.

2.5 Differentiation of the rates of tax on different products is not without certain economic consequences. As a rule, the level of consumption of any product tends to decline as the levies on it are raised. In consequence, production, investment and employment in particular industries are apt to show a downward trend. The extent to which this happens depends on what is known as the elasticity of demand. For some products, usually in the nature of necessities without close substitutes the demand is inelastic and the decline in consumption as a result of higher taxation is small. But the burden may fall on a section of society which we do not want to tax heavily. Then, there may be secondary effects on the output of other commodities the demand for which may fall as a result of consumers spending more money, on the taxed commodity. At the other extreme, there are products the demand for which is highly elastic. Their consumption falls more than proportionately to the rise in prices occasioned by higher taxation. If tax rates on such products are raised very high, not only can there be a fall in their production but there can even be a decline in the revenues derived from them. Apart from the direct impact of taxation on production, the expenditure of revenue by Government leads to an increase in the demand for various goods and services and this may have an impact on the pattern of production. The effects of differential taxation of commodities, on the allocation of resources as well as on production and employment must be kept in view in evolving a sound tax system.

2.6 There is a school of thought which urges that taxation should be neutral in the sense that it should not affect the freedom of choice of the consumer as between different products, of the producer as between different raw materials and other inputs and of the investor, as between different lines of production. With our commitment to planning it would be entirely legitimate to have recourse to different rates of indirect taxation on different products in order consciously to influence production and investment. At the same time such differentials in tax rates introduced on merely revenue considerations militate against the priorities; they may only frustrate rather than fulfil our objectives. While indirect taxation can be used for purposes of beneficent intervention in the market, it should not through unintended and unnecessary changes in relative prices and costs give the wrong signals to the economy. It should consciously promote and not inadvertently affect the efficient allocation of resources.

2.7 Any restructuring of the tax system cannot but take the fullest possible note of administrative problems. A theoretically perfect system may well break down in practice. During the course of our enquiry, we have heard numerous complaints about the irksomeness and the inequity of procedures, not only from those subject to indirect taxation but also from those who are responsible for tax collection. There is a clear need for simplifying procedures and also for some changes in the law in order that assessment disputes are minimised and disposed of speedily.

3. PRESENT TAX SYSTEM - ITS EVOLUTION AND WEAKNESSES

3.1 At the time of Independence, India inherited a system of indirect taxation in which the bulk of the revenue came from customs duties - import duties - at relatively low rates covering practically all imports, and export duties on a few selected items, like jute and tea, for which India enjoyed a somewhat monopolistic position in world markets. Excise duties were levied on about a dozen articles in all including motor spirit, tobacco, salt and matches. Sales taxes, which had begun to be imposed by provincial Governments after the necessary powers had been given to them under the Government of India Act, 1935, covered a somewhat limited range of items at rather low rates to start with, but the coverage was steadily extended.

3.2 In the years following Independence, as revenue requirements began to mount, excise duties began to gain an importance over customs duties because, on the consideration of conserving foreign exchange, only highly essential items were allowed to be imported and the accent of policy was on stepping up domestic production at the expense of imports. To start with, the level of excise duties on particular items was raised year after year. Soon the need was felt to widen the tax base by bringing more items within the excise net. In doing so, the emphasis at the early stages was on the taxation of raw materials and intermediate products in preference to consumer goods, because of administrative considerations. An excise on steel could be collected from the relatively few producers in the field far more easily and economically than a levy on the thousands of manufacturers of steel products. An additional factor which seems to have influenced the extensive taxation of industrial inputs rather than finished consumer goods was that a tax which was seen to fall on articles of mass consumption, particularly on those consumed by lower income groups, gave rise to much more resentment and criticism than the concealed levies which fell on the same products through the taxation of inputs. A levy on aluminium sheets (circles) was more readily acceptable than a levy on aluminium utensils though the former also affected the consumer price of pots and pans. Over time, the compulsions of raising additional revenues led to a steady extension of excise duties to more finished consumer goods as well. And through the Budget for the year 1975-76, a low levy of 1 per cent - raised to 2 per cent in the Budget for the year 1977-78 - was imposed on almost all manufactured products which were not otherwise covered by excise duties.

3.3 Import duties too, in the years after Independence, were repeatedly raised to provide additional revenue as well as for the protection of domestic industries and conservation of scarce foreign exchange. In the middle of 1965, with foreign exchange reserves falling below Rs. 100 crores, import duties were raised to unprecedented heights. Speaking broadly, three rates came into effect -- 40 per cent for machinery, 60 per cent for industrial raw materials and 100 per cent for manufactured goods. As a result of subsequent changes particularly in 1971, and the levy of an auxiliary duty, the duty presently amounts to 45 per cent on most basic raw materials and machinery, 75 per cent on processed industrial materials and semi-processed goods and 120 per cent on fully processed goods including consumer goods. Certain items like foodgrains, are allowed duty free while there are other items on which the levy is above 200 per cent. In addition to these duties, a countervailing duty, equivalent to the excise duty for the time being leviable on like articles if produced or manufactured in India, is also collected in most cases.

3.4 Sales taxes levied by State Governments have also steadily increased in importance. Their coverage has been extended to include not only consumer goods but also raw materials and components and other inputs that go into the production of consumer goods as well as capital goods. The

system of levy of sales tax varies from State to State. The three main types are the single point, double point and the multipoint, the last having the character of a general turnover tax. In practice, there are mixtures of these types in individual States.

3.5 In addition to the three principal indirect taxes referred to above, there are a few others to be taken note of. One is the octroi duty which is levied in some States by municipal bodies on goods entering into the municipal area - usually on the basis of their weight. These duties are meant to enable the municipal bodies to raise their own resources. Then there are the excise levies on medicinal and toilet preparations containing alcohol or narcotics whose proceeds accrue to the States though the imposition is under a Central enactment, namely, the Medicinal and Toilet Preparation (Duties of Excise) Act, 1958. To prevent the possible misuse of these preparations as intoxicants, the levies on these preparations were kept high. Through the Finance Act, 1976, the rates were further increased. In this process, a number of drugs needed for the treatment of very serious ailments also get taxed at very high rates. We have also State Excise levies on liquor, which yield about Rs. 460 crores per annum, though their percentage share in States' own tax revenues have declined since 1950-51. The taxes on road transport operations, namely, motor vehicles tax and tax on goods and passengers also contribute more than Rs. 400 crores a year and have been a fairly steady source of revenue for the States.

CASCADING EFFECTS

3.6 From the brief account of the evolution of various indirect taxes in the country, the most significant weakness of the system which comes to notice is that it is not an integrated system but a juxtaposition of a number of systems. Though the levies fall mostly on the very same products, their cumulative effect is not looked at or regulated by any single authority. While individually the systems do pay regard to progression as well as to economic factors, since the main emphasis in each of these levies is to bring in revenues and since each of them has been subject to ad hoc autonomous changes under the pressure of circumstances, their cumulative effect does not adequately subserve these objectives.

3.7 When taxes fall both on inputs and on the final product, such of these taxes as are levied on an ad valorem basis fall not only on the value of the products but at each stage they fall on the taxes that may have been earlier levied on them. Alongside, there is an escalation of costs and profits at each stage. When an input is subjected to excise and/or sales tax, the manufacturer who uses it needs a larger amount of working capital to maintain the necessary stock of the inputs. In the process, the cost of his final product gets raised. Besides, when he works out his own profit margin as a percentage of his costs and arrives at a price, he earns - justifiably in his opinion - a higher quantum of profit. On this price the excise on the finished product is worked out. Then comes the sales tax which is levied on the price inclusive of excise duty. Thereafter, the product goes to the wholesaler and then the retailer, each of whom once again has to get a larger amount of finance from the banks which raises his costs and profit expectations.

3.8 The snowballing which has been described in the preceding paragraph is usually referred to as the phenomenon of cascading, the effect of which is to raise consumer prices, because of the escalation of costs and profits by more than the sum total levy which the different taxes cumulatively add up to. In other words, the increase in consumer prices due to cascading is appreciably greater than what accrues to the exchequer by way of additional revenue.

3.9 The undesirable consequences which flow from the phenomenon of cascading are many, the most important of which are the following :-

- (a) With widespread taxation of inputs by more than one authority it is not possible to control the incidence on final products. It is only after a great deal of research, sometimes not even then, that the total increase in the cost and price of a final product due to multiple levies on intermediates can be determined. As the total effective tax incidence on any given product becomes fortuitous, the task of grading levies on different products on the criterion of placing a lower burden on the poor and a higher burden on the rich becomes more difficult. Thus, by way of illustration, on insulin, an important anti-diabetic drug, and chloroquin phosphate, an important anti-malarial drug, while the nominal rate of excise is 2 per cent and even sales tax has been kept low at 4 per cent in some States, the cumulative levy adds up to nearly 27 per cent and 33 per cent of ex-factory price, respectively.
- (b) The taxation of inputs tends to promote vertical integration, encouraging industries to produce more and more of the inputs needed by them rather than purchase them from ancillary industries. To discourage this trend, excise duties are often levied on components manufactured by a producer for captive consumption. But this solution cannot work in respect of sales tax. Since no sales of components take place in such cases, sales tax cannot be levied on them. Thus the levy of sales tax on bought out components hits the growth of ancillary industries in the small scale sector which supply to the larger manufacturers.
- (c) The use of indirect taxation as an economic tool also gets blunted. Varying rates of tax on raw materials and intermediates imposed for revenue reasons affect producer's choice between different factors of production in unintended ways. This leads to the uneconomic use of scarce resources and misdirection of investments contrary to national priorities.
- (d) The general escalation of costs due to cascading, apart from the inequitable burden it places on different income groups within the country, acts as a positive handicap in the efforts to increase exports because it reduces the competitiveness of Indian products in overseas markets. Although an elaborate system for the grant of drawback of duties has been evolved, the amount of drawback granted seldom equals the actual customs and excise duties paid at successive stages of the manufacture of a given product. Further the sales taxes paid are not taken into account in the drawback calculations. There is, therefore, a recurring need for giving various forms of cash assistance and other incentives to Indian exporters which often result in the imposition of anti-dumping duties and other restrictions by importing countries.

3.10 The following table illustrates the ways in which different duties and taxes levied by different authorities bring about a marked difference between the nominal rates of excise duties and sales taxes imposed on the products and the total cumulative levies on them.

TABLE

Product description	Input duties/taxes as percentage of ex-factory price				Nominal excise duty/sales tax on finished product		Total cumulative duty as percentage of ex-factory price
	Customs	Excise or countervailing	Sales Tax	Total	Excise %	Sales tax %	
1	2	3	4	5	6	7	8
<u>Insulin - anti-diabetic drug</u>	21.1	-	-	21.1	2.0	4.0	27.2
Chloroquin phosphate antimalarial drug	37.2	0.5	Neg.	37.7	2.0	4.0	43.8
Analgesic tablets (strips)	13.6	1.0	0.9	15.7	12.5	3.0	31.6
Electric bulb 60W	8.5	9.2	1.4	19.1	15.0	4.0	38.7
Flourescent tube light	2.7	5.9	1.4	10.0	40.0	4.0	55.6
Ceiling fan 1200 mm sweep	3.2	4.1	4.2	11.5	15.0	14.0	42.6
Dry cell batteries	13.8	6.3	1.9	22.0	20.0	9.0	52.8
Steel Cabinet	-	10.1	3.8	13.9	20.0	15.0	51.9
Refrigerator 286 litres	5.5	9.8	2.9	18.2	75.0	15.0	119.5
Water cooler	17.5	5.2	3.5	26.2	20.0	20.0	70.3
Commercial vehicle (trucks and bus chassis)	3.1	8.0	2.1	13.2	12.5	12.0	39.2
Truck tyres (Nylon Cord)	16.1	1.3	4.1	21.5	55.0	10.0	92.0
Storage battery	11.9	2.0	1.0	14.9	17.5	16.5	51.7
Asbestos roofing sheets	14.4	10.3	0.8	25.5	15.0	6.6	48.1

TABLE (Concl.)

Product description	Input duties/taxes as percentage of ex-factory price				Nominal excise duty/sales tax on finished product		Total cumulative duty as percentage of ex-factory price
	Customs	Excise or countervailing	Sales tax	Total	Excise %	Sales tax %	
1	2	3	4	5	6	7	8
PVC armoured cable - Aluminium conductor	-	21.7	8.0	29.7	5.0	4.0	38.9
Enamelled copper winding wire	22.5	15.8	3.3	41.6	10.0	4.0	56.0

Note:- The above figures in cols. 2 to 5 which are for certain representative products of selected manufacturers, give only the effect of taxes on first stage inputs. If the impact of taxes paid on inputs of inputs is also taken into account, the cumulative levy will be significantly higher in several cases. Thus, in the case of commercial vehicle, it is estimated that the impact of taxes on inputs of inputs is itself about 6.88% of the ex-factory price. Further, sales tax rates vary from State to State and the rates applied here are those known to be applicable in the State in which the factory manufacturing the product is located.

3.11 It is evident from the table that in the phenomenon of cascading a number of taxes play their part. We have procedures, to which we shall turn later, to give relief from cascading in so far as they relate to excises. But excise does not always appear to be the major element in causing distortions. Therefore, when we deal with sales taxes we have discussed this aspect more fully. We have also examined the question of giving relief from import duties on inputs keeping in view the economic considerations, namely, protection to industry or discouraging the use of scarce inputs.

3.12 For the rationalisation of the indirect tax system, therefore, it would not be enough to think of possible reforms within each individual tax system, but also to consider in what ways the problems created by the inter-action of the different taxes levied by different authorities can be brought under a discipline which will ensure that they function in unison and harmony to promote common objectives and serve the needs of resource mobilisation, promotion of social justice and conformity to economic priorities.

4. DISTRIBUTION OF THE BURDEN OF INDIRECT TAXATION

4.1 One of our terms of reference requires us to examine the incidence of indirect taxation on households in different expenditure groups. An attempt to measure the incidence of indirect taxes in India was last made by the Department of Economic Affairs, Ministry of Finance in 1968-69, and it related to the year 1963-64. That study, as well as earlier ones, was based on National Sample Survey (NSS) data on consumer expenditure. In order to get a more up-to-date picture of the distribution of the burden of indirect taxation among households, we commissioned the National Institute of Public Finance and Policy to undertake a fresh study of incidence on the basis of comprehensive consumer expenditure data collected by NSS for the year 1973-74.

4.2 While the present study has broadly adopted the same assumptions and basic procedures as the earlier ones, an attempt has been made to incorporate several improvements in methodology and to use additional information for the purpose of allocating tax burden. Mention may be made in particular of the allowance that has been made in the present study for the fact that taxes falling on goods used by Government should not be allocated to the household sector. Also, collection of commodity-wise data on sales tax yield enabled a better allocation of sales tax burden than in the earlier studies. However, several limitations remain. These as well as details of methodology and sources of data together with a fuller treatment of the study, are given in Part II of the Report. In spite of the limitations, the estimates that we have obtained from the Institute's study may be said to reflect at least the broad pattern of the distribution of the burden of indirect taxation. The table below gives indirect taxes paid as per cent of consumer expenditure (cash as well -- total) for different per capita expenditure groups, ranging from the poorest group with a monthly per capita expenditure not exceeding Rs. 15/- to the highest expenditure group with a monthly per capita expenditure above Rs. 100/-.

TABLE

Indirect Taxes As Per Cent Of Total Expenditure And Total Cash Expenditure By Per Capita Expenditure Groups

(1973-74)¹

Monthly per capita expenditure group (in Rs.)	Rural		Urban		All India	
	Tax as per cent of total expenditure	Tax as per cent of total cash expenditure	Tax as per cent of total expenditure	Tax as per cent of total cash expenditure	Tax as per cent of total expenditure	Tax as per cent of total cash expenditure
0-15	2.91	4.55	3.63	4.44	2.96	4.56
15-28	3.33	5.25	6.31	6.79	3.63	5.46
28-43	4.45	7.27	7.36	7.93	4.89	7.41
43-55	5.18	10.32	9.66	10.31	6.85	10.31

TABLE -Concl'd.

Monthly per capita expenditure group (in Rs.)	Rural		Urban		All India	
	Tax as per cent of total expenditure	Tax as per cent of total cash expenditure	Tax as per cent of total expenditure	Tax as per cent of total cash expenditure	Tax as per cent of total expenditure	Tax as per cent of total cash expenditure
55-75	6.71	11.40	11.86	12.70	7.92	11.82
75-100	10.02	16.43	14.80	15.85	11.40	16.21
100 & above	16.17	22.46	30.19	31.35	21.96	26.77
All households	8.03	12.87	17.96	19.03	10.54	14.96

4.3 In this presentation, all households with per capita expenditure per month above Rs. 100 are lumped together into one class. Considering that per capita expenditure of Rs. 100 per month would mean only about Rs. 500 or 600 of household expenditure per month, (or Rs. 6000-7200 per year), one would certainly have liked to have this broad group broken down to represent the middle, upper middle and rich households' expenditures. However, we understand that in canvassing information on consumer expenditure the NSS had broken them down into only three categories namely, per capita expenditure groups Rs. 100-50, Rs. 150 to Rs. 200 and Rs. 200 and above. And in the advance tabulation specially done for us only a limited number of groups could be accommodated and these groups were coalesced into one. The most important feature of the estimates presented is that they indicate a progressive distribution of the tax burden in terms of per cent of expenditure. Thus, taking rural and urban households together, we find that the indirect tax burden expressed as a proportion of expenditure increases progressively from about 3 per cent for households with per capita monthly expenditure not exceeding Rs. 15/- to nearly 22 per cent for those in the group with expenditure above Rs. 100 per capita. Even if the highest expenditure group is left out, the percentage burden is nearly four times on the next highest expenditure group (Rs. 75-Rs. 100 per capita) as on the lowest expenditure group.

4.4 The same progressive pattern of distribution of indirect tax burden is seen to prevail among rural and urban households taken separately, except that the burden on the urban households is distinctly higher than on the rural households in the corresponding expenditure classes. This difference is partly due to the higher proportion of non-cash expenditure for the rural households, particularly in the lower expenditure classes, and partly due to differences in the pattern of consumption between rural and urban households. The study of incidence by the Ministry of Finance for the year 1963-64, referred to earlier, also revealed a progressive distribution of indirect tax burden, but it is important to note that the present study indicates a much more progressive distribution of the burden than the Ministry's. Although the expenditure groups used in the two studies are not strictly comparable, it could be said that the percentage burden on the lowest expenditure groups is shown to be significantly smaller in our study, while the burden on the highest expenditure group is only marginally different.

4.5 It should be remembered that the progression that we have found is only with reference to expenditure. One would like to know if the distribution is also progressive in terms of percentages of incomes of households, i. e., whether upper income groups pay a higher proportion of their income as indirect taxes. Unfortunately, we are not in a position to provide an answer as the distribution of income by expenditure groups - or vice versa - is not known. It is likely that at the upper end of the income scale, consumption expenditure becomes a lower proportion of income than it is at the lower end. So indirect taxes may tend towards reduced progression or even regression at the top. However, the fact that the top expenditure group in urban areas (which would also be the top income group in the country) pays as much as 30 per cent of its expenditure as indirect taxes indicates clearly that if the highly progressive direct taxes which the more well to do in that group pay (or should be paying) are also taken into account, the tax structure as a whole in India is progressive with respect to income. And as far as indirect taxes alone are concerned it is noteworthy that, in spite of the widespread taxation of inputs, the tax structure turns out to be uniformly progressive over the entire range of expenditure considered.

4.6 While the structure of indirect taxes is progressive with reference to expenditure, it cannot be overlooked that indirect taxes fall even on the poorest sections of society. Thus, urban households with monthly per capita expenditure of Rs. 15 or less at 1973-74 prices (corresponding to Rs. 19.5 or less at current prices) pay 3.6 per cent of their meagre expenditure, which is likely to equal or exceed their income, in taxes; and those in the Rs. 15 - Rs. 28 per capita expenditure group (Rs. 19.5 - Rs. 36.4 at current prices) pay as much as 6.3 per cent of expenditure in indirect taxes. In absolute terms, this means that an urban family of five spending Rs. 75 per month pays about Rs. 2.70 per month as indirect taxes whilst a similar family spending about Rs. 140 per month pays about Rs. 8.85 per month. As far as the first group is concerned, the main contributors to the burden are: central excise on lagar, fertilizers (through consumption of agricultural products), tyres and tubes (used by buses and trucks) and jute manufactures (used for moving foodgrains), and sales taxation of foodgrains and atta. As far as the latter group is concerned, the main contributors to the burden are: central excises on sugar, tobacco products, iron and steel, diesel oil (through use of trucks and buses) and jute manufactures (for moving foodgrains) and sales taxes on foodgrains and atta, vegetable oils and fats and jute manufactures.

4.7 The table below gives details of the share of Central and State indirect taxes, in the tax component of consumer expenditure by various per capita expenditure groups.

TABLE

Central and State Indirect Taxes as Per Cent of Consumer Expenditure by per capita expenditure groups (1973-74)

	Monthly expenditure groups (in Rs.)							
	0-15	15-28	28-43	43-55	55-75	75-100	100 and above	All households
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
<u>Rural</u>								
Central Taxes	<u>1.68</u>	<u>1.86</u>	<u>2.58</u>	<u>3.68</u>	<u>4.25</u>	<u>6.32</u>	<u>10.30</u>	<u>4.99</u>
Central Excise	1.42	1.50	2.01	2.92	3.27	4.85	7.87	3.85

	Monthly expenditure groups (in Rs.)						TABLE - Contd.	
	0-15	15-28	28-43	43-55	55-75	75-100	100 and above	All households
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Import duty	0.26	0.37	0.58	0.76	0.99	1.48	2.43	1.14
State taxes	<u>1.23</u>	<u>1.47</u>	<u>1.86</u>	<u>2.50</u>	<u>2.56</u>	<u>3.70</u>	<u>5.87</u>	<u>3.04</u>
Sales tax (including sales tax on motor spirit)	0.67	0.85	1.02	1.23	1.31	1.77	2.60	1.49
State excise*	0.22	0.27	0.32	0.63	0.37	0.93	1.82	0.73
Others	0.34	0.35	0.53	0.64	0.78	1.00	1.44	0.83
All indirect Taxes	2.91	3.33	4.45	6.18	6.71	10.02	16.17	8.03
<u>Urban</u>								
Central Taxes	<u>2.42</u>	<u>3.74</u>	<u>4.56</u>	<u>5.97</u>	<u>7.61</u>	<u>9.41</u>	<u>20.99</u>	<u>12.03</u>
Central Excise	2.42	3.11	3.75	4.94	6.25	7.77	16.78	9.73
Import duty	0.00	0.63	0.81	1.03	1.36	1.63	4.21	2.30
State Taxes	<u>1.21</u>	<u>2.57</u>	<u>2.80</u>	<u>3.69</u>	<u>4.25</u>	<u>5.40</u>	<u>9.20</u>	<u>5.93</u>
Sales tax (including sales tax on motor spirit)	0.30	1.63	1.86	2.35	2.69	3.01	4.51	3.23
State excise	0.00	0.13	0.02	0.26	0.16	0.79	2.27	1.01
Others	0.91	0.82	0.92	1.14	1.41	1.60	2.41	1.69
All Indirect Taxes	3.63	6.31	7.36	9.66	11.86	14.80	30.19	17.96

* on alcoholic drinks.

	Monthly expenditure groups (in Rs.)						TABLE -Conclid.	
	0-15	15-28	28-43	43-55	55-75	75-100	100 and above	All households
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
<u>Rural and Urban combined</u>								
Central Taxes	<u>1.72</u>	<u>2.05</u>	<u>2.88</u>	<u>4.13</u>	<u>5.04</u>	<u>7.21</u>	<u>14.71</u>	<u>6.77</u>
Central Excise	1.47	1.66	2.27	3.31	3.97	5.69	11.55	5.34
Import duty	0.24	0.39	0.61	0.81	1.07	1.52	3.16	1.43
State Taxes	<u>1.24</u>	<u>1.58</u>	<u>2.01</u>	<u>2.73</u>	<u>2.88</u>	<u>4.19</u>	<u>7.24</u>	<u>3.77</u>
Sales tax (including sales tax on motor spirit)	0.65	0.93	1.16	1.44	1.63	2.13	3.39	1.93
State Excise	0.21	0.25	0.27	0.54	0.32	0.89	2.01	0.80
Others	<u>0.39</u>	<u>0.41</u>	<u>0.59</u>	<u>0.74</u>	<u>0.92</u>	<u>1.18</u>	<u>1.85</u>	<u>1.04</u>
All Indirect Taxes	<u>2.96</u>	<u>3.63</u>	<u>4.89</u>	<u>6.85</u>	<u>7.92</u>	<u>11.40</u>	<u>21.96</u>	<u>10.54</u>

One significant conclusion that can be drawn from this table is that Central taxes have a much greater progression in comparison to State taxes.

4.8 The table below gives a broad picture of the distribution of the burden of taxes on selected consumer goods and intermediates among urban households in different expenditure groups.

TABLE

**Distribution of the burden of indirect taxes as per cent of
total consumption expenditure (1973-74)**

Commodities	Monthly per capita expenditure groups (in Rs.)							All urban households
	0-15	15-28	28-43	43-55	55-75	75-100	100 and above	
Food grains and atta*	0.30	0.37	0.36	0.33	0.28	0.24	0.18	0.26
Sugar	0.61	0.46	0.60	0.55	0.54	0.51	0.38	0.47
Tea & Coffee	0.00	0.05	0.14	0.15	0.22	0.33	0.28	0.23
Vegetable products, oil & fats	0.00	0.33	0.46	0.52	0.50	0.50	0.40	0.47
Kerosene oil	0.00	0.48	0.51	0.54	0.51	0.50	0.45	0.50
Drugs and medicines	0.00	0.09	0.17	0.23	0.28	0.36	0.52	0.36
Tobacco products	0.00	0.34	0.57	1.03	1.16	1.55	3.12	1.00
Liquor*	0.00	0.13	0.02	0.20	0.16	0.74	2.46	1.03
Cotton fabrics	0.00	0.12	0.01	0.18	0.51	0.59	1.68	0.81
Art and rayon silk	0.00	0.00	0.00	0.02	0.15	0.25	1.31	0.52
Matches	0.00	0.05	0.07	0.10	0.09	0.06	0.05	0.07
Soap and detergents	0.00	0.08	0.11	0.11	0.12	0.12	0.11	0.11
Paper and paper products	0.00	0.03	0.03	0.09	0.21	0.20	0.31	0.22
Motor spirit	0.00	0.18	0.21	0.26	0.28	0.29	4.45	1.66
Refined diesel oil	0.00	0.33	0.35	0.52	0.73	0.79	1.36	0.88

*Taxes on these commodities are levied only by the States.

TABLE -Concl'd.

Commodities	Monthly per capita expenditure groups (In Rs.)							All urban households
	0-15	15-28	28-43	43-55	55-75	75-100	100 and above	
Tyres & tubes	0.61	0.10	0.10	0.13	0.16	0.17	0.39	0.23
Iron & steel	0.00	0.48	0.54	0.68	0.76	0.80	1.30	0.91
Total for 17 items	1.52	3.62	4.25	5.64	6.66	8.08	18.75	10.53
Total incidence for all indirect taxes	3.63	6.31	7.36	9.66	11.86	14.80	30.19	17.96

From this one can see at what level of expenditure taxes on important consumer goods become significant and also whether the incidence of taxes on particular goods is regressive or progressive. Among the food products, the taxes on sugar and foodgrains and atta affect all expenditure groups. Even the lowest expenditure group pays nearly one per cent of its total expenditure of less than Rs. 15 per capita per month, as taxes on these products. As might be expected, taxes on these products are regressive even with respect to total expenditure. However, in the case of sugar it cannot be assumed with certainty that the entire quantity of levy sugar purchased by the lower expenditure groups is consumed by them. To the extent that such sugar gets diverted for other uses, the regressiveness may be overstated. On the other hand the incidence in regard to cotton fabrics may be understated as the general tendency is to purchase them during certain seasons and the study may not have fully reflected such contingencies. The taxes on kerosene become significant at the level of the second lowest expenditure group (Rs. 15-Rs. 28 per capita per month), and its incidence tends to be proportional with respect to expenditure. This is also broadly true of the excise on matches, although the percentage burden is so low as to be of no great consequence. Taxes on drugs and medicines also effect the poorer classes, although in their case the incidence is clearly progressive. A broad conclusion that emerges from this analysis is that a reduction in the weightage of taxes on mass consumption goods such as foodgrains, sugar and kerosene that tend to be regressive or proportional, would serve to increase the degree of progression of the indirect tax system as a whole. As regards drugs and medicines, the same purpose could be served by reducing the weight of tax on the more widely used varieties of drugs.

4.9 Another important fact brought out by the above table is that the taxation of certain intermediate products such as iron and steel, diesel oil and tyres and tubes, has a pervasive effect. Thus, as pointed out earlier, the tax on tyres and tubes is one of the important elements in the tax burden of the lowest expenditure group; the tax on iron and steel and refined diesel oil reach all but the lowest expenditure groups. However, the incidence of these taxes turns out to be progressive. But when we look at the problem from the standpoint of equity and social justice, the mere fact of progression is not enough and our aim must be to have lower rates of taxation on what we regard as basic necessities and articles whose consumption we want to promote rather than discourage

From this angle, it would have to be examined whether the level of the levies on certain product groups such as drugs and medicines or those which impinge on transport costs, would need some reconsideration.

4.10 The shares of the different expenditure groups in total consumption expenditure and their respective shares of indirect taxes have also been worked out. The information presented in the table below also gives the percentage of the population in different expenditure groups.

TABLE

(figures give per cent of total)

Per capita consumption expenditure (rupees/month)	Population of households	Share of		
		Consumption expenditure of households	Consumption expenditure of households less indirect taxes	Indirect Taxes
1	2	3	4	5
Upto 15	0.64	0.14	0.15	0.04
15-28	11.19	4.58	4.93	1.58
28-43	29.80	18.75	19.93	8.70
43-55	20.31	17.42	18.14	11.33
55-75	19.63	22.08	22.73	16.58
75-100	10.16	15.35	15.20	16.61
Above 100	8.27	21.68	18.92	45.16
Total	100.00	100.00	100.00	100.00

4.11 It is seen that the highest expenditure group, forming about 8 per cent of the population, accounts for 22 per cent of consumption expenditure inclusive of taxes and contributes about 45 per cent to indirect taxes. These taxes have the effect of reducing the share of this group in consumption expenditure from 22 per cent to about 19 per cent (See column 4). At the other end of the scale, the lowest two expenditure groups, forming about 12 per cent of the population, account for only 4.7 per cent of expenditure and contribute 1.6 per cent of indirect taxes. As might be expected, there is quite an unequal distribution of consumption expenditure with the share in population of the lowest three expenditure groups (41.6 per cent) being higher than their share in consumption expenditure (23.5 per cent). At the upper end of the scale, the two highest expenditure groups account for 37 per cent of expenditure while their share in population is only around 18 per cent.

RATIONALISATION OF THE CENTRAL EXCISE DUTIES

5.1 The brief account given earlier of the evolution of Central Excise duties would show that it has passed through four distinct phases.

- (i) Reliance on taxation of relatively few products mostly in the nature of finished consumer goods;
- (ii) Extension of tax net to inputs in preference to finished products;
- (iii) Taxation of a widening range of consumer products but on a selective basis; and
- (iv) Extension of the tax base to cover all industrial products except those deliberately excluded.

5.2 Some of the weaknesses of the excise tax structure on which we dwell later arise from the fact that in reality there was no clear shift in the policy regarding the pattern of taxation from one phase to another but a superimposition of the new phase on the old one without any attempt to make appropriate adjustments in taxes imposed earlier. To start with, heavy reliance was placed on high taxation of relatively few products such as, tobacco, petroleum products and subsequently of certain basic raw materials. The high taxation of a select range of products including inputs has persisted even when the tax base has been widened. Now that excise duties contribute over 50 per cent of the total tax revenues of the Centre and transfer nearly 6 per cent of the national income to it, we feel that the time has come when a conscious attempt should be made to rationalise the rate structure which has come into being as a result of ad hoc changes in the rates on individual products introduced from year to year.

ELASTICITY OF EXCISE DUTIES

5.3 The first objective of any rationalisation must be to impart adequate income-elasticity to the system. A study by the National Institute of Public Finance and Policy shows that for the period from 1963-64 to 1974-75 the elasticity of excise duties with reference to national income worked out to only about 0.75. If we could raise elasticity of excises to at least unity, if not higher, then there may be no need to make changes in the rates on individual products from time to time.

5.4 In our view, the lack of elasticity of excises has been due to inadequate coverage of commodities as well as the widespread reliance on specific duties which had been a characteristic in the past. Per contra, sales taxes have an income elasticity of more than unity because of their almost universal coverage and ad valorem nature. Excise duties have recently attained a near universal character and we welcome this development. Even if some products have to be exempted on social, economic and administrative considerations, the extended coverage of excises, as obtains presently, should improve the built-in elasticity of the system in the long run.

5.5 What is needed additionally to ensure adequate elasticity is a much greater use of ad valorem duties in lieu of specific duties. The trend, we are happy to note, has been in this direction. However, since we have heard pleas both from the trade as well as from the administration in favour of specific duties as against ad valorem duties, we set out below the pros and cons

of the two types of duty and the reasons why we prefer the extension of the ad valorem system:

(a) Specific duties result in higher revenues only when there is an increase in the physical volume of the output. They do not yield additional revenues when on account of improvement in quality or for any other reason the value of the output goes up while the volume remains unchanged. Therefore, whenever prices rise, the proportion of it which accrues to the exchequer declines and the elasticity of revenue tends to be less than unity.

(b) Specific duties tend to be regressive. They fall more heavily on the cheaper varieties of a product which lower income groups consume. Thus, a specific duty on electric fans has a heavier ad valorem incidence on the utility types and lower on the fancy ones. In general, with specific duties the producers tend to switch over their production to the more expensive varieties. An ad valorem duty on the other hand encourages the production of lower-priced goods.

(c) The view is sometimes put forward that ad valorem duties, by accentuating the price rise, increase inflationary pressures. We do not agree with this view. When due to the shortage of a product or inflationary conditions prices rise and windfall profits are made, ad valorem duties augment revenues and play an anti-inflationary role. It is only when the rise in prices is attributable to rise in costs that an ad valorem duty may be said to add to the price rise. Inflation in India has generally been engendered by an imbalance between demand and supply either because of a shortage of key commodities or a general increase in money supply. Ad valorem duties in such circumstances restrain rather than augment inflationary pressures.

(d) It is also argued that ad valorem duties are difficult to administer as disputes over valuation are widespread. In our view, this objection is not without substance but the administrative difficulties could be got over more appropriately by legal and procedural reforms, which we discuss later, than by reversing the healthy trend towards the extension of ad valorem rates.

5.6 Once excise duties have become sufficiently income elastic by their extended coverage (a feature of recent origin) and the maximum possible switchover from specific to ad valorem duties, it would not be necessary to undertake an annual revision of the rates applicable to individual products which has been the characteristic of the past. Changes in the rates on individual products would, in that event, be only necessary on economic considerations such as, to correct short term imbalances in demand and supply, or to signal new investment priorities. When it is desired to divert a higher percentage of national income to the exchequer, an upward revision in rates would no doubt be necessary but the increase on individual products would be small because it could be spread over a very wide field. The tax system would then attain a measure of stability.

TAXATION OF CONSUMER PRODUCTS

5.7 For the tax structure to be enduring apart from ensuring adequacy of revenues, it must be acceptable from the point of view of equity and be consistent with our economic priorities. The most important consideration in regard to equity is the degree of progression. Our study shows that the indirect tax system as a whole is progressive with respect to consumer expenditure. Yet we have to consider whether a greater measure of progression can be imparted to it. Before considering the possibilities of doing so, we must look at the existing rates of excise duties on the finished products which consumers buy. The first thing which strikes us about the prevailing rates is their very wide

amplitude, ranging from 2 per cent to as high as 370 per cent, or, if we leave aside the tobacco and petroleum families the taxation of which has a logic of its own, from 2 per cent to 100 per cent. There is also a multiplicity of rates within this wide range and the differences between the rate on one product and another is too small to be significant in a number of cases. The table below gives a broad indication of the different rates of ad valorem duties and the kind of consumer products which are subject to these rates, leaving out tobacco and petroleum products as well as the textile family the products of which are themselves subject to a wide variety of rates:

TABLE

Sl. No.	Rate of Duty	Description of representative consumer products covered by the rate
(1)	(2)	(3)
1.	2%	Various consumer products falling under item No.68 of CET, such as utensils (other than of aluminium), cutlery, umbrellas, furniture (other than steel), agarbattis, printing and writing inks, stationery articles, spectacles and spectacle frames, brushes, leather manufactures, articles made of cement and concrete, fire-works, per-fumery, Ayurvedic and Homeopathic medicines, artificial jewellery, boiled sweets, toffees etc.
2.	2.5%	Certain categories of life saving drugs.
3.	3%	Certain categories of soap containing sodium palmitate.
4.	5%	Household laundry soap, vanaspati, low priced television sets, laboratory glassware, certain types of calculators and photographic paper.
5.	5.5%	Common varieties of white printing paper for exercise books and text books.
6.	6%	Motor vehicle trailers.
7.	10%	Food products (Biscuits and Butter/Cheese), chocolates, prepared or preserved foods such as jams, jellies, canned fruits, soups etc., tooth paste, low priced toilet soaps, typewriter ribbons, High Alumina refractory cement, fans table pedestal, cabin, carriage, and circulator fans of smaller sweep, electric supply meters, agricultural tractors, motor cars used as taxis, forklift trucks, footwears, playing records, watches, clocks and time-pieces, adhesive tapes, pressure cookers, electric lighting fittings (switches, chokes etc.); polishes and creams (for footwear, furniture etc.) scouring powders and pastes.
8.	11%	Miniature bulbs.
9.	12%	Electric fans for industrial use.

TABLE - Contd.

Sl. No.	Rate of Duty	Description of representative consumer products covered by the rate
(1)	(2)	(3)
10.	12.5%	Detergents, Patent and Proprietary Medicines (excluding certain life saving drugs), commercial vehicles, tractors (other than agricultural), two and three wheeled motor vehicles (scooters, motor cycles, auto-rickshaws), certain varieties of coated/waxed paper and paper boards.
11.	15%	Levy sugar, simple aerated waters, fertilizers, certain varieties of printing and writing paper, higher priced toilet soaps, glass shells, glass globes and chimneys for lamps and lanterns, electric bulbs of wattage not exceeding 60 and sodium or mercury vapour discharge lamps, ceiling fans and other electric fans of higher sweep, office machines, vacuum flasks, radio sets of one or two bands, jeeps and motor cars other than passenger cars (e.g. pickup vans, ambulances etc.) of specified engine capacity.
12.	17.5%	Passenger cars, Khandsari, Storage Batteries.
13.	20%	Perfumed hair oils, linoleum, water coolers, gramophones, record players, record playing/changer decks, higher priced television sets, cinematograph projectors, cameras, steel furniture, safes and strong boxes, zips, playing cards, metal jacketed dry batteries.
14.	25%	Tyres for tractors, motor cycles scooters and auto-cycles, superior varieties of printing and writing paper (e.g. Art, Bond/Bank paper etc.), chinaware and porcelainware (other than tableware, sanitaryware and glazed tiles), paper jacketed dry batteries, domestic electrical appliances, electric bulbs of higher wattage, low priced tape recorders.
15.	30%	Plastic sheets, sheet and plate glass, glassware (like tableware, phials etc.) tablewares of china and porcelain, radio/transistor sets of 4 bands and certain sets of 3 bands of specified value, higher priced tape recorders.
16.	35%	Sanitarywares and glazed tiles of porcelain/china, radio sets of 5 or more bands, stereo or hi-fi systems.
17.	40%	Domestic refrigerators (upto 165 litres capacity), electric fluorescent tubes, air coolers, white cement.
18.	45%	Free sale sugar.
19.	50%	Rubber foam products such as mattresses and pillows.
20.	55%	Tyres for motor vehicles (e.g. for cars, trucks and buses), aerated waters containing concentrates.

TABLE - Concid.

Sl. No.	Rate of Duty	Description of representative consumer products covered by the rate
(1)	(2)	(3)
21.	60%	Cosmetic and toilet preparations (other than perfumed hair oils) such as beauty creams, face, baby and talcum powders; lipsticks, shampoos and shaving creams.
22.	70%	Articles of polyurethane foam such as mattresses, quilts and pillows.
23.	75%	Refrigerators of capacity exceeding 165 litres, deep-freezers and bottle coolers.
24.	100%	Air-conditioners.

NOTE: In the case of sugar, the duties are inclusive of additional excise in lieu of sales tax.

5.8 It will be seen from the above table that under each rate category there is a wide assortment of products of very different kinds. Thus, the 5 per cent rate is applicable to items as different as washing soap and vanaspati on the one hand and certain types of television sets and electronic calculators on the other, which are items of interest to very different income groups. We do recognise that considerations other than progression have to be taken into account in determining the tax rate on a given product. For example, if a product is consumed mainly by upper income groups but has a large employment potential it may well be not taxed at a high rate. A lower rate may also be justified for products of industries whose growth is accorded high priority in the scheme of planning. However, we find it difficult to believe that the multitude of rates which exists in the excise system today is the result of a precise determination of the kind of levy appropriate for each product on either social or economic considerations. They appear to have come about rather as a result of the quick, ad hoc decisions which are made at budget time to cover a deficit.

5.9 A multiplicity of rates while not contributing significantly to the attainment of any of the objectives of the tax system makes the tax administration as well as tax compliance a complicated matter. It leads to innumerable disputes over the classification of individual products on which depends the rate of tax leviable on them. Further, differentiation in the rates of tax on consumer products interferes with the choice of the consumer as between products. While such interference would be legitimate if it serves a justifiable purpose, where there is no special reason for doing so, like products should not be taxed in a discriminatory fashion. One of the steps towards rationalisation would be to fit the various consumer products into a limited number of rate categories.

5.10 Because of the widespread taxation of inputs, the total or cumulative excise levy on any product will be different from the nominal rate of duty applied to it. It is the cumulative levies that are relevant from the point of view of progression, and the limited number of rate categories we are suggesting are in terms of these cumulative levies. Now, if we try to fix nominal rates on individual products with meticulous regard to the taxes on its inputs, we would end up with a plethora of rates, and the objective of reducing the number of rate categories will in consequence be

frustrated. Thus, the taxation of inputs complicates the task of rationalising the duty structure on final products on the basis of a determinate degree of progression. However, as we shall argue below for good economic and revenue reasons, the taxation of inputs can not be unconditionally done away with. Therefore, the only logical solution to this problem is to gradually introduce relief for input taxes at the stage of taxation of final products, thereby eliminating the divergence between nominal and cumulative rates on the latter. Pending such a reform, the task of rationalisation of consumer product rates should be approached from a pragmatic angle. We may for the present ignore minor differences between nominal and cumulative rates and aim at fixing only a limited number of nominal rates while keeping in mind the total levies we wish to apply to particular products.

5.11 According to the rough estimates that we have made, the average rate of excise duties on consumer products (excluding tobacco, petroleum products and goods falling under Tariff Item No. 68) inclusive of the taxation of their inputs is around 20 per cent. This can be treated as the mean rate and what we have to consider is what other rates below it and above it would give us adequate scope to take care of the social and economic factors which may justify lower or higher rates of taxation while safeguarding the existing level of revenues. It might be possible to achieve these objectives if we had only 5 different rates of zero, 10, 20, 30 and 40 per cent into which most consumer products could be fitted. The exceptions to this rate categorisation would be the products of tobacco and petroleum families, matches and textiles whose taxation has its own logic. Apart from the simplicity in administration which this would introduce the difference in the rates between different products would become socially and economically meaningful. However, considering that we are starting from a very complex base as well as taking into account a number of other factors to which we refer below, some in-between rates would also be necessary.

5.12 A range of items will have to be kept free of excise duties on social considerations: e.g., foodgrains, or because it would not be administratively worthwhile to bring them within the excise network: e.g., products of various types of small rural industries, or on the ground that the large employment potential of certain products might be eroded if any levies are made on them: e.g., handloom textiles or on the consideration that the tax on their inputs is already so high that they need not be taxed any further: e.g., aluminium utensils.

5.13 While we regard 10 per cent to be a reasonable rate to be applied to products on which for one reason or another the tax has to be kept at a low level, we recognise that there might be need to have a rate of 5 per cent between zero and 10 per cent. Some of the products of widespread consumption such as vanaspati and refined vegetable oil could be placed in this rate category and it may not be considered advisable to tax them at higher rates. Then again on products whose inputs are taxed somewhat heavily and for which there are likely to be administrative problems in giving relief from input taxation at least for the present, a nominal rate of 5 per cent may be the practical answer.

5.14 The mean rate of 20 per cent could be applied to the generality of products which do not fall in the category of mass consumption goods or necessities and for which there are no reasons to justify a higher rate of taxation. The rates of 30 per cent and 40 per cent could be applied to products which are in the nature of comforts and luxuries generally regarded as suitable for higher levies on both social and economic considerations. While deciding the rate category two other factors should also be taken into consideration, namely, the proportion of the income of the consuming class that is likely to be spent on the product and whether the product is durable or has to be bought at short intervals.

5.15 The rate of 40 per cent is not meant to be a ceiling. However, higher levies should be introduced selectively after a careful consideration of all the factors involved. From the revenue angle, the elasticity of demand for the product would have to be taken into account to make sure whether a higher rate would not mean a more than proportionate fall in consumption which would result in a loss of revenue. Products whose demand is inelastic are apt to be in the nature of necessities rather than luxuries and a high rate of tax on them has generally to be avoided on considerations of equity. However, if the product is one on which the outlay is insignificant, even if it is a necessity it could be taxed at higher rates in the interests of revenue without imposing a heavy burden on lower income groups. A good illustration is provided by matches the high rate of tax on which can be defended on the ground that the burden on the consumer is very small. A high rate of taxation can also be justified when it is the intention to curb the consumption of any product rather than to encourage it, e. g. in condition of shortage or to conserve foreign exchange or even on social considerations. Thus, though it has been argued before us that the revenue from tobacco would increase if there was some lowering of rates, Government may well prefer to discourage its consumption even if it means lower revenues. Finally, there may be items which rank low in our scale of priorities. To discourage their consumption tax rates higher than 40 per cent would be justified. In fixing the rate in such cases a distinction should be made between those where the object is to discourage new investment while allowing full production out of the capacity already installed and those where the intention is to reduce production because it entails a running draft on scarce resources. In short, rates above 40 per cent should be applied after a careful case by case consideration.

5.16 When proposing that consumer products be fitted into a number of specified rate categories we have pointed out that some product families may not lend themselves to such treatment. One of them is tobacco the taxation of which has recently been studied by another Committee many of whose recommendations have been accepted and implemented by the Government. We have therefore not gone into this area. In the petroleum family too some of the tax rates are well above 40 per cent for reasons peculiar to its pattern of production and consumption. Further, the taxation of petroleum products is inextricably mixed with the price policy followed by the public sector undertakings from which the bulk of petroleum products emanate and the profits of which accrue to the exchequer. As the pricing of petroleum products has been the subject matter of study by a separate Committee we have not gone into the tax structure of petroleum products. However, the textile family, which for various reasons cannot be fitted into the pattern of consumer goods taxation that we have suggested calls for special comments because of its importance. While we discuss the taxation of various kinds of textiles made of different fibres as well as of the inputs of this important industry a little more fully in Part II of our Report we have made some observations later in this section.

5.17 The mean rate as well as the other rates we have indicated refer to the cumulative excise levies on the products. Recognising the multiplicity of tax rates and the considerable divergence between the cumulative and the nominal rates which exist at present in several cases due to the taxation of inputs, it would be necessary to move towards this objective of having a limited number of cumulative rates by first introducing nominal rates in multiples of 5 per cent ranging from 0 to 35 per cent. In fixing the nominal rates, the burden of input taxation should be kept in mind and the objective should be to approximate to the cumulative rate appropriate to a given product. Thus, where the impact of input taxation is substantial the nominal rates should be fixed lower than the rate categories of 10 per cent to 40 per cent recommended above. As and when the relief of duties paid on inputs is provided the nominal rates could be stepped up closer to the desired cumulative rates.

TOWARDS GREATER PROGRESSION

5.18 Since the whole range of consumer products is involved it would not be practicable for us to spell out precisely the rates that should apply to different consumer products. What we can do is to set out a number of considerations which may help Government to make the tax system more progressive, though in doing so both revenue and economic considerations will have to be borne in mind. In the last analysis some value judgements would have to be exercised which we as a Committee cannot do.

5.19 Though our study has shown that the indirect tax system as a whole is progressive as per cent of consumption expenditure it has also brought out that even those whose per capita expenditure was less than Rs. 15/- a month (at 1973-74 prices) paid nearly 3 per cent of their total expenditure by way of indirect taxation of which Central excise accounts for a little less than half. Can something be done consistently with the requirements of revenue to give any further relief to the very low income groups, particularly those who can be said to be below the poverty line which is generally drawn at the level of per capita monthly expenditure of Rs. 40/- Secondly, the data on which our studies are based club together in one category those whose monthly expenditure is just above Rs. 100/- and those whose monthly expenditure runs to four digits. We are therefore unable to measure the degree of progression as between per-capita expenditure groups within this broad category. However, we may consider whether there are possibilities of introducing such changes in the tax rates as would ensure greater progression as between different per-capita expenditure groups above Rs. 100/- a month. With these questions in mind we offer below certain comments which may help Government in taking appropriate decisions.

5.20 First of all, we must emphasise that while there are many products which are consumed by upper income groups which the poor do not buy at all, their revenue potential is inevitably small in a country where the bulk of the population is poor. On the other hand, what the poor consume even in very small quantities per capita have a tremendous revenue potential because their total consumption is so large. If all the products consumed by the lower income groups were to be exempted from excise levies there seems to be little prospect of retaining any thing like the present level of revenues by raising the rates of tax on products which only the upper income groups consume. Although there is a general tendency to criticize any tax that impinges on the poor, we feel that many of the taxes which do fall on products consumed by the poor can be defended given the constraints within which the tax policy has to be framed. We have already pointed out that the high rate of tax on matches can be justified on revenue grounds even though they are purchased by even the lowest income groups because the expenditure on them is insignificant in per capita terms. Likewise, the duty on kerosene which had to be raised since it was being used in admixture with diesel oil for trucks and buses, would be difficult to reduce in order to give relief to lower income groups. We cannot therefore recommend a general reduction in the rates on all goods consumed by the poor. We would have to identify products where a reduction in excise duties would give a reasonable measure of relief to the lowest income groups without jeopardising other important economic social objectives. In the selection of these products one important test to apply would be whether the product accounts for a high or a low proportion of the expenditure of those to whom it is intended to give relief. A second test to apply would be whether it is a product whose consumption we want to encourage or discourage.

5.21 Our study of the pattern of expenditure on major items by urban households for 1973-74 as between different expenditure groups reveals that the highest proportion of consumer expenditure for all expenditure groups is on articles of food and beverages. But the proportion of the expenditure on this item to total expenditure shows a steady decline as the level of expenditure rises for all those whose per capita monthly expenditure is above Rs.43/-. Further, there are changes in the relative importance of different items between the upper and lower expenditure groups. Any reduction in the tax on those food items which constitute a higher proportion of the expenditure of the lower expenditure groups would improve progression. The fact that foodgrains and atta are totally free from any excise levies is a factor contributing to the progressiveness which we have found in the indirect tax system, though sales taxes and the inter-State sales tax on these items by themselves are somewhat regressive. Salt is also not subject to excise. The main articles of food which are subject to excise levies are sugar, tea, coffee and edible oils. From the study referred to in section 4 it is seen that the excise duty on sugar is regressive although for reasons explained earlier, the weightage of sugar in the expenditure pattern of the lowest expenditure groups is somewhat exaggerated. But there is no doubt that among the items which are subject to excise, sugar accounts for the highest proportion of expenditure of those whose monthly expenditure is less than Rs. 75/- per capita and the rate on it - 15% on levy sugar and 45% on free sale sugar is distinctly high. In determining what the new rate should be various factors such as the dual pricing policy, export needs and protection to khandsari will have to be taken into account. A reduction in rates of duty on tea and coffee will be less effective from the angle of improving progression because they account for a lower proportion of the expenditure of lower income groups than sugar. Among edible oils, vegetable oils as such are not subject to tax and only refined vegetable oil and vanaspati are taxed and that too at low rates.

5.22 Clothing is usually regarded as next in importance to food when we think of the basic necessities of life. However, the lowest expenditure groups spend much less on clothing than on sugar or even tea and coffee. It is only those whose per capita monthly expenditure exceeds Rs.55/- who seem to spend more on clothing than on tea and coffee and in the per capita expenditure group of Rs. 75/- to Rs. 100/- a month, clothing becomes more important than sugar. The low outlay on clothing among those whose expenditure is below Rs.55/- a month can be explained by the fact that they treat clothing as a durable product to be replaced only when it is worn out. Given the fact that the proportion of outlay on clothing rises steadily along with the increase in per capita expenditure textiles would be an item in respect of which tax relief might be of tangible benefit to those whose per capita monthly expenditure is just above Rs. 100/-. In evolving the rates applicable to cotton textiles a definite effort has been made to tax the lower income groups at lower rates. The real weakness in the tax structure on textiles till recently was that it was based on the belief that lower income groups bought only coarse cotton cloth. In actual fact studies of expenditure pattern reveal that for the expenditure groups above Rs. 28/- per month per capita, cotton fabrics show a decreasing proportion of the total expenditure on clothing. The total levies on cloth other than of cotton, namely, woollens which are necessities in colder climates, and those made of synthetic or artificial fibres, are very much on the high side. Curiously enough, pure silk fabrics are totally tax free. While somewhat detailed comments on the complex system of taxation on the textile industry are given in Part II of our Report, here we would like to make the following general observations:

- (i) The taxation of cotton fabrics should be based on the price before tax — the lowest rate of tax to be applied to the cheapest varieties of cloth. Those in higher price brackets can be taxed at higher rates. In the light of this criterion, the application

of a uniform rate on all fabrics with average count of 40 and above (commonly known as fine and super fine fabrics) needs reconsideration, as under the existing system some varieties of such fabrics, e. g., dhoties and sarees, used even by the lower income groups get taxed at the high rate of 15 per cent.

- (ii) With a view to encouraging the production of cheaper fabrics a very low rate, or even no duty, could be prescribed for varieties priced below a certain value limit. This would impart further progression to the tax structure of cotton textiles.
- (iii) On considerations of progression, the tax structure should not create a bias in favour of particular counts/denierage of yarn or particular kinds of raw materials used in the manufacture of cloth. The world over fabrics made of synthetic raw materials are deemed to be the poor man's fabric because they are cheaper, more durable and easier to launder than pure cotton fabrics. In India, the pattern seems to be different because rates of taxation (including the effect of input taxation) place fabrics not made of cotton beyond the reach of lower income groups. If the differentiation in excise tax burden between cotton and non-cotton fabrics is narrowed, there is likely to be a shift in the pattern of consumption which may in part at least offset the revenue loss.
- (iv) The conditions of scarcity and high profits when domestic production of synthetics was low and imports were banned, which at one time justified the high duties on these items, no longer exist. Thus a lowering of the duties on some of the raw materials can be of much benefit to lower income groups. Cheap and plentiful supply of all types of raw materials for textiles would not only benefit the consumer but also generate additional decentralised employment. Some synthetic fibres are already being hand spun and hand woven.
- (v) The assessment of duty in the prevailing system entails laboratory tests to determine the counts denierage and nature of yarn used. Every attempt should be made to get away from this cumbersome method of assessment.

5.23 Next to food and clothing, shelter is regarded as a basic necessity of life. An attempt could be made through fiscal policy to encourage construction of more low-cost houses. For such a purpose attention will have to be given both to direct and indirect taxes. So far as indirect taxes are concerned we offer some comments in regard to cement when discussing the taxation of capital goods.

5.24 Another item which we have looked at from the point of view of affording relief to low income groups is medicine. The nominal rate of excise on what are known as life saving drugs is only 2.5 per cent. Other "patent and proprietary" drugs are taxed at 12.5 per cent. Then there are some drugs which are taxed at very high rates under the special Central enactment which covers drugs containing alcohol or narcotics - ranging from drugs required in the treatment of cancer to ordinary cough mixtures. In attempting a revision of the levies on drugs we suggest that the following considerations should be borne in mind:

- (i) The percentage of expenditure on drugs and medicines does not on the average seem to be high. This should not mislead us to minimise its importance. The expenditure is incurred only when there is illness and in such an eventuality the burden of the tax on them may be unbearably high for some income groups.
- (ii) The belief that the rich buy the branded drugs while the poor go in for others is not well founded. In fact, for the common ailments people find it much more economical to buy an advertised preparation than to go to a doctor for prescription. The bulk of the consumption is of drugs which are patent or proprietary.
- (iii) The prime justification for the high levies on certain drugs covered by the Medicinal and Toilet Preparations Act is the possibility of their being diverted to use for non-medicinal purposes as a cheaper intoxicant than alcoholic drinks. In the process drugs used for treating serious ailments get taxed at very high rates.

We would in fact recommend that a panel of qualified experts should be set up to exclude from the high levies on drugs covered by the Medicinal and Toilet Preparations Act (a) those medicinal preparations which cannot possibly be used for non-medicinal purposes, and (b) those which inspite of the possible risk of such diversion merit taxation at a lower rate because they are needed for the treatment of critical ailments.

5.25 Our incidence study brings out that the taxation of the road transport has a perceptible impact even on the lowest expenditure groups as it raises the cost of every necessity. Any measure which lowers the cost of transport would be helpful to all income groups and more particularly to the low income groups who will benefit through the reduction in the cost of the articles they consume as well as of personal transportation. There have been many studies which have recommended a lowering of the taxation on the road transport system. The revenue yield from this source is very high and the levies are made by many authorities, with the result no effective reduction in the tax burden on this sector has been made. On the other hand, the cost of transport has gone up further with the hike in the fuel prices. We have undertaken a detailed study on the taxation of trucks and buses which we shall be discussing in Part II of our report. For the present we would make the following observations:

- (i) The above study reveals that the tax burden on the operating costs is much more significant than the tax on the capital value of trucks and buses. However, the capital cost of trucks and buses is undoubtedly important in influencing the availability of road transport services. Public authorities, like statutory corporations, which operate bus services have difficulties in finding adequate capital to augment their fleet. Even private operators with limited means have to depend on borrowings from banks and other institutions to buy trucks and buses. Any step which can be taken to lower the capital cost of trucks and buses and thus augment their fleet will on the one hand engender a good deal of extra employment and on the other, by improving the supply, relatively to demand, lead to some lowering of the burden on the consumer.
- (ii) As regards running costs, though fuel and lubricant are the principal elements, some of the replacement items, particularly, tyres and tubes, are also significant. In fact, the levy on tyres and tubes came out as an identifiable element in the tax burden on even the lowest expenditure groups.

5.26 Some of the items to which we referred above are substantial contributors to revenue. Even a reduction of one percentage point in the tax rate of any one of them could mean a loss of a few crores of rupees in revenue. Therefore, even if they accept our line of reasoning, Government may not find it possible to make substantial reductions in rates in a single year. The rate reductions might have to be brought about in stages. However, we would like to point out in this context that a minor reduction in duties may not get passed on to the consumers. It would, therefore, be preferable, in so far as Government wish to stagger the pace of change, to make significant reductions in the rates on selected items to which they wish to give priority in consideration rather than to make small reductions over a wide range of items.

5.27 In order to ensure that any concessions given in the interests of progression do not result in a net loss of revenue, it should be recognised that the objective cannot be achieved as we have already indicated by picking up a number of articles which are mainly or exclusively of interest to the rich since the revenue potential of such items is limited. We would have to find scope for requisite compensating revenues through the scheme of rationalisation itself.

5.28 Because in the past, when more revenues had to be found, the effort had been to look for a few products rather than at the whole range of products, we have ended up with some products being taxed at much higher rates than they deserve to be while others remain relatively under-taxed. The tax potential of a small increase on a large number of items can best be illustrated by looking at the revenue possibilities of item No.68 in excise tariff. It includes a miscellany of items not previously taxed because none of them individually seemed to be particularly rewarding as a source of revenue. If we leave aside the capital goods covered by this item - and we recommend that the capital goods included under it may well be given a separate tariff classification because the considerations governing their taxation have to be different as we shall discuss later - an increase of one per cent on the remaining products, it is estimated, would mean an additional revenue of about Rs. 20 crores per annum net of the relief available for inputs covered under this item when they are taken for further use in the manufacture of dutiable goods. The fact that the goods classified under this item are subject to the lowest rate of duty in our excise tariff is not the result of any conscious decision that they should be taxed at even lower rates than products like vanaspati. As part of the scheme of the rationalisation of the duty structure we have to consider what the general rate for the miscellany of the products covered by this item should be. Secondly, the question should be examined whether any particular products deserve to be taxed at a rate higher than the general rate.

5.28 Moreover, the rationalisation of the duties on various consumer products under the categories we have suggested may yield some extra revenue to compensate partly for the lowering of duties on items of interest to the lower income groups, because in the course of rationalisation the level of duty on a number of products might have to be raised to the level of the mean rate. Such a course might raise the tax on some products consumed by those whose incomes cannot be said to be high. But the reduction in the rates applicable to the kind of products we have discussed above, while giving relief to all income groups, is expected to have a significantly higher impact on the lower income groups. As food, clothing, shelter, drugs and transport constitute the basic necessities of life and expenditure on them forms the major part of the total expenditure of the lower income groups, the total burden on them as a result of the rationalisation that we have suggested should go down even though the duties on some of the products which they consume might go up. It is our belief that the changes in the tax structure on consumer products that we have suggested should improve the progression in the system apart from simplifying the tax administration.

TAXATION OF INPUTS

5.29 We have indicated earlier that the taxation of inputs complicates the task of even rationalising the rate structure on final products because of the divergence it introduces between the nominal rates and the cumulative levies on different products, have suggested that for the present, rationalisation may be attempted in terms of nominal rates while keeping in mind the cumulative levies that we wish to apply to different products. It is, however, clear that our objectives of reform will not be achieved unless we deal adequately with the problem of input taxation; otherwise, not only will the divergence between nominal and cumulative levies and various distortions caused by input taxation continue but any future changes in the rates of tax on goods used as raw materials or other inputs would upset the relative burdens that have been arrived at as a result of rationalisation.

5.30 One of the reasons for the widespread taxation of inputs at fairly high rates in the past was that a very large number of consumer products, for administrative or other reasons, was not subject to excise levy at all. It could well be argued that now that the excise base has been expanded to cover almost all finished products the taxation of inputs could be eliminated in order to get rid of the distortions that it gives rise to. Such a solution, however, has to be ruled out for a number of reasons. First of all, in our country a fairly large sector of production cannot be taxed directly through excise levies; they can be reached only through the taxation of the inputs they use. A second reason for having a levy on inputs is that quite often what is an input for certain industries is also used as a final product by consumers. Several of them are of the nature of components used by manufacturers as also demanded by consumers for replacement purposes, such as tyres and batteries. If they are free from taxation while the final products embodying them are subjected to tax, not only will the replacement consumption—which may be considerable—escape taxation but manufacturers will be tempted to sell their products without incorporating the tax free components as thereby the value of the final products and therefore the tax levied on them will go down.

5.31 Therefore, the ideal solution to the problem would be to make a distinction on the basis of the nature of use and not on the basis of category of goods. Whatever is used for further production by the manufacturers, who are themselves liable to tax, may be given suitable tax relief for, while the same product, if it goes direct to consumers, could be subject to tax at the appropriate rate. Under such a system, it would be possible to have an extended taxation on final products with adequate progression avoiding the kind of distortions that, as things are, creep into the effective tax burdens. This solution would call for a comprehensive system of tax credits in respect of excise duties paid on inputs on the lines already provided, though on a limited scale, under rule 56-A of the Central Excise Rules. For various reasons, the move towards an extended tax credit scheme may have to be phased out and we discuss more about it later. Before that, however, we may deal with the existing structure of taxation of inputs and the rationalisation required therein.

5.32 Studies undertaken by the National Institute of Public Finance and Policy, at our instance, have shown that as of 1975-76, if we left out tobacco, petroleum products and goods then subject to 1% levy, the average nominal rate of excise duties (that is, tax collected as a percentage of the value of clearance) was 25.3% on basic raw materials, 15.2% on other inputs (of the nature of intermediates, components, packaging materials etc.) and 13.5% on final products. In general, the

preferred pattern of taxation would be to tax raw materials at the lowest rates, intermediates at medium rates and the final products at the highest rates. An important step towards rationalisation would therefore be to put the existing rates of tax on the three categories of goods in the reverse order.

5.33 Any significant reduction in the average rate of tax on raw materials would have to be accompanied by a compensatory upward revision in the rates on final products, as otherwise it could result in a substantial loss of revenue. The Institute's study referred to above brings out, that as of 1975-76, if the average rate on raw materials had been reduced by 5 percentage points the resultant revenue loss would have been about Rs. 110 crores per annum. If this was to be made up by a general rate increase on consumer products, excluding those falling under item 68, tobacco and petroleum products, the rate of duty would have had to be stepped up on an average by about 1.8 percentage point. However, if the consumer products falling under item 68 were also considered for a higher duty, the extent of increase on other products would be correspondingly less.

5.34 Though we should ultimately aim at bringing the average incidence on raw materials to a level lower than the average incidence on consumer products, in our view, there is a more urgent need for rationalising the existing rate structure on raw materials to eliminate the various inconsistencies within it. At present, there is a wide variation in the rates on individual raw materials—ranging from 5 per cent for synthetic rubber to more than 100 per cent for certain synthetic fibres, apart from the raw materials subject to 2 per cent levy under item 63. The table below illustrates the average ad valorem incidence on some of the basic raw materials as at present.

Table

Average incidence of excise duty on various raw materials

Sl. No.	Description	Average <u>ad valorem</u> incidence
1.	Synthetic Rubber	5%
2.	Acids	10%
3.	Gases	12%
4.	Caustic Soda and Soda Ash	10%
5.	Dye-stuffs (1) Pigment Dyestuff	12%
	(2) Others	30%
6.	Glycerine	15%
7.	Plastic resins	38%

TABLE — Concl'd.

Sl. No.	Description	Average <u>ad valorem</u> incidence
8.	Aluminium	
	(i) Levy	81%
	(ii) Non-levy	44%
9.	Copper	
	(i) Virgin	28%
	(ii) Other (scrap based)	2.5%
10.	Iron & steel products (excluding mini steel plant products)	23%
11.	Zinc	
	(i) Unwrought	25%
	(ii) Other (scrap based)	3.5%
12.	Lead	7%
13.	Textile fibres	
	(i) Polyester fibre	115%
	(ii) Rayon fibre	17.5%
	(iii) Cotton & wool	nil

Note:- In the case of metals subject to specific rates of duty (at S. Nos. 9 to 12) the average incidence has been estimated on the value base as of 1975-76 with suitable projections while for Aluminium the incidence shown is the average for a major primary producer. For textile fibres the incidence has been arrived at on the basis of current average prices.

5.35 There are a wide variations in the rates of duty not only as between different raw materials, but also as between different varieties within the same family. For example, in the case of iron and steel products, though the average rate is around 23 per cent, the incidence of specific duties varies between less than 1 per cent (for certain alloy and special steel) and more than 40 per cent (in the case of some galvanised sheets); in the case of chemicals, the rates vary between 10 per cent and about 40 per cent while the rates on synthetic fibres vary between 15 per cent (glass fibre) and more than 100 per cent (polyester fibre).

5.36 We feel that in rationalising the rate structure on raw materials the underlying approach should be to get an economically sound tax structure on them and a socially equitable rate on final

products. We would recommend that raw materials that are close substitutes should be treated similarly except where there are good economic reasons for discouraging the use of any particular raw material. In the latter case, it would be desirable to apply a differential excise which should not be eligible for any tax offset at subsequent stages. And high rates of taxes on particular materials imposed for special reasons in the past need to be reduced in the interests of lowering the cost of production in the economy as a whole. Thus, by not interfering with the producers' choice a more efficient allocation of resources can be ensured.

5.37 To illustrate, copper and aluminium can, for a large variety of purposes, be substitutes for each other. On the consideration that our deposits of copper ore are very limited and we depend substantially on imports, while we have plenty of bauxite, we could have a higher rate of duty on copper than on aluminium. In fact, at one time conscious efforts were made through the tax system to increase the use of aluminium in place of copper for electrical industries. Subsequently, because of shortage of aluminium and the desire to increase the availability of electrical grade aluminium, various changes were made resulting in the present high levies. In our view, there would be a good case in the longrun for considerable lowering of duty on aluminium. The phases and stages in which such reduction should be made is a matter for judgement by the Government.

5.38 Similarly, in the case of raw materials for textiles, while cotton, silk and indigenous wool are free from excise levies, synthetic fibres such as polyester, nylon and acrylic have been subject to duty at very high rates. In the past, inadequacy of domestic production and lack of foreign exchange to import such fibres in sufficient quantities have been reasons for the higher levies. With the improved foreign exchange position it should be possible to allow sufficient imports to meet domestic demand. This would increase revenues even though the excise duties on the products would have been reduced because both the volume of imports of fibre and production of yarn and fabrics would go up. The consideration that the products of modern technology should be taxed at higher rates is one which we must get away from. Both in the interests of promoting employment and ensuring adequate production of cloth, which is a basic necessity, we must make the fullest possible use of synthetics. We are happy to learn that a synthetic fibre is now being hand-spun and hand-woven and emerging as a raw materials for Khadi. The indirect tax system must encourage rather than discourage these trends.

5.39 Apart from reducing unjustified discrimination between competing raw materials, changes in the excise duty on raw materials should aim at lowering the costs of those consumer goods on which we are anxious to avoid having too high a cumulative levy.

5.40 Turning now to inputs other than raw materials (e. g. components and packaging materials), a rationalisation in the existing rates on them will be desirable for more reasons than one. Presently, the rates of excise duty on them vary from 2 per cent (for inputs falling under Item 68) to 55 per cent ad valorem (for tyres for commercial vehicles) - a very wide range indeed. In general, those inputs which are capable of being used as final products (e. g., for replacement purposes) should be subject to such rates of duty as may be appropriate for them as finished consumer products, while components which are primarily used as inputs should be subject to the same rates of duty as applicable to the finished products in whose manufacture they are mostly used. In both cases, the aim should be to provide relief in respect of taxes paid on such inputs to producers who use them for further manufacture, through procedures such as rule 55-A, even if it necessitates some adjustments in the rates on final products.

5.41 The taxation of packaging materials needs a special consideration. To the extent that they serve a purely decorative purpose, the level of duty on them may be of no special concern. However, most products, including those in the category of daily necessities have to be packed in certain ways in order that they may be delivered to the consumer in a convenient form without damage, pilferage or adulteration. The present level of taxation on packaging materials is rather discriminatory and high in certain cases. It is necessary to rationalise the rate structure on packaging materials so that, in general, the excise duty burden on different products within this class is broadly the same. Differentials could, however, be introduced on valid economic considerations such as to discourage the use of a particular packaging material in view of the scarce materials that have gone into its production. Further, the impact of the cost of different packaging materials varies. Thus, aluminium foils, a major packaging material for the drug industry, bears a higher incidence of excise duty, which affects the cost of various essential drugs. We would recommend that where duty on packaging materials adds considerably to the cost of manufactured commodities, which are essential in nature; the question of providing credit of duty paid on packaging materials should be considered.

5.42 The earlier discussion brings out the reasons why we cannot completely give up taxation of inputs. While rationalising the rate structure for different categories of inputs, we will have to consider ways in which the various distortions caused by the taxation of inputs can be minimised, if not altogether eliminated. One of the ways would be adoption of a Value Added Tax system at manufacturer's stage which, as we discuss later, may take some time to introduce, if Government decides to do so. In the meantime, it would be necessary to make fullest use of the existing provisions and procedures to give relief from the cascading effects of input taxation. We notice that at present relief from input taxation is provided in several instances by different mechanisms, the most important being, (i) the operation of rule 56-A of Central Excises Rules under which manufacturers of only certain specified goods are allowed to take credit for the excise/countervailing duty already paid on raw materials and components when paying duty on the finished products; (ii) the set-off procedure provided by specific exemptions under which the duty paid on particular inputs is allowed to be adjusted against the duty liability on specified finished products; or (iii) the movement of specified inputs without, or on partial, payment of duty under Chapter X of the Central Excise Rules. Instead of the restricted application of these procedures as at present, we would recommend a much freer and liberal use of these provisions. In particular, the tax credit allowed under rule 56-A should neither be confined to inputs having the same tariff classification as the finished goods-as is generally the case at present, - nor should it be restricted only to raw materials or components but should cover wherever circumstances so warrant packaging materials and consumable stores also.

5.43 On revenue, administrative and other considerations, relief to different industries from duties paid on their inputs may have to be provided in a phased manner. In providing such relief priority should be given to those final products the cumulative impact of excise duties on which is substantially higher than the rate at which we feel it should be taxed. Where input taxation is substantial, though the cumulative rate may be lower than the rate at which the commodity deserves to be taxed, the relief under rule 56-A could be given to minimise the cascading effects which raise the costs unnecessarily. In such cases, however, a suitable adjustment in the rate of duty on the final product could be made.

TAXATION OF CAPITAL GOODS

5.44 Until recently, plant and machinery, with a few exceptions to which we refer later, were exempt from excise levies. They did, however, bear the duties imposed on their inputs - mainly ferrous and non-ferrous metals. With the introduction of a general levy of 1 per cent. under item 68 of the Excise Tariff in the 1975-76 Budget, since stepped up to 2 per cent., these capital goods are also subject to 2 per cent duty. If one takes into account the levies on various inputs, the cumulative incidence of excise duties in a number of cases of industrial machinery (charged to 2 per cent. nominal duty at present), varies from about 2.6 per cent. to about 5 per cent.

5.45 Apart from machinery which is taxed at 2 per cent., referred to above, machinery items which are taxed at higher rates include diesel engines (5.5 per cent. to 11 per cent.), power driven pumps (5 per cent.), electric motors (5 per cent. to 20 per cent.), and refrigerating and air-conditioning equipment (20 per cent. to 100 per cent.).

5.46 A good case can be made out for keeping the rates of excise duties on capital goods at a low level if not for exempting them altogether. One reason for such a view would be that since one of the prime objectives of indirect taxation is to discourage consumption and promote savings so as to provide resources for investment, a levy on investment goods makes little economic sense. Another consideration is that since capital goods would be used for production, it would be much more rewarding from the revenue angle to levy appropriate rates of excise on the products manufactured than to have a levy on capital goods themselves. It has also to be borne in mind that through concessions in direct taxation Government try to stimulate investment in various industries and it would not be very logical through indirect taxation to raise their costs. As against this, it can be argued that raising the cost of capital goods would generate greater employment through increasing use of labour-intensive techniques. However, it is important to remember in this context that while in a certain narrow range of activities (machinery and human labour can be said to be competitive, over quite a wide range) installation of new plant and machinery generates additional employment.

5.47 Our view is that in general, capital goods in the nature of plant and machinery should not be subject to a cumulative excise levy higher than 5 per cent., unless there are good and identifiable reasons for a higher imposition. Applying this logic in more concrete terms, we are inclined to make the following recommendations:

- (i) The excise levy of 2 per cent. on capital goods classified under item 68 in general could be retained at the present level so long as there is no provision for relief of excise duties paid on their inputs.
- (ii) It should be considered whether there are good reasons for diesel engines and power driven pumps and electric motors which are used as capital equipment, to be taxed at rates higher than those applicable to other capital goods. In regard to refrigerating and air-conditioning machinery used for industrial purposes, it should be considered whether the present rate of 20 per cent. is itself not too high and whether the present concession should not be extended to cover other industrial applications as well.

- (iii) Identifiable items of machinery or equipment which are clearly seen to reduce employment opportunities may be taxed at higher rates so as to discourage their use.

5.48 While discussing duties on capital goods, a word is necessary about cement. In every capital project - in industry, dams, bridges, roads and houses cement is a key and substantial ingredient. It cannot be used as consumer good by itself. We feel that the present rate of duty of about 28.5 per cent. on grey cement, which was until recently as high as 38.5 per cent. is very high raising the cost of all capital projects and inhibiting labour intensive and socially desirable activities such as house building. As a source of revenue its net contribution would be considerably lower than the budgeted figure because Government departments are the major buyers of cement. The main reason for the high levy that we have been able to identify is that whenever a shortage developed the duty was raised to mop up excess profits of the intermediaries, but it was not reduced when the supply position eased. We would recommend that in the long run, cement duty should be brought down substantially. The reduction may well be phased to keep pace with improvement in the supply position.

5.49 What we have said in the earlier paragraphs may look merely like a plea for reduction in duties on various items. This is because, in looking at the rate structure, it has been much easier to spot cases where levies seem to be unjustifiably high. While we do not rule out the possibility of some loss of revenue in the process of rationalisation, we consider that the overall aim should be to conduct this exercise in a manner which would not result in a loss of revenue. Further, it is our belief that with the rationalisation recommended in the tax structure, there would be a general stimulus to production. To the extent this happens, the revenue loss would be offset.

5.50 We feel that once the excise system has been rationalised on the lines recommended by us, it should be possible to impart not only elasticity but also stability to the system. It would then not be necessary to resort to changes in the rates of tax on particular commodities from year to year as the yield from excises could be expected to grow proportionately or even slightly more than proportionately, with the growth in national income and/or increase in prices. If at any time it is desired to divert a still higher percentage of national income to the exchequer, then we would prefer that there should be a small and uniform percentage increase in the rates of tax on all products so that the basic structure of taxation and the relative rates on different products would not be disturbed. It has been estimated that, with the existing tax base, a half percentage point increase in rates of tax on all products, or a one percentage point increase in the taxes on final products, will yield around Rs. 100 crores. Such an across-the-board increase in the tax rates obviously spreads the increased burdens evenly among all the sections, and if substantial relief is provided in respect of input taxation, the increase in the rates of tax on inputs would have no secondary effects on the rates of tax on final products, whose relative burdens would remain unaltered. Thus, if the basic rate structure is according to accepted norms of social justice and is consistent with our economic priorities, there should be no serious public opposition to a general increase in rates of a small magnitude.

6. EXCISE CONCESSIONS TO THE SMALL PRODUCERS

6.1 The practice of excluding small producers from the excise network, which started initially on the consideration that the cost and botheration involved in including them would not be commensurate with the revenue earned, has in the course of years developed into a wide range of exemptions. At present in several cases if a product is manufactured by large scale industry it is subject to excise, sometimes at fairly high rates, but the same product if manufactured by certain classes of producers is wholly or partially exempt from the levy. This device thus functions as a kind of protective duty which enables those to whom the concession is extended to stand in competition with large scale manufacturers. The consideration, therefore, is now primarily economic rather than administrative in character.

6.2 Encouragement to the decentralised sector, to small scale industries, to labour intensive technology, to entrepreneurs with limited resources and the like, is a part of our accepted social philosophy. In some cases the necessary protection from large scale producers is provided by preventing the latter from taking up the production of certain products. More generally and in the majority of instances, concessions in regard to excise duties, sometimes in addition to physical restraints on production by the large scale sector, are the main instruments used for the purposes. Since these concessions have been extended to different products at different times the criteria used for determining eligibility to the concession as well as the nature of the concession itself shows considerable variation leading to complicated administrative procedures. Moreover, some of the yardsticks applied in determining eligibility have the effect of inhibiting the normal natural growth of the enterprise. There is also considerable variation in the extent of benefits that accrue to different types of producers.

6.3 Among the criteria used for the grant of concessions to small producers in different industries are :

- (a) the value or quantity of clearances effected in a year;
- (b) number of workers employed;
- (c) use of power; and
- (d) the value of the plant and machinery installed.

sometimes more than one criterion has to be satisfied in order to get the benefit of the concession.

6.4 Except for the criterion of non-use of power, the others have the effect of penalising any expansion which results in the producer crossing the dividing line. Thus, if clearances exceed the level subject to which exemption is available, full tax becomes generally payable on the entire clearances of the financial year in question including that part of the production which may have been already sold without making any provision for excise. As a result a producer who, towards the end of the financial year, finds that he is approaching the limit subject to which exemption is available faces a choice between stopping his production, clearances or paying a punitive duty on his entire output or concealing his production. Similarly, if the exemption is based on the criterion that the number of workers does not exceed a particular figure the full employment potential does not get utilised. Thus, the application of the criterion penalises higher employment.

When the value of the plant and machinery installed is the dividing line, again a unit which could considerably expand its output by adding some additional equipment finds that it would not be worth-while doing so. One of the consequences of the adoption of these criteria is that often there is a fragmentation of what should really be one unit into different units in order not to lose the benefit of the concession.

6.5 We feel that there would be considerable advantage in having a uniform yardstick which would be applicable to all small producers as a class. The best criterion in our view would be the value of production. However, in order that it does not suffer from the weaknesses referred to above we would recommend that the concession should be on a slab basis so that when the prescribed value limit is exceeded the producer does begin to pay excise duty but he continues to derive concessional treatment until his annual output reaches a level which can be considered to put him definitely out of the category for which the concession is intended.

6.6 The value limit to be taken into account for the grant of concession on the lines proposed above may well have to vary from industry to industry. The value of the final output may, in some cases, seem to be very high because what the producer may have done is only to put together expensive components or ingredients to make the final product ready for the consumer. In some instances he may have done no more than carrying out some blending and packaging operations. If we could adopt the criterion of value added by the producer it would be much easier to have a uniform yardstick applicable practically to all the small producers. However, deriving the value added may present considerable difficulties. We are, therefore, outlining below a scheme which could basically be applied to all but which may need to be liberalised in some instances.

6.7 At present, under the Income Tax law, producers whose annual turnover is more than Rs. 2.5 lakhs are required to maintain accounts. Using the same line of demarcation there would be considerable merit in exempting from excise levies producers whose output is below Rs. 2.5 lakhs. We would also suggest that value of output upto Rs. 2.5 lakhs should be duty-free for all small producers. In our view producers having annual production valued below Rs. 15 lakhs could be considered as small producers, though in exceptional cases a higher limit could be fixed.

6.8 The extent of concession that should be given to production between Rs. 2.5 lakhs and Rs. 15 lakhs now needs consideration. One of the distortions caused by a system under which a producer either pays the full rate or is totally exempt is that it provides the maximum protection and incentive to the production of such goods as are subject to the highest rates of excise duties. This means that small producers benefit more if they come into the highly taxed luxury industries than if they take up the production of common man's necessities which are taxed at relatively low rates. A more rational arrangement would be to have a tax rate for the small producer which would be lower than the rate applicable to the large producer by a specified number of percentage points. We are inclined to the view that, if production above Rs. 2.5 lakhs and upto Rs. 10 lakhs pays a concessional rate of duty lower than the effective rate of duty payable in the organised sector by 3 percentage points, probably, most industries in the small sector would find it adequate. Production in excess of Rs. 10 lakhs would begin to pay the normal rate of duty. When the producer's output exceeds Rs. 15 lakhs in any particular year he would be required to pay full duty but only from the next financial year.

6.9 What we have outlined above is essentially a model, which while giving protection to a small producer when he is small, will not be an inhibiting factor in his becoming large. The slab system would ensure that a small producer is not worse off at any stage by increasing his production. Whether the value limits at the various stages should be Rs. 2.5 lakhs, Rs. 10 lakhs or Rs. 15 lakhs as we have suggested or whether higher slabs are necessary would depend upon how high the material costs of the producers are. In cases where the value added is small and value of the bought out items is too large, the slabs may have to be appropriately raised. What we are trying to project is a basis and method of giving concessions to the small producer, which would be free from the defects we have noticed and which would enable the application of a similar, if not identical yardstick for all the small producers, who need to be sheltered from competition from the large scale manufacturers, instead of laying down different criteria and giving concessions which cannot be readily compared.

6.10 Once the above approach is accepted, the existing concessions based on various criteria would have to be replaced by it, except where complete exemption from duty is granted for certain sectors of industries or for producers who do not use power in the source of manufacture. The latter consist primarily of cottage industries and traditional crafts which may deserve exemption as much on administrative as on social considerations.

✓ PROCEDURAL SIMPLIFICATION

6.11 One of the points to be remembered when thinking of the small producer is that quite apart from the tax burden the procedural requirements of complying with excise regulations may often create problems. The Self-Removal Procedure (Review) Committee had recommended a scheme of simplified procedure which with certain changes, came into effect on the 1st March, 1976. Under the simplified procedure producers in a select number of industries, instead of paying the duty for every clearance, do so on a monthly basis.

6.12 The duty liability is first calculated per annum (after going through a rather complicated procedure) and actual payment made in equal monthly instalments - payable in advance before the commencement of each month. This liability is normally fixed for a three year block period, but there are provisions to alter this under certain circumstances, such as where the tax rates change or where the clearances exceed the base clearance by 50%.

6.13 The Self-Removal Procedure (Review) Committee had felt that the scheme, because of its various attractions, would be opted for by almost 95% of the eligible assesseees. We find that as on 1.1.1977, about 25% of the eligible assesseees in the 46 industries, notified under the scheme, have not opted for the scheme and are working under the normal (physical) control system. If the completely exempt units working under the scheme are excluded, it is noticed that the number of duty paying units under the scheme is less than the number of units paying duty under physical control system, though eligible for the scheme. Among the reasons brought to our notice for not opting for the scheme are the following:—

(a) the law incorporating the provisions of the simplified procedure is not only difficult for the assesseees to understand but sometimes too complicated even for the assessing officers;

(b) the three year block period for which duty liability is fixed is too long since it is very difficult for small units to forecast their demand and production for such a length of time;

(c) the requirement of the advanced payment of tax (that is, six days before the commencement of the month) also places a strain on the financial position of the producer.

(d) the inadequate relief which the scheme provides in many cases has resulted in a situation where the duty liability of some assesseees actually works out to be more than what it would be if duty is paid on every clearance; and

(e) the lack of any provision in the scheme for exemption from duty when there is no production due to unavoidable circumstances such as lay-off, strikes, power break-downs etc.

6.14 Basically, the simplified scheme has much to commend itself. What seems to have gone wrong is that in drafting the relevant legal provisions the attempt has been to take care of all the possibilities of any unintended loss of revenue, however minor, while not enough attention has been given to the difficulties of the assessee. We feel that the scheme should be made more attractive and more widely applicable. Towards this end:

(i) the law incorporating the scheme should be simplified and a version of it which is not in technical language should be made available to make it easily intelligible to the tax administration and the tax-payers;

(ii) there should be a concerted attempt to educate the smaller manufacturers about the attractive features of the scheme, both by the Department as well as by Chambers and Associations of small scale industries;

(iii) instead of fixing the duty liability for three years' block period which, in our opinion, is too long. Government should consider whether the duty liability should not be fixed for a shorter period. Under the French forfait system (on which S. R. P. Committee appears to have relied while recommending this procedure) the duty liability is revised every two years while in the Brazilian forfait system the revision is made annually;

(iv) if the period for which the duty liability is fixed is reduced, the Government should also consider whether there is any need for revision of the duty liability within the block period whenever the clearances exceed by 50% of the base clearance, as at present, so long as the producer remains eligible for the concession;

(v) advance payment of the duty liability on monthly basis should be given up. The duty could be paid within seven days of the commencement of the month; and

(vi) there should be a provision for a downward assessment if there is a steep decline in production, not purely accounted for by seasonal factors, for example, in cases of shut downs for a period exceeding one month due to unavoidable reasons.

LIBERALISATION OF CONCESSIONS

6.15 Apart from these procedural changes, if our recommendations regarding the concessions to be given to small producers are accepted, the benefits of the simplified procedure would also need

to be enlarged. Thus all producers, whose base clearance determined in accordance with the scheme does not exceed Rs. 10 lakhs could be made eligible for it as against the present value limit of Rs. 5 lakhs. The duty liability of any eligible unit would also have to be calculated on the basis of exempting the first Rs. 2.5 lakhs and making the appropriate concessional charge for the succeeding slabs of higher production.

6.16 One point which Government may well consider is whether the scheme of concessional treatment should remain confined to a few selected industries as at present or can be liberalised and extended to almost all industries. The present scheme of concessions has emerged out of representations made by existing small producers who face difficulties. However, if we are to encourage small entrepreneurs to venture into new fields then there would be a good deal to be gained by liberalising and widening the scheme of concessions so that more and more people are encouraged to enter new fields of production in the small sector with the assurance that they will enjoy some excise concessions which will serve to protect them from competition from large scale industries. Of course, there are certain types of products such as tobacco, petroleum products and matches to which the scheme outlined above cannot, for obvious reasons be extended.

7. ROLE OF CUSTOMS DUTIES

7.1 As pointed out earlier, import duties, in addition to being a source of revenue, are also used for providing protection to domestic industries and for conserving foreign exchange. The latter two functions are also performed by import control. When there is a regime of extensive control over imports, any discussion of import duties has to proceed with regard to the kind of import licensing policy in force.

7.2 From the purely revenue angle, imported products must be subjected to at least the same rates of taxation as like products of domestic origin. A somewhat higher levy could also be justified on the ground that those who consume imported products make a draft on a scarce resource, namely, foreign exchange. In the mid-sixties, when the country was facing a serious foreign exchange crisis, there was a very sharp and substantial increase in import duties. This was intended to act as a strong disincentive to imports and to prevent importers from making exorbitant profits, which arose because the volume of permitted imports of most products was much less than the domestic demand for them. These high levels of duties persist even today when there has been a radical change in the foreign exchange position and a significant change in regard to the external value of the rupee, and we are anxious to draw upon our reserves to accelerate growth.

7.3 A strong case could be made out in today's conditions for a sizeable across-the-board reduction in import duties which, if they led to a substantial increase in imports, would, among other things, be helpful in curbing inflationary trends. The limiting factors would be considerations of revenue and the importance of ensuring adequate protection to domestic industries.

CONSUMER GOODS

7.4 From the point of view of raising revenue, it should be noted that a high rate of import duty does not necessarily mean large revenues. If imports continue to be restricted or banned through licensing, the revenue yield would not be very significant. As it is, although consumer goods as a class pay import duties of 120 per cent. or more, the revenue derived from them is insignificant because by and large the import of most consumer goods is severely restricted and the one consumer item of which we have made substantial imports from year to year, namely, foodgrains, is duty-free. However, in the altered foreign exchange context and with our concern for the augmentation of revenues, we would urge that a special study should be undertaken to see what class of consumer goods can be allowed to be imported in a larger measure without entailing a wasteful use of foreign exchange. Imports of some of the luxuries of the rich may well continue to be banned, but it is to be remembered that when duties are higher than 100 per cent, every rupee worth of foreign exchange released for the purpose would mean the withdrawal of over two rupees from internal circulation, more than half of this would accrue as revenue to Government and can be used for socially worthwhile purposes. Further there are many consumer items of interest to lower income groups whose prices, because of the ban on imports, are so high that only the rich can afford them. After a careful review, it should be possible to allow imports, on a more liberal basis, of articles already being allowed for import as well as of new ones which will satisfy the needs of various consumer groups as well as professional classes like doctors, photographers and even students and sportsmen. In quite a number of cases the prices paid by the consumer for imported products is far higher than what would be justified by the import duty because of the restrictions on the imports of those products which give them scarcity value.

INDUSTRIAL INPUTS

7.5 The most important sources of revenue from import duties are industrial inputs and capital goods. The arguments that we have advanced in relation to excise duties on these items have equal validity in respect of import duties on them. Their impact on domestic industries and prices as well as the burden they impose on various income groups are very similar in character to those occasioned by excise levies. The widespread belief that levies on imports impinge only on the upper income groups is erroneous. As indicated in the table under para 4.7 import duties do impinge on even low expenditure groups. A wide range of imports are used in the production of goods which are consumed by all sections of the community. Furthermore, the raw materials and components which are permitted for import are those needed by our industries to maximise their output which has a favourable impact both on the price level and on employment - the two major areas of current concern. We, therefore, favour a downward trend in the import duties on inputs, provided the import policy is sufficiently liberal to ensure that the benefit of reduction will go to the consumers of those products.

7.6 However, since import duties on inputs are such an important element in the revenues derived from customs duties, on revenue consideration alone, the scaling down of duties may have to be both selective and phased taking into account the following factors:

(a) whether a reduction in duty will help lowering the prices of the kind of things which in our discussion on excise duties we have included in the category of basic necessities such as food, clothing, shelter, education, health and transport.

(b) whether reduction in duties, while lowering the revenue realisation per unit of import, would in fact augment revenues because the volume of imports would go up.

(c) whether the cheapening of certain imported products would have a long-term favourable effect on the development process, including promotion of employment.

(d) whether the duty on a particular input is unduly high, compared with the levies on competing inputs.

7.7 Of course in any downward revision of duties, care will have to be taken to ensure that it does not have an adverse impact on domestic industries since import tariffs are legitimately used for protective purposes. If, as in pre-Independence days, tariffs were the sole instruments of protecting domestic industries, we would first need to determine appropriate levels of duty for different industries in order to protect the existing ones and to encourage investment in industries from the point of view of import substitution on the merits of each case. But after the country's foreign exchange position deteriorated import control became the main instrument, not only for conserving foreign exchange but also for affording protection to domestic industries and since controls on imports, even though liberalised, continue to exist, it becomes necessary to consider what the relative roles of import duties and import control should be in affording protection to domestic industry.

7.8 For items in which we are self-sufficient, imports are anyhow not allowed and duties are not really significant either from the revenue angle or for purposes of protection. However, time and again occasion does arise to allow some imports of products in this category because for one reason or another a shortage has developed. If the import duty is so high that the imported product will cost much more than the domestic product, the attempt to import more in order to relieve

domestic shortage gets frustrated and it is only when shortages have forced domestic prices up that imports can begin to be helpful. Often in such cases import duties have had to be reduced, e. g. edible oils and synthetic fibres. But on account of time which is inevitably taken in making such adjustments, there is avoidable damage to the internal economy. Therefore, for products which are only to be imported to meet unforeseen contingencies, import duties should be such as to equate landed cost with domestic prices. Since imports of these articles are not normally allowed, there would be no loss of revenue if for this purpose duties have to be lowered.

7.9 Similarly, the level of duty on inputs in respect of which the country is able to meet a substantial proportion of total requirements from local resources and only the gap between domestic production and demand is met by imports by actual users, should be such as to keep domestic and import prices at par.

7.10 Goods, of which there is only small domestic production at high costs but the bulk of whose supplies comes from imports that are much cheaper, the right way of protecting domestic industry would not be through a high import duty on the bulk of the supplies. It would be better either to give a subsidy to the domestic producer or to arrange for a pooling of prices so that the product continues to be available at a reasonable price and goods made out of it do not become unduly costly.

7.11 By way of illustration of the points made above we would cite the following instances:

(a) The import duty on raw wool used to be 45% and is now 75% while cotton, another natural fibre for the textile industry, is duty-free. In the case of cotton some protective consideration could have come to play because we produce most varieties of cotton. In the case of raw wool, the varieties produced domestically are mostly used for non-wearable fabrics; so the protective angle is not very important. So long as our priority, seemingly dictated on foreign exchange considerations, was to allow the import of cotton liberally and restrict the import of wool severely, the differential treatment in respect of duties was justifiable. But the position needs to be reviewed particularly now when our foreign exchange position is more comfortable. A major consequence of making the cost of the raw material itself so high is to put woollen garments virtually beyond the reach of lower income groups, even in areas where the winter is quite severe, as well as to prevent the expansion of the decentralised sector. According to such information as we have been able to gather almost the entire production of domestic wool goes to the weaving of carpets and certain types of blankets and coarse fabric, while it is imported wool which is mainly used for making most of the wearable fabrics including handloom fabrics as well as for hand-spinning and knitting. The revenue loss from a sizeable reduction of import duty on this item may well be offset by larger imports. The consequent lowering of the cost of wool would at the same time enlarge the access of lower income groups to woollen garments and generate considerable extra employment in the process. An important consideration governing wool is that because it is a seasonal product, imported stocks have to be carried practically for the whole of the year and interest charges on the import duty alone itself add another big percentage to the total cost of raw materials.

(b) Domestic production of copper meets only a part of our needs. In fact, from one point of view, it would be better to conserve our supplies of copper ore as a strategic reserve rather than maximise domestic copper production to save foreign exchange. In any event, the cost of domestic copper is high. In addition, there is an excise on it, the level of which was raised when world prices of copper had shot up and indigenous copper actually became cheaper. Today, the import duty

including countervailing duty on copper is so high that its use in many traditional industries in making vessels and ornamental wares is almost disappearing. Besides, the very high duty, namely, about 90% c.i.f. price, has an impact on the price of a large number of electrical products for which copper is the main material. It would be worth considering whether such protection as the domestic industry may need could not be provided by a price pooling arrangement since anyhow copper imports are canalised through the M. M. T. C. Somewhat similar consideration would apply to Zinc and Lead as well.

(c) From many points of view asbestos cement sheets are much better roofing than corrugated galvanised iron sheets. The import duty on asbestos fibres puts the price of asbestos cement sheets too high for it to go into widespread use. Here again there is a very small, high-cost domestic production to protect. Price pooling arrangements could well be made to lower the cost of asbestos cement sheets.

(d) There are practically no prospects of indigenous supply of products like Cobalt, Tungsten and Nickel. Such products should also be taxed at lower rates.

7.12 Import duties on items which are not being produced in the country give to investors a yardstick by which to judge whether their production would be economic. Very high rates of import duty may encourage import substitution regardless of costs. While, obviously, the policy of import substitution must be pursued and sustained by a tariff structure which encourages it, care has to be taken to ensure that except for items where for strategic reasons self-sufficiency is considered to be important, priority in the matter of import substitution is given to products which would need a low level of tariff protection, i. e. products whose domestic costs will not be too high in relation to import prices. This consideration is particularly important in the development of industries which produce raw materials which sustain a large number of other industries. The high cost of raw materials naturally affects the cost of all the products made from it. As a result, not only would the burden on the consumer go up, but also the employment created by the development of such high-cost industries would be at the expense of much greater employment downstream.

7.13 A specific case can illustrate the point. The import duty of 320 per cent. on stainless steel sheets induced some very high cost units to come into being. When the Government proposed a reduction of duty to 120 per cent. in the last budget, it was found that some of the units could not stand competition with imports and therefore the duty was finally fixed at 220%. In consequence, while employment and profits in the existing high cost units was protected, the possibilities of much larger gainful employment to those who would have made products of stainless steel including utensils was jeopardised.

7.14 To sum up, from a purely economic point of view, lowering of import duties on raw materials would be desirable. The danger of a loss of revenue often gets exaggerated, because the prospects of higher revenues on account of larger imports as well as increased excise revenues - as larger imports of inputs result in higher levels of domestic production - are not taken into account. Of course, protection to domestic industry has to be ensured. However, we consider that even with a reduction, adequate protection may continue to be available in most cases. Further we do have other methods than a high tariff to protect domestic industries. Finally, both from the point of view of economic growth and increasing revenue, any lowering of duties should go hand in hand with liberalisation of imports and preferably be preceded by it. The reduction in import duties which we have suggested may not need compensating increase in other duties to safeguard revenue provided there is adequate liberalisation of imports which in today's conditions seems possible.

CAPITAL GOODS

7.15 Turning to industrial plant and machinery and capital goods, in general, the arguments we have adduced for only a moderate rate of excise duty on them is equally valid for import duties with the difference that adequate arrangements must be made to ensure protection to domestic machine building industries. Here again, account has to be taken of protection to existing industries, maintaining a level of duty which would encourage further investment in this sector and having a particularly low rate for those items of equipment whose production in the country in the near future is not considered to be likely or worthwhile. Further, the importance of ensuring complementarity between import control and import duties is particularly necessary in the case of capital goods because their imports are usually licensed on a case-by-case basis. For capital goods industries, which are well established, it would be preferable to liberalise licensing, the tariff being retained at a level which is enough to give adequate protection to domestic producers. For industries which are newly set up and meet only a part of domestic capacity much greater reliance on import control will have to continue because of the general prejudice which exists in favour of imported machinery and which can only be overcome over a period of time.

AUXILIARY DUTY

7.16 There is no need to maintain a basic duty and an auxiliary duty as separate levies on imports. The latter duty is purely a revenue raising measure. As separate duties complicate the rate structure, we suggest that consolidated rates should replace them.

COUNTERVAILING DUTIES

7.17 Countervailing duties which are imposed on imports and are equal to the excise duties levied on the like products produced indigenously are fully justified on economic considerations. The assumption underlying these is that import duties serve a protective function and have the effect of equalising the landed cost of the imported product with the ex-factory cost of the indigenous one. Therefore, the levy which is made by way of excise duties on the latter must also be imposed on the former, if the protective function of the import duty is not to be eroded. In actual fact because our import duties are so much higher than what would be justified on considerations of protection of domestic industry, the countervailing duties raise the price of imported products to a far greater extent than would be economically defensible. Since the principle behind the levy of a countervailing duty is sound we would not recommend its abolition and would rather see a scaling down of import duties for the reasons explained earlier. However, all too often because the excise tariff classifies items according to trade practice, products which are being imported on the consideration that there is no domestic production are hit by the countervailing duties. For example, insulating paper used in the electrical industry is subjected to the excise duty which is applicable to ordinary paper. A clear decision should be made by Government and preferably embodied in the law on the subject, that no countervailing duty should be levied on any import unless it would compete with an indigenous product which is paying the excise duty.

AD VALOREM VERSUS SPECIFIC DUTIES

7.18 The point has been made to us that ad valorem import duties have the effect of making imports more and more expensive as inflation in other countries raises the price of imported supplies. In dealing with this point in respect of excise duties we have argued that the higher revenue yield from ad valorem duties when prices rise are not inflationary, because they divert a part of the manufacturers' extra profits in conditions of shortage to the exchequer and they also act as a curb on demand. The same logic cannot apply to imports. Import duties do not transfer the higher profits of overseas suppliers due to inflation to the Indian exchequer. Further the higher demand which engenders the price rise is not Indian. On the other hand some of the other objections to specific duties to which we have referred earlier remain. Ad valorem duties encourage the importer to get the cheapest possible product because the cheapness gets accentuated by the ad valorem levy. Specific duties would encourage the import of more expensive types of goods the incidence of duty on which would in ad valorem terms be lower. Further there are a wide range of products such as machinery on which specific rates of duty will not be practicable. On the whole we feel that there might be a case for making specific levies on primary products which do not have a wide variation in terms of quality and the prices of which are subject to sharp fluctuations both upwards and downwards such as metals, fibres and agricultural products.

EXPORT DUTIES

7.19 The importance of export promotion is well recognised and has led to the subsidisation of some of our exports. The days are gone when we could look upon export duties as a source of revenue. Their role in the future would be essentially an economic one of driving a wedge between high overseas prices and low domestic prices so that export demand does not unduly raise internal prices. Care has to be taken to ensure that frequent and sudden changes in export duties on short term considerations do not damage the long term prospects of our exports. Apart from export duties, the fact that our system of indirect taxation taken as a whole has the effect of raising the cost of our exports and the existing systems of drawbacks do not provide for full rebate of internal levies are matters of concern. We shall be discussing this problem fully in Part II of our report.

8. REFORM OF SALES TAX SYSTEM

8.1 Over the years, sales taxes have become more intensive and more extensive, accounting for 55% of the States' revenues, which amounts roughly to Rs. 3, 500 crores in 1975-76 as against 27% of the total States' revenues of about Rs. 220 crores in 1950-51.

MERGER OF SALES TAX WITH EXCISE

8.2 A strong plea has been made to us by representatives of trade and industry as well as others for abolishing the sales tax as a separate entity and making appropriate enhancements in the excise levies, the proceeds of which could be earmarked for the States. In support of this view, it has been argued that if a number of separate authorities independently levy a tax on the same products, there can be no rationalisation of the tax structure which is the main aim of the Committee. When a single authority levies all the taxes on a particular product, it can take into account all relevant considerations - the burden on the consumer as well as impact on production and investment in the industry. Such a Central levy would be easy to rebate when exports take place. There would be considerable saving in the cost of collection. The diversion of trade as well as of production centres from one State to another, which differential rates of sales tax lead to, would be eliminated. The harassment caused by the requirements to comply with the laws, procedures and forms of different States, which make life difficult for small traders as well as manufacturers who buy their raw materials and components from different States and also sell their products in different States, will be removed.

8.3 State Governments, on the other hand, have emphatically argued against such a course. In part they seem to be afraid that no matter what assurances are given, their revenues will suffer as a result of the change. They have some unhappy memories of the way in which, after they agreed to replace the sales tax on textiles, tobacco and sugar by additional excise duty, their revenue from these items remained virtually frozen, though the Centre got higher revenues from them by raising the basic excise duty while keeping the additional excise duty unchanged. Perhaps they are influenced by the consideration that in each plan States are expected to step up their own level of resource mobilisation and they do not for this purpose get any credit for what they receive by way of a share of Central taxes. Further, more important than mere revenue considerations, State Governments feel that any reduction in the powers of the State to tax its own people and having to depend on Central subventions instead would erode their autonomy. Finally, when a State has to mount its own tax effort for which it has to seek the support of the State legislature, it has a greater sense of responsibility and explores every possibility of economising on expenditure. The increasing dependence of States on Central subventions tends to undermine financial discipline.

8.4 While there is a considerable amount of truth in the criticisms levelled against the existing systems of sales taxation by trade and industry, the proposal to completely abolish sales taxation and to confine commodity taxation to the points of production may itself be criticised on a number of grounds. The popular belief that excise duty and sales taxes fall on the same base, though levied by two different authorities, is not altogether correct. Estimates made by the National Institute of Public Finance and Policy indicate that nearly Rs. 500 crores of sales tax are being currently collected on goods not subject to excise duties. This is a net contribution

to revenue from taxes on goods such as agricultural products and output of small manufacturers as well articles of jewellery which, for administrative and other reasons, central excises do not reach. Further, even when the same product is subject to both excise duties and sales taxes the area of overlap is not total. The increase in value which takes place between the ex-factory stage and the point at which it reaches the ultimate consumer due to costs of transport and distribution as well as the profits of wholesalers and retailers cannot be taxed through excise duties. The levy of sales tax can cover this part of value added. From the purely economic point of view, confining taxation to the point of production suffers from the disadvantage that it comes at an early stage in the chain of transactions and, therefore, leads to a certain degree of cascading. In any case, the consequence of a simple abolition of sales tax from the angle of resource mobilisation would be a substantial loss of revenue to compensate for which something like a 50 per cent. increase in excise duties on the average would be necessary, given the present base of excise taxation.

8.5 In considering the future role of the sales tax system, a choice has to be between two alternatives:—

(a) Through a constitutional amendment, the levy of sales taxes can also be made a Central subject and thereafter a rationalised system of indirect taxation on domestic production and consumption can be administered by the Centre;

(b) An attempt can be made to reform the existing State sales tax system so that they are freed of most of their weaknesses.

WEAKNESSES OF THE SYSTEM

8.6 In making a choice between the two alternatives, the final judgment will necessarily have to be political. Without taking any position on the subject, we attempt in the succeeding paragraphs to analyse the weaknesses of the sales tax system and the possibilities of reform.

8.7 Strictly speaking, Central excise duties and sales taxes levied by States should play distinct roles. [Excise has relevance to the process of production which means an imposition on producers' prices with a country-wide incidence of the levies made on them. On the other hand, sales tax, being essentially a tax on consumption levied by a State Government, should be confined to consumers within the State without either interfering with manufacturing costs or impinging on products consumed outside the State.]

8.8 [Unfortunately, the sales tax system, as it has evolved and as it exists today, has become a burden on the producer raising his costs and ex-factory prices. The extensive sales taxation of inputs is one of the major contributors to the phenomenon of cascading to which we have referred earlier. Through the inter-action of sales taxes and excise duties and the consequent increase in costs and profits, it often happens that the burden on the consumer of the final product does not always bear any semblance to progression to which both the Centre and the States individually attach importance in fixing nominal rates on final products. Sales taxes also tend to encourage vertical integration and handicap the development of ancillary industries in the small scale sector because sales tax cannot fall on components produced within a factory for its own consumption but it hits components bought from ancillary industries unless there are special exemptions.]

8.9 The taxation of inputs also means that its burden falls on consumers outside the State. While procedures exist for refund of excise duties on a product when it is exported outside the country the sales tax paid on inputs are not rebated. Similarly, when the product is sold to other States, the producing State is able to tax the purchaser in consuming States even though there is concessional treatment of inputs under most of the States' sales tax systems which are often not extended to sales outside the State. In consequence, the more developed States which have attained high levels of agricultural or industrial production are able to derive additional resources by taxing consumers in other States while the resource mobilisation capacity of the less developed States which have to depend on most of their needs being met by imports from other States is weakened. This is evident from the table below, which indicates the revenue derived by different States from Central sales tax.

T A B L E

(Figures in Rupees lakhs)

Name of State	1973-74	1974-75 (R. E.)	1975-76 (B. E.)
Andhra Pradesh	957	900	954
Assam	170	196	198
Bihar	674	1481	1676
Gujarat	1865	2124	2336
Haryana	1245	1300	1428
Himachal Pradesh	14	12	17
Kerala	501	675	775
Madhya Pradesh	1614	1900	2100
Maharashtra	5591	7700	6900
Karnataka	1285	1600	1800
Orissa	582	606	890
Punjab	1017	1350	1553
Rajasthan	587	655	725
Tamil Nadu	2082	2594	2994

Name of State	Table-Concl'd.		
	1973-74	1974-75 (R. E.)	1975-76 (B. E.)
Uttar Pradesh	527	1000	1050
West Bengal	2507	3500	3760
Delhi	1328	1871	2697
Total	22546	29464	31853

Source

1. State Budget documents for figures relating to States.
2. Delhi Administration for figures relating to Delhi.

8.10 [Though it might be true that even less industrialised States, which produce some essential raw materials like steel get sizeable revenues from the Central sales tax, the fact remains that it is the more industrialised States that get a greater benefit and are in effect in a position to export their taxation to other States.]

[This trend is also further accentuated by the high rates of tax under the Central Sales Tax Act though the Act itself was enacted with the objective of restraining this possibility.] Initially, the rate of Central sales tax was deliberately kept low at 1 per cent. following the recommendations of the Taxation Enquiry Commission headed by Dr. John Mathai. [The main object in fixing the rates of Central sales tax at the low level of one per cent. was to ensure that while some revenue accrued to the exporting States, it did not result in raising unduly the burden on the consumers in the importing State. Further, it could plug the possible loopholes of evasion which would open if goods sold across the State borders were totally free of taxation. However, under pressure from States, the rate of Central sales tax has been steadily raised from one per cent. to 4 per cent. and today it has become an instrument of transferring resources from less developed to more developed States.]

STEPS FOR REFORM

8.11 Against this background, we need to examine whether instead of completely doing away with an independent sales tax system, it is possible to reform sales taxes and rid them of the major defects pointed out above.

8.12 [The adverse effects of sales taxation of inputs can be remedied by ensuring that sales taxes are levied only on finished products and not on inputs.] The excise system does have certain procedures for giving relief from excise levies on inputs when products are exported but when they are sold domestically, the relief is available only in a limited number of cases.] Most States also provide for relief or concessional treatment in respect of input taxation. The difference is that while

the Central scheme gives the fullest possible benefit to products sold outside the country and only very limited relief from input taxation for products consumed internally, States do not usually give full relief but only concessional treatment. Besides, while such concessional treatment is generally extended to all industries, it is often not made available unless, the sale of the final product takes place within the State. Obviously, relief from input taxation must be given both by the Centre and by the States if it is to produce the desired results. We have already urged that the Centre should provide for a system of extensive rebate of excise duties on inputs, to start with under the existing provisions. The question arises as to how parallel action could be ensured in respect of sales tax.

ENLARGEMENT OF LIST OF DECLARED GOODS

8.13. One way in which the above objective could be achieved is to enlarge the list of declared goods. Parliament has powers to declare any particular product to be of special importance in inter-State trade or commerce and impose restrictions and conditions in respect of sales tax thereon. These powers were acquired by the Parliament in pursuance of Mathai Commission's report, which spelt out the following guidelines for inclusion of items in the list of declared goods:

- (i) The commodity should be a raw material or largely in the nature of raw material;
- (ii) either as raw material or as finished goods based on such material it should be of special importance in terms of volumes in inter-State trade; and
- (iii) for the country as a whole, the product should also be of special importance from the point of view of the consumer or industry.

8.14 However, there is no legal limitation on Parliament's discretion in this respect. The list of declared goods originally included some key raw materials like coal, cotton, hides and skins, iron and steel, jute and oilseeds, the three consumer products in respect of which additional excise duties by voluntary agreement replaced sales tax, namely, cotton fabrics, sugar and tobacco as well as some other consumer products, namely, rayon and art silk fabrics and woollen fabrics. Using these powers, the Centre can keep the sales tax on a number of inputs not used as final products at very low levels, though clearly the inputs to be selected for the purpose must be such as could be said to be of special importance in inter-State trade or commerce.

CENTRAL SALES TAX

8.15. Another measure within the sphere of Central legislation which would reduce the extent to which the taxes imposed by one State affect consumers in others and also bring about some restraint in the taxation of inputs would be to reduce the Central sales tax on inter-State sales if necessary by stages to its original level of one per cent. Indeed this change in our view is the one most urgently needed in the interests of equity between States. All too often discussion on the role of sales tax proceeds on the assumption that it is mainly an issue between the Centre and the States while one of its disturbing features is the way in which it can lead to inequitable distribution of resources among States. Once the rate of inter-State sales tax has been lowered, the States will

find it desirable in their own interests to lower the tax on inputs. Otherwise, manufacturers will try to import them from other States and thus pay no more than the inter-State sales tax.] In fact even now levies on inputs which are higher than the inter-State sales tax lead to purchase of inputs from other States. Thus, transformer oil is being imported by industries in Tamil Nadu from Kerala, paying the lower inter-State sales tax of 4 per cent. against Tamil Nadu's sales tax of 8 per cent on the same product. Other instances have also come to our notice. Certain chemicals which are being produced in Uttar Pradesh are being imported into Uttar Pradesh from Gujarat while the State's own production gets sold in the State of Bihar because the local sales tax on the products is higher than the rate of inter-State sales tax.

MEASURES OF REFORM

8.16. [In our view, it is both possible and desirable to take measures towards removing the major weaknesses of the sales tax system, within the framework of the existing constitutional provisions;

- (i) It should be possible to persuade the State Governments to accept a more rational and simplified system of sales taxation on the lines recommended below. However, if voluntary agreement with the States is not found to be practicable, it would become necessary to include the powers to levy sales tax in the concurrent list. This would enable the Centre to exercise a restraining influence to the extent necessary without taking away the power of the State to levy taxes on their own residents.]

[One of the recommendations made by the expert groups which have studied the sales tax systems of individual States has been that the sales tax should be a single point tax. Such a tax could be either at the first stage or at the last stage.] The first stage tax is in several respects an equivalent of excise duty. The tax would thus be confined only to manufacturers within the State and those who import goods from other States. Whilst it would be easier to collect because a large number of dealers will not require to be covered, it cannot absorb the value added subsequent to the manufactured or import within the State which is one of the factors distinguishing Sales tax from excise duties.]

[On the other hand, the last point sales tax, in operational terms, would mean that sales to parties who are registered dealers under the Sales Tax Act will be exempt from sales tax and the tax will be levied when the sale is made either to a consumer or to any one else who is not so registered. In such a system, there will also be a provision for the exemption from Sales Tax on sales of raw materials, intermediate products to the registered manufacturers.] If the taxation of inputs gets virtually eliminated, the need to extend the list of declared goods to cover major inputs may not arise.

[Therefore, the levy of sales tax at the last point would have clear advantages as it would tax the value added subsequent to the manufacture and would also do away with the evils which arise from the taxation of inputs without appropriate provisions for relief or drawback. It will also minimise the outlay on working capital as a manufacturer/distributor does not have to pay taxes at the first point of purchase, which he will otherwise be able to recoup only on his sale of the finished product etc. However, one of the arguments against a last point sales tax has been that it involves a large number of small traders and that a single point sales tax levied on the

final sale is fraught with serious risks of evasion. It is in this context that a double point sales tax, as is in vogue in Maharashtra and Gujarat becomes relevant. The levy of double point tax is generally confined to a few commodities which do not pass through controlled channels. Though the advocates of this system claim that this plugs evasion, the fact remains that the same risk as exists in the case of last point sales tax regarding evasion equally applies to the double point sales tax in respect of the second point of sale. Further, in its operation it will be necessary to fix appropriately two low rates at the first and second stage or make a provision for a set off at the second stage to avoid cascading effects. In either case, the system cannot be said to be that simple in its operation and to possess the characteristics of a better system, which could be efficiently and smoothly implemented. On a balance of all the considerations, we favour a single point tax at the last stage. >

- (ii) [The second important step to be taken towards rationalisation of the sales tax system is to bring about a reduction in the rates of Central Sales Tax from the existing 4% to the level of 1%, by stages if necessary. Such a low rate of tax on inter-State Sales while serving as a means of preventing large scale evasion of tax on internal sales (which may be passed off as inter-State sales), would also go a long way towards preventing the export of taxation levied by one State to the residents of other States.]

8.17. [Compliance with sales tax regulations in the matter of book keeping etc. places a heavy burden on small traders. It would, therefore, be desirable to raise the limit for compulsory registration to a reasonably high level in the case of dealers other than manufacturers and importers within the State. For this purpose, dealers with an annual turnover above Rs. 2.5 lakhs should be required to register themselves.] This figure is a good line of demarcation as under the Income Tax Act also, assesseees are required to maintain accounts if their turnover exceeds this figure. [This change would also reduce the number of establishments which have to pay sales tax.]

8.18. It should be quite possible and even desirable to make registration under the sales tax voluntary for a wide range of retailers. If they do not register then the supplies which they obtain from wholesalers will bear the sales tax, but so far as they themselves are concerned, they would not be involved in any sales tax accounting. Thus, on the whole, the change suggested above may reduce the cost of collection to the State on the one hand and irksomeness to the small trader on the other.

NEED FOR UNIFORMITY

8.19. We have said earlier that State Governments should have reasonable flexibility in the administration of sales tax laws because conditions differ from State to State. However, there are some features of sales tax legislation which call for a measure of uniformity. Otherwise they create problems both for State Governments as well as for trade and industry. While a large number of products can be taxed at different rates, there are some on which rate differentials encourage uneconomic diversion of trade in a manner which also results in a loss of revenue to the State with a higher rate of taxation. Thus for the more expensive consumer goods, cars, refrigerators, tyres and the like, it often pays the consumer, if the difference between sales tax rates is large enough to make purchases in other States than his own. Another valid

point which has been made to us is that there are many products for which the Central Government or the producers try to maintain a uniform all-India price but different rates of sales tax result in divergence of price from State to State. Thus there is an unequalised price for cement. Drug manufacturers are required to mark the maximum retail price of the product on the package. Manufacturers of products like vanaspati also maintain uniform all-India prices. However, so far as the consumer is concerned, because sales taxes are extra, the price not only varies from State to State but because of the provision that local taxes are extra, the maximum prices fixed by manufacturers or Government lose their sanctity and the consumer may well be charged much more than what might be justifiable on account of the sales tax. Similarly, in the case of petroleum products, diversity in rates affect running costs of transport differently and cause diversion of trade. In respect of these products it would be desirable to have uniformity in the rate of sales tax. This can be achieved by voluntary agreement among States. Further, for some of the essential goods like cement, medicines, vanaspati and petroleum products, it may be desirable even to consider the question of levy of an additional excise duty in lieu of sales tax.

8.20. Another area of reform would be to bring about uniformity in sales tax legislation and procedures obtaining in different States. Variations in the wording of the law and in the forms prescribed thereunder lead to considerable difficulties to those operating in more than one State. Because the wording of the law differs, High Court rulings on their interpretation also differ. Having to fill different forms in different States create their own problems. Uniformity would eliminate some of the irksomeness of the present position. It could be achieved either through a Central legislation by getting the consent of the States under Article 252 of the Constitution or by the drafting of a model law by a Central Agency like the Law Commission, which each State could adopt. Alternatively, a small group of representatives from different States could be set up who could jointly evolve the draft of such a law, after agreement on these matters. Such a legislation need not touch upon the rate structure, which each State would be free to determine acting within its own legislative powers

NEED FOR STUDY OF SALES TAX SYSTEM

8.21. Turning now to problems which relate to the efficacy of the sales tax system as they prevail in each State, we are happy that many States have in recent years had studies of their sales tax systems undertaken by expert bodies. We feel that this is a healthy trend. The economy of each State has its own peculiarities. Levels and sources of income differ from State to State. Therefore, studies of all connected problems by expert bodies in each State would be most helpful. It would, in our view, be even better if the studies were comprehensive enough to take into account all the resource possibilities of the States rather than concentrate on the single source of revenue. There would be added advantage if the same body were to undertake studies in a number of States so that the experience and practice of each State could be of benefit to the others.

ALTERNATIVES TO COMPENSATE LOSS OF REVENUE

8.22. State Governments may feel that some of the recommendations we have made above will expose them to a serious loss of revenue. Our approach throughout has been to avoid this and we believe that with appropriate adjustments in rates, loss of revenue can be avoided. Thus, the reduction in the rate of inter-State sales tax would be and could be offset in two ways. Firstly,

with the increase in the inter-State sales tax a growing volume of inter-State transactions is taking place on a consignment basis. As no inter-State sale takes place the tax gets avoided. In fact it is only the relatively small dealers who find it difficult to circumvent the tax in this manner. If the tax rate is lowered, the subterfuge will no longer be a paying one. Secondly, to the extent that the revenues derived by a State on its sale outside the State go down, its capacity to have a higher sales tax on products originating outside the State would go up. It is true that for each State the loss and gain may not quite balance but in general there would be a more equitable distribution of sales tax revenues between different States. As regard the loss that may seem to arise from a reduction in the taxation of inputs, appropriate adjustments of rates on final products should make up for the shortfall without really raising the burden on the consumer.

IMPLEMENTATION OF SIXTY-FIRST REPORT OF LAW COMMISSION

8.23 In addition, we would draw attention to certain possibilities of extending sales taxation which within the existing legal and constitutional framework remain untapped. In its 61st report, the Law Commission observed that several transactions fall outside the concept of sale because of the absence of the essential requirements of sale. For example, a transaction between a hotelier and a resident customer of a hotel - if there was a consolidated charge for boarding and lodging - would be one of providing services and would not be taxable under the head 'sale of goods'. The Commission noted that the primary difference between a contract for work (of service) and a contract for sale of goods was that the service was intangible and it would be difficult to identify the service component in the final product produced, despite the fact that a part of even the whole of the materials used by the contractor for making the final product may have been his property. In other words, this is because the distinctiveness of the two components embedded in the final product, namely, goods used and the services performed got blurred, though the transactions relating to works contracts resembled a sale in substance. Thus the sale of an air-conditioner is subject to sales tax but a contract to air-condition a building which does entail the supply of air-conditioning equipments escapes taxation. Similarly, sales of automobile spare parts are taxable but a contract to repair or overhaul a vehicle is not subject to sales tax. The recommendations of the Law Commission to bring the kind of transactions referred to above within the sales tax net should be implemented.

8.24 Opportunity can also be availed of to implement the recommendations of the Law Commission in regard to taxation of hire-purchase transactions. As the law stands, it is only when the final instalment is paid then the sale becomes effective and, therefore, the tax is not leviable on earlier instalments. Steps should also be taken to implement the other recommendations of the Law Commission to plug evasion. We particularly commend the enactment of provisions analogous to the provisions in the Gujarat Sales Tax Act, which has been upheld by the Supreme Court, for facilitating and enforcing the recovery of any amount illegally realised as tax by a private person whether as sales tax or any other tax.

8.25 At present there is sales taxation of goods but not of services. In many advanced countries, services rendered by lawyers, architects, accountants, consultants etc. are subject to tax. A point in favour of such taxation is that the upper income groups spend more on services while lower income groups spend more on goods. At the same time in Indian conditions the introduction of such a tax has to be on a very selective basis. Otherwise self-employed persons and certain types of economic activities may be adversely affected. In the absence of adequate data, it is not known whether

such a tax would yield sizeable revenue. We suggest that if Government consider it desirable to tax services the revenue potential as well as the practical problems of such taxation should be further examined. We are inclined to the view that if such a tax were to be introduced it should be under Central legislation and administration - even if the proceeds of the tax go to the States. One reason for this is that sales of services often have an inter-State character. Further, any such taxation will have to take into account its effect on the national economy as a whole. In particular, it would be important to ensure that services sold to producers are not made subject to taxation because they are in the nature of inputs; otherwise the same problems of cascading and distortion that have arisen now in respect of taxation of sale of goods will also arise in respect of taxation of services.

9. ALTERNATIVES TO OCTROI

DEFECTS OF OCTROI

9.1 Octroi has been found to be undesirable and harmful by almost every Committee that examined its working in the past, whether set up by the State Government or by the Centre. The following striking features have made it distinctively obnoxious:—

(i) As the levy is often collected as a specific duty in terms of weight, the incidence of the tax is regressive. Watches get taxed at lower rates ad valorem than cloth.

(ii) Its administration is cumbersome and vexatious. Wide discretionary powers vested in low paid staff have led to corrupt practices.

(iii) The numerous barriers set up for collecting the tax at the points of entry as well as the very complicated procedures involved in getting refunds affect the smooth flow of trade.

(iv) It immobilises a large number of transport vehicles for unconscionably long periods of time.

(v) The cost of collection of the tax is disproportionately high in relation to the revenues derived therefrom. For example, the Wankhede Study Group's report for Maharashtra shows that the percentage cost of collection to gross octroi income was about 23.4 for 1968-69 in respect of 97 village panchayats and 22.6 for 210 municipal councils. The Lakdawala Committee report for U.P. shows that for 1972-73, the cost of collection was 7.2 per cent. in respect of KAVAI cities namely, Kanpur, Allahabad, Varanasi, Agra and Lucknow.

(vi) Its economic impact, in addition to some of the adverse cascading effects as in sales tax, is undesirable in one other respect; it encourages the concentration of industries in metropolitan areas, particularly Bombay and Calcutta. Factories located within these areas can reach a large mass of consumers free of octroi levies. Even ancillary industries get located near the larger factories to escape this levy so that the components they sell do not pay any octroi.

SEARCH FOR SUBSTITUTES

9.2 Nevertheless, State Governments within whose jurisdiction octroi has been traditionally levied have not been willing to get rid of it on the ground that they are unable to find a suitable substitute through which they could recoup the revenue that would be lost as a result of abolition of octroi. We are unable to accept this argument, as quite a number of States, e.g. Tamil Nadu and Bihar have been able to make arrangements for the financing of their local bodies without recourse to octroi. Perhaps one factor which is causing the reluctance to replace octroi duties by any other is the feeling that people had got accustomed to the impact of the octroi which is not visible to those on whom it ultimately falls while any new tax will give rise to a good deal of resistance.

9.3 Another factor which seems to have discouraged State Governments from going ahead with the abolition of octroi and its replacement by some other form of local or State taxation is the expectation that somehow the Centre can be persuaded to make good the loss of revenue on account of the abolition of this tax. Some State Governments, like Maharashtra and Gujarat, which

had appointed Committees to go into octroi duties, did not proceed to give effect to the alternatives recommended by these committees because in the meantime the Central Government took an initiative in the matter which engendered the hope that it will be the Centre and not the States which will have to look for alternative sources of revenue.

9.4 When the question of a Central levy in lieu of octroi was being discussed, a surcharge of 20 paise per litre of excise duty on high speed diesel was being seriously considered. While the larger road transport fleet owners may well prefer this course, because their economies will improve with the larger turn around of vehicles, there is, from the national point of view, a good deal to be said against this course or any other which would mean Central compensation to States levying octroi, the burden of which may fall on States whose municipal bodies do not levy an octroi and have had recourse to other measures such as higher property tax to finance themselves. An increase in the tax on diesel will have an allround effect on costs and prices of goods. In particular, it will increase the cost of agricultural operations which may lead to increase in prices of agricultural products. There is, moreover, the question of maintaining parity in prices between kerosene and diesel. For these reasons, we do not favour an increase in the levy of diesel to compensate the loss of revenue that may arise on account of abolition of octroi.

9.5 In considering alternative levies to take the place of octroi duties the question arises on whom the burden should fall. The less industrialised States have taken the line that the levy should fall on the people of the municipal areas who enjoy the municipal services. This view ignores the fact that octroi, although it is nominally levied on goods which enter municipal limits, does cast a burden on the surrounding rural community who often draw most of their supplies of industrial products from shops within the municipal area. Further, octroi affects the prices which farmers get for their produce which they sell within the octroi limits, while seemingly octroi falls on the consumer through higher prices. Part of it also falls on the producer who gets lower prices.

9.6 The other view which has been put forward is that metropolitan cities and particularly the port towns serve the entire country through their industrial out-put and port facilities. Therefore, it would be legitimate for the entire country to contribute towards the cost of their maintenance. In our view, while it is legitimate and proper that for the development of the infrastructure for international ports and the industrial complex around them there should be, as there is, provision for Central assistance under our plans. The cost of maintaining and running municipal services should appropriately fall on the people who earn salaries, wages and profits in those areas and not be passed on to the consumer outside except in the form of the costs of the products or services which these areas provide to the hinterland.

9.7 On the whole, therefore, we feel that resources for the up-keep of municipal areas consequent on the abolition of octroi should be found by taxation by the local authorities or by the State Government but not passed on to the Centre which means the country as a whole. To the extent that this can be done by purely local levies e.g., increased property and water tax or a tax on professions as has been done in States where octroi is not levied the local authorities would be in the best position to determine the rates of levy.

9.8 However, if recourse has to be had to commodity taxation as a substitute for octroi on the ground that octroi was levied on products, we would very much favour the levy being made by the State than by municipal bodies.

9.9 This would mean the State undertaking such commodity taxation as may be necessary to provide resources for municipal bodies - unless it were to be decided that all commodity taxation is taken over by the Centre and sales taxes are replaced by excise duties - and taking such measures as they deem appropriate to ensure an equitable distribution of the tax burden on the sharing of its proceeds among the municipal bodies.

9.10 In its effect, octroi operates very much like sales tax. One major difference is that it does not apply to what is produced and consumed within the octroi limits. This can hardly be considered to be a point in its favour which would justify its retention as a separate entity. If octroi were replaced by some device which would be in the nature of an extension or enhancement of the sales tax, the tremendous saving in the cost of collection, in the cheapening of transport and the elimination of losses due to faulty or dishonest administration would enable the requisite amount of resources to be mobilised with possibly a decrease in the aggregate burden on the consumer.

FEASIBLE ALTERNATIVES

9.11 Various suggestions in this regard have been made from time to time. A flat turn-over tax has been suggested in more than one study by Committees appointed by State Governments. In Maharashtra, the Wankhede Study Group suggested such a tax limited in its operation to turnover of dealers covered under the Bombay Sales Tax Act. According to the Study Group, the turnover should exclude (i) exports, (ii) declared goods, and (iii) commodities covered by the scheme of additional excise duty in lieu of sales tax, but however, include even those items which are exempt under the General Sales Tax Act. The Group had recommended the levy of a flat rate and estimated that a rate of about 0.7 per cent would yield enough revenue to compensate local bodies for the loss on account of abolition of octroi. The Lakdawala Committee has also likewise recommended that the octroi should be abolished and replaced by a one per cent. tax levied on turnover which would compensate the loss on account of octroi.

9.12 Another alternative would be to have a simple surcharge on sales tax. A surcharge on sales tax would mean differential increase in the taxes on commodities taxed at different rates. This would make for complications and could lead to sharp increase in the tax of items which may already be heavily taxed. We are, therefore, inclined to support a small turnover tax for various reasons including the fact that at least two competent committees looking at the problem from the States' point of view have recommended it. We would favour limiting the rates of turnover tax to less than one per cent and if any additional resources are needed they should be found by the local bodies without getting into the field of commodity taxation.

9.13 While we have discussed various alternatives to octroi our main emphasis is on getting it abolished rather than on any particular alternative to replace it. Though, the suggestions made above are not free from defects, the weaknesses and adverse effects of the octroi system outweigh them. We would urge that so long as State Governments agree to the abolition of octroi they may have reasonable latitude in the matter of devising alternatives.

9.14 It may well be, that the octroi revenue in certain areas is so large that State Governments may hesitate to do away with them, however strong the case may be for such action. If necessary the operation can be carried out in two stages. Octroi can be abolished in the municipal areas through which trunk road transport services operate in transit while for the present they could be allowed to function only in places like Bombay and Calcutta which are largely terminal points. However, this can be but a temporary expedient, only if calculations show that otherwise a very substantial additional levy by the State Government would become necessary.

10. LONG TERM REFORM OF THE INDIRECT TAX STRUCTURE.

10.1 In the course of our analysis of the weaknesses of the existing system of indirect taxation in the country (vide section 3), we had indicated that given the magnitude of the problems and the interaction of taxes levied by different authorities, it would not only be enough to consider reforms within each individual tax system, but it will be necessary to think of more far-reaching changes to bring about a harmonious functioning of the various elements in the system. In sections 5 to 8, we have discussed some of the major steps that should be taken in furtherance of the objective of rationalisation of the tax structure. In order to mitigate the problem of cascading and to minimise the overlap of excise and sales taxes, we have suggested that on the one hand, there ought to be a lowering of excise levies on raw materials and on the other, restrictions could be imposed on the power of the State Governments to levy sales taxes to the extent needed to ensure that there is no undue increase in the cost of production and that each State essentially taxed its own residents without jeopardising national priorities. A rationalisation of the excise duty structure on final products has also been recommended along with the extension of the provision for tax set-off to narrow down marked divergences between nominal and cumulative levies.

10.2 These changes would not only initiate the process of reform but should be capable of bringing about a marked improvement in the existing system. However, they could only go part of the way. If it is our objective to eliminate, or reduce to negligible proportions, cascading and distortions in relative factor prices caused by import, excise and sales taxation, we would have to think of making long-term changes in the direction of a system with generalised set off for taxation of inputs. The main reason for this is that a simple reduction in the rates of duty on a raw material and other inputs, particularly in the case of excise duties, could only proceed up to a point; beyond that it not only involves huge losses in revenue but also relieves certain types of consumption and products from taxation. Consequently, if revenue losses are to be made up, final products which are already taxed would have to be subjected to further taxation. Besides, taxation at different stages is required to keep evasion under check. Thus, a system of set-off becomes central to the whole scheme of rationalisation of any extended system of indirect taxation. It is in this context that we need to consider the subject of value added taxation.

VALUE ADDED TAX (VAT)

10.3 The evolution of indirect taxes in India is in many respects similar to the course it has taken in most other industrialised and developing countries. The emergence of an extended system of excise taxation, or the overlapping between an excise tax system and a multi-point general sales tax, the problems of distortions and cascading that these give rise to, the attempts to deal with such problems—all these developments have manifested themselves in different developed and developing countries as their economies grew complex and the burden of their fiscal system steadily increased. It was then realised that in order to avoid distortions, promote exports and to make intervention beneficent, selective and purposeful, it was necessary to think of a different system embodying a principle which would eliminate the above mentioned problems even under an extended commodity tax system. In pursuance of this objective, today, almost the whole of Western Europe (including the United Kingdom) as well as a number of developing countries, such as, Brazil, Argentina and Ivory Coast, have gone on to the Value Added Tax (VAT) system. The question naturally arises whether India too, faced with similar problems, could and should adopt VAT. In fact, our terms of reference require us specifically

to examine the feasibility of adopting some form of VAT in the field of indirect taxation. If the answer is in the affirmative, we have further been asked to indicate what would be the appropriate stage at which the principle of VAT should be applied. When we elicited the views of trade and industry on the subject, we found that although there were several who expressed doubts and reservations about the administrative feasibility of adopting VAT in India, there was an impressive measure of support for such a change - one important source of such support being the Federation of Indian Chambers of Commerce and Industry.

10.4 A detailed exposition of the VAT system is given later in the Report. Essentially, VAT in its comprehensive form is a tax on all goods and services (except exports and Government services), its special characteristic being that it falls on the value added at each stage - from the stage of production to the retail stage. However, in practice, no attempt is made to ascertain the amount of value added, but instead each tax-payer is allowed to deduct from the tax payable on his output the taxes he has paid on his inputs. Administratively, this is a simpler way of reaching the value added. It is also clear that the producers are in effect freed from the taxation of inputs at every stage. Thus, a distinctive merit of the VAT is that it enables a country to have an extended system of commodity taxation and yet avoid the problems of cascading and escalation of costs that are concomitants of general sales and excise taxes. It is also relatively easy under the VAT system to completely free exports of internal commodity taxation.

10.5 In European countries that have adopted the full-fledged VAT system, VAT is applied to internal production as well as imports while exports are exempt. Individual imported commodities may be, and are, in addition subject to protective duties. This means, that apart from affording a certain degree of needed protection, imports are placed on the same footing as domestic products for the purpose of taxation.

10.6 The VAT in its comprehensive form extends from the mining and manufacturing stages to the retail stage. It can replace all other forms of internal indirect taxes. Thereby, the maximum benefit can be derived from VAT. However, such a total or near total replacement is, for obvious reasons, more easily done under a unitary system of Government than under a federal system, for, in the latter, the State Governments need to be given certain independent powers of taxation.

10.7 The first question we need to consider is whether we should take as our long-term objective the replacement of the existing systems of excises, sales taxation and octroi by a comprehensive VAT. This would have several economic advantages. It would also be consistent with the oft-expressed desire of trade and industry to deal with a single tax authority in the indirect tax field, which in turn is at the root of the demand for the merger of sales taxes with excises. We have discussed in section 8 the arguments for and against the proposal and drawn attention to the political judgement involved.

10.8 However, there is a more important problem to be faced, namely, the administrative problem of enforcing VAT at the wholesale and retail stages, because firstly, the number of tax-payers to be dealt with gets larger as we move further down the line in the chain of transactions; and secondly, the smaller dealers in a developing country and even in developed countries, maintain only a primitive form of accounting and may find it extremely difficult to cope with the accounting requirements of VAT. There is also the further consideration that wholesalers, and even more the retailers, are likely to be dealing in a variety of commodities so that the matching of output and input taxes becomes difficult.

VALUE ADDED TAX AT MANUFACTURER'S STAGE (MANVAT)

10.9 For these reasons, we consider that it would be premature now to think in terms of a comprehensive system of VAT extending down to the retail level. But in order to put Central taxation on a rational basis, we would urge that serious consideration be given for moving over to a VAT system at the manufacturing level - the so-called MANVAT. It is our view that in the ultimate analysis a satisfactory solution to the various distortions and problems that arise from an extended system of excise taxation lies in the adoption of MANVAT. The main advantage of MANVAT would be that it would altogether eliminate cascading on account of taxation of raw materials and other inputs. The tax levied on a final product would be the total tax on it and the tax on inputs at earlier stages will not affect its cost or price. The consequent reduction in interest charges and in successive mark-ups would also be favourable factors as far as prices of final products are concerned. The community would know the real tax burden on each product and it would also facilitate the gradation of different products under lower or higher rates in order to achieve the desired degree of progression. MANVAT may also minimise the requirement of physical checks to ensure that there is not much evasion. Besides, the competitiveness of our products in the export markets will get a major thrust.]

10.10 From the administrative angle, MANVAT should not present insurmountable difficulties. From the point of view of accounting, the larger manufacturers would not find it too difficult to cope with the requirements of VAT and the number of tax-payers to be dealt with would be manageable. Though the smaller manufacturers in certain industries would pose some administrative problems, keeping in view the experience of other countries and the fact that the major part of excise revenue is collected from a relatively smaller number of large producers, it should not be difficult to devise special schemes for the smaller producers consistent with the socio-economic objectives of encouraging their growth.]

10.11 Theoretically, VAT can be applied in two ways: either a given rate of tax can be applied to a base which is equal to the value of output minus the cost of inputs, or the producer may be allowed to deduct from the tax payable on output, the tax he has paid on inputs. The latter is referred to as the tax credit method. This is the method that we would recommend for adoption in India for MANVAT. This method would ensure that the actual rate of tax paid on a final product would be equal to the nominal rate of tax on it. Moreover, this method would enable us to tax value added at stages before the manufacturing stage where MANVAT may not be made applicable for some reasons.]

10.12 Under the VAT system, relief is provided in respect of taxation of inputs. One question that arises in this connection is whether the capital goods purchased by a producer should be considered as inputs for this purpose. In most of the European VAT systems, relief is provided also for the tax paid on capital goods. However, under Indian conditions, it would not be prudent to provide such tax relief not only on revenue considerations but also in order not to give encouragement to capital-intensive methods of production. Our aim should be to provide relief in respect of taxes on all inputs including physical ingredients, consumable stores and packaging material.]

10.13 We have pointed out earlier that present excise tax system contains a provision under Rule 56-A for set-off of tax paid on inputs against the tax payable on the output, under certain conditions. The tax credit available under the VAT is exactly of the same kind. The extension of the scope for relief under Rule 56-A, which we have recommended, would in fact be one of the preparatory steps for the introduction of MANVAT. The main difference between an extended system of application of Rule 56-A and the MANVAT is that the former is based on procedures involving physical checks, whereas the latter would be mainly based on the invoice or the accounts method. We have heard that a number of cumbersome regulations have to be complied with in order that a producer may avail himself of the benefit of Rule 56-A; for example, the information

about the receipt in the factory of the input concerned has to be communicated to the tax authorities within a specified period. Obviously, such a stipulation would create complications if the application of this provision were to be made general.

10.14 If the excise tax system only were to be put on a value added basis, relief would be given only for excise tax paid on inputs. Such a relief cannot be given either in respect of sales taxes or customs duties. Hence, if sales taxes continue in roughly the present form, they would impinge on inputs and much of the advantage of MANVAT would be lost. Therefore, simultaneously with the introduction of MANVAT, or even preparatory to it, the existing system of sales taxation would have to be reformed along the lines we have indicated in section 8. Since the implementation of our recommendations would nearly eliminate sales taxation of inputs sold to taxable manufacturers, if MANVAT also were to be introduced, we would in fact be reaping one of the main advantages that flow from a comprehensive VAT. However, just as the conversion of the excise tax system into MANVAT would not have much significance unless the salestax system is also reformed, it would be equally true that there would not be much force in our insisting on the States to refrain from taxation of inputs if Central Excises continue to fall on them irrespective of economic considerations.

10.15 As regards import duties, they cannot immediately be brought within the ambit of MANVAT. One of the main reasons for this is that at present fairly stiff rates on imported raw materials and intermediates are levied to bring in sizeable amount of revenue. Import levies on inputs will have to be reduced first to such levels as are necessary for purely economic considerations, namely, to protect domestic industry and to introduce an element of discouragement for the use of imported products. There would be no case for refunding the levies imposed for the above reasons, which should not be looked upon primarily as sources of revenue but are deliberately intended to raise the landed cost of the concerned imports. In addition to these, the equivalent of MANVAT on the same domestic products should be levied as countervailing duties. In course of time, after such rationalisation has taken place, when revenue needs permit it, relief under MANVAT could be made admissible in respect of such countervailing duties.

10.16 The advantages of the system that we are recommending are not simply theoretical. If a system of MANVAT were to be adopted and sales taxation on inputs were also to be eliminated, substantial benefits would accrue to the economy. In order to gain an idea of the major benefits that will be derived from the application of VAT, we have had carried out a study of the impact of the present system of taxation on costs and prices in an important industry, namely, the automobile industry. The study shows that in the case of truck and bus chassis there would be a saving in costs to the tune of Rs. 3000/- (about 5% of the tax-exclusive price), through the reduction of interest charges on working capital and the reduction in mark-up at different stages of production. The saving will still be sizeable even if VAT were to replace the existing excises alone. Additionally, a considerable amount of scarce working capital which is locked up as the tax component in inventories would be released for productive purposes.

10.17 In European countries as well as in certain developing countries, such as, Brazil, which have adopted VAT, while the system is made applicable to all industries, some products, such as, petroleum, tobacco and liquor, are in addition subjected to non-refundable excise duties. In Germany, a few more commodities are added to this list and all of them are subjected to what are called consumption taxes. Under Indian conditions, it would be preferable to keep quite a number of industries outside the scope of MANVAT and continue on them the present system of excises.

These would include industries in whose final products not much cascading of tax is involved as well as those whose products have to be taxed at special or at high rates for economic or sumptuary reasons. Taxation of such products has to follow its own logic and cannot be fitted into the general system. The kind of industries that we have in mind are petroleum products, tobacco and tobacco products, sugar, coffee, tea and matches. Together they yielded in 1976-77 Rs. 2081 crores which formed 46.4 per cent of total excise revenue. Incidentally, keeping them out of the system of MANVAT would correspondingly reduce the administrative burden of running the new system.

10.18 We would not suggest, however, that an attempt should be made to apply MANVAT to all the rest of the industries at one stroke. It would be prudent to make a start with 3 or 4 industries which produce final products (such as automobiles and diesel engines) in respect of which cascading and other ill effects arising from widespread input taxation are pronounced. Such a pilot project would enable Tax Administration to test out procedures and study the reaction of tax-payers.

An industry itself may have a wide range of products. If the experiment is to be made on a somewhat wider scale one could consider, say the entire range of products falling under the automobile industry. On the other hand, if the experiment is to be pinpointed, one could think of products like trucks, tractors and diesel engines for launching a pilot project. On the basis of the experience so gathered, attempts could then be made to extend the system. On the basis of such evidence as we have been able to gather about the operation of VAT in a number of developing countries, it would appear that the administration of a VAT confined to the manufacturing level would not be beyond the capacity of tax authorities in India. However, we recommend the cautious approach of starting with a pilot project, because in the interests of safeguarding revenue it is necessary to establish its workability before a widespread application of the system is contemplated.

10.19 As has been amply demonstrated by the experience of other countries, it would not be possible to work the VAT system with a plethora of rates of tax on different inputs and finished products. While theorists who advocate complete neutrality in indirect taxation argue in favour of a single rate of VAT, even most of the developed countries have found it necessary to have more than one rate of tax and also to impose additional higher levies on a range of luxury products. Before embarking upon MANVAT, it would be necessary, as one of the preparatory steps, to rationalise the excise duty structure so as to have only 4 or 5 rates. As we have argued earlier, in the rationalised duty structure, the same rate of tax should apply to final products which could be identified as belonging to the same group of necessities for life, conventional necessities or luxuries, depending upon the income group which predominantly consume them. Also, there should be non-discriminatory taxation as between competing raw materials or other inputs unless there are special economic reasons for a contrary treatment.

10.20 Another preparatory step for the introduction of MANVAT would be the extension of the scope for relief under Rule 56-A. We have also argued that the average rate on raw materials should be brought down. Once the number of rates of final product have been cut down, the burden of taxation on raw materials is reduced and relief under Rule 56-A has been sufficiently liberalised, the divergence between the cumulative levies and the nominal rates on the final products would be considerably narrowed down. The stage would then be set for the introduction of MANVAT.

19.21 [In applying the MANVAT system, some practical problems may have to be faced. A point often made is that the system would mean maintaining detailed books of accounts, casting, as a result, a much heavier burden of tax compliance on the small and medium scale manufacturers at present.] To assess the magnitude of this problem, the Committee's Secretariat undertook a small sample study of the purchase and sales pattern as well as the accounting system of manufacturers with different out-turn ranging from less than Rs. 2 lakhs per annum to that exceeding Rs. 1 crore per annum. All the manufacturing units covered under the study were found to be issuing invoices with comprehensive details. It was noticed that manufacturers whose turnover exceeds Rs. 15 to Rs. 20 lakhs per annum do, by and large, get most of their inputs under cover of regular invoices which are maintained properly. These invoices show detailed particulars, but excise duty is not shown where the purchases are from dealers. Such manufacturers keep detailed accounts of their purchases, production, sales and stocks in balance, of inputs as well as of finished goods. Though, in several cases, the bulk of the purchases of inputs was direct from other manufacturers, there were also purchases from local dealers and those situated outside. In the case of manufacturers whose turnover is less than Rs. 15 lakhs, accounts maintained for purchases, production and sales gave reasonable details though the system was not sophisticated enough. In their cases, the larger portion of their purchases were from dealers (and even retailers sometimes) and the corresponding invoices (which were generally obtained) did not mention the excise duty particulars. Thus it could be assumed that manufacturers whose turnover exceeds Rs. 15 lakhs could be reasonably expected to conform to VAT documentation without much difficulty. As far manufacturers with smaller out-turn (who incidentally contribute not even 5% of the total excise tax revenue as per our study), it is possible to devise special schemes, discussed later in Part II of our report, in order to reduce the burden of documentation under normal VAT. The smaller manufacturers could be subjected to a system of payment of duty somewhat on the lines of the existing simplified procedure, with certain modifications which could also take care that such producers do not suffer vis-a-vis others working under normal VAT. A scheme of grant of tax credit on a notional basis in respect of inputs bought from smaller producers working under the special scheme could be introduced so that the latter do not suffer a disadvantage vis-a-vis the tax paying larger manufacturers.

10.22 [A more important problem to be faced in extending the system of MANVAT would be on account of the fact that,] as indicated by our study, [several inputs even by the bigger manufacturers are bought through the medium of dealers who are not subjected to Central Excise. Such problems have been faced and successfully tackled by countries which have adopted VAT only upto the manufacturer's level.] Even France faced this problem when in 1954 VAT was initially experimented at the manufacturing stage and special schemes were devised for this purpose. [Based on the experience of other countries, it should not, therefore, be difficult to find an appropriate solution to this problem in the Indian context. One of the possibilities which could be explored would be a suitable liberalisation of the existing provisions of rule 56-A which already allows tax credit if there is one dealer in between two manufacturers. The other possibility could be to allow the dealers to register voluntarily and to empower them to issue tax vouchers. Perhaps, a better method may be to allow tax credit on a notional basis after deducting from the invoice prices a gross margin for the wholesale sector. Under this scheme, tax credits would be granted at notified rates, which would be related to the relevant rates of tax on the inputs as also the pattern of production of the inputs in the organised and small scale sectors.] In fact, a critical study of the schemes operating in other countries would be of great help in devising appropriate solutions in the Indian context. [The introduction of VAT for selected industries in the first instance, as recommended by us, would enable Government and Tax Administration to obtain a clear idea of the special problems of the kind that we have indicated above. On the basis of the experience gained, suitable schemes could be devised before extending MANVAT to other industries.]

10.23 Introduction of VAT in other countries has been preceded by a period of intensive training for tax administrators and education for tax-payers. [As we are contemplating the application of the VAT only to the manufacturing stage in India and since in practice it would fall mostly on producers who are also income-tax payers, the problem of educating the tax-payers would not assume such a large proportion as in countries like Brazil where the system is extended right up to the retail stage. [Nevertheless, the importance of an adequate educational programme cannot be over-emphasised. If our recommendation for the adoption of MANVAT is accepted by Government, it would be necessary to send a small team to study the operation of VAT in some countries including a few developing countries where this scheme has been working for a number of years. Only after that, a detailed programme of implementation could be worked out which would include, inter alia, evolution of appropriate return forms, and making the concerned industrial units familiar with their use, transitional problems relating to the treatment to be given to the inventories, the extent of computerisation, etc.

10.24 In conclusion, we may add that the initial measures of reforms of the indirect tax system that we have recommended in sections 5 to 8 would not only facilitate the change over to the new system, but are also desirable in their own right. Thus these reforms could be carried out even before a final decision is taken by Government regarding the MANVAT. However, it would be fair to point out that, for reasons stated earlier, they could only go part of the way towards rationalisation of indirect tax system in the country.

11. PROCEDURAL REFORMS

11.1 One of the important criteria in judging the soundness of any tax system must be how smooth it is in operation. In the subsequent part of our Report we have addressed ourselves to the problem of procedural reform in some detail. We nevertheless feel it necessary to highlight some of the problems and difficulties which arise in the course of assessment and levy of duties and our recommendations regarding the ways in which they could be removed.

ELIMINATION OF AVOIDABLE DELAYS AND DISPUTES

11.2 In indirect taxation, much more than in direct taxation, it is very necessary that the assessment of the duties payable should be made without much loss of time. Any delay can lead to one of the following consequences each of which is an undesirable one:—

(a) The producer sells his products on the basis of the higher assessment than he himself considers to be right and thereafter has recourse to appeal and revision procedures. In the event of a lower rate of duty being determined, he would get a windfall profit because he would have already charged his customers a price which would take into account the higher levy.

(b) The producer sells his product pricing it on the basis of a lower rate of excise duty than he is finally called upon to pay. If as a result of appeals etc. the levy of duty at the higher rate is upheld, the difference between the tax collected and the tax leviable would fall on the producer, sometimes without his being able to recover the difference from the persons to whom he has sold the goods.

(c) Sometimes products remain unsold until the classification or valuation disputes are decided. The latter may as well involve considerable delay.

11.3 It is therefore of the utmost importance that the process of giving a final decision on all issues such as classification and valuation and the grant of refunds and rebates should be speeded up to the maximum extent possible. The Self Removal Procedure (Review) Committee had recommended a time limit of three months for grant of refunds. The Central Board of Excise and Customs has also issued detailed instructions for reducing administrative delays. Despite these, delays continue to occur. This is not because of the slackness on the part of those concerned but the system itself is conducive to delays. Therefore, the attempt at reform must consist of three steps; revision of procedures so that possibilities of disputes and differences are reduced, if not eliminated, restructuring of the machinery for appeals and revisions and incorporation of appropriate provisions to deal with situations in which despite the reform, delays do take place.

11.4 Among the causes which lead to disputes and differences, the two most important are classification and valuation. This is particularly true of excise duties. As there are 136 tariff items covering almost the entire range of industrial production, the doubt often arises as to whether a particular product falls under one tariff item or another. This issue assumes a special importance because of the different rates at which excises are levied under different tariff items. Our recommendations regarding the considerable reduction in the number of rates as well as of plying the same rate of duty to like products, if accepted, will in a way lead to a reduction in the number of disputes over classification since the number of cases in which the rate of duty will differ according to classification would be far fewer than they are at present.

RESTRUCTURING OF TARIFF

11.5 However the most effective way in which disputes over classification can be minimised is by having each tariff item defined in sufficiently precise terms so as to leave as little room for doubt as possible about the correct classification of any product. There is now in existence an internationally accepted classification known as Customs Cooperation Council Nomenclature (CCCN) which classifies products in far greater detail than ever before attempted. We have adopted it with various modifications in our customs tariff. There is another classification base, equally detailed, which we use for purposes of sea borne trade accounts. Then there is our excise tariff which generally follows the terminology adopted by Indian trade and industry. Because of the greater precision in the nomenclature, the administration of the import tariff does not present serious problems. On the other hand, in the levy of excise duties, there are frequent disputes over classification. Further, such disputes affect the customs administration also because the excise duty payable on a product is leviable as countervailing duty on imports as well.

11.6 It would therefore be of considerable advantage if the excise and customs schedules are aligned completely with each other. At the same time, there is force in the argument that for a very large number of assesseees who are subject to excise duties the use of familiar trade names is much more intelligible than a technical definition of each product. The Tariff Revision Committee had recommended the restructuring of the Central Excise Tariff and alignment of the customs schedule with the excise schedule to the extent possible. While recommending a CCCN based customs tariff it conceded that for purposes of excise, complete adoption of the CCCN based tariff may not be desirable and for a range of products the Indian commerce or trade identity may continue to be used.

11.7 We endorse the recommendations of the Tariff Revision Committee relating to the revision of nomenclature of excise tariff. It is desirable that this revision is synchronised with the process of rationalisation of the rate structure on the lines recommended by us. Care must be taken to avoid a situation in which a product which is not being manufactured in the country at all becomes subject to a countervailing duty when it is imported simply because the excise tariff classification is not sufficiently detailed. To facilitate co-relation between the customs and excise tariff schedules for the purposes of levying countervailing duty it might be useful if the import tariff schedule contains a cross reference to the excise tariff schedule.

VALUATION UNDER EXCISE LAW

11.8 Ambiguity and doubt about classification are not the only sources of disputes which often result in prolonged litigation with the disadvantage referred to above. A good deal of dispute arises over the valuation of a product. The excise duty should normally be levied on the ex-factory selling price. There has been concern over the possibility that a manufacturer may sell to someone in special relationship with him at an artificially low price in order to pay a lower amount of duty. This is a problem which arises in direct taxation also and the principle of arm's length transactions is used in judging the correctness of the value of sales. To guard against this danger, it has been felt necessary to introduce the concept of "related person" in the excise law. From what we have heard on the subject, it appears that this concept is being interpreted in a way that goes beyond its original purpose and justification. Selling through dealers, distributors and agents is a normal established trade practice for a wide range of products and the

margin allowed to such dealers and traders can also be fairly high in some cases, because after sale-services have to be provided or promotional expenses for sales have to be incurred. Therefore, the real test to apply should be whether the kind of terms on which goods are being sold to such distributors and agents etc. would be available to any independent buyer or whether there would be any preferential treatment to any special class of people. Applying this concept, transactions between holding and subsidiary companies and companies under the same management can clearly be treated as transactions between related persons. In such cases the price charged by the related person to independent buyers could be the basis for assessment. There may also be situations in which some dealer or dealers may have a special relationship, perhaps a family relationship, with the producers while other buyers do not. So long as the goods are available to all of them on the same terms then there is no reason to suspect the bonafides of the transactions between the manufacturer and such dealer(s). In other words, the concept of related person should be applied much more strictly and for this purpose the law on the subject should be made clear to avoid future disputes. Another type of problem which arises is in regard to difference between the ex-factory price and the purchase price of wholesale dealer/distributor. This difference may be due to the transport cost, or due to the cost of any special packaging needed to facilitate the transport, or due to other elements of cost which the distributor may have to incur, e.g. in marketing or in servicing machinery items which are sold. Clearly these elements should not be treated as a part of the assessable value. Even when the transaction is with a related person, to the extent that the party concerned does incur expenditure on transport, marketing and the like, the price realised by him cannot be said to be the price at which the manufacturer could have sold the product to some one who was not a related person. Therefore it would be appropriate for the law and the rules to make allowance for it.

11.9 Further, there is another problem area which relates to equalised freight. In some cases, Government themselves provide for this, as in the case of cement and steel. For some other products, manufacturers themselves maintain an all-India price which absorbs the amount of freight incurred. The existing provisions allow deductions in respect of actual freight incurred in the transportation of excisable goods from the factory to any other place; however, no deduction on account of equalised freight is allowed primarily on the ground that it does not represent the actual cost of transportation. In principle, there is no reason to treat them differently. The mere fact that in the latter case it is an average expenditure does not alter the basic position that it represents the cost of transport. We, therefore, recommend that where the manufacturer establishes his average transport cost he could be allowed to claim a deduction from the all India price while determining the assessable value.

11.10 Once the concept of a related person has been redefined to remove the genuine problems raised by trade and industry, the present practice of the manufacturer getting the prior approval of the price list could be dispensed with in all cases where the sale is to an independent buyer. This would eliminate delays in the removal of goods from the factory and assessment in most cases could be made on the basis of the invoice price.

11.11 The validity of the amended law which is now in force and in which we have suggested some modifications has been challenged in a number of writ petitions filed in different High Courts. It is possible that different views may be taken in different High Courts on the points at issue. Ultimately, a Supreme Court verdict alone could finally settle the issues. The whole process may well take years. Since a sale of the product may well be proceeding in between on certain assumptions depending on the final verdict, assesses as a class may reap a windfall profit or suffer a sizeable loss. The case for arriving at finality as early as possible is therefore very strong and hence we would urge that the question of amending the law should be examined urgently. Side by side, Government could consider requesting the Attorney General to move the Supreme Court under Article 139-A of the Constitution to transfer these cases to itself so as to enable a speedy determination of the issues involved.

INDEPENDENT MACHINERY TO RESOLVE DISPUTES

11.12 While we have discussed above the ways in which the volume of disputes can be reduced, we have no reason to believe that they will disappear. The need for appropriate procedures for appeal and revision therefore needs consideration.

11.13 There has been widespread demand both from trade and industry and other sources that there should be an independent machinery to resolve disputes under Customs and Central excise laws to replace the present arrangements under which such matters are generally disposed off by departmental officers. Almost all the commissions, committees and other similar bodies who have considered the matter in the past, starting with the Taxation Enquiry Commission (1954), have recommended the setting up of an independent machinery for the purpose. Recently, the Supreme Court had also occasion to point out the desirability of setting up of a quasi-judicial tribunal for deciding cases under customs and excise laws. We endorse the above suggestion.

11.14 The principle of separation of the judiciary from the executive is enshrined in our Constitution. It has been applied extensively even in the matter of taxation. In the administration of income tax independent tribunals have been set up. The main argument that we have heard in support of continuing present procedures under which final decisions are taken at the level of the Central Government is that in the matter of indirect taxation quick decisions are necessary. A judicial tribunal because of the kind of procedures it would follow cannot give such quick decisions. We have ourselves emphasized the importance of avoiding delays in settling issues pertaining to indirect taxation. In supporting the setting up of an independent quasi-judicial tribunal our emphasis is not on a change of procedures. We would very much hope that it would not be impossible to avoid the kind of procedural complexities which contribute to delays. The important thing to ensure is that assesseees should not feel that their ultimate Court of redress consists of people whose prime responsibility is to collect revenues for the Government. Whilst it may be true that when hearing appeals or revision petitions Members of the Central Board/Officers of the Central Government do take an objective view, the point has been made to us that sometimes they are inhibited in the exercise of their judgement by the consideration that their verdicts could be questioned by revenue audit. In the later part of our Report we set out in some detail our thoughts on the composition of the tribunal and its functions. The main point of principle which we are anxious to emphasise here and which we hope will have the approval of the Government is that while appeals which lie to the Appellate Collectors could continue to be disposed off by them, the second appeal arising therefrom should be heard by a body which will be, and will seem to be, truly independent of and separate from the executive. An exception to the approach that the second appeal alone should go to the independent body could be the cases where the original order has been passed by the Collector. In such cases, the first appeal itself may lie to such a body.

AMENDMENTS TO LAW

11.15 Appeals to the High Court on points of law against orders passed by the tribunal will of course continue. The possibility of divergent views being taken by different High Courts cannot therefore be ruled out. While the Supreme Court will have to be the final arbiter in all such matters we would put forward one point for Government's consideration which may help in reducing the number of cases going to the Supreme Court and the time which it must inevitably entail in getting a final verdict from the highest judicial authority in the land. More often than

not, it is some ambiguity in the wording of the law which gives rise to doubts about its interpretation and occasionally leads to different interpretations by different authorities and courts. We feel that whenever the wording of the law gives rise to any doubts, Government should immediately apply its mind to see whether the doubts cannot be resolved by an appropriate amendment of the wording of the law. Where tariff is concerned, the opportunity to do so comes at least once every year when the Finance Bill is presented to Parliament. In important and urgent cases an amending Bill can be introduced in Parliament at other time as well. The advantage of such a course would be not only to reduce the volume of litigation but also to ensure that the problems which arise when there is any doubt about the tax liability in a particular set of circumstances will at least prospectively be removed. There have been instances when, following the Supreme Court verdict, Government have found it necessary to legislate retrospectively. Timely action may reduce the number of occasions where recourse has to be had to such a device.

11.16 The question should also be examined whether in cases where an assessee has collected from his customers a higher amount on account of excise duty than could have been levied under the law as it stood should he not be made to credit to the Government the full amount which he has recovered from his customers on account of the excise duty. A provision of this nature has been made in the sales tax law of Gujarat, the validity of which has been recently upheld by the Supreme Court.

11.17 As stated earlier in this part of our report we have confined ourselves to some major points of principle. In the course of our enquiry we have had a large number of representations from trade and industry which we have discussed with Collectors of Customs and Central Excise as well as Members of the Central Board of Excise and Customs. As these pertain to a wide range of problems which must necessarily be dealt with in some detail we shall be dealing with them in the appropriate part of our Report devoted to procedural problems.

14. INDIRECT TAXATION AS AN ECONOMIC TOOL.

- 12.1 Our terms of reference require us to examine a number of economic issues, particularly :
- (a) the role of indirect taxation in promoting economic use of scarce resources;
 - (b) the impact of indirect taxes on prices and costs;
 - (c) the advisability of using concessions in in-direct taxes to assist particular industries or particular sectors of an industry; and
 - (d) the role of indirect taxation in mobilising resources and the question of inter-action and a proper balance between indirect and direct taxes in our tax structure.

12.2 These issues are complex. Decisions on some of them entail a value judgement which can only be exercised at political levels. We have nevertheless analysed the likely impact of particular policies in the field of indirect taxation on different sectors of the economy as well as on the economy as a whole, and have formulated a number of recommendations.

12.3 Thus, we have argued earlier that to ensure the economic use of resources, in general, like products should be taxed at the same rates, except when there are good economic or social reasons for discrimination. We have also made a distinction between general input taxation for revenue purposes for which tax credit may be given and a special levy on an input for discouraging its use, if found necessary. In a planned economy like ours, there may be legitimate grounds on which we can interfere with the consumer's choice between different articles of consumption and the producer's choice between different raw materials and techniques of production.

12.4 In regard to prices and costs, while recognising that indirect taxes are likely to be passed on to the consumer and therefore they do lead to an increase in the prices of the products concerned, we have drawn attention to some of the adverse effects of the present high levies on inputs (imported as well as domestically produced) which tend to raise costs and prices beyond the levels which can be justified on revenue considerations. We have dwelt on the role of import duties in providing protection to indigenous industry and examined at some length the concessions in indirect taxes given to the small decentralised sectors of industry. We have also pointed out the reasons why in developing countries indirect taxes have to play a larger role in mobilising resources than direct taxes. In this section, we propose to examine the kind of role which indirect taxes can play in a somewhat wider context, particularly in respect of inflationary and recessionary trends and in generally stimulating production and investment.

INFLATION AND RECESSION

12.5 In any consideration of the use of fiscal measures as a tool of economic policy, attention must be bestowed both on direct and indirect taxes in order to decide which of them or what combination of measures in both sectors would give optimum results. It is, therefore, necessary to evaluate the role and the possibilities of both direct and indirect taxes in controlling inflation. Speaking broadly, direct taxation when it is universal in its application curbs aggregate demand without

affecting the freedom of choice of the consumer as between different products. Indirect taxation can affect the demand for different products differently, and can serve the purpose of curtailing the demand for those which are in short supply. The use of indirect taxes as a supplement to direct taxes to curb demand in a situation when prices in general are showing an upward trend acquires special validity in Indian conditions because :

- (a) direct taxes apply only to a small fraction of the population;
- (b) prices of particular products often register sharp increases not because the demand for them has gone up but because of a failure on the supply front;
- (c) often when there are general signs of inflation particular industries may be facing a demand recession.

12.6 It would not be quite appropriate to look at indirect taxation merely as a means of restraining demand for particular products by raising their prices. Inflation too brings about a balance between demand supply by raising the price level. The difference between the price rise which results from inflation, often due to deficit financing, and the price rise which results from indirect taxation which is used to reduce budgetary deficits, lies in the fact that inflation hurts the weaker sections of society most while some of the affluent sections may even gain due to inflation. The price rise due to an increase in indirect taxation can and should be orderly so as to conform to concepts of social justice and act as a check on excess profits. Besides the price rise under inflation tends to repeat itself, whereas the rise in prices occurring due to an increase in indirect taxation leading to a reduction in purchasing power, is expected to be an once-for-all phenomenon.

12.7 Certain types of products, such as the basic essentials of life cannot be subjected to higher excise duties with a view to cutting down the demand for them. If, due to a failure of monsoons, a shortage of foodgrains or cotton develops and there is a trend for food and cloth prices to shoot up, it would be of course unthinkable to try to deal with the situation by accentuating the price rise. The curb on demand in such cases would be much better brought about through rationing. We would add that the mere imposition of price control without effective measures to curtail demand through rationing only leads to hoarding and blackmarketing. The role of indirect taxes in respect of such products should be to augment supplies by lowering duties on imports of like products as well as by preventing their diversion to less essential purposes through higher levies on the alternative uses to which they can be put. Thus, if cotton shortage is responsible for raising the price of cloth, lowering of import duties on synthetic substitutes for cotton as well as raising of excise duties on non-wearable fabrics can help.

12.8 The identification of products on which duties should not be raised in order to curb the demand for them is of course a matter of social judgement. However, we would like to point out in this context that if there is a rise in the price of a product which is taken into account for calculating the quantum of dearness allowance, due to an increase in tax on it, there should be no compensatory increase in dearness allowances. Otherwise, the main burden of the tax would fall on the most vulnerable sections of society, namely, those who are unemployed or who earn their wages in conditions in which there is no prospect of dearness allowance being paid to them, e. g. agricultural labour.

12.9 When rationing is not desirable or possible, indirect taxation can act as a check on abnormally high profits, as prices rise, to bring about a balance between demand and supply. It can do

so more effectively than price control which curbs the profits of the honest but results in a tax free windfall to the unscrupulous. If the excise duty is ad valorem, in conditions of a mild price rise it would automatically ensure that the level of tax per unit of output goes up. It is true the profits of the producer would also be rising. This would encourage increased production of the article. A good portion of extra profit will go to the exchequer by way of direct taxes. If the increase in price is particularly sharp, the rate of excise duty can be stepped up as a regulatory measure. In doing so, care should be taken to ensure that the incentive which higher profits provide to the expansion of production is not wholly destroyed.

12.11 Further, it must be emphasized that as soon as the imbalance between demand and supply is removed, there should be a cut back in the regulatory duty. We have come across many instances where the duty was justifiably raised on essential products in conditions of scarcity, but subsequently when the shortage disappeared the duty was not reduced because of rising revenue needs. In order to counter such trends Government might consider whether windfall accretions to revenue of this kind cannot nationally be segregated from the mainstream of resource mobilisation and utilised primarily for meeting sudden unforeseen demands on revenue or, better still, in a manner which would go to augment the supply of the product in question. In any event such regulatory levies should be kept distinct from the basic rates and be subjected to annual review.

12.11 We now turn to a situation in which there is a shortage of demand rather than supply. In Indian conditions, with a rising population and continuing efforts to step up the level of investment even though the level of savings is not adequately high a general recession should not as a rule occur. If there are any signs of it, the overall level of investment in the economy should be stepped up without a corresponding increase in resource mobilisation so as to give a boost to demand. The techniques of having recourse to tax cuts as many developed countries do would not be the best answer to recession in India.

12.12 However, a general recession in Indian conditions is much less likely than a situation in which, even when there may be a general inflationary trend in the economy, particular industries may be faced with a demand recession. In such conditions there is a clamour for reducing the indirect tax burden on them. The mere fact that an industry is losing cannot be a reason for giving tax concessions to it. We have argued that not every rise in the level of profits should occasion a rise in the rate of indirect taxes on the product. Similarly, not every decline in profits should lead to a reduction in the levy. Indeed the expectation of frequent changes in the rates of indirect tax can generate many speculative trends which may themselves bring about or accentuate the kind of situation which the change in the tax rate is expected to correct. The expectation of a possible reduction in duty may lead the trade to reduce its offtake from the industry, just as on the eve of the budget when a rise in taxes is expected there is a speculative rise in prices. The latter often gets further aggravated by the restrictions, which are sometimes imposed by the authorities. On the quantum of clearance of excisable products from the factory.

12.13 Nevertheless, conditions may arise in which a reduction in the duty can, as a temporary expedient, be given to an industry facing a demand recession, just as there may be occasions for raising duties when supply falls far short of demand. Thus, when in the interests of maintaining production and employment, extra bank credit is being extended to any industry to enable it to carry larger stocks of the finished product, a temporary duty reduction could well be considered to stimulate demand.

THE PRODUCTION ANGLE

12.14 There has been a great deal of discussion on the need for and the possibility of using concessions in excise duties for the purpose of encouraging larger production. Excise duty adjustments have in fact been used for encouraging production in particular industries in several ways. In the paper industry, excise duty is lower for units with production capacity below a certain level. There have also been cases in the past when the concession was available provided clearances did not exceed a certain limit (e.g. tyres and aluminium). The underlying consideration was to give relief to units whose costs were high because their scale of production was low. The most comprehensive of such concessions is the one announced in the 1976-77 budget under which production in excess of a certain norm, which is different for new units and older units, qualifies for a 25 percent reduction in the rate of excise duty applicable to such production.

12.15 A concession in indirect taxes can affect output in two ways. If it is passed on to the consumer and results in a lowering of price it can stimulate demand and thus encourage higher production. This is more likely to happen in cases where the prevailing level of excise duty is on the high side and the price elasticity of demand for the product is relatively high since the reduction in price on account of the tax concession could be significant. In cases where as a result of the high consumer price inclusive of excise duty the effective demand is less than the potential of domestic supplies from existing capacity, there would be a case for a reduction in excise duty to boost output. Such a situation is likely to arise when excise duties have been hiked up in conditions of scarcity and there has been a subsequent augmentation of the production potential. It could also arise when the duty has been consciously raised on any product whose demand is highly elastic to meet any particular set of considerations. Generally speaking, a high duty which leads to significant under utilisation of the licensed capacity cannot be justified. From the purely revenue angle, the reduction in duty may be partially, wholly or more than offset by the additional revenue accruing from the increase in sale. But where the higher duty is meant to discourage further investment flowing into a particular activity which on social or economic considerations is deemed to be a low priority activity, the point will need to be considered whether the reduction in duty would run counter to specific policy objectives.

12.16 The other case is where as a result of the excise duty concessions the producer is able to increase his realisation by keeping to himself a larger part or whole of the benefit accruing from the reduction in duty. Even a small improvement in realisation per unit of output could have a significant impact on the unit's profitability. The producer would then have an incentive to produce more than the normal, even if it meant a rise in cost of production of the additional units of output, provided there is an unsatisfied demand for the product or the demand is growing at an adequate rate. A reduction in duty not to lower the price to the consumer but to increase the profitability per unit of output to the producer can be considered in the following types of cases:

- (a) When a product is subject to price control and there is a rise in costs, and if it is intended that consumer prices should not rise the duty reduction could offset the increase in costs. However, in all such situations the most serious consideration should be given to the possibility of allowing an appropriate increase in prices rather than have recourse to a measure which amounts to indirect subsidisation.

- (b) In a capital scarce economy, if an increase in capacity would involve substantial capital costs it might be justifiable through excise duty concessions to encourage a higher production from existing installed capacity even though such higher production would lead to an increase in unit costs.

12.17 In the light of the above general considerations we comment below on some of the schemes of concessions for encouraging production in different industries as also for particular category of products within an industry.

HIGHER PRODUCTION RELIEF SCHEME

12.18 Presenting the budget for 1976-77, the Finance Minister stated. It has been decided to introduce a new scheme of excise duty relief to encourage higher production. The scheme visualises grant of relief in respect of selected commodities to the extent of 25 per cent of duty payable on goods produced in excess of production in a selected base year. The list of items included in the scheme covered 43 excisable products originally and a number of additions were made in July and September, 1976.

12.19 When the scheme was introduced it was widely hailed as a measure to boost production. Subsequently, there has been a good deal of criticism on the ground that its benefits have often gone to those who did not deserve them while others who really needed the encouragement gained little. The main points made in this context have been :

- (a) the scheme has the effect of benefiting newer units much more than the older ones;
- (b) the base year chosen works out to be highly favourable in some cases, particularly in those where production in the base year was unduly low because of special difficulties such as lack of power or raw materials or labour problems and the subsequent increase in production was going to take place anyhow whether or not any tax incentive was given;
- (c) industries subject to higher rates of duty benefit much more than those subject to lower rates, e. g., ~~the relief of 25 per cent of the duty payable~~ meant much more to industries like tyres and polyester fibre ~~which were subject to duties of 55 per cent and more than 100 per cent (in ad valorem terms), respectively,~~ than the industries like caustic soda and soda ash which are subject to duty at only 10 per cent;
- (d) often in the case of industries where lack of demand was the main impediment to increase in production the concession did not mean more production overall but only a redistribution of the same level of production among different manufacturers of whom the more efficient gained at the expense of the others.

12.20 We would not of course recommend any modifications in the scheme while it is in operation. It is not desirable as a rule to modify concessions once announced during the period of their validity. However, we feel that the scheme should be discontinued after the initial period of three years is over. Thereafter, any concessions which may be given should take account of the weaknesses of the present scheme. In particular schemes meant to encourage higher production from existing units should not be extended to wholly new units whose case we discuss below:

ENCOURAGEMENT TO NEW UNITS

12.21 The plea is frequently made that new units suffer from the disadvantage that the cost of their plant and machinery on account of inflation and other factors would be much higher than of old established units. Their cost of production would, therefore, be higher. Since the market price for the same product must be more or less uniform, it is argued that unless the excise levy on the new units is lowered to enable them to earn an adequate return while selling at the same price as the older units, new investments will be discouraged.

12.22 In considering whether and to what extent duty relief should be given to stimulate new investment in any particular industry a number of factors have to be taken into account. Although new plant and machinery do cost more, often they are more efficient and have a higher level of productivity. The disadvantage in all cases may not be as great as the difference in the price of capital equipment would suggest. Then again, in a number of instances the market could absorb the production of new units at a price which would be remunerative to them despite their higher costs and what may stand in the way is some form of a control over prices. In such a situation consideration must be given to the possibility of allowing a higher controlled price than subsidising the product at the expense of the exchequer. In a regime of administered prices, pooling arrangements in appropriate cases could prevent excess profits to older units and keep down the increase in consumer prices. In the long run, the attempt to keep the price of an essential product at a level lower than the cost at which it can be produced by new units may lead to scarcities because it will stand in the way of new units coming up.

12.23 However, particularly in the case of capital intensive industries, the problem may be serious enough to warrant consideration being given to fiscal concessions. The best way to deal with the problem would be through devices such as the old development rebate or the comprehensive incentive scheme introduced in the 1976-77 Budget of investment allowance which has now been extended to cover all except a negative list of 30 relatively low priority industries. The terms on which finance is available can also help canalise new investment into desirable channels.

12.24 Having drawn attention to alternative possibilities of helping new units, we would not rule out the use of indirect tax concessions on a case by case basis if circumstances so warrant. In the case of certain capital intensive industries the quantum of relief to be given by way of investment allowance may have to be too high. Then there may be industries which will face a critical liquidity problem, if in the initial years they are subjected to a high rate of excise duty, particularly if the industry happens to be one in which in the initial years production is expected to be far below the rated capacity for one reason or another. In short, while we do not in general regard excise duty concessions as the best method of encouraging new investment in an industry, we recognise that there may be circumstances when such concessions could be justified. However, when excise concession is given to stimulate new investment, it should be made applicable to units which start production a couple of years after the announcement and should remain in force for an appropriate period from the date when production starts. Otherwise, the concession may be too generous to some and too meagre for others.

EXCISE RELIEF FOR ENCOURAGING THE PRODUCTION OF LOW PRICED
CONSUMER DURABLES.

12.25 With a view to achieving a fuller utilisation of the existing capacity and making available an amenity like refrigerator to a wider sector of the community, preferential tax treatment has been accorded to smaller capacity refrigerators over the last few years. Thus, as against the normal duty of 75 per cent charged for large sized domestic refrigerators, much lower concessional rates (viz. 40 per cent and 50 per cent) have been made applicable to economy class refrigerators of capacity not exceeding 165 litres. Similarly, to encourage production of cheaper varieties of television sets and thus enable a much large number of people to have an access to them, excise duty on low priced television sets has been reduced to 5 per cent as against the normal duty of 20 per cent in the 1976 Budget. This form of concessional excise can play an important role in boosting production of particular varieties. Experience has shown that production pattern has shifted towards standard models of the type which have been accorded the benefit of lower excise duties. This form of excise relief could well be extended to other consumer durables after a case by case consideration. The models favoured through excise concession should be the cheap varieties so as to provide a built-in incentive for cost reduction which would benefit a significant proportion of wage earners. On this consideration we feel that the dividing line between products taxed at concessional rates and those taxed at full rates should be value rather than physical specifications. When value is the limiting factor the producer tries to offer the best possible product within the prescribed price range, while when physical specification is the criterion for the concessions there could be a tendency to produce luxury rather than utility models meeting the requirement of specification which would sell at prices beyond the reach of the class of consumers for whom the concession was meant.

TAX CONCESSIONS FOR CERTAIN OTHER PURPOSES.

12.26 Excise duty concessions are often given on a long term basis to units which make use of non-traditional raw materials which would otherwise go waste or adopt labour intensive techniques of production. Certain types of paper based not on wood pulp but agricultural waste receive excise concessions. So do khandsari against sugar and handloom textiles against mill made fabrics. Such concessions are in principle legitimate. Care has, however, to be exercised to ensure that they are not excessive and do not lead to waste or uneconomic use of some other scarce resources. In deciding upon the nature and magnitude of concessions, a clear view has to be taken as to whether it is desired to stimulate a particular type of economic activity and to bring about a further expansion of the protected sector or whether the objective is merely to protect and ensure the survival of the existing weak units.

12.27 Sometimes fiscal intervention and tax concessions may be necessitated to meet sudden and unforeseen developments in particular sectors of an industry. Care should be taken to ensure that the measures adopted to deal with a short term phenomenon do not lead to undesirable distortions in the long run. Tax concessions can certainly be used to provide the necessary shelter to sectors and techniques of production when it is in the public interest to do so. Such concessions should be preferably given as a part of a well-conceived national strategy rather than in response to pleadings of producers who for one reason or another find themselves in difficulties. In exceptional cases, deserving of help, it may be better to consider schemes of outright subsidisation, so that the community is clearly aware of the cost of the assistance, than to attempt to devise tailor-made conces-

sions which cost the exchequer no less and whose benefits are often derived by those for whom they were never meant. The belief that tax concessions can bale out any producer who runs into difficulties must be rooted out.

INVESTMENT ANGLE

12.28 Special care has to be taken to ensure that changes in the tax structure which may alter investment priorities are not introduced except after the fullest consideration. Capital for us is a scarce resource. We cannot afford infructuous investment. When within the framework of policies and particularly as a result of fiscal concessions investments have already been made, the concessions should not be withdrawn without adequate notice unless they are already time bound.

12.29 Whenever Government desires to introduce an added measure of stimulus or restraint in respect of any particular type of economic activity consideration need not be confined to changes in the rates of indirect tax alone. Among the instruments which Government can deploy for the purpose, are, (i) direct taxation; (ii) the price policy; (iii) the terms on which credit from banks and other financial institutions is made available; and (iv) measures of control.

12.30 Investment decisions are influenced by expectations of the net return on the capital employed. In a free market economy if the demand for a product shows signs of outstripping its supply, the price shows an upward trend which encourages new investment. A control on the price of a product does not give timely signals to the investor and in general it encourages him to invest in areas where there is no price control and where he has hopes of making high profits. Since products subjected to price control are usually in the category of what are known as essentials, there has been a pronounced trend for investing in products which are categorised as non-essentials. To reverse this trend, one of the possibilities which would need to be considered would be an adjustment in the price control policy.

12.31 The second possibility would be to consider ways in which products which are subject to price control can be helped to lower their costs. In reckoning his cost the producer would take into account the indirect levies on the product. For products subject to price control in which further investment is needed, care must be taken to see that indirect taxes do not lower profit expectations of priority industries relative to non-priority industries.

12.32 Another possibility would be to make available long-term finance on concessional terms for expanding the priority industries which are subject to price control. The kind of terms on which institutional finance is available to an entrepreneur affects his investment decisions in two ways. What he pays by way of interest charges and the provision he has to make for the amortisation of his loans enter into his cost-profit calculations. Secondly, the people who invest in the equity capital of an enterprise inevitably and rightly expect a higher return than those who make secured loans to it.

12.33 Direct taxation as a rule affect the level of returns to the investor by taking away a part of the gross profits which he earns. However, if his costs are not more than covered by the prices at which he is able to sell his product and he does not earn any profit, a lower rate of direct taxation would not help him. The only way in which direct taxation can help him to improve his profitability as distinct from the share of profits which he can retain, is by measures which help him to reduce his costs. These generally take the shape of allowing depreciation at enhanced rates so that his overneds get reduced.

12.34 Finally, there are licensing controls of various types. They are more effective in preventing investment going into undesirable channels than in promoting the flow of investment into desired ones. To stimulate investment in industries whose growth needs to be accelerated fiscal policy can play a significant role. When discussing customs duties we have drawn attention to the inter-relationship between import control and import duties. Similarly, selective or differential commodity taxation is as potent a factor in influencing the flow of investment as industrial licensing under the Industries Act. At the very least, it should be ensured that indirect taxation and industrial licensing work in unison and harmony rather than at cross purposes. If licensing policy for any product is restrictive a relatively high excise duty would be called for while if the industrial licensing policy is liberal both direct and indirect taxation can help in achieving a good rate of growth in the industry concerned. A tax on a commodity enters a wedge between supply and demand prices and can be used to modulate market forces in accordance with the national priorities. . Indeed it is possible to use indirect taxation as the main instrument for regulating the flow of investment so that it acts as a substitute for investment licensing. The level of the tax plus cost of production will determine the selling price and the tax should be so adjusted as to restrict the flow of resources into different industries to the desired extent.

12.35 To complete the picture we would add that the manner in which the resources, mobilised through taxation or otherwise, are spent or invested by Government is equally significant in the impact which it has, social and economic, on the life of the community. The picture of progression of the tax system can be modified for the better or for the worse by the pattern of budgetary outlays depending on the income groups which benefit from Government investment and expenditure. To the extent that some products are subsidised they may accentuate or moderate the burden which the tax system places on different income groups. The kind of demand which emanates from the public sector also operates as a powerful force in determining the patterns of investment in the economy.

13. CONCLUDING OBSERVATIONS

13.1 The prime purpose of a tax system is to mobilise real resources needed for promoting economic and social progress. But the very process and manner of resource mobilisation, the incidence of taxation, and the encouragement or discouragement that it gives to diverse economic activities, are not without their own socio-economic consequences. From the social angle what is most needed is that taxation should have an adequate measure of progression. From the economic view point, the tax system should encourage the kind of economic activity to sustain which resources are being mobilised, while at the same time, should least reduce the efficiency of resource use.

13.2 For the tax system to subserve these objectives it must have stability. It should not be tinkered with frequently either in the interest of revenue or to deal with day-to-day problems or to resolve the difficulties of particular producers. The need for higher revenues should be met in a manner which does not upset the structural balance of the system once it has been rationalised. This, we believe, should be possible if the system is rationalised and changes effected along the lines of our recommendations.

13.3 In conclusion, we would like to summarise the highlights of our findings and recommendations so as to bring out the major directions of change in the tax system that we envisage. The system of indirect taxation that we have today is the result of a more or less uncoordinated growth of major individual indirect taxes levied independently by the Centre and State Governments and Local authorities. The structure of each of the major individual indirect taxes is itself not entirely rational or internally consistent, and their interaction often serves to compound their harmful effects. The objectives of tax reform should, therefore, be to eliminate the overlapping of different taxes and to rationalise the internal structure of each of the taxes in such a way that they are rid of their major deficiencies and would become the building blocks for a harmonious indirect tax system in the country. The most serious deficiencies in the system of indirect taxation can be traced to (a) the widespread taxation of raw materials and other inputs under import, excise and sales taxation, mainly for raising revenue and not always with adequate regard to the economic consequences flowing from such taxation; (b) the overlapping coverage of excise and sales taxation over a wide range of products; and (c) the inequitable distribution of tax burden among States inter se through the attempts of particular States to export part of their taxes to the residents of other States.

13.4 In the field of excise taxation, our major proposals relate to: (a) the rationalisation of the duty structure on final products such that progression could be more easily achieved and our economic priorities fulfilled; (b) rationalisation of the rates of duties on raw materials such that materials that are close substitutes will be treated similarly unless there are special economic reasons to the contrary and high rates of taxes on particular materials imposed for special reasons in the past will be curtailed in the interest of lowering the cost of production in the economy as a whole and (c) taking major steps within a time-bound programme of action towards the solution of the problem of cascading, first by extending the application of existing procedures for the relief of input taxation and finally moving over to a system of Value Added Taxation at the manufacturers' stage.

13.5 Import duties on products fall mainly on raw materials, intermediates and machinery. This has the effect of bringing about a general increase in the cost-price structure which, apart from being undesirable in itself, tends to make our industries less competitive in the international market. The very high level of import duties on some products generates a vicious circle which leads other industries to seek higher protection in order to survive. A reversal of this trend, particularly when our foreign exchange position is comfortable, is necessary. The long term objective of the reform of import taxation should be to lower the rates of taxation on different inputs and machinery to levels that would be necessary to give adequate protection and have an element of discouragement of imports. Such adjusted levies would serve purely economic purposes and to them would be added a countervailing duty equivalent to the excise on similar commodities/products. We recognise that this reform could only be gradually carried out. Once import duties are rationalised along the lines suggested above, they could be harmonised with the operation of the excise tax system because then the countervailing duty on imported products would be given the same treatment as excise duties on domestic products.

13.6 In the field of sales taxation, our proposals are based on the principles (a) that sales taxation by a State should essentially be imposed on its residents without impinging on costs of production in the economy and without significantly affecting the residents of other States, (b) that the principle of a unified market within the country should be preserved, (c) that if the tax is to play a distinctive role it should cover also value added at the post-manufacturing stages, and (d) that there should be as far as possible uniformity in procedures and even in the broad structure of taxation in different States. Accordingly, we have recommended that the State Governments should gradually move over to a single-point tax at the last stage. Secondly, sale of inputs to registered manufacturers should be free of taxation so that, as under excise, so also under sales taxation, inputs would be completely free from levies. Thirdly, the inter-State sales tax, now subject to a ceiling rate of 4 per cent, should be gradually brought down to one per cent.

13.7 The principle of a unified market implies that there should be no import or export duties when goods move within the country from State to State or from place to place. We have, therefore, recommended that octroi, which are in the nature of import levies and often act as transit levies, should be totally abolished.

13.8 If our major recommendations are implemented, the resulting system would approximate to an integrated and extended indirect tax system ranging from the import and manufacturing stages to the stage of the large retailers, with full relief for input taxation and therefore completely free from problems of cascading and distortions in the allocation of resources. At the same time, excises and sales taxes would have clear and distinctive roles within their rightful spheres and would enable us to maintain relatively unchanged the division of tax powers as contemplated in the Constitution.