

A Model for Designing the Rate Structure of Sales Tax

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The literature on public finance suggests broadly two criteria for designing the rate structure of a tax, namely, equity and efficiency. The former demands a relatively higher tax rates on luxuries than non-luxuries, and the later reverse of it.^{1/} The existing rate structure of sales tax in the States, on the whole, reveals that policy makers prefer to use the equity criterion (see Section I). However, a problem a tax administrator faces is : what should be the relative difference between the tax rates on different types of commodities so that a desired level of equity can be achieved. The recent developments on optimal taxation theory suggests a method based on social welfare function which takes into account both efficiency and equity criteria. However, its practical utility in this context is limited particularly with respect to the level of availability of data in developing countries.

This paper attempts to suggest a simple operational technique to evolve the rate structure of sales tax so as to achieve the desired level of equity in the tax system. The paper comprises two sections : the first briefly examines the rate structure of sales tax prevailing in the major Indian States and thereby to show whether any principle underlies the rate structure ? and the last attempts to devise an operational technique for designing the rate structure and illustrate the technique with the help of examples.

I. Rate Structure of Sales Tax in Major Indian States

Table 1 gives information on sales tax rates on different commodities in all major States. Overall, States levy lower taxes on mass consumption goods than on luxury goods. For example, cereals and pulses are taxed at not more than 4 per cent or are fully exempted from the tax in some States; non-hydrogenated edible oils are subject to rates ranging from 2 per cent to 6 per cent;