Value Added Taxation in the States: The Challenges Ahead

By

M. Govinda Rao*
J.V.M. Sarma

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Please address all correspondence to:

J.V.M. Sarma/M. Govinda Rao
Visiting Faculty
Indian Institute of Management
Bannerghatta Road
Bangalore 560 076
India

Fax: (080) 6644050

(*was Visiting Faculty at IIMB)

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J V M SARMA

Abstract.

The need for coordinated development of domestic trade taxes in Indian federal polity has shifted the focus to reforms in the States' sales tax systems. The detailed analysis has led to a concensus on the need to transform the prevailing sales taxes into a destination based consumption type value added tax. The attempts to reform the sales taxes, however, have not been always in the right direction and, in addition, have met with resistance from traders. Based on the experience gained so far, the paper attempts to set out the strategy and stages of reform towards evolving the value added tax which is less distortionary and more acceptable to the traders.

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I. Introduction.

An important component of structural adjustment initiated in 1991 has been the reform of the tax system. In the first phase of reforms, the emphasis has been to simplify and rationalise Central taxes within the framework provided by the Tax Reform Committee. The attempts have been to broaden the base, lower and simplify the rate structure, and streamline the administration and enforcement. There has also been an attempt to rationalise customs duty in terms of lowering the peak and average tariff rates, and reduction in their dispersion, and of excise duties in terms of the coverage of MODVAT facilities to larger number of commodities and capital goods. Though it is too early to pass a judgement, these reforms surely have led to improvement in the structure of Central taxes as the share of direct taxes in the total increased sharply from 19 per cent in 1990-91 to 29 per cent in 1995-96.

With the reforms under way at the Central level, the focus has now shifted to the reform of State taxes, particularly the sales taxes. This is because, the sales tax contributes close to 60 per cent of the States' own tax revenues and almost a third of the domestic trade taxes in the country. Therefore, it is important to rationalise the sales tax systems prevailing in different States to minimise the relative price distortions and pave the way for coordinated and harmonised development of the domestic trade taxes.

The recent discussions on the desirable direction of reforms in sales taxes have pointed towards the need to transform the prevailing sales tax systems into a consumption type value added tax (VAT) to be levied by the States concurrently with the VAT at the manufacturing stage leviable by the Centre.[1] A number of States have already taken steps to rationalise their sales tax systems with a view to ultimately achieve the desired reforms. However, there are considerable variations across the States both in the direction, content and sequencing of reforms and the time is now ripe to understand and analyse the

measures taken hitherto. At the same time, many of the States have been facing resistance from the traders, and in order to make the VAT acceptable to the tax payers, it is necessary to go into the reasons for their apprehensions.

The objective of this paper is review and analyse the progress of sales tax reforms in the States, and indicate the sequencing of the measures needed to rationalise the sales tax systems based on the experience of other countries. Section II discusses the desirable form of domestic consumption taxes in India. In section III, we discuss, review and analyse the progress in rationalising the sales tax systems in different States. Some lessons of experience of introducing VAT in Thailand, another developing country, with a large number of small dealers and a complicated sales tax system with 21 rate categories before it was replaced by a single rated VAT is discussed in Section IV. In the light of the experience gained so far and the sequencing of reforms in Thailand, the transitional steps towards achieving the VAT at the State level in India are suggested in Section V.

II. The Reform Of Domestic Trade Taxes in India : important Issues.

The complexities of and relative price distortions arising from the prevailing excise and sales tax systems have been very well documented by several studies and reports of the committees and study groups. (Burgess, Howes and Stern, 1993, government of India, 1992, NIPFP, 1994, NIPFP, 1995). Briefly, the levy of manufacturing excises by the Centre and the predominantly first point sales tax by the States has created parallel systems of taxation with narrow base. The multiplicity of rates and exemptions in both the systems has contributed to enormous complexities. In some States there are as many as 20 tax rates and when the rate differentiation in turnover taxes and surcharges are taken account of, the number of rates would work out to be more (NIPFP, 1994). Although in the case of excise duties the tax credit facility on inputs and capital goods has been extended to a large extent, in most States sales taxes continue to be levied on inputs, capital goods and final consumer goods alike. Given the oligopolistic market structure, this has contributed to the levying of tax on tax, and mark up on tax at successive stages of production and distribution chain. In addition, the levy of inter-State sales tax, which is in the nature of a tax on inter-State trade has nullified the advantages of a large common market by impeding the free flow of inter-State trade. Besides causing unintended relative price changes, this has contributed to significant inter-regional inequity. It is for these reasons, the National Institute of Public Finance and Policy (NIPFP, 1994) study team appointed by the Ministry of Finance opined, "Domestic trade taxes in India are in urgent

need of reform. .....The system that is operating at present is antiquated, complex - according knowledgeable experts, the most complex in the world - and injurious to the economy in many ways." (P.1).

It must be noted that in a federal polity like India where the States enjoy significant tax powers, tax system reform involves not only rationalisation of the structure and administration of taxes according to the principles of tax policy, but also coordinated and harmonised development of consumption taxes to minimise the distortions arising from Center-State and Inter-State overlapping and competition. Therefore, the NIPFP study team after considering various alternatives concluded that the feasible solution is to have a dual VAT: the Center converting the Union excise duty into a manufacturing VAT and the States transforming the existing sales taxes into a VAT at the retail level.

At the Central level, the recent initiatives have considerably simplified and rationalised the excise duties. The replacement of the system of gate passes with the invoice based assessment system, conversion of specific levies with *ad valorem* tax and reduction in the number of tax rates, and extension of MODVAT credit to most commodities and more importantly, to capital goods have brought about significant degree of simplification and rationalisation of the tax. Nevertheless, much more remains to be done in terms of the rationalising the structure of the tax, extending the tax credit, improving the information system, and administration of the tax, before converting into a full fledged manufacturing level VAT.

III. Reform of Sales Taxes by the States.

At the State level, efforts are under way to bring the States together to agree for transforming their existing sales tax systems to VAT systems. The issues of feasible type of VAT to be levied and the stages by which this has to be reached have attracted considerable attention by both academicians and policy makers in the last few years. Towards forging a consensus, the Union Finance Ministry appointed a Committee of States' Finance Ministers from 10 different State governments to work out the rationalisation measures and their sequencing to achieve a rational and a coordinated structure of sales taxation in the States.

In keeping with its terms of reference, the Finance Ministers' Committee, laid down the steps to transform the prevailing State sales tax systems into a consumption type VAT at the retail stage. In the first stage, rationalisation in tax rates are to be attempted

that would bring about a certain measure of harmony in the tax systems while preserving the States' flexibility and autonomy. The Committee, by general agreement fixed four floor rates, namely, 0, 4, 8 and 12 per cent for general commodities and two special floor rates of 1 and 20 per cent on a few high value and conspicuous items classified on the basis of the prevailing rate structures in the States. In the second stage, that is by April 1997, the sales tax incentives for industrialisation should be done away with. The policies in this sphere in the past have led to 'the race to the bottom' with the States competing with one another to provide in some cases, 'open ended' and 'comprehensive' tax incentives (Tulasidhar and Rao, 1986). In the third stage, provision should be made for relieving the tax paid on inputs and capital goods. This should be followed by further rate rationalisation, and reduction and eventual elimination of the tax on inter-State sales tax.

However, in view of the high dependency on sales taxes as a source of revenue, the decision to adopt the VAT at the States' level is bound to be based on more introspection and analysis. Each State would like to take its own time to weigh the pros and cons in assessing the costs and benefits of the conversion process. Nevertheless, a number of States have already taken steps to rationalise their sales tax systems with a view to ultimately achieve this objective and others have been deliberating on the feasible measures to be taken towards levying the VAT in the near future. States like Andhra Pradesh, Kerala, Rajasthan and West Bengal have attempted to introduce the VAT principle by extending the sales tax to stages beyond the first point sale in respect of selected consumer goods and a number of States are considering reform on similar lines. Maharashtra, on the other hand, has introduced a tax on resale of goods with a set off on the tax already paid for all dealers with a turnover of more than Rs 50 lakh and intends to extend the coverage to dealers with smaller turnover over the years.

It must be however, conceded that the experience of the States that have already taken the initiative, is not all that encouraging. For example, in Andhra Pradesh, the first point sales tax was converted into a VAT for 19 commodities but the move was strongly resisted by the traders because of the vagueness in the laws and procedures in respect of the definition of a "retailer", the threshold limit, the conditions for claiming the set-off on the purchases, and so on. In Tamil Nadu, the introduction of VAT in respect of services has been challenged in the High Court by Sundaram Finances.

As mentioned earlier, the Finance Ministers' Committee has recommended four floor rates for general commodities by including all supplementary levies like the additional turnover tax and surcharge on sales tax. The States like Karnataka have

rationalised the levies on these lines, but have allowed the turnover tax and surcharge on sales tax to continue. As even the turnover tax rates vary depending on the range of turnover, the number of tax rates are much larger than the rates indicated in the schedule. The Committee's recommendation is only on fixing the floor rates and there is no reason why the States can not merge these supplementary levies with the basic rates and simplify the rate structure further.

While the intention of fixing the floor rates by the Finance Ministers' Committee was intended to prevent the "race to the bottom", there is every danger that it could work as a cartel. Therefore, it needs to be assured that the measure is intended only to be transitionary - to minimise the "free-riding" effects of inter-State tax competition, and eventually leading to further rate reduction. Even so, it must be noted that the States may find rationalisation difficult, if the Union Territories continue to undercut the tax rates as in the past. The Union Home Ministry is not a party to the agreement reached in the States' Finance Ministers' Committee, nor have they been involved in further discussions on rationalisation. As the present government at the Centre represents the interest of a number of regional parties, it is eminently placed to ensure conformity by the Union Territories in any measure of rationalisation and should act so in order to minimise the harmful effects of intergovernmental competition. Unless the tax systems of the Union Territories are brought in line with those of the States, any hope of evolving a coordinated and efficient consumption tax structure in the country will be belied.[2]

Conceptually, the recent reforms in the sales tax systems undertaken by the States fall into two categories: First is extending the tax beyond the first point of sale with a set off on the tax already paid *selectively* on specified finished consumer goods. Second is extending the tax on *all* finished consumer goods up to the wholesale or semi-wholesale stages identified by specified turnover base. In either case, the objective is only to broaden the tax base by including transactions beyond the stage of production and import into the State.

It would, however, be erroneous to characterise these reforms as the introduction of VAT as has been done by the States for political reasons. These measures can, at best, be called the initial steps towards achieving the VAT. This is so because, firstly, the principle of VAT is applied only at the post-manufacturing stage on the distribution and trade margins, and the cascading effects of taxes levied on inputs and capital goods continue to prevail. It must be mentioned in fairness though, that some of these States have lowered the tax rates on selected inputs, or have evolved mechanisms to significantly

relieve the taxes on them. There is however, no systematic attempt to relieve the taxes on inputs and capital goods. Secondly, the States have been selective in their coverage, ether in terms of commodities or the turnover limit. Such reforms, instead of simplifying the tax system actually, may contribute to its complexity and thereby generate a lot of hostility from the traders towards VAT. The introduction of VAT principle on *specified commodities* can create a lot of inconvenience to the traders and tax payers, for, the dealers now have to maintain separate accounts on the sale of commodities subject to the VAT principle and on those that are not. The selective extension of the coverage to specified commodities at post-manufacturing/ import stages may also create lobbying and special interest groups to keep themselves out of the additional coverage. Thirdly, the tax is confined only to goods, and services continue to be outside the purview of the levy. The extension of the tax to services would require the amendment of the Constitution. A number of services enter into the production of goods and *vice versa* and therefore, if the dual VAT system as recommended by the NIPFP study team has to be implemented, both the Centre and the States should have concurrent powers to levy tax on services to relieve the input taxes. Fourthly, no mechanism has so far been developed to relieve the tax included in the commodities sold on inter-State trade. Finally, as proper VAT is not in vogue, it has not been possible to calculate the refunds on (zero-rate) the exports.

Simplification of the rate structure would, no doubt, reduce the compliance cost to some extent, but by itself, this is unlikely to be attractive to the tax payers as there are additional compliance costs of paying the tax, and claiming a set off on the tax already paid. As already mentioned, the reforms so far implemented merely attempt to extend the tax to stages subsequent to the first point by setting off the tax paid in the previous stage. Thus, the resellers who were not required to pay the tax earlier are now required to pay the tax, which naturally invokes resentment. They are also required to keep more detailed accounts than in the past. Therefore, by itself, mere rate rationalisation is unlikely to convince the dealers that paying the tax in stages beyond the first point would confer any advantages on them until a full fledged VAT is introduced. At the same time, extension of the tax to post-manufacturing and import stages without the willing cooperation of the dealers is not likely to succeed and it is therefore, important to demonstrate the definite advantages to them.

IV. The Experience of Thailand in Introducing the VAT:

In introducing the VAT, much can be gained from the experience of other countries that have successfully implemented the tax. Particularly, in undertaking the initial reform measures, the experiences of developing countries like Thailand has much to offer. This is because, Thailand, like India, has a large number of small dealers. Before the introduction of the VAT in January 1992, Thailand also levied a cascading type "Business tax" on the producers, importers and dealers in various services at as many as 21 rate categories. This was replaced by the VAT at a single rate (with very few exemptions on unprocessed food items, farm inputs and educational and health services) on all dealers having a turnover of more than 600,000 Baht. Even though the revenue neutral rate was estimated at 10 per cent, the tax was levied at a lower rate of 7 per cent to ensure easy acceptability and better compliance.[3]

Some important lessons from the experience of Thailand in introducing the VAT are notable. First, the tax was introduced after a thorough preparation for almost five years. The government appointed as many as eleven working groups to work out the details, evolve necessary legal framework, build the information system and computerisation, cater to the educational and training needs of the tax payers and tax officials and to coordinate the work of the various working groups to ensure a smooth transition. In this task international advisers and consultants also played a very important role.[4] The preparation also created the confidence to the policy makers and showed that even with a low tax rate, the targeted revenues could be realised. The reforms resulted in the simplicity, lower tax rate, a properly worked out scheme of tax relief on inputs and capital goods and the most important, the provisions to refund the tax to the exporters within a month.

Second, policy environment was created to switch over from the cascading type tax with the 21 tax rates to a single rate consumption type VAT. Of course, in India inter-state tax competition makes it more difficult to make such a radical change in one stroke, but significant rate reduction and rationalisation is within the realms of feasibility as some of the States like Karnataka have found when they reduced the number of tax rates drastically last year.

The most important feature of the reforms in Thailand, however, is the system of simplified tax assessment introduced on the small dealers. The tax is applicable to all those dealers with a turnover of more than 600,000 Baht. However, all dealers upto 1.2 Million

Baht may opt for a simplified system of assessment by simply paying the tax at 1.5 per cent of their turnover. Those above this limit are required to pay the tax at 7 per cent with set off provided for the tax already paid. The smaller dealers who pay the simplified tax are not a part of the 'ring', and the tax paid by them can not be set off. If, however, they intend to be a part of the 'ring', they could voluntarily register and opt for the regular assessment. As most of the dealers falling below 1.2 million baht are retailers, the cascading from the turnover tax is minimum. This principle can easily be incorporated in the reforms in the sales tax systems in India.

V. Transition Towards the VAT : Suggested Measures.

In the interest of minimising cascading effects and relative price distortions, and improving revenue productivity of the tax system, there is a general agreement that the prevailing sales tax system should be transformed into a consumption type VAT. It is therefor, important that the reforms in the sales tax systems undertaken by the States should facilitate a smooth switch over to VAT. It is also important to create a vested interest for such a reform. Given the complexity of the prevailing system and the large number of players involved in the game, this can only be reached in stages with well backed up research and preparation. However, it is necessary to lay down the various stages and evolve a definite time table to be followed by all the States and Union Territories to ensure that the reforms are in the indicated direction and progress in achieving the goal is broadly uniform.

The first step in the introduction of the VAT is to rationalise the existing tax rates on the lines suggested by the State Finance Ministers' Committee, and extend the tax beyond the first point by setting off the tax paid at the previous stage. Some of the States have already taken steps and many are contemplating action in this direction. However, it is important to ensure that the reform does not fail even before it begins, and the success of rationalisation and expansion of the tax base, as mentioned earlier, depends on three important factors.

First, the rate rationalisation into four floor rates should be done taking account of all supplementary levies like surcharge on sales tax and turnover tax. If these supplementary levies are continued and if their rates too are differentiated depending on the turnover range of the dealers, there will be much more rate differentiation than what is intended and the purpose of minimising rate differentiation will be defeated. Once removed the policy makers should desist the temptation to introduce such levies from time

to time to meet the exigencies of revenue. More importantly, it must be noted that the rationalisation exercise can not succeed unless the Union Territories are actively involved in it.

Second, it is important work out the revenue neutral rates as the tax base is expanded in order to demonstrate the advantages of the VAT to the tax payers. The emphasis should be on long term revenue productivity coming from the better tax compliance. It must be noted that Thailand levied the tax at 7 per cent even when the revenue neutral tax rate was 10 per cent, and this went a long way in the acceptability of the tax. Interestingly, this ensured a high overall revenue productivity as the revenues increased at the average rate of about 30 per cent after the adoption of VAT. Interestingly, the reform led to significant improvements in the buoyancy of income and corporation taxes besides the VAT. With improved buoyancy, the task of fiscal adjustment was rendered easy, and the Government could in fact, reduce the marginal rate of income tax from 50 to 37 per cent, and of corporation tax by 5 points to 30 per cent. In contrast to this, much of the resentment in Canada against the levy of the goods and services tax was due to the perception that the rate of tax levied was not really revenue neutral and the new tax rate did not take into account the expansion of the tax base which included services.

Third, it is important to have the tax payers on the side of reforms. One method that can easily be adopted to minimise hardship to the dealers and significantly reduce the burden on the tax officials is to have a simplified tax levied at the rate of 2 per cent (or lower) on the turnover of all dealers with, say less than Rs. 10 lakhs and the regular VAT on the remaining. At present, the tax on their turnover is in the range of 1.5 to 2 per cent and even in Karnataka where in addition to the regular sales tax, a turnover tax and a surcharge on sales tax is levied, the average rate works out to about 2.5 per cent. The tax paid by the dealers paying the simplified tax will, however, not be deductible as they will not form a part of the ring. If, however, any of the dealers in this category want to be a part of the ring they could opt to voluntarily register and pay the tax at regular rates. In this way the smaller manufacturers and wholesalers are not disadvantaged. Most dealers falling below Rs. 10 lakhs are in any case be retailers and the cascading resulting from levying the tax on their turnover will be minimal. This reduces the burden of keeping detailed accounts and invoices to significant proportion of the dealers. In Karnataka for example, dealers below Rs. 10 lakh turnover constitute 77 per cent of the total and they account for only about 6 per cent of the taxable turnover and the tax paid (Table 1). Even

this arrangement can be reached in stages, initially having simplified assessment on dealers below Rs. 50 lakhs and gradually extending the coverage to dealers below that after acquiring the experience. This will exclude almost 92 per cent of the dealers from keeping detailed record of invoices and accounts, and they account for just about 15 per cent of the turnover and tax paid.

From this point of view the Maharashtra model of taxing the value added subsequent to the first point on all final goods by dealers above Rs 50 lakh turnover is preferable to the system of selectively extending of post manufacturing value added on specified commodities. This can help to expand the tax base to post manufacturing/import stages and minimise the resistance and eventually help the transition to a full fledged VAT.

The second stage of reform involves the extension of the sales tax on services and this calls for the amendment of the Constitution. Neutrality in taxation calls for the taxation of services and given that many services enter into the production and distribution of goods, the value added tax eventually adopted will have to relieve the tax on services as well. As both the Centre and the States will be levying the VAT, there is no reason why the taxation of services should be an exclusive prerogative of the Centre. It would be ideal to give concurrent powers to the States to levy tax on services. Of course, some meritorious services like social services may be kept out of the purview of taxation by both the Centre and States.

In the third stage, it is important to eliminate all forms of tax reliefs and incentives for industrialisation. Simultaneously, the States can introduce the system of providing tax credit on the purchases of inputs and capital goods to the manufacturers. This is a more neutral and better form of incentive than the various types of incentives provided by the States. However, as the central sales tax will still be in vogue, the principle can be extended to purchases within the state, which, from the national viewpoint is not entirely desirable as it can result in inter-state tax spillovers. However, as a transitional step, this may be the next best solution.

The fourth stage of reform involves further rate rationalisation into one or at the most two rates estimated to ensure revenue neutrality by taking into account the expanded tax base. Simultaneously, the Central sales tax should be abolished, the input relief extended to all inputs and capital goods, whether bought from within or outside the State. This would also require the creation of a clearing house mechanism to relieve the tax on inter-State sales to ensure that the tax collected by the exporting State is returned to the

State where the final sale tax place. It is necessary to recognise that a full-fledged VAT can not be achieved unless inter-State sales tax is significantly brought down and eventually, all such sales are either zero rated or set off.

Abolition of inter-State sales tax will be the most contentious issue in the introduction of VAT. Due to the fear of losing revenues, the States have not been able to come to the agreement on the issue of abolishing or even reducing the inter-State sales tax. Of course, political leadership in a number of States did not hesitate loose large amount of revenues for populist reasons like introducing prohibition or to initiating a number of subsidies and transfers. But, it is unlikely that they will be easily persuaded by the need to reform the tax system by abolishing the central sales tax unless a compensatory mechanism is introduced though, the revenue from the tax constitutes just about 17 per cent of the sales tax revenue. The Centre could work out a scheme to pursued the States to give up the inter-State sales tax in return for giving them the power to tax services. After all, if the economy is fully liberalised and import of consumer goods allowed at low rates of tariffs, the States would lose a lot of business if they persist with the inter-State sales tax. (Import may become cheaper than purchasing from other States. If necessary, the Centre may also provide a compensation to cover a certain percentage (say 50 per cent) of the revenue from CST in each State for a specified period (say, three years) until the reforms are firmly in place and revenue productivity of the tax system shows significant improvement. The compensation may be based on the latest years' revenue from the CST or the average of the last two/ three years. As it is, the introduction of the VAT, backed by a proper information system is likely to enhance the revenue productivity of personal income and corporate taxes significantly and as the amount of compensation involved is within the realm of feasibility, the Centre can certainly do so in the interest of efficiency.

In any case, the fear of losing revenue is likely to weigh heavily in any rationalisation measure leading to the introduction of the VAT. Unless the bureaucrats are assured that they will not be penalised in the case of short term revenue loss, they are likely to develop a cold feet. It is therefore, important for the Centre to create a fund to compensate the States in the event of a significant shortfall in revenue. The detailed modalities of compensation can be worked out and the multilateral institutions can also be asked to assist the fund as they have shown a keen interest in the sales tax reform in recent years.

It is important that the detailed steps involved are discussed threadbare by the Centre and the States and a detailed time table drawn up by which time all the parties concerned will undertake the reform measures needed. Once broad measures are agreed upon and the time table drawn, it is necessary to appoint a number of working groups by the States to work out the structural, legal, operational, and transitional details, the development of the required information system, computerisation of the returns and the creation of the clearing house mechanism. This will ensure a certain measure of uniformity and harmony in the evolution of the VAT and also adherence to a time bound plan of removing the inefficiencies and distortions that bedevil the sales tax systems at present.

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Distribution of Sales Turnover and Tax Paid by Range of Turnover Illustration From Karnataka State(1994-95)					
Range of Turnover (Rs. Lakh)	Number of dealers	Gross Turnover (Rs. Crore)	Taxable Turnover (Rs. Crore)	General Sales Tax Paid* (Rs. Crore)	Percentage of Tax Paid to Gross Turnover
<10	171224 (76.7)	4553.6 (6.6)	1414.6 (5.9)	115.1 (5.6)	2.5
<50	205882 (92.2)	12627.7 (18.2)	4398.5 (18.2)	298.9 (14.6)	2.4
>50	17351 (7.8)	56717.5 (71.8)	19746.0 (81.8)	1744.7 (85.4)	3.1
Total	223233 (100.0)	69345.2 (100.0)	24144.5 (100.0)	2043.6 (100.0)	2.9

* Includes turnover tax also.
Figures in brackets represent percentage to totals.
Source: A Profile - Commercial Taxes Department, Government of Karnataka, 1996.

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[1] For a detailed discussion on the desirable form of consumption taxes, see, Burgess and Stern, and more particularly, the Report of the Study Team on Domestic Trade Taxes, (NIPFP, 1994) and also, Joshi and Little, 1996.

[2] The distortions in the State tax structures caused by the Union Territiories can be highlighted by the example on the taxation of motor cars at 3 per cent by Chandigarh Administration. This has forced Punjab to levy the tax on motor cars at 3.5 per cent, lower than the tax rate levied on even foodgrains! Some States have resorted to the levy of entry taxes on motor vehicles to minimise the diversion of trade into Union Territiories having low tax rates, additing to the complexity and distortions.

[3] For details, see NIPFP (1995), Appendix.

[4] This was also true of Indonesia where the team led by Malcolm Gillis of Harvard University not only provided the blueprint for the introduction of VAT, but also took a lead role in providing training to the tax officials.