VII. A REVIEW OF STATE TAXES

The separation of taxing powers between the Centre and States enjoins a collective effort on both forms of governance to record tax collections as close as possible to the available potential. In this respect, if respective shares of Central and State tax collection is any indication, States seem to have applied a relatively larger effort to garner tax resources. This has been in evidence since early 1990's when the States's share in total tax collection increased from 33.5 percent in 1989-90 to 38 percent in 1999-2000. Upon closer examination it is revealed that more than State's applying extra effort in relation to GDP, it is the deterioration of Centre's performance in relation to GDP, which has accounted for a larger share of States tax resources.

Thus, while Gross Central taxes in relation to GDP fell from 10.69 to 8.80 percentage points, State's own tax revenue remained by and large stationary at 5.38 percentage points. Clearly, maintenance of performance is not enough and this has prompted both the Eleventh Finance Commission and Advisory Group on Tax Policy and Tax Administration to assign higher targets for States for their terminal year projections. Thus, Eleventh Finance Commission seeks an improvement of State taxes to 6.44 percent of GDP in 2004-05 and the Advisory Group assuming the same pace of improvement arrives at a target of 6.90 percent in 2006-07.

An improvement of the order of 1.52 percentage points envisaged by the Advisory Group over the period 2000-07 is no small task. To make this order of improvement possible, one starts with focussing on State Sales tax, which easily being the most dominant accounts for 59 percent of aggregate State taxes in 1999-2000. In fact with State Excise, the total share stands at 74 percent. The next question therefore addresses the necessary steps required to further improve the yield from sales tax.

Fortunately some of the steps have already been initiated. The consensus on uniform floor rates of Sales tax across States and withdrawal of sales tax exemptions to industries is one such instance. The consensus has ensured that States do not indulge in tax concessions for the purpose of diverting trade and manufacturing activity into their territory. Hitherto, this was definitely not resulting in revenue gain as was expected by State Governments. The consensus therefore seeks to reverse this trend and augment the sales tax revenues of all States. In fact for most of the States, the adoption of floor rates has implied elevation of existing rates, which must definitely translate into higher revenues.

Unfortunately, the consensus on floor rates has been managed on only around 200 items with around 100 items still eluding consensus. While a comprehensive coverage is the immediate objective, it may still not equate the total number of operative rates with the number of floor rates. Thus, in many States, a specified category of commodities has more than one operative rate even though all rates may be above the assigned floor level. A single rate equal or above the floor rate is clearly called for if total number of operative rates in each State is desired to kept at a minimum size for the purpose of simplifying VAT administration. As a result against five floor rates, the maximum number of operative rates will also be five.

For the sole purpose of augmenting revenues, withdrawal of sales tax incentive with *prospective* effect is clearly not adequate. As of now many industries, which have been recently exempted are enjoying exemption for as long as twenty years. Clearly the beneficial impact of withdrawing exemption cannot be *immediately* felt unless exemptions are withdrawn with *retrospective* effect. While legal fall-outs of this policy stance may require further examination, sustenance of goodwill between Government and Industry will surely entail sympathetic considerations along lines, which may recompense affected industries on a gradual basis.

The next step on the agenda is to move over to State Value Added Tax (State VAT). Integral to this adoption is the withdrawal of Central Sales Tax (CST), which hitherto was making dealers send goods to importing States laden with tax. The imported tax was taxed again under first point general sales tax in the importing State resulting in

the phenomenon of ‘tax on tax’, a practice not admissible under VAT. The committee, which managed a consensus on uniform floor rates is working towards gradual withdrawal of CST as well. However, the task is insurmountable as net exporting states stand to lose revenue for which some compensatory formula is yet to be evolved.

Further, unless CST is withdrawn, one cannot even contemplate a system of VAT within each State. For if a closed system of VAT is adopted in the presence of CST, local importers would shift purchases from outside the State to within as doing so would enable them to claim tax credits and increase their profit margin. Free market trade would again stand distorted, the very outcome which a State level VAT seeks to arrest. Thus, one cannot talk of State level VAT in presence of CST and the latter must be done away with before one treads the path of transition. Once the transition to State VAT is accomplished, the revenue implications are highly favourable. For this would expand the tax base by including value additions of those dealers located after the first point trade, which hitherto are left out under the system of first point sales tax. The expansion of base would make VAT revenue more buoyant, both in terms of GDP growth and profit margins of all traders.

At present, there are no countervailing duties on imports with respect to state sales tax (later to become a system of State VATs), except the special additional duty, which only partially addresses the problem. In order to provide a level playing field to domestic industries within each State, a countervailing duty with respect to State VAT may have to be thought of in the changed context where quantitative restrictions and high tariff walls have been withdrawn.

The system of State VAT would fail to deliver the desired results if it is not supported by an appropriate administrative backup. Unfortunately, very little progress has been reported on this front with only token computerisation of Sales tax departments undertaken in few States. Undoubtedly, since State level VAT will be adopted in the near future, under this assumption, notwithstanding the delays in reaching a consensus on CST, States must invest in evolving a suitable administrative back-up under which comprehensive computerisation of sales tax returns is imperative.

While doing so, computerisation must be oriented towards enabling collating of information both within and across the States. Information, when collated would satisfy the following requirement intrinsic to checking evasion. Information on gross sales reported by a dealer will be sent to the jurisdiction where the sales are made so that the concerned Sales tax department there could cross check this information with the purchase records furnished to it by the dealer, who has made the purchase and *vice-versa*. Under this system, the exporting jurisdiction would benefit by correctly assessing the reported sales for the purpose of estimating Gross VAT payable and the importing jurisdiction would benefit by correctly assessing the reported purchases for the purpose of estimating the admissible tax credits. *It is essential that even before the imposition of State level VAT, the administrative mechanism should be put in place so that a few trial runs would help determine revenue neutral VAT rates.*

If inclusion of dealers located after the first point trade expands the State VAT base, inclusion of additional commodities will have an identical impact. Among other things, elimination of tax rental arrangement under the levy of Additional Union Excise duty, on sugar, tobacco and textiles to State Governments has been argued by Eleventh Finance Commission as well. These commodities by virtue of being classified as items of mass consumption are taxed at low and identical rates across the country by the Central Government and transferred to States through formulas devised by Finance Commission. These items do not attract any State levy, which inhibits States from maximising their tax yield and consequently their own revenues. While transfer of these commodities to States would enhance overall tax buoyancy, the social impact of higher and differential rates will stand to be addressed by States individually.

Under State level VAT, inclusion of State Excise may or may not be undertaken. In any case, the structure of State Excise levy has to be suitably amended. Presently, State excise on liquor is levied as a specific duty based on the alcohol content. The duty gets included in the sale price of liquor on which a sales tax is levied. Thus it is the increase in value additions due to higher sale price of liquor, which is taxed with no contribution resulting from the specific duty due to changes in manufacturing costs. There is no justification for levying an identical excise duty on foreign scotch vis-à-vis a domestic brand even if the alcohol content in both is same. After all distilling costs of a

superior brand is bound to be higher, which must be captured by an appropriate tax tool. If the specific duty were to be converted into ad valorem rate based on the manufacturing cost of liquor, not only the Excise revenue but subsequently the sales tax revenue would tremendously improve their yields. Even under the system of VAT where Excise credit may be given against sales tax, the buoyancy under the amended structure will still be higher than under the present disposition.

In a regime where ad valorem rates are first best rates for maximising tax bouyancy, there is no reason why these rates cannot be instituted with respect to Motor Vehicle tax as well. While a few States have moved over from specific rates based on the weight of the motor vehicle to ad valorem rates, others have not undertaken this transition. This may be due to the notion that Motor Vehicle tax being compensatory in nature for the damage caused to roads must therefore relate to the weight of the Motor Vehicle. However, if one were to recall the basic annals of a sound system of taxation, one of the requirements is that any tax system must be progressive. Motor Vehicle Tax could be progressive only if it is related to the price of the vehicle. There is no justification for vehicles belonging to luxury car segment to pay the same tax as a small car segment, even if their weights happen to be identical.

One of the major State taxes, which have a tremendous scope to improve its yield are duties on Stamps & Registration. Experience shows that a much lower yield vis-à-vis available potential is due to a large gap between registered value of transacted land and the prevailing market price. The under reporting of transacted price, which is in region of more than 50 percent of the market price has proved to be the bane for a healthy collection of registration duties. Few States have tried to set this right by resorting to State purchases of land in those cases where registered value is perceived to be grossly low in relation to the market price and subsequently disposing it off at a better price obtained through auction. Others have declared region specific floor prices for using these for assessment if registered values fall below floor prices. However, Stamps & Registration duties in relation to GDP has only marginally improved from 0.38 in 1989-90 to 0.47 in 1999-2000. Clearly, none of the two efforts has resulted in substantially increasing the collection whereas it is common knowledge that real estate prices have phenomenally increased during the last decade. There is no alternative therefore but to

improving upon the administrative machinery. While budgetary provision for enabling State purchases of land could be suitably enhanced, region specific floor prices must be continually reviewed, at least on an annual basis.

One of the biggest sources of evasion of Stamps & Registration duties is outstation registration wherein for instance property purchased in West Bengal could be registered in New Delhi and *vice-versa.* Evasion is further aggravated if rates of registration are different in the two centres. State wise revenue generation from this source could be protected if all centres agree not to register out-station properties and have identical rates in order to eliminate any incentive for doing so. Further, since registration is not mandatory, some form of building tax may also be considered in lieu of registration with the proviso that it would be waived if the property is registered in the first place.

A review of State taxes cannot be complete without discussing the levy of Agriculture Income Tax (AIT). AIT as of now is almost non-existent and is present in the variant of plantation tax in a few States and some historical, non-revised rates of land revenue in others. Expectedly, land revenue is merely 0.8 percent of GDP in 1999-2000. For the singular purpose of increasing the yield, many options have been discussed with a productivity based land tax, levied and collected at the level of local bodies being the most prominent of all. However, from a broader perspective of raising tax mobilisation at the State level, AIT holds very little promise. This is because of a declining share in GDP of the Agricultural sector due to which it is admitted AIT may not figure in the priority list of proposed tax reforms.

What however does figure prominently in the priority list is the expanding share of services (including construction) in GDP, which offers a substantial scope for levying service tax. A service tax, suitably legislated at the State level would not only secure a buoyant source of revenue to State Governments but reduce pressure on the manufacturing sector to garner revenues for Government. In fact, this is one way by which State Governments could agree for withdrawal of CST and also refrain from raising sales tax rates much above the floor rates for increasing their revenue. It is in the fitness of things therefore that Advisory Group though including service tax in the

Central domain requires it to increase from 0.10 percent in 1999-2000 to 0.57 percent in 2006-07. In fact, services by being a part of a comprehensive State VAT could help achieve this target.

In the absence of service tax, the expanding share of the service sector is resulting in substantial investment in small savings. Since 80 percent of the net small savings is lent to State Governments on an automatic basis, net borrowings or Gross Fiscal deficit of States grow in an unbridled manner without any link to expenditure requirements. The imposition of services tax could easily mop up some part of income generated in the service sector, which while entailing positive implications for revenue generation would also keep the growth of borrowings and consequently Gross Fiscal Deficit in check.

In conclusion, it must be reiterated that if the State taxes have to meet the targets set by the Advisory group for 2006-07, the terminal year of the Tenth Plan, the focus must be towards ensuring a transition to a full fledged State level VAT, changing specific duties to ad-valorem rates under State Excise and Motor Vehicle tax, drastically improving assessment of Land prices for raising collections under Stamps and Registration and effecting a suitable legislation to enable States to levy service tax.