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**Indirect Tax Reform**

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## Indirect Tax Reform

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This review of the Report of the Jha Enquiry Committee on Indirect Taxation is, in one sense, partial because it is based on only the first part that has been released to the public.\* The other part has yet to see the light of the day. Though the immediate interest in the Report has been occasioned by the forthcoming 1978-79 Budget, it would be only fair and proper if one concentrates largely on the substantive conclusions and recommendations of the Committee.

### General Bias

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

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\*Presenting the Budget for 1976-77, Shri C. Subramaniam announced the decision to appoint a committee to review the existing structure of indirect taxes in the country. The Committee was headed by Shri L.K. Jha and had apart from three economists/civil servants, three representatives of trade and industry, two of them from Chambers of Commerce. Part I of the Committee's report outlining its main conclusions and recommendations was presented to the present Government in October, 1977 and has now been made public. Part II has also been submitted but has not been released.

Reading the above summing up in the very first few pages of an almost 200-page long report, the Committee's bias in favour of centralisation, in the tax field, was hard to miss. It only remained to speculate how far the Committee went in that direction, given its wide ranging terms of reference including the one entitling it to suggest changes necessary in the Constitution to implement its recommendations. Personally, I was relieved when I read through the Report and found that it had rejected the suggestion to abolish State sales taxes and that the farthest it went was to suggest that only if the States cannot be persuaded "to accept a more rational and simplified system of sales taxation on the lines recommended now" and "if voluntary agreement with the States is not found to be practicable, it would become necessary to include the powers to levy sales tax in the concurrent list."

Not that I agree at all with the aforesaid suggestion of the Committee for the transfer of sales tax to the concurrent list. On the whole, the States have shown quite a good performance with respect to sales taxation. The rate of growth of sales tax revenue has been at least as good as of Central excise. Sales taxes, on the whole, have shown a higher income elasticity (of more than unity) than Central excise (of 0.75) so that revenues of the former could improve with lower, or less frequent, enhancement of rates. This, the States could achieve in spite of the constraints (such as those imposed by provisions about (1) declared goods, (2) additional excise duties in lieu of sales tax and (3) inter-State sales taxation) which various Central legislations imposed on them in this regard.

Let me straightway make my position clear on the subject of centralisation. It is my judgement, naturally a political judgement altogether, that for a country of our size and variety what is needed to keep it together is less, and not more, of centralisation. So to the extent that the Report under review invokes existing or new powers with the Centre to achieve its objectives, however laudable in themselves, I consider them retrograde.

#### Cumulative Burden

But quite independently of one's view on the desirability or otherwise of increasing centralisation, the Jha Committee's observation that because the cumulative effect of indirect taxes is not looked at, or regulated by any single authority and because in pursuit largely of revenue each taxing authority tends to introduce autonomous changes, the progressivity or economic objectives are not served is not quite borne out by the Committee's own empirical findings, at least not in so far as progressivity is concerned. According to the tax incidence study commissioned by the Committee, the indirect "tax structure turns out to be uniformly progressive over the entire range of expenditure considered", the incidence ranging from 3% for households with per capita monthly expenditure not exceeding Rs.15 to nearly 22% for those in the group with expenditure above Rs.100 per capita. (Incidentally, the Committee is quite aware that since at the upper end of the income scale consumption expenditure is likely to comprise a lower proportion of income, the

tax incidence with reference to income may "tend towards reduced progression or even regression at the top"). So the case for centralisation or even bringing different tax authorities "under a discipline", as the Report puts it, does not appear to be strong, not on the ground of progressivity. If the problem is of calculating the cumulative incidence from time to time, let the exercises be undertaken to determine it on a regular basis.

Still, to dismiss the Report under review on the score that its political judgement runs counter to one's own would be rather unfair. Let us turn therefore to its major conclusions and recommendations.

#### Suspicious Deficiencies

According to the Jha Committee, the most serious deficiencies of the existing Indirect taxes, Central and State, can be traced to (a) taxation of inputs, (b) overlap of excise and sales taxation over a wide range of products and (c) inequitable distribution of tax burden of sales tax between States. The major proposals of the Committee, therefore, are aimed at rectifying these deficiencies.

#### Input Taxation

To start with input taxation, it is the Jha Committee's finding that the average nominal rates of excise duties, in 1975-76 were 25.3% on basic raw materials, 15.2% on other inputs and 13.5% on final products, an ordering that the Committee would frankly like to see reversed, but revenue-wise a reduction by percentage points on inputs could be made up by stepping up the tax on final production by 1.8 percentage points. Evidently, the tax base at the final stage is almost 3 times as large as at the intermediate stage. As for import duties, no precise figures are given but we are assumed that "the most important sources of revenue from

import duties are industrial inputs and capital goods", a situation that the Jha Committee would evidently disapprove of even though the rate applying to most basic raw materials is 45% compared to 75% on other inputs and 120% on final products, an ordering that obviously conforms to the Committee's line of reasoning. The explanation for the revenue still coming largely from input taxation is the obvious one, namely the quantitative restrictions which apply to the imports of fully processed goods with a view mainly to encouraging domestic processing. With respect to the State sales taxes, though the Report speaks of "the extensive sales taxation of inputs, no attempt seems to have been made by the Committee (on the evidence at least of the part being presently reviewed) to quantify it. However a table is given in the Report, of 16 selected items, to illustrate "the ways in which different duties and taxes levied by different authorities bring about a marked difference between the nominal rates of excise duties and sales taxes imposed on the products and the total cumulative levies on them". This table throws light on the relative incidence of input taxation imposed in different forms. According to this table, for 9 out of 16 items import taxation of inputs accounts for 20% or more of the cumulative duty; for 11 items the excise on inputs accounts for 20% or more of the cumulative duty and for only one item does sales taxation of input works out to 20% of the cumulative duty. If we take import and excise duties together, imposed as they are by the Centre, then for 14 out of 16 items the input taxation accounts for 20% or more of the cumulative levy.

#### Cascading

Anyway, why was input taxation so very bad? When taxes fall on both

inputs and final products they fall not only on the value of the products but at each stage on the taxes levied on them earlier. Also at each stage, there is a profit mark up including the mark up on tax paid. Also, industry or trade has, at each stage, to get a larger amount of finance which raises costs. All this is usually referred to as cascading, which has its undesirable consequences such as (a) it is difficult to control the incidence on final products, (b) it promotes the tendency to vertical integration and (c) it places exports at a competitive disadvantage.

But as the Committee is fully aware, input taxation has often times to be resorted to on economic and/or administrative grounds. Since the bulk of input taxation, as the illustrative table referred to above shows, is imposed by the Central Government itself, as either customs or excise duties, the rationalisation, one could think of seriously, should have taken on the form of an item by item examination to check where, and to what extent, input taxation had outlived its grounds - good economic and administrative reasons - original or subsequent. Where these grounds remain valid, the economic ones in particular, there is no question of providing a set off at the final stage. (Otherwise, the whole purpose will be defeated. My own judgement is that at India's present stage of development the economic grounds will become more, and not less, pervasive. To the extent this judgement is valid, the case for a comprehensive system of offset for input taxes becomes extremely weak. The case for a VAT, even the limited variety advocated by the Jha Committee, namely MAI-VAT applying to manufactured commodities only, is even weaker. I am not opposed, however, to allowing for offsets of revenue duties so long as the authorities fix the rates at the final stage in full awareness of the possibility of offset.

### Capital Goods

A distinction has been drawn by the Committee between the taxation of inputs and the taxation of capital goods. Although, excise duty on industrial machinery is normally low (cumulative incidence is estimated to vary from about 2.6% to 5%), the Committee's case is for keeping the rates low, if not abolish them altogether. Let me refer also to the related recommendation made by the Committee, in the context of encouraging new industries, favouring the old development rebate or the new investment allowance which, thanks to the 1977-78 Budget presented by the present Finance Minister, covers "all except negative list of 30 relatively low priority industries". To me both the recommendations are anti-employment. They derive from a view which ignores not only that within practically every industry there is considerable scope for substitution of capital by labour but that there is always considerably greater scope for choice between more and less capital intensive industries and that concessional treatment of capital goods tilts this choice in favour of the former.

### Tax on Cement

Interestingly, the case for reducing the duty on capital goods, particularly those other than industrial machinery, is illustrated by the Committee by reference to, what is regarded by it as a very high rate of duty on cement. As the Committee puts it, though cement is "a key and substantial ingredient" of construction activity still it is taxed at a very high rate of 28.5% on grey and 38.5% on white cement, a rate which raises the costs of all capital projects and inhibits a labour intensive and socially desirable activity like householding.



Apparently, the Committee believed that at its present controlled price inclusive of tax, there was an excess supply of cement. Actually, the situation has been exactly the opposite and cement is difficult for an ordinary person to buy at a premium of less than 50%. In fact, practically every other day, the Cement Controller in the Central Ministry of Industry is urging the public, through large ads, to "conserve cement for development projects" by using "less of cement and more substitute materials." The same ad. points out, by way of illustration, that "homes and walls don't need cement, they can last and endure on lime mortar". May be, the Committee chose the wrong item to underline its case for taxing goods at lower rates. However, in the process the Committee has, unwittingly though, demonstrated the fallibility of arbitrary numbers, whatever they are.

#### MULTIPLE RATES

While we are still on the subject of excise, let us take note of the eminently reasonable recommendation of the Committee to reduce the number of rate categories. Whether the rate categories should be as few as eight, 0 to 35 in multiples of 5, and whether the range should be as narrow, as that suggested, are matters of judgement which is bound to differ from time to time.

#### Switchover to Advalorem Duties

Reference was made above to the relatively lower income elasticity of excise revenue. This derives principally from the fact that still considerable revenue is accounted for by specific duties. The Committee has pleaded, quite rightly in my opinion, for "the maximum possible switchover, from specific to advalorem duties". It is bound to lend a larger measure

of income elasticity to excise revenue.

### Import Duties

While no major reform is suggested with respect to import duties, the Committee is openly averse to very high rates of duty that now obtain and has urged that now when our foreign exchange position is comfortable the trend should be reversed with the long term objective of lower rates of duty on inputs and machinery. As was stated above, inputs are already taxed to import duty at rates lower than those applying to consumer goods for the understandable reason that such differential taxation encourages domestic processing. Evidently, what the Jha Committee is pleading for is a lowering of absolute rates of import duty. Due homage is paid however to the need for protection.

### Sales Taxes

From what has been pointed out already, it should be obvious that it would be quite unfair to criticise sales taxes on the ground that they impinge on inputs and thereby "disturb" the incidence on final production. The Committee also draws a few other inferences in regard to sales taxation which, to say the least, are arguable.

The sales taxation of inputs, observes the Report, "also means that its burden falls on consumers outside the State". Not necessarily. The input taxing State itself may be manufacturing and consuming the finished products. And if a State gives concessional treatment to inputs used in manufacturing within the State the concession is available also to consumers of final products outside though the latter have to bear the inter-State tax. The fact that the Statewise collections of inter-State sales tax favour the better developed States reflects more the anomalous legal

position today under which while agricultural inputs largely escape inter-State taxation, industrial products cannot rather than the inequity in the system of inter-State taxation. One would have liked to see the Jha Committee recommend steps to remove the above anomaly rather than a drastic reduction from the present 4% to 1% of inter-State sales tax. Was it realised that the relative position of the States, even under 1% inter-State sales taxation, would remain as inequitable as before, though all would be collecting considerably lower revenue?

Since reduction of inter-State sales tax will, by itself, not ensure uniform prices of durable goods like cars and refrigerators and essentials like cement, medicines, vanaspati and even petroleum products, the Committee recommends that the additional excise duty in lieu of sales tax should cover such items with a view to preventing uneconomic diversion of trade. But one fails to notice any recognition by the Committee that in a country with wide inter-regional disparities it may be quite in order to promote some diversion of trade and industry to secure a more equitable inter-regional distribution.

Possibly, the least acceptable of the Committee's recommendation on sales tax would be that the States should move over to a system of single point taxation at the last stage. That the bulk of sales taxation throughout the country is single point is true for any one to see. But to suggest that it should be all levied at the last stage ignores that the stage or point of taxation is usually decided upon for each item depending upon its channel of trade. You tax an item at the point where it is easiest to reach administratively. You cannot sacrifice this administrative advantage for the sake of reaching the value added after the ex-factory stage; in the process even the ex-factory value changes largely

to escape the sales tax net. While I do not wish to be misconstrued as suggesting that every thing is fine with sales taxation, I am constrained to say that the Jha Committee's conclusions and recommendations do not bear the stamp of thorough understanding of the issues in sales taxation.

Concluding Observations

As I said at very outset whatever the suggestions for structural reform, the immediate interest in the Jha Committee's report derives, very largely from such of the observations and recommendations, dispersed all over the report, as may get reflected in the forthcoming Central Budget. I have deliberately tried to resist that temptation, for the Report must, in all fairness, be judged on the basis of its long-term suggestions for indirect tax reform.

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