TOWARDS A COMPETITIVE ECONOMY:
VAT AND CUSTOMS DUTY REFORM

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VAT AND CUSTOMS DUTY REFORM

Content

I. INTRODUCTION

It is possible to look at different taxes in isolation or in a broader context. Each has its advantages and disadvantages. In this paper we examine the issue of indirect tax reform, with a special focus on customs duty reform. Customs duty in India consists of 'basic' tariff, which is the protective element, and the Additional Duty of Customs (AD), which is a counterpart of excise duties paid by domestic manufacturers i.e. countervailing duty (CVD). In recent years a Special Additional duty (SAD) has been introduced, which is supposed to be the counterpart of taxes imposed by States on domestically produced goods.[1] Thus the customs duty as a whole is intimately related to the domestic taxes, and it is useful to view customs duty reform in the overall context of direct tax reform.

A.   EXCISE & SALES TAXES

There are a number of indirect taxes at the Central and State level, often cascading or overlapping. The most significant on the domestic side are Central Excise taxes (later MODVAT then CENVAT), Central Service tax, Expenditure tax, State excise, sales & entertainment taxes, the Central Sales Tax (CST),[2] and State taxes on specific services. There are also a host of minor taxes imposed by the States on the sale, purchase, storage and movement of different goods.

Since 1990-91 central excise tax revenues have fallen by about 1 per cent point of GDP. About 0.7 per cent of GDP drop occurred in the first few years after the introduction of MODVAT. One of the reasons is that unlike in many other countries that introduced a VAT system did so by replacing in one year all their existing indirect taxes by the simple VAT, the process has been excessively drawn out in India. Over 100 countries across the world have a Value Added Tax system of indirect taxes. The process still remains incomplete in India, however, in that even the Central Excise Tax system is still much too complex and hemmed in by restrictions and has some way to go before it becomes a true Central Value Added Tax (CENVAT). In the case of the States an even greater distance remains to be traversed.

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[1] This is strictly true iff states do not impose further taxes on the sale of imported goods after they move from the port/airport or out of the State in which it is located.
[2] The revenues from the CST are normally accounted for under the State sales tax.

B.   CUSTOMS DUTIES

The customs duty "collection rate" for any year represents the total customs duty collected under all three sub-heads (basic, AD & SAD) divided by the total value of imports during the year. The simple 'average' customs duty is in contrast the average of the "basic" customs duty rates (published in the customs tariff manual). The "peak" tariff rate also refers to the same 'basic' customs tariffs and is the highest general rate applying to a large majority of imports. Selected commodities (e.g. alcohol) have a 'basic' rate higher than the 'peak' rate. We define the "maximum" rate as the highest rate including the goods with tariffs exceeding the 'peak' rate.

India's customs tariff rates have been declining since 1991. The "peak" rate has come down from 150% in 1991-2 to 40% in 1997-98. The downward momentum was reversed the next year with the imposition of a surcharge. This momentum has resumed with the reduction of the "peak" rate to 35% in 2001-2 and 30% in 2002-3. The average tariff rate has therefore declined over the 1990s.   Our customs duty collection rate has consequently declined from about 47% in 1990-91 to 29% in 1995-96. The collection rate rose to 31% in 1996-97 before resuming the downward trend in 1997-8 (27%) to reach 23% in 1998-99. It has declined by about 1% point per year thereafter to reach 21% in 2000-1.[3] Average customs tariffs rates, however, remain among the highest in the world.

Out of a set of 122 countries for which data on (simple i.e. unweighted) average customs tariffs was available for 1999 or one of the three preceding years, India had the third highest average tariff rate (32.2%; rank 120th).[4] Only Cambodia and Pakistan had higher average tariffs than India.[5] Emerging market economies like Czech republic (6.8%), Turkey (8.2%), S. Africa (8.5%), Chile (10%), Mexico (10.1%), Argentina (11%), Venezuela (12.6%), Russia (13.9%), Poland (15.9%) and Egypt (20.5%) had average rates ranging from 1/5th to 2/3rd of India's 32.2%.

Given the past statements of all finance ministers during the nineties on bringing India's customs tariff rates to East Asian levels it is also useful to look at the tariff rates of

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[3] Economic Survey 2001-2
[4] The WTO data is compiled by them based on information from member countries, WDI, World Bank and other sources.
[5] The Cambodian data is for 1996, when India's average tariff was probably higher.

these countries. After Cambodia,[6] Thailand had the highest average tariff of 17.1%, followed by Vietnam (15.1%), Indonesia (10.9%), Philippines (10.1%), Taiwan (8.8%), S. Korea (8.7%), Malaysia (7.1%) and Singapore & Hong Kong (0%). All our South Asian neighbours such as Sri Lanka (20%), Bangladesh (22.2%) and Nepal (17.7%) as well as our northern neighbour China (16.8%) had lower average tariffs than us.   "This creates additional problems of import diversion and smuggling. The fact that India has some form of free trade arrangement with several of its neighbours means that it becomes profitable to import many items into these countries and then export them to India. Any objective assessment would suggest that Indian industry can surely compete with industry in these countries and there can be no rationale for an average rate higher than that of Nepal [8]." [7] Bringing down India's import tariffs below those prevailing in Nepal will reduce the incentive to use Nepal as a conduit for tariff jumping.

Reform of the import duty structure within the existing commitment to bring the peak duty rate on "basic" customs duties to 20% creates certain constraints on rationalisation of the entire structure and elimination of anomalies by 2004-5. It is necessary to eliminate end-use and other exemptions that have been accumulated in an ad-hoc manner over the past several decades. Besides reducing complexity, litigation and incentives for evasion & corruption, this has the additional benefit of facilitating the elimination of anomalies.

Even if our peak rate is brought down to 20% by 2004-5, we will still have some way to go to reach the tariff levels of East Asia as they stand today. In the meanwhile most ASEAN rates are to be reduced to the 0%-5% under the ASEAN free trade (AFTA) agreement. This will reduce the average rates of Thailand, Indonesia and Malaysia even further below ours. Similarly China has made commitments to reduce tariff rates over the next 3 to 5 years. The average tariff rates of the large OECD countries are clustered round 5%, with Canada at 4.6%, USA 4.8%, Australia 5%, Japan 5.2% and EU 5.6%. Switzerland (0%), Norway (3.3%), New Zealand (3.8%) have lower average rates. It is therefore imperative, to go beyond the existing commitments, and bring peak rates to E. Asian levels during the 10th Plan and to Developed country levels during the 11th plan.

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[6] Cambodia and Laos have been admitted into ASEAN only recently.
[7] [8] refers to references at end.

II. VISION 2010

A.   *Analytical Insights*

The structure of indirect taxes has to be viewed in an integrated manner not just as between the Centre and States, but also across the entire range of taxes on goods and services imposed by both these levels of government. It is useful to start by ignoring the complications introduced by administrative costs, tax evasion and corruption. In this ideal world, the social welfare maximising, 'optimal' indirect tax structure for raising a specified amount of revenues is given by the so-called Ramsey rule: That is a differentiated set of taxes on (final, finished) consumer goods and services. The same tax rate applies whether the consumer good is domestically produced or imported, as there is no room for protective customs duties in this structure.[8] There is no tax in this optimal indirect tax structure on raw materials, intermediate goods or capital goods.   To implement the optimal differentiated structure requires a detailed knowledge of the demand elasticity and cross-elasticity for all goods & services as well as the social welfare function. No country has thought it of practical use or sufficient importance to obtain these detailed econometric estimates and use them to derive the detailed differentiated indirect tax structure. This theoretical exercise, however, provides several insights that are useful in constructing a practical, yet reasonably efficient, indirect tax structure.

The most important insight is that there should effectively be no tax (i.e. zero rate) on raw materials, intermediate goods, capital goods and services used for production of goods & services. The second insight is that efficiency considerations drive the differentiated structure of consumer taxes towards higher rates on goods & services with low demand elasticity. In the case of de-merit goods like cigarettes & tobacco products and (perhaps) hard liquor this proves easy to apply. However, as necessities have lower elasticity of demand than luxuries this runs contrary to the equity objectives that tend to drive the tax structure in the opposite direction (assuming a reasonably strong desire for social equity as commonly professed in India). The net result depends on the detailed elasticity.

There are two other lessons that involve a greater element of judgement: That efficiency and equity considerations tend to balance each other and that a near-uniform structure of indirect taxes may be a useful starting point for a reasonably efficient and

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[8] That is, Basic customs duties are 0 in the optimal tax structure.

equitable tax system. Another is that there is a case for taxing at a somewhat higher rate goods & services that are complementary with leisure (e.g. goods & service for entertainment), though the force of this argument is diluted in a large population countries (like India) with substantial or 'hidden unemployment' or 'under-employment.

This is the appropriate point in which to bring in the problems of tax administration, evasion and corruption that loom so large in developing countries (emerging markets) and which this theoretical exercise has totally ignored. Logically the structure of optimal taxes based on reality (varying administrative costs, evasion costs & corruption possibilities) would differ markedly from that given by the "ideal." There is wide agreement among tax experts who advise governments on tax reform that these problems argue strongly for having an indirect tax structure that is simple and as close to uniformity as possible. Complexity facilitates and encourages tax evasion and corruption. It also provides an incentive for lobbying by powerful organised groups to obtain special favours for themselves. This sets in motion a spiral of complexity, evasion & corruption that is not based on any empirical knowledge (of elasticity) and results in a tax structure that bears no relationship to the so-called ideal "optimal."

The second implication of this reality (administrative costs, evasion, corruption) is that the best way to implement a uniform structure of indirect taxes is through a value added tax. A uniform value added tax (VAT) has the same efficiency & equity properties as a uniform sales tax on final finished consumer goods, but by collecting the tax at multiple points and in smaller doses it minimises the incentive for evasion. It also has (in principle & if implemented properly) the property of catching at a later stage the tax evasion that has taken place at earlier stages of production/ value added. These considerations have led an overwhelming majority of countries (not just developing but even developed) to replace their existing indirect taxes by a Value Added Tax.

Revenue considerations argue against reducing the protective (basic) customs duty to zero by 2010. Lower collection costs and the greater difficulty of evasion suggest that non-zero protective duties (basic duty of customs) may not be as inefficient in developing countries with severe administrative problems in tax collection as they are in the "ideal" world. If a separate revenue target is fixed for revenues from this tax source, then a close to uniform basic customs duty perhaps creates the least distortion.

We are now in a position to spell out a vision for an indirect tax structure for the country (Centre & States) that will be simple, efficient and equitable. This should ideally replace all central and state government taxes on goods and services.

B.   *National VAT*

An ideal indirect structure for the country would in our view consist of two sets of indirect taxes (a constitutional amendment would be needed for this purpose):   A single uniform rate National VAT on all goods and services (except for a limited number of pre-specified exemptions) and State sales taxes on a dozen specified goods with a pre-specified upper limit on the sales tax rate for each of these goods.   The Central government would have the responsibility of setting the national VAT rate in consultation with the States and for administering it with the help of the States as needed.   Preliminary calculations suggest that a VAT of 15% may be sufficient to ensure revenue neutrality with respect to existing Central & State indirect taxes.   The proceeds from this tax would be shared between the Central government and the States in the proportion necessary to ensure that there is no diminution of the States' indirect tax revenues.   To ensure that the indirect system is equitable, and to support positive externalities, the following goods and services would be exempt from the VAT: Food, including processed (cereals, pulses, vegetables, fruits, milk & products and possibly sugar), Drugs, Medical Equipment & medical services (Diagnostic; Disability compensating or Disease preventing/curing), Environment friendly fuels (Cooking gas, kerosene), Educational services and Knowledge services (Educational material, R&D, Testing, Consultancy).   There would also be a sales volume exemption of Rs. 1 or 2 lakh (say) based solely on the need for minimising compliance & administrative costs.   All other exemptions should be abolished.   Administration of the system for transactions up to some limit (Rs. 10/20 lakh say) could perhaps be decentralised to the States.

In addition, the State government would have the right to levy sales taxes on a limited set of final, finished consumer goods (to ensure that there is no cascading & no taxation of intermediate goods).   The maximum total tax on any good or service should not exceed 50%.[9]   This means that with a VAT rate of 15%, the sales tax must not exceed 35% (upper limit/maximum).   Such a high rate could however be applied only to de-merit goods such as tobacco products (cigarettes, cigars, chewing tobacco) and hard liquor.   Fuels with negative

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[9] The incentive for tax evasion becomes so strong that corruption is sure to follow.

environmental externality, such as petrol & diesel, could be subject to a maximum sales tax of 25%. The same maximum rate could also apply to cars and low ($\leq$ 5%) alcohol beverages like beer & wine.[10] A few other items such as Air travel, Air Conditioners, Motor cycles/scooters & home entertainment products (excluding radio & TV), Entertainment services like cinema, Hotels & Restaurants service, could be subject to a maximum sales tax of 15% (i.e. 0% to 15%).[11] Across the world, Sales taxes are normally levied at the point of sale to the consumer. Because of evasion & related problems, India follows the practice of "first point sales tax," where the tax is collected at the point of sale by the producer. Strictly speaking this is better termed as an excise tax. However, as long as cascading and multiple taxation are avoided and all States follow the same method, either method can be adopted.

Both the national VAT and the State Sales taxes would apply to imported consumer goods & services in the same way as they do to domestically produced ones.[12] Imported goods would enter the VAT chain at the point of entry into the country and from there on be treated exactly as if they had been produced in India.[13] The final point of sale collection (of sales tax) has the merit that each State can collect its own sales tax on imported goods. If the first point Sales tax (excise) methodology is adopted then an excise/sales/SAD tax will also have to be collected (on the specified set of goods) at the customs point on behalf of the States. This creates undue complexity if the States have different rates of tax on the same good.

C.   DUAL VAT

The proposed National VAT and related sales tax structure will require an amendment to the constitution. Given the nature of the change this will have to be preceded by extensive discussion between the Centre and the Sates. Development of a consensus, the formulation and completion of this process and its implementation could take a decade, if not more. It is therefore useful to set a more pragmatic target for the Tenth Plan that is not only desirable in itself, but can also act as a half-way house to the ultimate goal. In our view this is a Dual VAT structure that, (a) replicates for the Centre the structure envisioned for the National VAT, but without violating (in spirit) the existing constitutional powers of the Centre and the

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[10] This does not include non-alcoholic carbonated beverages. These should not be subject to sales tax.
[11] Note that the VAT would replace the existing set of entertainment taxes, expenditure tax, sales tax etc. The case for an additional sales tax is therefore much weaker.
[12] Though the AD reflects the former the congruence between SAD & the latter is questionable.
[13] There are certain special situations such as temporary import or re-import of previously exported goods that would have to be treated differently as detailed below.

Sates, and (b) transforms the existing State taxes into a system that includes as many of the features of VAT as possible. This may however require some constitutional modifications to close the loopholes in the VAT chain.

1. CENVAT

The most important element of Dual VAT is a Central VAT that approximates as closely as constitutionally possible the National VAT outlined earlier. The main features of such a CENVAT can be summarised as follows:

a) Universal incidence & Set-off

To be called a [central] VAT, the excise tax must become comprehensive and universal, so that every producer pays excise duty on his total output of goods. Excise paid on all excised or excisable inputs used in the production or marketing of the good whether they are "consumable," "design and drawings", or anything else must be deductible from excise paid on the final output. Extension of the system to the wholesale level would facilitate a continuous chain of deduction or set-off. An constitutional change or agreement with the States that allows the central government to bring wholesale trade into the CENVAT net, while promising to return to them the revenues from value added at the wholesale stage would be desirable.

b) Single Basic Rate

The key to a comprehensive VAT type system is a single general or basic ad-valorem rate, which is eligible for VAT deduction (or credit).[14] The base rate has been set at 16%, even though a 15% rate is somewhat simpler for taxpayers (as is the metric system).[15] This rate falls in the band in which most countries' VAT rates lie. Most of these countries do not, however, have separate state sales taxes. Our state sales taxes are mostly in the range of 8% to 12%, with a few rates (e.g. cars, petrol) as high as 20%. If sales and other domestic taxes were incorporated our domestic indirect tax rates would be among the highest in the world.

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[14] We can switch from a deduction to credit system once the computerised checking system is in place.
[15] $1/10^{th}$ of value+1/2 of the $1/10^{th}$.

When we extended the MODVAT system during the nineties, we had consciously chosen to provide for full expensing of the excise paid on capital goods rather than set up a system of annual depreciation related deductions. The spreading of the excise deduction on capital goods over two years (i.e. an implicit straight line depreciation over two years) in the 2000-1 budget unnecessarily complicates the system and vitiates the potential benefits from drastic simplification of the administrative system & procedures. It also raises the effective excise tax on capital goods by about 3%. The high tax rate on polyester, a hangover from the past, constitutes a serious violation of the uniform basic rate principle.[16] The high excise rates on carbonated beverages also violate the spirit of the CENVAT.

c)   Equity

An equitable indirect tax system requires (in my view) lower effective indirect tax rates for basic human necessities. Food is a very important part of the consumption basket of the poor. With such a large proportion of the population poor and an equal proportion (APL) living under the threat of poverty, food products must be exempted from the CENVAT to ensure that it is equitable. Ill health is an important cause of people moving from above the poverty line (APL) to below the poverty line (BPL). In principle, therefore medicine/drugs and medical equipment (i.e. disease & injury related) should be fully exempt. The current system of exemptions for life saving drugs, life saving equipment and special gadgets and equipment for the handicapped could be universalised to cover all scheduled drugs, and drugs & medical equipment required to prevent or treat disease and disability.

This is also consistent with the renewed thrust for Knowledge Based industries (like bio-technology) and Agriculture. The new system of deemed credits for agriculture (proposed below) would allow us to retain the basic CENVAT rate on processed food, while reducing the currently high effective rate on value added by food processing companies. When poverty (as per current definition) is eliminated and the country reaches middle-income levels in the next decade (2010 to 2020) these exemptions can gradually be phased out.

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[16] As recommended by the Revenue Department committee on, "Extension of MODVAT to Textiles", Department of Revenue, MOF June-July 1993.

d)   Positive Externalities

Lower tax rates can also be justified on selected goods on environmental grounds. Thus natural & biological fertilisers & pest-retarding agents could be exempted from CENVAT, as they act as substitutes for artificial fertilisers & pesticides, which are polluting water sources. Production & supply of Biogas and solar energy should also be completely exempt. There should also be a lower rate of tax on clean fuels such as LNG and LPG, as these fuels are substitutes for polluting kerosene and fuel wood.[18]

e)   Special Excise

A balancing of revenue and equity considerations also suggests a *few higher rates for demerit goods* like tobacco products (cigarettes, cigars, chewing tobacco or mixed in pan masala) and for *final, finished, luxury consumer durable goods* like cars. These should be in the form of a 'special excise', which is not eligible for VAT credit. Special excise rates of 5% (4%), 15% (14%) and 20% (19%) would be appropriate if the base CENVAT rate is 15% (16%).

Special excise can also be imposed on grounds of environmental pollution. Thus polluting fuels like Motor Spirit and Diesel as well as selected dyes & chemicals that damage water sources could have special excise taxes on top of the general rate of 15% (16%). The special excise should not exceed 25% (24%) so that the total does not exceed 40%.

f)   Import & Export

All imports would also be subject to an identical deductible VAT and non-deductible special excise as on domestically produced goods. The 'Additional Duty' must be renamed CENVAT to make it WTO compatible. The customs department must keep a separate account for this CVD/CENVAT so that it can be distinguished from protective customs duty and accounted for in the CENVAT accounts. *Exports* would be zero-rated and entitled to a refund on CENVAT paid (as they are today).

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[18] For this reason there should be no subsidy on Kerosene and the general CENVAT should apply. Government efforts should be focussed on facilitating commercial supply of cooking gas to all urban & semi-urban households & to promote Biogas in rural areas.

2.   SERVICE TAX

Central Service tax reform and extension must be designed to integrate it with the CENVAT by the end of the 10th Plan, keeping in mind the ultimate objective of a National VAT. The central service tax should therefore be integrated into the CENVAT by the end of the 10th plan. Then all services, particularly modern production services such as transport, communication and financial services, under the tax authority of the centre would also be subject to the same basic CENVAT rate. Similarly the tax paid on any services used as input (e.g. "telephone" or "insurance") into the production of excisable services or goods would be deductible (set-off). Any comprehensive Service Tax law must keep these objectives in view.

The second essential feature of the service tax law is that a service must be treated identically no matter who the producer is. Thus education services should be exempt independent of whether they are provided by the government, the co-operative or corporate sector. Thirdly, just as administrative convenience requires that low volume producers be exempted from excise, low volume producers/sellers of services should also be exempt. There seems to be no cogent reason for setting different limits for goods & services. Fourth, as the Service tax administration is a completely new one, it must be built on the best and highest standards of modern tax administration to be found across the globe. In other words it must be technology (e.g. web filing & computerised checking) & data intensive and analytical (accounts, economic flows) rather than manpower intensive and physically intrusive. It can thus serve as precursor for a modern VAT administration.

3.   STATVAT

The initial focus on harmonisation of State sales tax rates came from the fact that a National VAT must have a uniform basic rate. The objective was to move the States' sales tax systems to a MODVAT type of system and to simultaneously reduce the disparity in rates between the Sates. It appears that the first objective has been lost sight of in the effort to harmonise rates. In fact even the latter objective seems to be getting distorted by the fiscal crises to one of raising the rates. It is necessary to return to the original objective keeping firmly in view the objective of moving to a National VAT by 2010.

D.   *Customs Duty*

The broad operational approach to customs duty reform adopted during the 1990s remains valid. This consists of reducing peak rates, removing exemptions and simplifying the system. We however need a clear vision of where we will be at the end of the decade along with a schedule of customs duty reductions, so that economic agents (companies, business and farmers) can plan new investments rationally with better understanding of the policy environment. The country should move, in our view to internationally competitive rates of customs duty protection by the end of the current decade. This will give sufficient time for industry and agriculture to adjust to these changes, and for government to ensure that domestic controls and bureaucratic constraints are eliminated.

Customs duty reforms can be carried out in two phases, with the basic "peak" rate of import duty reduced to 10% by the end of the tenth Plan and to 5% by the end of the eleventh Plan.   More important, with the "peak" rate down to a reasonable level, virtually all exemptions can be eliminated by 10th Plan end so that 10% becomes the "standard" customs duty rate. At that point more than 9/10th of importable goods would be subject to a uniform basic customs duty of 10%. The "maximum" tariff rate would however be higher (30%). During the second phase the "peak" rate would be reduced from 10% to 5% and the "maximum" rate brought down to the "peak" rate of 5%. At this time there would be a single uniform basic custom duty rate of 5% on all goods.

The basic rate of duty on many agricultural goods and on cars is currently higher than the "peak" rate of 30%. These highly protected items with above-peak tariff rates consist of either agricultural materials or automobiles. It may be difficult to bring all these down to 10% by the end of the 10th Plan. The high rate exceptions should, however, be limited to a maximum of 1/10th of the tariff lines (at the 4 or higher digit level). The basic customs duty on these above-peak items should generally not exceed 20% in 2006-7. In extreme cases (e.g. hard liquor) not exceeding 1/100th of the tariff lines (at the 4 digit level), the basic customs duty can temporarily exceed 20% but should not exceed 30% in 2006-7. Thus 30% must become the "maximum" customs duty rate by the end of the 10th Plan.

Virtually all end-use exemptions as well as all temporary exemptions (considered below) would be abolished when the 10% peak rate is achieved.   There is already a commitment to reduce the peak customs duty to 20% by 2004-5 (as proposed by the Finance

Minister in the 2001-2 budget and reiterated in the 2002-3 budget). The phased reduction in the "peak" rate of basic customs duty should continue thereafter to 15% in the next year and to 10% by the end of the tenth plan. The minimum duty on exempt items earlier subject to a 5% duty would be raised to 10% by the end of the tenth plan. *At this point all anomalies would be removed with the exception of those arising from international agreements and higher temporary protection of agricultural raw materials*.

A single uniform rate of basic (protective) customs duty on all imports has many attractive features:

a. It ensures that the nominal protection for all imports is the same thus eliminating all classification problems and disputes, resulting in substantial saving in administrative and legal costs.

b. It makes it much easier to administer the duty free import regime for exporters. As a single rate applies to all imports only a total value of imports needs to be specified in any advance license, making actual import 100% flexible. Similarly any draw back or refund calculation only needs the value of imports used in export production.

c. Most imports can in principle be on self-declaration basis and customs staff can focus their time and energy on checking smuggling (through mis-decleration of quantity or concealment of item) and chronic misstatement of price.

d. If the uniform rate is reasonably low the incentive for smuggling will be minimised and make the administrative problem of checking it, manageable.

e. With a single, uniform nominal duty the effective protection rate is also identically equal to this rate. The rate of effective protection is therefore neutral and equal for all value added by domestic producers. This will increase the efficiency and competitiveness of the entire economy.

f. Uniform effective protection on all producer goods is more equitable in that it removes the discrimination against other producers. Higher protection for one set of producers inevitably results in lower protection for some other producer.

g. In the case of final finished consumer goods, there is much greater economic justification for a single uniform basic customs duty equal to that on producer goods

(with AD/CVD = domestic taxes on consumer goods), than there is for a single uniform rate VAT or CENVAT (applying equally to domestically produced and imported goods).

h. A low uniform rate duty will have the additional benefit of reducing our weighted average tariff rates below those prevailing in neighbouring countries. Our economic interests will then become much more closely aligned with theirs. Indian industry and agriculture will have much less to fear from special free trade arrangements with our neighbours than is the case today.

i. A low uniform duty that is close to the average for ASEAN countries will enhance India's case for closer economic integration with ASEAN. We can then take the lead in the formation of an Asian Common Market, instead of being treated as a highly protected pariah economy.

j. Such a regime will eliminate the continuous lobbying that now takes place, and the special benefits to large industry & powerful interest groups and losses to the small and unorganised, that inevitably result from such lobbying.

III. AVERAGE PROTECTION

A.   *Exchange Rate & Nominal Protection*

Most people look only at the explicit tariff rates when thinking of the degree of protection.   The exchange rate also influences protection and can be viewed (in layman terms) as providing additional protection to that provided by tariffs.

The nominal protection available to Indian producers of tradable goods (as a whole) is a combination of the exchange rate of the Indian rupee and the weighted average tariff-rate. At any point in time, different combinations of average customs tariffs and exchange rate can give the same level of protection.   This can be illustrated for 1999 by using the weighted average tariff quoted above (29.5%) and the average exchange rate prevailing in 1999-2000 (43.3327). The following table shows the combinations of weighted average tariff rates and exchange rate that would have given the same level of protection in 1999.

Table 1a. Equal Protection Combinations of Tariffs and Exchange Rate

	Exchange Rate (%)	Wtd. Avg. Tariff(%)	Rupee price of imported item per $ of US price
1	41.57	35	Rs. 56.12
2	43.17	30	Rs. 56.12
3	43.33	29.5	Rs. 56.12
4	44.89	25	Rs. 56.12
5	46.76	20	Rs. 56.12
6	48.80	15	Rs. 56.12
7	51.01	10	Rs. 56.12

To illustrate, let us consider a domestically produced item that costs Rs. 50. If the same item is available in global market for $1, the domestic producer of this item will have a protection of Rs. 6.12   (56.12 – 50) no matter which tariff-exchange rate combination in columns 1 & 2 of table 1a prevails.

For any given protection level, combinations with high customs duty rates, however, reduce the competitiveness of the Indian economy. These combinations are inefficient as they bias the overall economic system against exports. This is because a depreciated exchange rate (at the prevailing domestic prices) gives equal incentive to exports and import substitution, while a higher tariff gives a greater incentive for import substitution vis-à-vis exports.

1.   Inflation & Real Exchange Rate

Because of our higher rate of inflation compared to the world, over time, domestic costs also increase faster than international prices so we have to also adjust for this differential inflation. This means that we have to look at the real instead of the nominal exchange rate. The same basic principle however, continues to apply. There will be a combination of real exchange rate and weighted average protection that will give the same level of protection in 2000 and 2001 as the protection that was available in 1999 (as calculated above). For instance the inflation rate (WPI) in India in 2000-1 was 7.2% and the global inflation was about 3.2% (assumed). Maintenance of average protection at the 1999 level would have required an average exchange rate of Rs. 46.7 per $ if the weighted average tariff was reduced to 20% in 2000-1.

2.   Peak Rate

It is useful to see how the exchange rate changes illustrated in table 1a affect the goods subject to the peak rate. The following table, uses the actual peak rate prevailing in 1999-2000. Thus for instance if in 1999-2000 the peak rate had been reduced to 30% and the weighted average tariff to 20%, both average protection and protection of goods subject to the peak rate would have remained unchanged if the exchange rate was simultaneously depreciated to Rs. 46.76 per $ (from the actual average of 43.33). As is to be expected, commodities subject to the peak rate have higher protection than the weighted average protection. One indicator of this is the relative rupee price per US$ of imported item $(60.67/56.12 = 1.081)$ which is 8.1% higher than average for commodities subject to the peak tariff rate.

Table 1b. Combinations of Tariffs and Exchange Rate that provide equal protection

Exchange Rate (%)	Peak Tariff(%)	Rs. price of imported item per $ of US price
43.33	40	Rs. 60.67
44.89	35	Rs. 60.67
46.76	30	Rs. 60.67
48.88	24	Rs. 60.67
51.01	19	Rs. 60.67

3.   Non-Tradable Costs

An argument is often made that industry needs higher tariff protection, because of the relatively *high cost of infrastructure services and bureaucratic red tape* in India vis-à-vis other countries. High cost of non-tradable goods like infrastructure services relative to competitor countries is an economically valid argument for having a more depreciated exchange rate. In other words the higher protection should come through exchange rate depreciation rather than through higher tariffs; the former helps producers of exports and import competing products, while the latter helps only import competing producers. ***A high tariff protection leads to a high cost economy and erodes the competitiveness of the economy***. If non-tradable costs in any country with a freely floating currency are rising faster than those in other countries, the exchange rate will (ipso facto) automatically depreciate relative to these countries.[19] In an economy with a managed float, the exchange rate must be allowed to depreciate if the non-tradable costs increase. Such an exchange rate adjustment restores macro-economic and external balance.[20]

It should be noted that to the extent that different sectors are differentially affected by infrastructure costs and/or bureaucratic harassment costs, their relative competitiveness would be affected. This does not, however, provide an argument for greater protection of those industries that are most infrastructure-dependent or are subject to the greatest dead weight loss from bureaucratic interference. If infrastructure cannot be improved or bureaucratic costs reduced, there is no gain to the economy from promoting and protecting

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[19] This should not be confused with the problem of exchange range management when there are large capital movement. This problem has to be dealt with what ever the level or changes in non-tradable costs.

[20] It does not however, remove the deadweight burden on the economy, which reduces the per capita income of the economy besides adversely affecting investment and growth (i.e. future per capita income).

such industries more than others. Such protection will merely increase the dead-weight loss to the economy as a whole. The only sustainable solution is to improve infrastructure availability & quality and reduce harassment through policy and institutional reform. This will reduce the dead weight burden on those specific industries as well as the economy as whole, thus improving current & future (through higher investment & growth) per capita income.

4. Lifting of QRs and Imports

It is often asserted that an elimination of Import controls (particularly the lifting of Quantitative restrictions on consumer imports over the past few years) and the reduction in tariff rates has led to higher imports and adverse affect on domestic industry. The import data does not support this contention. Import of "Bulk consumption" imports (in US$ value) have declined by 4.3% in 1999-2000 and 40.7% in 2000-1. Similarly "capital goods" imports have declined by 10.9% in 1999-2000 and further by 2% in 2000-1. Non-oil imports as whole grew by only 3.2% in 1999-2000 and then fell by 8.5% in 2000-1. In April-January 2001 they have grown by 9.4%. At this rate they would barely exceed the import levels in 1999-2000.

B. *Effective Protection*

The protection that directly affects any individual producer is the effective protection rate applicable to his production operation. Any given producer uses a variety of inputs to produce output. In the process he adds value to the inputs he has bought from others. The process of production is in effect the process of adding value to the inputs, using capital and labour (factors of production). The effective protection that the producer gets on his process of value addition depends on the value added proportion, the average import tariffs/duties on the inputs used and the tariff on the output. A simple formula based on these parameters can be used to calculate the effective protection rate (EPR) based on these three parameters. This can be illustrated through a simple example.

Consider an internationally competitive producer who produces output using only one input. Assume that the input-output ratio for this item is 0.7. Then the value added ratio is 1-0.7 = 0.3. In other words for every $1 of output produced he has a value added of $0.3. Let the exchange rate of the rupee against the dollar (Rs. per $) be any number, which we can

denote as e. Then the value added by this globally competitive producer measured in rupees is equal to Rs. 0.3 e .

Now consider an Indian producer of the same item, who has a tariff rate of 20% on his output and 15% on his input. The "landed cost" of his imported input will be equal to Rs. 1.2 e while the "landed price" of the imported output which competes with his domestically produced output will be Rs. 1.15 e. The amount of margin available to the producer (inclusive of wages to be paid to labour) is the difference between the "landed costs" of the output minus the "landed cost" of the inputs used in producing this output. This value is equal to,

$$1.2e - 0.7 * 1.15e = 0.395 \ e$$

per unit of output produced by the domestic producer. This is also equal to the value added at domestic prices. The effective protection rate is therefore defined as the difference between the this margin and the global value added as a percent of the global value added, that is,

$$EPR = 0.395 \ e \ / \ 0.3 \ e - 1 = 0.316$$

Thus the effective protection rate for this particular producer is neither 20% (the nominal protection rate) nor 5% (20% -15%) but 31.6%.

The higher the effective protection rate the greater the room for inefficiency. The EPR therefore measures the degree of inefficiency that the domestic producer can have in value addition as a percent of the global efficiency norm of value addition in the production of this item. In the above example the producer can be 40% more inefficient than the globally efficient producer.

The variation of the effective protection rate with different input ratios and input tariffs is illustrated in greater detail in Table 2a and Table 2b. These show the set of cases in which the peak rate of duty is 20% with not even one item having a higher duty. Part I of table 2a illustrates the case of a producer subject to a tariff rate of 20% on his output, but with tariffs on inputs ranging between 0% and 20%. The average input tariff can therefore lie anywhere between nil and 20%. The first row shows that if all inputs used by the producer have an import duty of 20% then the effective protection rate is also 20% no matter what the proportion of value added. This result also implies that a uniform rate of import duty/tariff of

20% ensures an effective protection of 20% for all. Similarly *a single uniform rate of basic customs duty of 10% as proposed by us will ensure that all producers of all goods have an effective protection of 10%* (last row of part II of this table).

The other rows of part I illustrate the variation in effective protection rate (EPR) arising from differences in proportion of value added and differences in the average tariff rate on inputs. The effective protection rate is inversely related to the proportion of value added by the producer and the average tariff rate on inputs used by the producer. Thus EPR rises as we move from the northwest corner to Southeast corner of the table. For all goods at the peak rate of duty (20%) the effective protection rate ranges (in the table) from 20% to 400%.[21] Even if the average input duty is only 5% points less than the output duty (i.e. 15%) the effective protection can be higher than 100% (2nd row). A two-tier duty structure with consumer goods at 20% can result in some having an EPR of 200%. *Thus with a varying rate of import duty on inputs, the effective protection rate can be quite arbitrary and random.*

The second important lesson from this table is that the producers who add the least value tend to get the highest protection. This can be illustrated by considering a case in which all raw material and intermediate goods have customs duty rate of 10% while most consumer goods have a customs duty rate of 20%. For this latter set of goods the effective protection increases from 21% if the value added ratio is 0.9 to an EPR of 30% if the value added ratio is 0.5 to 110% if the value added ratio is 0.1 (3rd line, part I, table 2a). In other words *the higher the use of imported/importable inputs the higher the level of effective protection*.

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[21] In general it can even be higher.

Table 2a: EFFECTIVE PROTECTION RATE [EPR]: Variation with value added & input tariff

	Value Added							
Average	0.9	0.7	0.5	0.4	0.3	0.2	0.1	0.05
Input				Input Ratio				
Tariff duty	0.1	0.3	0.5	0.6	0.7	0.8	0.9	0.95

I.   Output Tariff =   20%

	0.9	0.7	0.5	0.4	0.3	0.2	0.1	0.05
20%	20%	20%	20%	20%	20%	20%	20%	20%
15%	21%	22%	25%	28%	32%	40%	65%	115%
10%	21%	24%	30%	35%	43%	60%	110%	210%
5%	22%	26%	35%	43%	55%	80%	155%	305%
0%	22%	29%	40%	50%	67%	100%	200%	400%

II   Output Tariff =   10%   Negative Protection

	0.9	0.7	0.5	0.4	0.3	0.2	0.1	0.05
20%	9%	6%	0%	-5%	-13%	-30%	-80%	-180%
15%	9%	8%	5%	3%	-2%	-10%	-35%	-85%
11%	10%	10%	9%	9%	8%	6%	1%	-9%
10%	10%	10%	10%	10%	10%	10%	10%	10%

III   Exemption: Output Tariff =   0%   Negative Protection

	0.9	0.7	0.5	0.4	0.3	0.2	0.1	0.05
10%	-1%	-4%	-10%	-15%	-23%	-40%	-90%	-190%
5%	-1%	-2%	-5%	-8%	-12%	-20%	-45%	-95%
1%	-0.1%	-0.4%	-1%	-2%	-2%	-4%	-9%	-19%

Table 2b: Three Rate Structure (10%, 15% & 20%) : Effective Protection Rates

I	Items with Tariff = 10%				Negative Protection			
20%	9%	6%	0%	-5%	-13%	-30%	-80%	-180%
18%	9%	7%	3%	-1%	-7%	-20%	-58%	-133%
15%	9%	8%	5%	3%	-2%	-10%	-35%	-85%
11%	10%	10%	10%	9%	9%	8%	6%	1%
10%	10%	10%	10%	10%	10%	10%	10%	10%

II	Items with Tariff = 15%							
20%	14%	13%	10%	8%	3%	-5%	-30%	-80%
18%	15%	14%	13%	11%	9%	5%	-8%	-32%
15%	15%	15%	15%	15%	15%	15%	15%	15%
11%	16%	17%	20%	22%	26%	33%	56%	101%
10%	16%	17%	20%	23%	27%	35%	60%	110%

III	Items with Tariff = 20%							
20%	20%	20%	20%	20%	20%	20%	20%	20%
18%	20%	21%	23%	24%	26%	30%	43%	68%
15%	21%	22%	25%	28%	32%	40%	65%	115%
11%	21%	24%	30%	34%	42%	58%	106%	201%
10%	21%	24%	30%	35%	43%	60%	110%	210%

Note: It is assumed that there are no exemptions.

In contrast to part I, where the produced item was subject to the peak duty of 20%, in part II the item has an output duty of 10%. Thus the average input duty can be higher than the output duty. This can give rise to the problem of *negative protection*, i.e. instead of protecting the product, the structure ends up penalising and discouraging the domestic production of some group of commodities. Part II of table

2a shows that negative protection arises when the value added proportion is low and the average input duty is higher relative to the output duty (north east corner of the table). For instance negative protection is seen to arise when the value added proportion is less than 0.5 (50%) and the average input duty is 20% (1st row, part II).

The table also shows that negative protection can arise even if the average input duty is even 1% point higher (11%) than the output duty (3rd row of part II). Thus *any effort to offer higher effective protection to favoured commodities can result in negative protection to those not so favoured*.

Part III of Table 2a shows the effective protection that results from tariff exemptions (i.e. zero tariff). In this case there is negative effective protection if there is even one input that has a positive import tariff. This is irrespective of the degree of value addition in this situation.

There is only one normal situation in which an exemption does not create negative protection. That is an exemption, which is available for inputs used for export production. In this case as the product is competing in the international market its output tariff is implicitly zero, while all exempted items are going into its production only. Thus effective protection is also zero in this case.

Table 2b shows the range of effective protection rates that can arise if the peak rate is 20% and there are only three import tariff rates (10%, 15% and 20%) and no exemptions. The weighted average tariff on inputs can lie anywhere between 10% and 20% (e.g. 11% or 18%). Items with a tariff rate of 10% are likely to have negative protection if the value added ratio is less than 0.5. Similarly items with a tariff rate of 15% are likely to be vulnerable to negative protection if the value added proportion is less than 0.25. At the same time effective protection can range as high as 100% (or higher). Items with a tariff rate of 20% and input rates of 10% may have even higher effective protection rates of the order of 200%.

With this background we can start addressing the issue of the desirable structure of tariff rates.

IV.   STRUCTURE OF TARIFFS

The second important issue in tariff reform is that of the desirable structure of tariff rates. The issue of anomalies in the tariff structure is also linked with this issue.

A.   *SINGLE/UNIFORM*

We have shown above that a single uniform import tariff implies that the effective protection for all producers is also equal to this single uniform tariff. Thus all producers and all uses of capital and labour are equally protected. Such a system also eliminates the possibility of negative protection as well as arbitrarily high rates of protection. Such a system is neutral, promotes efficiency and competitiveness and eliminates all administrative hassles and legal disputes about classification.

Thus the policy objective of achieving a uniform rate of import duty on imports by end of the tenth Plan would require raising all tariff rates currently below 10% to 10% while at the same time bringing down the peak rate to 10%. The phasing over the intervening years would depend on other factors to be considered below, with some products to adjusted more gradually than others.

B.   *TWO TIERS*

In the public debate on Indian tariff reform, the proposal for a three-tier structure of tariff reform has often come up. The commonly mentioned categories are "raw materials," "components & parts" and "finished goods." Unfortunately every producer seems to have his own definition of what these terms mean, so that what one set of producers' call "components & parts," another set call "finished goods."   Before we can consider and discuss the merits or de-merits of such proposals it is essential to define these terms and have a shared/common understanding of what they mean. At the broadest level we can define two categories of goods: Producer goods and Consumer goods.

1.   Producer Goods: Intermediate & Capital Goods

A "producer good" is any good that is used to produce any (other) good or service. Within this category it is also possible to distinguish between "capital goods" and "intermediate goods." The latter include what is commonly referred to as "Basic goods." A "capital good" is one that provides a service without losing its essential functional

characteristic, form or shape (though it may wear-out or depreciate). A capital good is therefore also one, which is "finished" in the sense that it will not go through any further transformation in a production process. An intermediate good on the other hand is one that is transformed in some way in the process of being used for production into some other form or shape. By definition therefore an "intermediate good" is not finished or final as it can and will be used by another producer to produce another intermediate good, a capital good or a consumer good.

The intermediate good category includes not only industrial/manufactured goods but also natural resource based items of agricultural, animal or mineral origin like cotton, leather and clay. Such non-industrial, natural resource intermediate goods can be called "raw materials." In principle therefore, we can define two sub-categories of intermediate goods: Industrial and "raw materials." This distinction, however, has no special implication in a 21st century economy, as industrial intermediate goods are used in the production of raw materials and vice-a-versa.

At some time in the past there may have been commercial crops grown under rain fed conditions and using no fertiliser, pesticides or agricultural machinery. It will be difficult to find such a crop today. In the past, unprocessed agricultural crops were considered the prime candidates for treatment as "raw materials," on which import tariffs could be kept relatively low. Paradoxically such crops now have among the highest tariff rates in the country, even in excess of the 'general peak' rate of 30% (table 3 below).

In contrast modern production of crude oil, coal and unprocessed raw minerals is generally quite capital intensive, requiring larger amounts of machinery & equipment. Thus its Effective Protection Rate is more sensitive to the relative tariff on capital goods. In other words, higher (lower) than average tariff on capital goods will reduce (raise) the effective protection much more on such mineral products than on many industrial goods.

Both capital and intermediate goods are used in the production of other goods (and therefore called producer goods). The tariff rates on both are in general equally important in determining the effective protection of user industries. The fact that capital goods are "finished" is therefore not directly relevant to the appropriate structure of tariff rates. There is thus no logical reason for splitting up producer goods into two or more categories or tiers.

2.   Consumer Goods

In contrast to producer goods, consumer goods are used only by individuals for their consumption. Consumer goods by definition have to be "finished" in the sense that they are ready for use without undergoing any further production process. If any such process is still required then they are not classified as consumer goods but as intermediate goods. For instance cloth that has to be sent to a tailor or seamstress for conversion into clothing would be classified as an intermediate good and not a consumer good. Similarly a TV set is a consumer good while a CKD or SKD kit that contains 100% of its components would strictly be classified as intermediate as it has to go through the process of assembly. Only after assembly is it finished and ready to be used by the consumer.

Though both consumer goods and capital goods are "finished" in the sense defined, the latter are an input into production of goods and services, while the former are not. The tariff rate on a consumer good, strictly defined, thus does not influence the effective protection rate on any other good. In principle therefore it is possible to define a set of final, finished consumer goods, the tariff rate on which can be different from or higher than the tariff rate on any producer good.

In practice however, such a strict application of the definition is very difficult and there will be capital goods that are also commonly classified as consumer (durable) goods.[22] Many such dual-use items are used in commercial & industrial offices and service establishments and constitute an input in the production and marketing of goods and services. Buildings, cars and room air conditioners are the most prominent examples of such "dual use" capital goods.

The analysis so far shows that it is possible in principle to have a two-tier structure of tariff rates with one rate for consumer goods and another for producer goods. The division of all goods into these two categories may, however, be quite difficult in practice. In addition to the problem of dual use, there is also the problem of drawing a line between the final, finished consumer good and its sub-assemblies. This can be demonstrated by examining the Input-output (I-O) table for the economy.

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[22] Some economist insists on following the strict definition of consumer goods & services. They classify all consumer durables as capital goods that supply a consumer service. Thus an individual or household that owns a car is acting simultaneously as a producer and consumer of transport services. In this categorisation only the transport service of the car is a consumer service, while the car is a capital good.

3.   IO Tables & Block Recursion

Though IO tables are no longer in common use across the world, their construction necessitates and clarifies the definition of intermediate and final goods (capital & consumer). A basic understanding of the IO table is useful in determining the practicality and merit of having a tiered structure of tariffs. The main body of the IO table shows the flow of intermediate goods (i.e. goods that are used in the production of other goods) from the producer to the user sectors.

The 115-sector IO table constructed by the planning commission shows that there are many blank squares (empty cells) indicating that the output of every sector is not used in the production of every other good.[23] The IO table also shows that it is not possible to define a set of sectors (A) whose output is used in the production by other sectors (B), but which do not use the output of B. Technically such a situation will result in an IO matrix that is recursive or block recursive. An examination of the IO table does not reveal such a recursive structure. In other word each of the 115 goods or services directly or indirectly (through another good or service) enters into the production of every other good or service. It is therefore virtually impossible to break up the set of intermediate goods into two or more tiers in any rational fashion.

The I-O table also shows that at this level of dis-aggregation all 98 goods are used as intermediate inputs, out of which 60 are also consumer goods for private individuals. Within this sub-group of 60, 19 are also used as capital goods. Thus at this level of dis-aggregation it is extremely difficult to draw the line between consumption and intermediate or capital goods. As a practical matter it is only possible to select a few important consumer goods (based on the 6 digit HIC classification used in the tariffs) for the purpose of having a distinct tariff.

C.   ANOMALIES & EXEMPTIONS

1.   Anomalies

An anomaly is one in which the tariff on a producers' input is higher than on his output. This will reduce the effective rate of protection for the producer(s). There may, however, be some other inputs on which the tariffs are lower than on the output. The full

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[23] We have used the 1993-4 IO table for illustration.

effect on the effective protection rate depends on the weighted average tariff, taking account of the tariff rates on all inputs. For the purpose of exposition we define a minor or micro anomaly as one in which any input has a higher tariff than the output and a major anomaly as one, in which the import weighted average input tariff is greater than then the output tariff.

Even a major anomaly does not necessarily result in negative protection, which is the most serious form of major anomaly. As demonstrated in the section on effective protection rates, negative protection will result if the input ratio is high. This analysis of effective protection rates also shows that if one or more producer goods is provided higher effective protection through higher than average tariff rates, then it is very likely that there will be many goods with an EPR less than the average nominal protection as well as some with negative protection (table 2a). *Thus anomalies can only be completely eliminated if there is a single uniform rate of tariff on all intermediate and capital goods.*

It also follows that an input tariff rate that is equal to the tariff rate on output is **not** (we emphasise not) an anomaly. It is impossible to devise a system in which every single producer has an input tariff rate lower than the output tariff. Quite the contrary starting from a uniform tariff rate on all intermediate and capital goods, reduction of the tariff on even one input instantaneously produces a minor anomaly for the supplier of inputs. An attempt to eliminate the newly created anomaly merely shifts the anomaly backwards, requiring further tariff reductions. If we extend this process backwards to every producer we will eventually come back to the producer from which we started and reduce his output duty (as this is a direct or indirect input for some other producer). The final result of such an iterative procedure would be zero duty on all intermediate and capital goods.

It is not possible to eliminate all anomalies immediately by moving straight away to a single uniform rate. We have therefore to focus first on major anomalies and then move on to the minor ones. The approach adopted will eliminate virtually all anomalies by the end of the tenth Plan.

2. Exemptions

Exemptions are the opposite of anomalies, as they represent a lowering of the duty below what it should be. Thus they simultaneously lower the effective protection to the exempted industry while raising the effective protection rate for all user industries. The impact on the effective protection rate is generally arbitrary and unknown. Inefficiency is

thereby created without a clear knowledge of the benefits to the economy and society. Exemptions are by now widely known to lead to administrative problems, legal disputes, tax evasion, collusion and corruption. While end-use exemptions have been virtually eliminated from the excise tax system with the introduction of CENVAT, the customs duty structure is still riddled with them. ***No new end-use exemptions should therefore be given, and existing ones should be phased out at the earliest.***. All exemptions should be phased out over the next five years. This will also moderate the revenue loss from reduction of the peak rate.

An argument is sometimes made that a product should be exempted from customs duty because it is "not made in India." An exemption from import duty is likely to result in negative protection of this item and reduce the incentive for production of this good in India. It will also raise the effective protection for user industries and thus favour them over all other industries. It would be quite illogical to give higher protection to every industry whose inputs are not produced in India. There is no logical argument for promoting industries that do *not* use domestic inputs.

We can identify about 280 specific exemptions of which over 100 are end-use exemptions. Of the 280 exemptions about 60 exemptions are the result of international commitments made earlier, about 40 are due to administrative reasons and constraints and over 60 are due to social reasons. The rationale for these three categories of exemptions are analysed subsequently. More than one-third of the exemptions (about 100) however, are due to industrial pulls and pressures from user industries. There is no economic justification for these exemptions except to raise the effective protection provided to user industries and thus provide them with hidden (non-budgetary) subsidies. The fact that they simultaneously reduce the effective protection to the producer industry evidently carries less weight. They consequently favour the former at the expense of the latter. In other words they effectively tax producers to subsidise the users, distorting the commodity prices, creating inefficiency and imposing deadweight losses on the whole economy. About 43 of these 100 exemptions have rates of 15% and will be eliminated when the peak rate reaches 15%. 50 of them have a rate of 0% or 5%. Immediate elimination of these exemptions will raise the duty rate dramatically and then bring it down with the peak rate. We therefore recommend that the duty rate be raised to 10% within the next two years for the majority of these exemptions (appendix table).

D. CONSUMER GOODS

We have shown that at least in principle it is possible to differentiate the import duty/tariff on a finished, final consumer good from the standard uniform rate on intermediate and capital goods. In this section we will examine the desirability or otherwise of having different tariffs for such "pure" consumer goods as well as for "dual use" items that are used both in consumption as well as in factories and offices and thus affect the cost structure and effective protection.

1. Higher Tariff

There can be an argument for imposing a higher tax on certain "pure" consumer goods so as to discourage their consumption/use. This does not however translate easily into an argument for imposing higher import tariffs on the "undesirable goods." Thus for example, if as a nation we want to discourage the consumption of alcohol the best way to do this is to have higher excise taxes and an equivalent additional duty. This is indeed what we already do. Imposition of a high import tariff on the other hand cuts off competition from better quality alcohol, and removes the incentive for upgrading quality. It also provides an incentive for smuggling.

There are a number of items such as automobiles (cars), two-wheelers, air conditioners, furniture & fixtures that are used both by consumers and producers (dual use). Higher tariff protection in such cases will have adverse effects on the effective protection provided to all industries, because they constitute a part of the costing structure. Clearly the adverse effect will be greater the higher the proportion of such items in the total value of inputs.

There is one argument in the trade literature that has often been used to justify "protection," of both "pure" consumer goods & dual-use items such as cars, the "Infant Industry Argument." Even in this case, however, the (so called) first best or efficient solution is a direct subsidy to producers. Direct subsidies have the additional benefit of transparency in that the cost of protection of each protected item is measured by the known subsidy. Higher than standard tariff rates are a second or third best solution, which favours influential producers over the average consumer and creates unnecessary complexity that very often leads to evasion, corruption and litigation. The last argument underlies the move from a

complex excise tax system to a CENVAT with one standard rate; it applies with equal if not greater force to import tariffs.

It is very important to note that an industry cannot be an "infant" forever; it may be an "infant" for 5 years or at the outer limit 10 years. Twenty and thirty year old industries can by no stretch of imagination be called "infant industries." As time passes the negative efficiency effects of protection on the industry itself (complacency induced by the removal of the threat of imports) begins to outweigh the temporary incentive for import substitution. This adds to the negative effects on the Effective Protection (EPR) provided to user industries. Thus any such protection must be limited in both scope and time.

Modern industrial economics has produced a much more sophisticated version of the infant industry argument, in terms of economies of scale arising from learning by doing and other learning processes. Theoretical possibilities are not easily translated into practical probabilities, however. Despite the much greater quantity and quality of data available in the USA and other OECD countries, researchers have not been able to identify specific industries that would clearly and unambiguously benefit from such temporary protection. It has proved even more difficult to demonstrate that such specific interventions would be welfare improving.

The actual pattern of high tariff protection above the (so-called) "peak" rate bears little relationship to any "learning by doing" or skill externality arguments. Most of these are agricultural goods for which no economist has made either a new industrial economics or an old fashioned infant industry argument (table 3).

2. Lower Tariff

There can also be a valid social argument for lower taxes on certain (pure) consumer goods like life saving drugs, medical devices & equipment and knowledge related goods. As in the previous case this is really an argument for reducing domestic consumption taxes like CENVAT and Sales tax along with the corresponding additional duty or special additional duty (CVD).[24] Reduction of domestic taxes and CVD is an economically efficient way of 'subsidising' the use of these items. The issue of reducing basic import tariffs below the standard rate of tariff should only arise once the consumption taxes have been set to zero.

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[24] See sections on CENVAT & National VAT.

Table 3: Items with above "Peak" Basic Customs Duty Rates

Chap No.	Description of Goods
	Agriculture & Allied
2	Poultry meat (Chicken leg)
4	Other Milk powder (0402.10, 0401.21)
8	Coconuts (0801.11, 0801.19)
8	Areca nuts, others (0802.90)
8	Dried grapes (0806.20)
8	Apples (0808.10)
9	Coffee (09.01)
9	Tea (09.02)
9	Pepper, cloves, cardamom (09.04, 09.06, 0908.30)
10	Rice in the husk (paddy) & husked (brown) rice (10.0610/20)
10	Semi-milled or wholly milled rice and broken rice (10.0630/40)
10	Wheat, maize/corn, spelt, sorghum, millet (10.01/05/07/0820)
12	Copra (12.03)
15	Soya bean oil, crude or refined (15.07)
15	Rapeseed/colza/mustard oil (crude or refined: 15.14)
15	Palm/groundnut/sunflower/safflower/coconut/other oils: crude
15	Palm/groundnut/sunflower/safflower/coconut/other oils: refined
16	Sausages/meat prods of meat offal/blood (16.01), other prepared meat/ offal/blood of fowls of species Gallus domesticus (16.0232)
17	Sugar (17.01)
22	Beer, grape must, wine, vermouth, other fermented beverages (22.03-06)
22	Un-denatured ethyl alcohol (2207.10)
22	Whiskies, rum, gin, vodka, liqueurs & cordials, etc. (22.08)
33	Alcoholic preparations used to manufacture beverages (3302.10)
40	Natural raw rubber latex (4001.01)
	Automobiles
87	Motor cars and two wheelers, used (87.03, 87.11)
87	Complete(CBUs of) Motor cars and two wheelers, new (87.03, 87.11)
	Other
98	Baggage articles, other than on transfer of residence, above Rs12000 (98.03)

Once this point has been reached, the classical, efficient, economic solution is quite clear.[25]   A direct subsidy on consumption is the best means of facilitating consumption. When there are a large number of suppliers (producers or traders) the administrative costs of such subsidy can be very high.[26]   Therefore under exceptional situation of high administrative cost and high standard tariff rate it may be socially desirable to reduce the customs tariff below this rate. Any presumed social benefit from higher use of these items has however to be weighed against the discouragement to import substitution, as effective protection is reduced and the possibility of negative protection arises.   The reduction should be considered an interim measure till the standard rate is bought down to a reasonable level.

3.   Government Consumption

In contrast to goods consumed by private individuals there is no valid economic argument for reducing taxes on goods consumed by or imported for the use of government or its subsidiary organisations.   This applies equally to domestic consumer subsidies as to import tariffs.   Replacement of tax subsidies by explicit budgetary subsidies is fiscally neutral.   There is however a great gain in fiscal transparency and potential accountability in shifting from tax subsidies (lower taxes) to explicit budgetary provisions. Conversely there is a loss (from giving tax subsidy) in terms of incentives for economising on the use of imported inputs and incentives for import substitution if such tariff subsidies are given. There is no economic justification in this case for lowering import tariffs below the standard rate.

A tariff exemption can be justified on National Security grounds.   The argument, however applies neither to other public/consumer goods bought by the armed services nor to parts used both by the civilian and defence production sectors.

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[25] Prof Bhagwati and Srinivasan demonstrated in a number of elegant papers that the best way of dealing with domestic distortions is through domestic policy changes to offset them, not through trade distorting measures (2nd best optima).
[26] As demonstrated in the case of food and petroleum subsidies.

V. CUSTOMS RECOMMENDATIONS

A.   *Target & Phasing*

The "peak" rate should be brought down to 10% by the end of the tenth Plan. This will give enough time for economic agents to adjust.[27] With some exceptions to be discussed below this peak rate must apply to all imports. As the current "peak" rate is 30% this can be done in the next four budgets by reducing the general peak rate by 5% in each budget.[28] This will bring our tariff rates in line with those prevailing in the emerging economies, while giving time to industry and others to adjust. A slower reduction schedule will see us falling behind ASEAN (as they plan to reduce their import tariffs further during this period) and delay the removal of existing anomalies.

As our analysis has shown, it is impossible to remove all anomalies unless a single uniform customs duty rate is imposed on all intermediate and capital goods. This would require raising the import duty rate on all goods having an import duty less than 10% to 10%. To give time to user industries to adjust to higher rates we suggest a phased increase in the basic customs duty rates on exempted goods. Thus, with some temporary exemptions to be discussed below all intermediate and capital goods should be subject to a minimum rate of 5% in 2004-5. In 2006-7 all exemptions would be eliminated and the minimum rate would be raised to 10% so that (almost) all anomalies are eliminated and no item has an effective protection rate of less than 10%.

Goods that currently have a custom duty rate of 25% would normally be left at that rate till the peak rate comes down to 25% and eliminates this anomaly. However we recommend that all producer goods (e.g. chemicals, plastic material, metals) be subject to a single uniform rate as soon as possible so that anomalies are eliminated. If this is done most producer goods would have a customs duty rate of 20% in 2003-4 and anomalies would be eliminated faster. Comprehensive, chapter wise phasing of the tariff structure is given in the appendix table.

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[27] It will also minimise the mobilisation of political resistance by those whose rents are affected.
[28] This does not mean that every single item currently at 30% will come down by 5% per year. Some of them may be brought down faster.

B.   *Capital Goods*

Domestic capital goods production has been the least protected of all sub-sectors and has probably had negative protection in some years. We would therefore recommend that this anomaly be removed next year (2003-4). Many capital goods currently have a duty rate of 25% or less, while the duty rate on several parts & components is currently as high as 30%. Rates on copper, which were as high as 35% in 2001-2 have been brought down to 25% in 2002-3 budget, following the recommendations of the Inter-ministerial group on Customs Duty reform.   As the peak rate will not reach 20% till 2004-5, the capital goods sector will continue to be disadvantaged for 2 years. We recommend that this anomaly be reduced through an accelerated reduction of the maximum duty rate on all minerals, metals, parts & components to 20% by 2003-4. An accelerated reduction in chemicals duties to the same rate is also recommended. This will minimise anomalies in many industries.

The whole mineral-metals-capital goods chain has to be addressed simultaneously so that old anomalies are corrected more speedily and no new ones are created. Many intermediate goods in the metals category currently have a customs duty rate lower than the peak rate. There are, however, more chemicals at the peak rate, and their maximum rate will fall faster next year. These intermediate goods, commonly referred to as basic goods, are widely used in a large number of downstream industries such as synthetic textiles. The accelerated reduction of import tariffs on metals will therefore help in *eliminating anomalies in several other user industries, so that a majority of anomalies can be eliminated by 2003-4.*

The very steep decline in aggregate investment and production of capital goods during 2001-2 and 2002-3 adds to the urgency of eliminating any potential negative protection of capital goods. The gains to the economy from the reduction in the cost of capital that will follow from accelerated reduction of tariffs on metals and chemicals will in our judgement outweigh any short-term losses to producers of these goods. In particular, any increase in losses of public sector SAIL (& other Public Sector Units) are a small budgetary price to pay in the short run, while SAIL itself will benefit in the longer run from the increased competition.

Though all special exemptions on capital goods imports should be eliminated eventually, it may not be feasible to eliminate all such exemptions by the end of the 10th plan. Roads are the best example of what economists define as a "Public good." Though major

national Highways lack one characteristic of a "Public good" namely "non-excludability," highways still constitute the best example of an infrastructure with high externalities. An argument can therefore be made for giving a little extra time for eliminating the exemption for specified construction machinery and material used in these projects. The Power sector in contrast is a "private good" (in terms of economic characteristics), but is perhaps the most important infrastructure sector because of its effect on production and growth. It also suffers from an abysmal policy framework, bad regulation and outright theft. The implicit fiscal subsidies that need to be made explicit are so large that this change is not conceivable in 3 years. We therefore propose giving more time to this sector to adjust by eliminating the exemption over a longer period.

C.   *Temporary Exceptions*

1.   **Alcohol**

As the earlier analysis has shown any social objectives for taxing alcohol more highly than other goods, can and are being addressed through excise/CVD. Rational implementation of these social objectives also requires that we distinguish between beverages with low and high alcohol content. Low alcohol beverages like beer and wine are universally accepted as being a food product.[29]   Beer and wine are therefore better categorised as agricultural products rather than as alcohol.

Because of the bulky nature of beer and wine, and consequent higher transport cost, import duty on beer and wine can be reduced at a faster rate than on alcoholic liquor, while still providing similar levels of protection. Till last year alcoholic beverages were protected both by quantitative restrictions and extraordinarily high duties. To give time to producers to adjust to competition, the import duty on beer, wine and similar low alcohol beverages should be brought down to twice the peak rate next year. Thereafter it should go down along with the peak rate (maintaining the ratio) so that the duty rate is 20% by the end of the plan. The import duty on all other alcoholic beverages should be reduced to three times the peak rate over the next two years. Thereafter, the import duty on alcohol should be reduced along with the "peak" rate (maintaining the same ratio) to reach 30% by the end of the 10th Plan.

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[29] Recent research, though not yet conclusive, suggests that they may even be beneficial to health when taken in normal quantities i.e. by the normal/average person and not for the purpose of getting drunk.

2.   Agricultural Goods

Till as recently as the early-nineties, the conventional wisdom in India was that (with the exception of edible oils and seeds) India was a competitive producer of all tropical agricultural goods. This view was held not only by specialists in agriculture and agricultural economics, but also by the average educated person. This conclusion implied that (with the exception of edible oils), Indian agriculture needed no tariff protection. Those economists and others inclined towards a "three tier structure" of tariffs invariably put all agricultural inputs as well as all agricultural items consumed by the common man into the first tier requiring the lowest import duty. In fact a few eminent economists went so far as to propose that import duties on agricultural goods be reduced to zero and all import restrictions be abolished forthwith. In the fifties and sixties there were also economists who argued that there should be an export duty on tea to exploit our near monopoly position, in other words the opposite of protection i.e. dis-protection in the sense of lowering (rather than raising) prices receive by domestic producers. It is ironic, that less than a decade later a number of agricultural goods including some types of rice & wheat have among the highest customs duty rates (far in excess of the peak rate of 30%).

There are arguments that can justify a temporary increase in customs duty rates above the peak rate. The common argument is that till a year or so ago almost all agricultural goods were subject to import controls and Quantitative Restrictions. Just as tariff rates on de-controlled industrial goods have been reduced gradually over the nineties, the agriculture sector must also be given a reasonable period to understand domestic and global market influences and gear up for competition. As the exchange rate is now much depreciated from what it was in 1991, this should not however be taken too literally. A gradual reduction in import duties on a limited number of agricultural goods (from the higher levels imposed on removal of Quantitative Restrictions) can, however, be justified.

In our view, there is an additional argument that, even if agricultural goods are still relatively competitive on average they are subject (because of dependence on weather) to much greater price fluctuation than industrial goods. Taken in conjunction with the relatively backward nature, in terms of information, communication and knowledge, of most Indian agriculture this can subject a large number of very poor people to unacceptable risk. This argument is buttressed by the existence of agricultural subsidies in developed countries, but

only for those goods that are subsidised and only to the extent of the subsidy.[30] We must therefore be extra careful when reducing tariff rates that protect the livelihood of so many people on the margins of existence from large price fluctuations and unexpected import surges.

Equal care must however be exercised in raising such tariffs, for two reasons: Most poor consumers are net buyers of food on the open market and therefore are harmed by high protection. High protection for agricultural goods may be inequitable, favouring well-endowed, surplus farmers at the expense of landless labourers, marginal farmers and unorganised sector workers. Two, the threat of competition can be a very effective spur to improved efficiency, and rates that are so high as to eliminate this threat completely are not in the interests of efficiency, productivity and sustained growth of agriculture.[31]

On balance therefore we recommend that from the next year the maximum customs duty rate on agriculture goods be reduced to two times the peak rate. The duty on all agricultural items that currently have a higher duty should be reduced to this rate. In the subsequent years the duty should be brought down along with the peak rate (remaining at twice the peak), reaching 20% by the end of the 10th Plan. This will give sufficient time to governments to help farmers' gear up to meet the competition by ensuring that the constraints to higher agricultural productivity and efficiency are removed.

3.   Cars

There are substantial economies of scale in automobile production. A decade or two ago it was thought the minimum efficient scale (MES) for car production lies between 500,000 to one million cars. The MES has gradually come down with the development of more flexible manufacturing techniques and greater out sourcing. Even if the engine and drive train were out sourced the MES would still be of the order of 50,000 to 100,000 cars. India can sustain a reasonably efficient and competitive small car industry at normal rates of tariff. It makes little economic sense for the nation to have a level of protection that forces manufacturers of large cars to set up manufacturing facilities well below the MES. Excessive protection only builds up uneconomic and uncompetitive industry that is likely to become

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[30] Subsidies on butter (EU) cannot be used to justify higher import duties on wheat. Further, a subsidy of 10-20% on a given product does not justify a 60-100% duty on that product.
[31] They are also a spur to domestic reforms that are essential to actualise these productivity gains, as for instance the removal of controls & restrictions on trade, storage, transport & agro-processing.

sick at some point in the future. FDI investors in car production were well aware when they entered the country that Quantitative Restrictions would eventually be lifted and that they would have to meet the external competition. Despite this a majority of international car companies have entered India.

The quantitative restrictions on cars and other automobiles were lifted last year. There is therefore an argument for giving some more time to car and two wheeler manufacturers to adjust to the threat of competition. Therefore we recommend that the tariff rate on cars and two wheelers should be kept at two times the peak rate. It should therefore come down along with the peak rate during the 10th Plan period to reach 20% by the end of the Plan. The same duty rate should apply to import of used cars and two wheelers. The strict safety, environmental and other regulations that have been imposed on the import of used automobiles are sufficient to ensure the interests of consumers and producers. The country can only benefit fully from the substantial FDI in the Indian automobile industry if foreign producers are subject to the threat of import competition. Research has shown that the gains to a country from FDI can be severely diluted if excessive tariff protection is provided. The automobile industry is a classic example of such tariff jumping. Ten years of complete protection (1990s) and ten years of tariff phasing (2000s) are sufficient for this industry to grow up into an adult.

D. Exemptions: Temporary

1. Medical

There are a number of exemptions in the current system relating to life saving drugs and medical equipment. Unlike other consumption goods, "life saving drugs & equipment" do not add to or give pleasure; they merely remove some disability or disease that a person has had the bad fortune to suffer from. Through a consultative process, lists of such drugs and equipment have been identified that are critical and are currently fully exempt from import tariff (i.e. 0% customs duty and 0% AD/CVD). As long as tariff rates remain high by international standards there is a legitimate social argument for lower rates on some of these life saving drugs and medical equipment. On the other hand a zero customs duty discourages the production of such drugs and medical equipment by creating negative protection.

The major identifiable and specialised inputs into the production of these life saving drugs and equipment that have been identified and exempted from customs duty would also be subject to a 5% import duty. When identifying "major inputs," the top 3-4 inputs constituting 50%-75% by value of inputs can be identified. Only these will continue to enjoy this exemption, while exemptions on minor inputs should be phased out completely. All end-use exemption relating to the exempted inputs themselves (i.e. second stage) should however be eliminated.[32] This will simplify the system while removing anomalies in input items and improving effective protection.

Out of the 280 exemptions identified, about 35 related to this health/medical category. Of these a majority were totally exempt till last year. A duty of 5% has been imposed on some of them in the 2002-3 budget as recommended by the Inter-ministerial working group on Customs duty reform. About 11 remain totally exempt, while 14 have a duty of 5%. We recommend that a duty of 5% be imposed on the exempted items in the next two years and be raised to 10% by the end of the plan, so that negative protection is reduced and then eliminated. There is also a category (containing about 9 notifications) of drugs and medical equipment currently subject to 15% customs duty. This rate can continue till it merges with the peak duty rate in 2005-6.

2.   Knowledge

Information and knowledge is usually embedded in some media like books or tapes. Unlike most other goods and services, however, information & embodied knowledge has economic externalities. Acquisition of information and knowledge by individuals benefits not just those individuals, but society as a whole. The greater the spread of knowledge, the more competitive and efficient the economy is likely to become. A number of items falling in this category have been identified and exempted from customs (& additional) duty.

One category of these knowledge exemptions relates to educational and technical material in various forms like books, video and digital. Another category of knowledge exemptions relates to R&D equipment, that have been given customs duty exemptions, many on an end-use certification basis. Creation of knowledge through R&D also has externalities as it benefits the whole economy (and often other economies as well). That is why countries

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[32] There could be extreme cases such as a first stage input that constitutes more than 75% of total value which itself is made from another input constituting more than 75% of its value. In such cases the exemption for second stage inputs can be phased out.

give patents for the fruits of R&D. A patent is a monopoly right given by the country for a specified period of time to encourage invention & innovation. Thus society balances the negative externality arising from monopoly against the positive (externality) benefit from R&D to decide on the optimal period of the patent.

There is also an economic rationale for subsidising R&D activity through direct explicit subsidies or through the income tax system. There is, however, little or no rationale for subsidising the purchase of specific items of R&D equipment by giving either customs duty or excise/CVD exemptions. Such exemptions are inefficient and can distort the R&D process. We therefore recommend phasing out of such exemption and their replacement by direct budgetary subsidies or income tax incentives where necessary.

Overall about 17 of the 280 exemptions identified relate to knowledge, of which 4 are end use exemptions. Only 4 of the 17 are totally exempt, while 17 are subject to a duty of 5%. These exemptions are justified as long as import duties remain very high. The former (0%) can be first raised to 5 % in the next two years and to 10% in the subsequent two years. The latter should be raised to 10% by the end of the tenth plan at which point all exemptions notifications can be deleted.

3.   General Social

There are a few other items in which social/economic arguments convince us to recommend slow phasing out of exemptions. Of the dozen exemptions relating to this category, three relate to food. This can be illustrated by the case of pulses where the duty was 5% in 2001-2. Giving more weight to consumer interests in pulse import, while giving more weight to producer/farmer interests in the case of cereals purely on the basis of self-sufficiency or lack of it is not a sustainable economic argument. Import duties on pulses (as with other items) by changing domestic prices also provide a signal to create and plant better varieties of pulses as well as to use better inputs including land for their production. As a consequence of the recommendation of the Inter-ministerial Group on Customs duty reform, the duty was raised to 10% in the 2002-3 budget, so as to provide a clear signal to researchers, seed companies and farmers. For the other two cases, onions & other cereals (rye, barley, oats etc.), the tariff rate should also be raised to 10% for the same reasons.

Most of the other nine exemptions relate to environmental concerns. The case of wood products is illustrative. There has been a tremendous denudation of our forests due to

the pressure of population on natural resources and the need for fuel wood. A lower customs duty directly encourages use of imported wood and lowers the pressure on domestic forests. At some point commercial forestry will become a viable option and customs duty can and should be restored to the standard rate when this become reasonable. We therefore recommend that the exemption on wood and wood products be raised to 10% in the last year of the 10th plan.

4.   Smuggling

Small, light high value items are particularly prone to smuggling as there are greater options for transport and concealment costs are lower. Given the porosity of our borders the effect of import duties on the incentive for and extent of smuggling cannot be ignored. The low import duty on gold and precious stones reflect an understanding of this effect. More generally, as long as import duties remain high relative to global levels some allowance in the form of lower customs duties has to be made. We have identified about 8 goods exemptions that are related to the need for minimising the incentive for smuggling. Of these three can be eliminated when the peak rate reaches 15% and one when it reaches 10%. Four of them have a rate of 5%, four of which can be raised to 10% in the next two years and one at the end of the plan period.

Theoretically the best principle to use in reducing the duty on such an item is that of the revenue maximising tariff. As tariffs on a commonly smuggled good are reduced below the peak the incentive for smuggling is reduced and the amount coming through legal changes will increase. The reduction on the tariff will also mean that the tariff revenue from the existing legal imports will go down. There will likely be a tariff duty rate below the peak at which the tariff revenue from the specific item is the greatest. This is the rate that should be chosen. As the information needed for determining this rate, is not currently available, a judgement has to be made.

E.   *Exemptions: Permanent*

1.   International Agreements

There are a number of international agreements that bind customs tariffs. These include the familiar GATT/WTO bound rates as well as the relatively new Information Technology agreements. Out of the total of 280 identified exemptions 43 are due to such agreements,

with nine relating to low bound rates and the remaining 34 to international agreements. There are 20 other exemptions that become necessary because of the lower rates resulting from international agreements. Of these 16 exemptions are on inputs used in the production of these low bound items, while 4 are the consequence of other international agreements such as the one to eliminate the use of Ozone depleting substances (ODS).

Out of the total 63 or so exemptions under this general umbrella 40 can be phased out over the tenth plan period (appendix table). When the standard rate reaches 10% by the end of the 10th Plan, about 23 such exemptions will however remain, 15 of which are totally exempt (0%), four are bound at 3% and four at 5%. These cannot be raised to 10% without violating international agreements. It is extremely difficult to remove anomalies created by some of these rates. Any such attempt inevitably creates more anomalies. We would recommend that *in future the government should not agree to bind itself to any customs duty rate below 10%. The govt(MOC) should also try to raise the items bound at 0% & 3% to 5% within this decade*.

2.   Exports

Taxation of exports on the destination principle implies that there be no tax on exports and that any taxes paid on inputs of goods or services (and thus embodied in the export) be refunded. Exemption of customs duty on imported inputs used in export production is therefore an inherent component of an efficient tax system. These exemptions should be embodied in the customs law. When the standard customs duty rate reaches 10% all 6 end use exemptions and 13 commodity specific exemptions given to facilitate exports by numerous small exporters should be eliminated. This will make it possible to have a semi-automatic system of refund to every exporter for all imported inputs used in export production. In other word there will be no need for product specific limits as all inputs will have a 10% duty (plus 15% VAT/AD) and only the value of inputs imported and used for export production will need to be kept track of.

3.   Transit

Ships and aeroplanes (including private yachts and planes) passing through the country as well as any consumer durables bought in by tourists, media persons and taken back with them are goods in transit and not really imports. There should be provisions in the

customs law to exempt customs duty on these and other goods in transit. To the extent that there is scope for misuse of these provisions, reasonable safeguards can be provided in the customs rules.

## 4.	Re-Imports

Re-import of goods produced in and exported from India should be legally exempt from import duty. A provision has to remain in the law that allows imposition of Additional Duty (CVD) on the residual value of the re-import. Provision would however be made in the rules for exempting all used items. This will leave only items such as unused ships stores to be taxed (CVD), so as to minimise misuse of the exemption.   If previously imported goods are sent for repair abroad, the value added by such a repair operation can legally be subject to customs duty but should be exempted under the rules for administrative convenience.

## 5.	Strategic

Strategic goods needed by the Defence forces, space research etc. can be exempted from customs duty through a general notification. This would include any components and parts that are unique to such systems, when imported for use in producing such systems indigenously. Commonly used parts and components used in civilian equipment and goods should not be included under this exemption. Nor should any item that is commonly used by civilians such as cars and trucks. They should pay the normal customs duty. An internal working group can be set up to examine all the import duty exemptions given to the armed forces so as to apply the above principle and weed out the above mentioned civilian items, parts and components and phase out their exemption.

Items imported for use by police and paramilitary forces do not come under this exemption. The existing import duty exemptions on these items should be phased out. Fiscal transparency demands that such a tax subsidy be replaced by an explicit budgetary expenditure.

## 6.	Administrative: Valuation

There are about 16 exemptions relating to valuation problems and difficulties. For instance items such as postage stamps, Awards & Trophies are hard to value are currently exempted on the grounds of administrative convenience. Another category of administrative problems

relates to gifted articles. Based on the invoice principle the customs duty payable on these gifts should be zero no matter what the customs duty rate. In the case of individual gifts it is difficult to determine whether there are any compensating payments that make the gift route merely a method for evading taxes. At the same time suspicion falls on genuine gifts resulting in harassment. About 14 of the 16 exemptions relate to genuinely zero value items that facilitate import without harassment. *Two of the exemptions can be phased out over the plan period (appendix table). The rest (14) could continue preferably in a single consolidated notification*.

F.   *Additional Duty: CVD*

Additional duty or countervailing duty is the counterpart of the domestic taxes imposed by the Central govt. It must therefore be equal to the CENVAT/Excise imposed on domestic production. Countries that have a full-fledged VAT call this element of duty as a VAT and we should consider whether it is possible for us to give it the designation CENVAT (instead of additional duty of customs). In any case, to clear the confusion among uninformed external observers who often wrongly treat this a form of protective duty, there should be separate accounting for this element in customs duty collection records. If this is done we will be able to separate the total customs duty collection rate into its two economically relevant components: The protective duty element and the counterpart of the domestic taxes.

In both customs and excise there can be legal obligations and constraints that require deviation from the efficient solution. The first best solution would be to modify the agreements. Till this is done, however, some deviation from the first best solution may be necessary. One example of this is the International competitive bidding procedure. The rules of this procedure are now being interpreted to say that the 15% price preference to domestic bidders can only be given if there is at least a 15% import duty on the capital goods for which the bids are being called. It is therefore been proposed that imports under the ICB procedure that are subject to an excise/CVD of 16% and import duty of 0% or 5% be henceforth subject to a basic customs duty of 15% and an excise/AD of 8%. This proposal is worthy of further consideration.

VI. CENVAT ISSUES

A. *EXEMPTIONS*

Exempted manufactured goods as well as wholesale trade must be brought into the net if we are to have a comprehensive CENVAT. This is the only way to ensure that the VAT chain is reasonably complete. There are some practical and conceptual problems, which can be solved as follows:

1. Primary Inputs

a) Agriculture

In the case of agro-based processing & manufactures, deemed credit must be introduced for all agricultural & allied products (jute, silk, cotton, tea, coffee, cocoa, leather, meat, fish & poultry).[33] Therefore at the first (excisable) stage of agro-processing only the value added is taxed at the basic rate of 15% (16%). Any subsequent processor will however, be allowed to set-off the deemed credit along with the tax paid on value added. Further the standard SSI exemption will be made applicable to the Value Added (instead of the entire value of output) to avoid disputes.

b) Other

A similar deemed credit can be considered for mineral materials obtained from the earth through the use of labour such as earth or stones (for making bricks, cement etc.). Once services are fully incorporated in the CENVAT a similar deemed credit may also have to be incorporated at the first stage for non-taxable service inputs at the stage of first taxable service.

2. Job Work

Job work done by numerous small, dispersed processors (including remaking of jewellery from gold ornaments supplied by customers) creates valuation disputes and complaints of harassment. Such job work (currently fully exempt & to be specified in the rules or procedures) will have the option of paying CENVAT on the basis of value added by

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[33] Processing of Food grain, pulses, vegetables & fruits by modern agro-processing industry should be fully exempted from CENVAT.

the Jobber. If this option is chosen the SSI exemption will apply to the added value (not the full value).

3. Construction

On site production or construction activities will be taxed on the basis of value added at the site with the SSI exemption applied to the value added and not the value inclusive of off-site inputs.[34] The producer will retain the option of opting for the normal system.

4. Government Purchase

All Government (municipal, state, central including strategic) related exemptions, will have to be initially compensated with a higher budgetary allocation on the principle of fiscal neutrality. The excise exemption for armed forces is being misused. This could be partly compensated by higher active duty allowances in border areas like Siachin & Kargil and insurgency areas. All fertiliser related exemptions, will also have to be made fiscally neutral through a higher budgetary subsidy.

5. Small Industry

The SSI exemption should be standard and available to all industries and services subject to excise tax. It should not be dependent on individual notifications and exceptions.[35] The current SSI exemption would have to be reworded/ modified to ensure that,

- SSI exemption value limit will be applied to value added (rather than turnover) in the classes of cases specified (above).

- An excisable input produced in a unit whose output is exempt will be entitled to an SSI exemption on the excisable inputs. The unit need pay CENVAT only on the value of production of the excisable inputs (not total final output) above the exemption limit.

- The excise law may have to be changed to promote outsourcing by large "branded companies" to SSIs while ensuring that the value added by them through marketing & branding pays due taxes. This can be done by treating the company along with the

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[34] These are currently fully exempt. Under the new system the CBEC can name the activities under the rules & procedures to ensure that there is no ambiguity.
[35] In almost every country with a VAT it is based on the volume or value of goods and services.

SSIs from which it out-sources, as a single manufacturing unit but giving a deemed SSI credit of 30-50 lakhs for each SSI (out) source in calculating the "branded company's CENVAT tax liability.

- Alternatively (and at the very least), Village, Khadi & Handloom activities carried out by separate producers should not be treated as a unit for the purpose of SSI exemption, even if marketing and sale is under a unified brand name. That is, each separate producer can avail of the SSI limit. To avoid disputes such organisations would be named under the rules & procedures.

B. ADMINISTRATIVE SIMPLIFICATION

These changes allow a drastic simplification of the excise or MODVAT system, which is the great advantage of a VAT or true CENVAT. This simplification is based on a complete transformation of the collection and administration machinery. It has the following related elements:

- An invoice and accounts based system of checking in place of routine physical checking.

- Basic data on the company (and its production units, warehouses, depots etc) would be entered once given an appropriate code number and stored on the computer.[36] It would *not* have to be entered on every invoice as at present.

- A simplified invoice *form* that focuses on values of inputs and outputs subject to the single VAT rate, and the source and destination of the inputs and outputs respectively. This is most effective if there is a single uniform base CENVAT rate with all goods treated equally on both the input and output side with respect to this rate. In this case the sale or invoice form would only require the total value of goods sold and the code number of the originating and destination units.[37]

- Monthly, quarterly or annual aggregation of the sales and purchase slips depending on volume of business (i.e. SSI have to do only annual aggregation, and only the largest

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[36] A 'CAN' (CENVAT account number) along the lines of PAN (personal account number for income tax).
[37] The form would require a little more detail in the case of goods subject to 'special excise'.

units have to do monthly aggregation). The aggregation would involve showing total value of purchases and sales by seller & buyer respectively, during the relevant period.

- A comprehensive computerisation of these aggregate returns, which allow cross checking of inputs, outputs value added and CENVAT paid, so as to detect evasion.

- This could be supplemented by industry wide database, which can be used to identify flow of goods and services entirely outside the VAT chain.

VII. FUTURE: 11th PLAN

An analysis of the 1990-91 BOP crisis and the subsequent reforms has shown [8] that the opening of the economy to international trade and capital flows has greatly strengthened the external account. The market oriented external trade regime can handle internal and external shocks much better, so that there is a strong argument for reducing the tariff rates to international levels during the eleventh Plan period. We therefore propose reducing the tariff rates down to OECD levels by the end of the eleventh plan from the (current ASEAN) levels projected for the tenth plan end (table 4). The ASEAN Free trade Area Agreement and the CEPT programme will bring ASEAN rates to the 0% to 5% range by 2010, even for "highly sensitive" agricultural goods & "sensitive" products (mainly agricultural) and even for the recent entrants like Cambodia & Laos. Our protective duty rates (and the VAT system) will then be competitive with those prevailing in developed and emerging market economies.

	Table 4: Customs Duty Reform Targets						
		10th plan	Eleventh Plan Period				
	Description of Goods	Last year	1st year	2nd year	3rd year	4th year	Last year
1	All Goods (excl 2-8)#	10%					5%
2	Specified Agricultural*	20%	15%	10%			5%
	(table 3)**						
3	Cars & 2-wheelers*	20%	15%	10%			5%
4	Hard Liquor	30%	25%	20%	15%	12%	10%
	(> 5% alcohol)						
	Exemptions						
	International Agreements						
5	15 specified goods	0%					@
6	4 specified goods	3%					@
7	4 specified goods	5%					5%
	Administrative/Valuation						
8	Specified goods (~20)	0%					0%
	National VAT (AD)						15%
	Note: # Could be brought down by 1% point per year during the 11th plan.						
	** Agriculture & allied goods include agro based products like wine & beer						
	(low alcoholic beverages with alcohol content $\leq$ 5%)						
	* Could be reduced by 2% point per year in the 3rd & 4th year of 11th plan.						
	@ International agreements should be modified to allow 5% tariff.						
	[If this is not done exempt (0%) goods are likely to increase]						

VIII. ANNEXURE

A. *References*

1   The Microeconomics of a Corrupt Tax Bureaucracy, DRD Discussion Paper No. 54, World Bank, May 1983.

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3   Tax Reform in Developing Countries: Issues, Policies and Information Gaps, <u>Public Finance</u> Vol. 43, No. 1 (1988), pp. 19-37.

4   Indirect Tax Evasion and Production Efficiency, <u>Journal of Public Economics</u>, Vol. 39(1989), pp 223-237.

5   Report of "Working Group on Extension of MODVAT to Textile Sector," 1993-94.

6   Tax Evasion, Corruption and Administration: Monitoring Tax Auditors Under Symmetric Dishonesty, paper presented at the <u>Conference on Political Economy</u>: Theory and Policy Implications, Washington, June 1997.

7   "Central Value Added Tax: CENVAT," Economic and Political Weekly, Vol. XXXVI No. 8, February 24-March 2, 2001, pp. 630-632.

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B. *Table A1: Phasing of Customs Duty Rates*