HARMONIZING SALES TAXES IN A FEDERATION
CASE STUDIES: INDIA AND CANADA

Amaresh Bagchi

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I. Introduction

India and Canada are two large countries of the world far removed from one another in many respects, not geographically alone. Canada is one of the richest countries of the world, while India is among the poorest. In human development Canada leads even the advanced nations; India figures among those at the bottom of the league. But there are many parallels too. Both the countries share a colonial past under the British and, more notably, both are federal democracies. Though the composition of its population is not as heterogeneous as that of India, Canada, like India has to contend with problems that are inherent in federations marked by sharp ethnic diversities and imbalances in resource endowment and economic development across regions.

Canada however has a much longer experience in federal governance and its system of federal-provincial arrangements in the fiscal arena is known to be one of the most developed in the world, conforming quite closely to the economic principles of fiscal federalism (Boadway,1993). How Canada has tried (and is trying) to grapple with the basic challenges that every federation has to face viz.,redressing the imbalances in the functions and finances of government at different levels, equalizing the fiscal capacity of subnational governments and harmonizing the system of taxation in the country, provides useful lessons for other federations like India. The manner in which India has gone about in addressing these tasks also would be of interest to Canada, and perhaps other federal countries. This paper seeks to review the approaches of Canada and India in resolving the problem of tax harmonization particularly the sales taxes. It should be acknowledged that the question of tax harmonization cannot be considered in isolation from issues bearing on vertical and horizontal imbalances and some of them will be touched upon in the course of the discussions. However, the focus of the present study is on issues in harmonizing the sales taxes in India and the lessons that Canadian experience offers.

The paper is divided into four parts. Section II sets out the context in which the issues relating to harmonization of sales taxes are currently under discussion in India in a historical perspective; section III presents an overview of Canada's approach to harmonization in sales taxation, the

progress so far and the prospects; section IV tries to draw lessons for India from Canadian experience.

II. Sales Tax Harmonization - the Indian Context

a. *Significance of sales taxes in India and infirmities*

In India, as in most federations, along with expenditure responsibilities, powers to levy taxes are divided between two layers of government, viz. the Union and the states. (Local governments can also levy designated taxes if authorised by the states). While powers in respect of taxes that fetch the bulk of the revenue belong to the Union, i.e., the national government, a variety of taxes fall within the domain of the states (Box 1).

BOX 1

Tax Powers of the Union and the States under the Indian Constitution (vide Seventh Schedule to the Constitution)

	Union		States
1.	Taxes on income other than agricultural income.	1.	Land revenue, including the assessment and collection of revenue, the maintenance of land records, survey for revenue purposes and records of rights, and alienation of revenues.
2.	Duties of customs including export duties	2.	Taxes on agricultural income.
3.	Duties of excise on tobacco and other goods manufactured or produced in India except - (a) alcoholic liquors for human consumption; (b) opium, Indian hemp and other narcotic drugs and narcotics, but including medicinal and toilet preparations containing alcohol or any substance included in sub-paragraph (b) of this entry.	3.	Duties in respect of succession to agricultural land.
4.	Corporation tax.	4.	Estate duty in respect of agricultural land.
5.	Taxes on the capital value of the assets, exclusive of agricultural land, of individuals and companies; taxes on the capital of companies.	5	Taxes on lands and buildings.
6.	Estate duty in respect of property other than agricultural land.	6.	Taxes on mineral rights subject to any limitations imposed by Parliament by law relating to mineral development.

Box 1 (contd.)

	Union		States
7.	Duties in respect of succession to property other than agricultural land.	7.	Duties of excise on the following goods manufactured or produced in the State and countervailing duties at the same or lower rates on similar goods manufactured or produced elsewhere in India: (a) alcoholic liquors for human consumption; (b) opium, Indian hemp and other narcotic drugs and narcotics, but ~~not including medicinal and toilet~~ preparations containing alcohol or any substance included in sub-paragraph (b) of this entry.
8.	Terminal taxes on goods or passengers, carried by railway, sea or air; taxes on railway fares and freights.	8.	Taxes on entry of goods into a local area for consumption, use or sale therein.
9.	Taxes other than stamp duties on transactions in stock exchanges and futures markets.	9.	Taxes on the consumption or sale of electricity.
10.	Rates of stamp duty in respect of bills of exchange, cheques, promissory notes, bills of landing, letters of credit, policies of insurance, transfer of shares, debentures, proxies and receipts.	10.	Taxes on the sale or purchase of goods other than newspapers, subject to the provisions of entry 92A of List I.
11.	Taxes on the sale or purchase of newspapers and on advertisements published therein.	11.	Taxes on advertisements other than advertisements published in the newspapers (and advertisements is broadcast by radio or television).
12.	Taxes on the sale or purchase of goods other than newspapers, where such sale or purchase takes place in the course of inter-State trade or commerce.	12.	Taxes on goods and passengers carried by road or in land waterways.
13.	Taxes on the consignment of goods (whether the sonsignment is to the person making it or to any other person), where such consignment takes place in the course of inter-State trade or commerce.)	13.	Taxes on vehicles, whether mechanically propelled or not, suitable for use on roads, including tsramcars subject to the provisions of entry 35 of List II.
14.	Any other matter not enumerated in List II or List III including any tax not mentioned in either of those Lists.*	14.	Taxes on animals and boats.
		15	Tolls.
		16	Taxes on professions, trades, callings and employments.
	* List II sets out the powers and functions of the states. List III relates to concurrent subjects.	17	Capitation taxes.
		18.	Taxes on luxuries, including taxes on entertainments, amusements, betting and gambling.
		19	Rates of stamp duty in respect of documents other than those specified in the provisions of List I with regard to rates of stamp duty.

Of the total tax revenue of the states raised in 1992-93 and 1993-94, nearly 60 percent came from sales taxes. In some states the proportion is as high as 68 percent (Table 1). Such dependence of subnational governments on the sales tax is not peculiar to India. The provinces in Canada (and the states in the USA) also derive a substantial part of their revenue from sales tax. What distinguishes sales taxation in India, from that prevailing in Canada is that:

- In India the power to levy sales tax within a given state belongs exclusively to the state concerned (subject only to some restrictions). This is because the assignment of tax powers under the Indian Constitution is based on the principle of separation as distinguished from that of concurrence. The Central government in India (referred to hereafter as the Centre) is empowered to levy duties of excise only on manufacturing and has no authority to go beyond the manufacturing value in determining the base. In Canada on the other hand tax powers except for customs and property tax run concurrently.

- Although in Canada both the federal government and the provinces can levy sales tax - presumably at all stages of trade - in practice the sales tax is levied by the provinces primarily at the retail stage. And so conflicts in the exercise of sales tax jurisdiction or "tax exporting" by one province to another have not been a major problem and that is the position in USA too although tax exporting does takes place there. In India on the other hand by virtue of a law enacted by Indian Parliament, the Central Sales Tax (CST) Act of 1956, inter-State sales too are liable to be taxed by the states of origin. Although the rate of tax is limited to a ceiling laid down by Parliament, this has resulted in tax exporting on a signifiscant scale. On an average, about 17 per cent of the revenue of the states from sales tax comes from the CST; in some states the proportion is as high as 34-35 per cent (Table 2), while in some it is no more than 7 per cent.

- Because of administrative ease, in India sales taxes have come to be applied increasingly at the first stage of sale in a state with the base overlapping considerably with that of central excises and in the absence of adequate relief for tax paid on inputs, this leads to cascading and several other undesirable effects. There is base overlap in Canada too but since the provincial sales taxes are on retail sales, cascading, though noticeable, is less acute.

TABLE 1

Structure of States' Own Tax Revenue
(Average of 1992-93 & 1993-94)*

(Rs. billion)

States (1)	Total tax revenue (2)	Direct taxes (3)	Indirect taxes (4)	Sales tax (5)
Andhra Pradesh	35.0	3.0	32.1	20.7 (59.0)
Bihar	16.6	2.1	14.4	10.9 (65.6)
Gujarat	36.7	2.8	33.9	24.7 (67.2)
Haryana	15.3	1.1	14.2	7.3 (47.6)
Karnataka	35.3	3.5	31.8	20.3 (57.4)
Kerala	20.9	2.4	18.5	14.2 (68.2)
Madhya Pradesh	25.8	2.1	23.7	11.8 (45.9)
Maharashtra	69.8	8.2	61.6	43.9 (63.0)
Orissa	8.2	0.7	7.5	4.9 (59.3)
Punjab	19.4	1.6	17.8	8.8 (45.2)
Rajasthan	18.6	1.7	16.9	10.1 (54.3)
Tamil Nadu	42.3	3.6	38.7	28.7 (67.9)
Uttar Pradesh	40.5	5.4	35.1	21.2 (52.3)
West Bengal	27.9	4.6	23.2	17.6 (63.2)

Notes: Figures in brackets denote percentages to total tax revenue.
* For 14 large states.

Source: RBI Bulletins

TABLE 2

Proportion of Central Sales Tax in States' Sales Tax Revenue

(Average of 1992-93 & 1993-94)

(Rs. billion)

States	Total sales tax			Central Sales Tax			Col.(7) as % of col. (4)
	1992-93	1993-94 (R.E.)	Average of col.2 & col.3	1992-93	1993-94 (R.E.)	Average of col. 5 & col. 6	
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Andhra Pradesh	18.5	22.8	20.7	3.2	3.3	3.3	15.9
Bihar	10.3	11.4	10.9	3.0	3.3	3.2	29.4
Gujarat	23.0	26.4	24.7	4.2	4.4	4.3	17.4
Haryana	6.8	7.8	7.3	2.2	2.7	2.5	33.9
Karnataka	17.8	22.8	20.3	4.1	4.0	4.0	20.0
Kerala	13.1	15.4	14.2	0.9	1.3	1.1	7.8
Madhya Pradesh	10.5	13.2	11.8	2.5	2.9	2.7	23.0
Maharashtra	41.4	46.5	43.9	7.5	8.6	8.0	28.3
Orissa	4.5	5.3	4.9	0.2	1.4	0.8	16.0
Punjab	8.1	9.5	8.8	2.1	1.9	2.0	22.6
Rajasthan	9.3	10.9	10.1	0.7	0.7	0.7	6.6
Tamil Nadu	27.4	30.0	28.7	3.6	3.8	3.7	12.8
Uttar Pradesh	20.2	22.2	21.2	1.4	1.7	1.6	7.5
West Bengal	16.2	19.0	17.6	5.9	6.5	6.2	35.2
All India	233.5	270.1	251.8	41.7	47.8	44.8	17.8

Source: R.B.I. Bulletins.

For revenue reasons, in India sales taxes are levied on all commodities including inputs and capital goods, while because of constitutional limitations, services are excluded from the base[1] discriminating against goods and in favour of services. This has given rise to interminable problems in separating out the service component in sale of goods taking place

in several instances, e.g., in the course of execution of works contracts, service of food in restaurants and so on. No such constraints operate in Canada.

These characteristics of commodity tax system in India have given rise to many acute problems: complexity, lack of transparency, distortions in economic decisions and inequities in interjurisdictional division of tax bases. It is increasingly felt that these problems cannot be resolved without harmonization.

Harmony is needed also because, in its absence, there is intense tax competition among the states to attract trade and industry to their respective jurisdictions. Generous concessions are offered to new industries, small industries and industrial units set up in backward areas through tax holidays and /or deferral of tax payment by almost all states to the detriment of revenue, as well as equity and causing problems for both enforcement and compliance. The base being narrow with the exclusion of services and concessions of various kinds, not to mention widespread evasion because of administrative weaknesses, the rates of tax have to be higher than would otherwise be necessary to collect the same amount of revenue, providing further impetus for evasion.

Pressure for revenue has impelled many states to go in for supplementary levies in the form of surcharges, additional sales tax and, in many cases, a turnover tax applicable at different stages of sale resulting in lack of transparency and uncertainty and, for several sectors unduly heavy burden of tax. That in turn generated pressures for further concessions for selected sectors and sections with the result that rates vary widely across commodities depending on their classification in the rate schedule which is based on distinctions that are often hair splitting, requiring judicial arbitration. Cases are taken to courts to decide questions such as whether "coconut" is a fruit or an oilseed.

To alleviate the burden of input taxation most states provide relief either through the suspension method or by applying a lower rate of tax on raw materials and other inputs (though not capital goods). But these concessions are confined only to inputs procured within the state and are clawed back unless the products are sold within the state or suffer taxation under the CST when sold inter-state. The CST Act lays down a ceiling of 4 percent on the tax leviable on inter-state sale where the transaction takes place between registered dealers, otherwise a minimum of 10 percent is chargeable when goods are sold across state borders

to unregistered dealers or final consumers.

Since the CST applies only when there is a sale, goods moving from one state to another on a consignment basis ("branch transfer") are not liable to tax. As this opened up opportunities of evasion/ avoidance, the states persuaded the Centre to get the Constitution amended to permit the levy of tax on consignments. No law has yet been enacted for levying a consignment tax and so the battle of wits between taxpayers and tax gatherers, of which the clawback provisions just mentioned is a manifestation, continues. Moreover, each state has its own laws and procedures prescribing different schedules and forms for compliance the number of forms in some cases running to over forty.

Domestic production and trade in India comes under heavy and haphazard taxation also by the Centre through duties of excise. Originally envisaged as a selective tax on a few commodities the ambit of central excises got widened over time - again to meet the requirements of revenue - encompassing the entire manufacturing sector barring those specifically exempted. The structure and operation of excises were also marked by all the problems that are encountered in the taxation at the manufacturer level, viz. the definition of manufacturing, valuation, demarcation between manufacturing and post-manufacturing expenses and so on.

Another source of problems and disputes has been the exclusion of services from the tax base and the narrow interpretation of the term "goods" by the courts in the context of sales and excise taxation.[2] Attempts have been made to overcome these problems but many of the difficulties persist.[3]

The economic impact of such a system of commodity taxation has not been fully investigated. It was however evident - and available studies corroborate it - that internal trade taxation has been a source of inequity as well as distortion and inefficiency in economic decisions and resource allocation (Rao 1993, Rao and Vaillancourt 1994), impeding growth and the competitive strength of Indian industries. As the recent study on the subject carried out at the National Institute of Public Finance and Policy (NIPFP) sums up:

> "The system (of domestic trade taxes) that is operating at present is archaic, irrational and complex - according to knowledgeable experts, the most complex in the world. It interferes with the free play of market forces and competition, causes economic distortions, and entails high costs of compliance and administration." (NIPFP, 1994.)

While equity has been a prime concern of public policy, given the complexity of the tax structure and the weaknesses of administration, it was not possible to ensure that the incidence of the taxes conformed to any desired pattern. In fact, it was difficult even to figure out who bore how much of the tax burden.

b. Reform Initiatives

That the structure of trade taxes has been harmful for the economy and probably not very equitable either is now well recognised. Attempts have also been made from time to time to reform the system.

Thus, a high powered Indirect Taxation Enquiry Committee (the Jha Committee) was set up in 1976 to look into the structure and recommend measures for reform. Following the recommendations of the Committee - though after nearly a decade - a rudimentary manufacturers' value added tax was introduced in 1986. No effort was however made to carry out any fundamental reform.

The need for thoroughgoing tax reform was felt acutely when the country embarked on a programme of structural adjustment of the economy in the wake of the crisis of 1991. The accent on efficiency in resource use as the key to faster growth consistent with stability brought to the fore the urgency of overhauling the tax structure to reduce dependence on foreign trade taxes as a major revenue source on the one hand and remove tax impediments to competition and free play of market forces on the other. That called for reorienting the tax structure to rely more on taxes on income and moving away from taxes that seemed to be distortionary and iniquitous. Hence the reform of direct taxes figured high on the reforms agenda.

It was, however, recognised that in the foreseeable future, indirect taxes would continue to be the mainstay of government revenues. In the situation prevailing in a developing country like India, if tax reforms were to be revenue neutral, if not yielding more revenue, and at the same time the decisions of economic agents were not to be needlessly interfered with, there was no alternative but to design a system whereby domestic consumption could be taxed comprehensively but without giving rise to the complexities and inefficiencies that mark the existing structure. That called for a rational and harmonized

system of trade taxes. It was also recognised that the best way to go about this task would be to have a value added tax on a wide base covering both goods and services, applied on the principle of destination and replacing the medley of various taxes on production and trade that had come into existence in the country at different levels of government.[4] The Tax Reforms Committee (TRC) set up in 1991 (with Prof. Raja Chelliah as Chairman) though concerned mainly with the central taxes, while laying down an elaborate blueprint for change in the tax structure, stressed the need to explore ways of introducing the value added tax in the country.

Following the recommendations of the TRC, several measures were taken to reform the Union excises and forge them into a fullfledged manufacturers' value added tax (called the modified value added tax or MODVAT) . While that helped to alleviate tax cascading to some extent, difficulties inherent in taxation at the manufacturer level persisted. To ease the problems of valuation, the TRC recommended that the MODVAT be extended to the wholesale stage, allowing the states to retain the additional revenue. The pitfalls of their recommendations are discussed in NIPFP (1994) in some detail and are not gone into here.

The other main component of domestic trade taxes, namely the states' sales taxes, however, remained unattended, although much of the distortions and non-neutralities in the system stemmed from the irrational structure and disharmony in the sales taxes operating at the states level. It became increasingly clear that the tax reform process could not be complete unless something was done on that front too.

Reflecting this concern, India's Finance Minister, Dr. Manmohan Singh, in the course of his Budget Speech for 1993-94 observed:

" . . . Our long term aim should be to move to a Value Added Tax system."

But he acknowledged that "this could not be done overnight". The reason was that, under the Indian Constitution, powers of taxing commodities are shared by the Centre and the states and it would not be easy to devise a VAT system within the existing constitutional framework that would be rational and administratively simple, and at the same time acceptable to all the parties concerned, viz., the Centre, the states and the people.

In order to help formulate a scheme that could find a broad consensus, the Union Finance Minister commissioned a study at the NIPFP in 1993. In its report submitted in April 1994, to which a reference was made earlier, the Institute, after appraising the present system and weighing the merits and drawbacks of various options, recommended a scheme of independent, dual VATs, one on manufacturers at the Central level by changing the Union exercise structure suitably and the other, state VATs replacing their sales taxes. To chalk out a programme of action in the light of the findings of the study and its recommendations, a Committee of Finance Ministers of the states was constituted in May 1994. That Committee after several sittings worked out a scheme of reform on which there could be an agreement.

Finally, the Finance Ministers of all states met on December 2, 1995 to consider the recommendations of the Committee that was set up by them in the wake of the NIPFP report. From reports in the press, it appears that there has been a broad consensus among the states on the introduction of VAT to replace their sales taxes in a phased manner after adequate preparations but no time frame could be laid down for the implementation of the reform for lack of agreement. The main problem is the abolition of the tax on inter-state sales. The states seemed to be reluctant to even consider the question as "no immediate solution could be found to the problem of the resultant revenue loss". On the contrary, the majority of the states pressed for the introduction of the consignment tax (only a few expressed strong reservation on the issue). So, the agreement related mainly to the harmonization of the tax rates by reducing their number and laying down a floor and phasing out the incentives for industrialisation. The floor rates proposed are 0,4,8 and 12 per cent for the general category of commodities and 20 per cent for special categories. Regarding inter-state sales tax, the members agreed to set up an expert group to examine the question of its abolition or reduction and the steps required to be taken to make India a common market without affecting the revenue of the state governments.[5]

On the face of it, the steps proposed to be taken by the states to reform their sales tax system, if fully implemented, should help to remedy some of the deficiencies of the present regime. Operating the sales taxes on the VAT principle that is, going down to the retail (or wholesale level) and providing relief for tax paid at intermediate stages would no doubt be a step towards VAT. It needs to be noted however that the basic objective of the reform, viz., to make the tax system neutral to trade and business decisions, externally and internally, by removing the distorting elements and moving towards a free-market regime cannot be

achieved unless something is done about the CST. In the absence of any steps to dismantle the CST, the reform measures agreed upon at the FM's meeting would mainly help to minimize tax competition. Tax exporting and non-neutrality with all their ill-effects on economic efficiency and inter-jurisdictional equity will persist. In other words, the fundamental objectives of harmonization will not be achieved.

The process of harmonization of indirect taxes would also call for removing another tax - levied at the states level (or by local governments so authorized by the states) - viz. octroi, a tax on the entry of goods into a local area. Universally condemned as a barrier to internal trade, the tax continues to operate in several states including the industrially advanced Maharashtsra and Gujarat and serves as an invisible instrument of tax exportation to other States.[6] To avoid cascading it would also be necessary to integrate the electricity duties now levied by states in thee VAT system. There has been no reference to this issue in the current discussions. Nor is there any proposal to integrate the other taxes that cause cascading and economic distortion such as the electricity duty.

In a way, the only benefit of the exercises so far would be to arrest the revenue loss that the states suffer because of competition in sales taxation. Whether the consequent increase in the tax burden will be conducive to growth would depend *inter alia* on how the additional revenue is going to be spent. Although an expert group is going to be set up to recommend ways in which the tax on interstate sales could be done away with or reduced, harmonization of sales taxation in the real sense does not seem to be in sight.

Apprehension of revenue loss is said to have been the main roadblock to the removal of both CST and octroi and thus harmonization. The reluctance of the states to consider seriously any suggestion to refrain from taxing interstate trade (and of local governments to give up octroi) together with insistence on the part of the majority of the states to go in for the consignment tax reflect a lack of conviction about the need for tax harmonization in a federation in the real sense and the desirability of going in for a true VAT system to replace all domestic trade taxes comprehensively. It is salutary to recall in this context that the system of sales taxation that was contemplated in the Constitution would have facilitated harmonization had it been implemented in the spirit in which it was framed. A look at the constitutional provisions in this regard as they originally stood and how they have evolved over the years would be instructive in this context.

c. *Road-blocks to Harmonization - A Historical Perspective*

Harmonization of sales taxes would have taken place in India without giving rise to the problems now being encountered had the states levied their sales taxes at the retail stage only, as was evidently envisaged in the Constitution while conferring the power to levy sales tax on the states. But that was not to be. As mentioned earlier, because of administrative reasons, the states moved the point of their sales taxes mostly to the first stage and they are now authorised to tax inter-state sales as well on origin basis with all its consequences for the indirect tax system of the country. There is ample evidence to show that the constitution makers did not intend this to happen and had contemplated the sales tax to be levied by the states by destination only.

Article 286 of the Constitution (vide Box 2) imposed certain restrictions on the sales taxation powers of the states. These restrictions were intended to prevent them from taxing (i) sales or purchases in the course of trade outside the territories of India; (ii) sales outside the state of levy where they result in delivery or consumption of goods in another state; and (iii) sales in the course of inter-State trade and commerce. Further, the States' powers to tax commodities categorised as "essential" by Parliament were made subject to prior approval of the President. In 1952, Parliament enacted a law - the Essential Goods (Declaration and Regulation of Tax on Sale or Purchase) - declaring a number of commodities as essential for the life of the community (e.g. cereals and pulses, fresh fruits and milk, meat fish and eggs, coal, iron and steel, and so on).

It can be easily seen that the rationale underlying the restrictions that debarred the states from taxing the sale of goods that resulted in delivery and consumption in another state was to ensure that sales taxation in the country proceeded on what is now known as the principle of destination. Unfortunately, in the absence of adequate safeguards against misuse and also because of judicial interpretation, the outcome of the restrictive provisions turned out to be quite different from what the constitution makers had in mind.

BOX 2

Article 286 of the Indian Constitution as it originally stood

"286. (1) No low of a state shall impose, or authorise the imposition of, a tax on the sale or purchase of goods where such sale or purchase takes place -

(a) outside the state; or
(b) in the course of the import of the goods into, or export of the goods out of, the territory of India.

Explanation:- For the purposes of sub-clause (a), a sale or purchase shall be deemed to have taken place in the state in which the goods have actually been delivered ass a direct result of such sale or purchase for the purpose of consumption in that state, notwithstanding the fact that under the general law relating to sale of goods the property in the goods has by reason of such sale or purchase passed in another state.

(2) Except in so far as Parliament may by law otherwise provide, no law of a state shall impose, or authorise the imposition of, a tax on the sale or purchase of any goods where such sale or purchase takes place in the course of inter-state trade or commerce:

Provided that the President may by order direct that any tax on the sale or purchase of goods which was being lawfully levied by the Government of any state immediately before the

commencement o this Constitution shall, notwithstanding that the imposition of such tax is contrary to the provisions of this clause, continue to be levied until the thirty-first day of March 1951.

(3) No law made by the Legislature of a state imposing, or authorising the imposition of, a tax on the sale or purchase of any such goods as have been declared by Parliament by law to be essential for the life of the community shall have effect unless it has been reserved for the consideration of the President and has received his assent".

The implications of the restrictions on the states' powers to tax inter-state sales as stipulated in the Article quoted above were explained by the Supreme Court in a case that came up before it in the following words:

> "Article 286(1)(a) read with the Explanation prohibits taxation of sales or purchases involving inter-state elements by all states except the states in which the goods are delivered for the purpose of consumption therein. The latter state is left free to tax such sales or purchases which power it derives not by virtue of the Explanation but under Article 246(3) read with Entry 54 of List II" (quoted in Taxation Enquiry Commission, 1953-54, vol. III).

The states took these observations to imply that they could realise tax from non-resident dealers in respect of sales to consumers or dealers situated within their jurisdictions,

and so proceeded to issue notices to dealers located in other states requiring them to pay tax on sale of goods for final use in their respective territories, get themselves registered and file returns. As all states started this practice, doing business in more than one state became very difficult.

The problems in the operation of the sales tax especially in the inter-state sale of goods were brought up before the Taxation Enquiry Commission (TEC) of 1953-54. The TEC considered a number of proposals to ease the problems including one that envisaged a national sales tax. The suggestion for a sales tax only at the national level was rejected by the Commission almost out of hand. The observations made by the Commission regarding the place of the states and the Centre in the sales tax system in the country in this connection are striking and deserve to be recalled in the current context. The TEC took pains to stress more than once that the states cannot do without sales tax but when two or more states are involved, sales tax cannot do without the Union. As they put it: "There is in the sales tax system not only a place for the Union, but an insistent need to give a place to the Union. That place being the whole sphere of inter-state sales".

As for the structure, the Commission recommended that the state sales tax systems should be broad based, and low-rated. Exemptions could be granted only for commodities of consumption by the poor but restricted to only a few. The Commission recognised that exception would have to be made in the case of raw materials sold by producers themselves - for administrative reasons and also to avoid adding unduly to the tax burden. "Apart from these", the Commission cautioned, "sales tax concessions are hardly a suitable method of encouraging particular industries, trades, activities etc."

For tackling the problems in inter-state sales taxation, the TEC recommended that the Parliament enact a law authorizing the levy of a tax on inter-state sales subject to a citing of 1% to be laid down by Parliament. The states would administer the tax and also retain the revenue.

In making this recommendation, the Commission rejected the premise underlying the constitutional provisions bearing on inter-state trade taxation - which had been upheld by judicial authorities - viz. that sale of goods should be taxed only by the state where the goods are consumed, in other words, the state of "destination" - and not by the exporting state or

the state of origin. The reasons advanced for recommending the levy of a tax on inter-state sales on origin basis were that taxation by the states of destination was making life difficult for non-resident businessmen and also had opened up opportunities for evasion through sale of commodities by registered dealers direct to unregistered dealers or final consumers located in other states. Collection of tax from the registered dealers in such situations was not possible for the state of destination, the Commission thought, for that would require "complete cooperation and coordination" between the two states and this could hardly be expected especially when the state of origin could have no interest in the transaction.

For cross-border sales by a registered dealer to an unregistered dealer, the TEC recommended that the tax be levied by the state of origin at the local rate but the proceeds in excess of the tax normally applicable to inter-state sales should be passed on to the importing state so that it could have the share of the tax that would be its due had it been transacted through registered dealers. The Commission recognised the problems in operating such a procedure but felt that with a normal tax applicable to them, such transactions would be at a minimum and so there would really be few occasions for accounting for the respective share of the exporting and the importing states.

Following these recommendations, the Constitution was amended in 1956 (Sixth Amendment Act). The Explanation in Article 286(1) that sought to enjoin the destination principle was dropped and entries were added to the Seventh Schedule to the Constitution to empower the Centre to levy tax on inter-state sales with the stipulation that it would be one of the taxes which can be levied and collected by the Centre but the proceeds will be "assigned" (meaning, devolved) to the states. Soon after this, Parliament enacted the law authorising the levy of the CST. This in brief was the genesis of the origin based inter-state taxation in India.

It is a pity that the TEC, while recognizing the role of the Centre in regulating the tax on inter-state trade and how absence of the Centre in the field was creating chaos in sales taxation did not adhere to the logic which it had itself expounded in the matter of taxation of cross-border sales to unregistered dealers, viz. that the bulk of the revenue from such an origin based tax should be passed on to the importing state. Perhaps, the TEC thought, a tax at a low rate by the state of origin would not matter. Obviously it failed to see that the taxes levied at the earlier stages (or on the inputs) would also inhere in the final products and so

origin based taxation of inter-state sales would imply substantial cascading and tax exporting giving rise to significant distortions in resource allocation and inter-jurisdictional inequity in tax base sharing especially since some states were net exporter of their products to other states while others were net importers. The inequity would have been mitigated had the proceeds of the CST been pooled and shared among the states on a fair basis. But that did not happen. Once the law was made and states were authorised to collect the tax and retain the revenue in full, there was no going back.

Currently the CST stands at 4 per cent. Apart from unequal tax base sharing, business also suffers acutely as a result. For instance, if an enterprise gets some of the components of its products manufactured in more than one state before assembling them, it has to pay CST at several stages. The only way open to it to avoid these taxes is to set up "branches" and so get the parts as "branch transfer". That is clearly an invitation to malpractice and is inimical to location of industries according to comparative advantages of each location.

It is also a pity that while the recommendation for inter-state sales tax was implemented, the TEC's sharp criticism of the restrictions on the states' powers in the matter of intra-state sales taxation went unheeded. In fact, the TEC disapproved of the attempt to restrict the powers of the states to tax sales within their territories by imposing ceilings on the tax leviable on the so called "essential goods" in no uncertain terms. To quote the TEC again:

> "There are good reasons why the state legislature and the state government may be left to decide for themselves the intra-state aspects of their sales tax law and regulation. It is they who will feel the impact of the discontented dealer and consumer, if these latter labour under a legitimate grievance, just as it is also the state government that stand to lose revenue on account of exemptions and tax-ceilings. The provision that now exists in the Constitution for the interference of the Central government in regard to sales tax on intra-state transactions would therefore seem to be inappropriate."(TEC, Vol. III, p. 51.)

Bypassing these observations and the underlying logic, the restrictions on the tax powers of the states in regard to intra-state sales were maintained and in fact incorporated in the CST Act in the form of a ceiling on taxation of "declared goods" at the same level as for inter-state sales. What happened subsequently is now history.

We have gone into the history of the enactment of the CST Act at some length as it throws light on what the constitution makers had envisaged and how inter-State taxation took

a course that was not intended because of inadequate appreciation of the rationale behind the original constitutional provisions. As mentioned already, the rate of CST has now gone up to 4% and the states are resorting to all sorts of measures to get out of the shackles of the "declared goods" provision (e.g. by slapping octroi, entry tax and so on), accentuating the chaos that marks the system of domestic trade taxation in the country.

Meanwhile the Central government struggles on to levy the modified VAT on manufacturing, encountering enormous problems. And so the taxation of domestic trade is going in a manner which is scarcely good for either the economy or the future of the federal polity in India.

Briefly, the present status of the system of internal trade taxation is as follows:

- The Centre continues to levy excise taxes on the manufacture and production of goods only (excluding services);

- The states levy sales taxes on goods (but not services, barring a few specified ones) mostly at the first point subject to the restrictions imposed under the Constitution which forbids sales taxation of import and export of goods but allows them to tax inter-state sales subject to a ceiling;

- Although the powers to tax sale of goods within their territories belong to the states, goods declared by Parliament as "essential" to inter-state trade and commerce and listed as such in the CST Act cannot be taxed at rates higher than what is laid down for taxation of inter-state sale. Moreover no sales tax can be levied on three commodities - viz. textiles, tobacco and sugar - for which additional excise duty is levied by the Union government under a tax rental arrangement.

The recent moves by the state Finance Ministers are intended to alleviate some of the difficulties arising from tax disharmony among the states by grouping the commodities under three categories, laying down floor rates for each, and by working out uniform procedures for compliance. But, as mentioned, there is no agreement yet to do away with the CST.

It would perhaps not be wrong to think that sales taxation by the states in India would not have taken the turn it did had the TEC not rejected the destination principle that had guided the constitutional provisions and found judicial approval, and recommended the enactment of a Central law to authorise taxation inter-state sale. From its discussion of the problems arising from the absence of such a law, it is evident that the TEC was concerned

primarily about the taxation of inter-state sales by the importing states and the evasion that was taking place because of cross border sale to unregistered dealers. Of course, implicitly the Commission recognised the right of the exporting states to the revenue from taxation of inter-state sales but it also wanted the tax to be at a low rate of 1 per cent only and for cross-border sales to unregistered dealers, would expect the tax in excess of 1 per cent to be passed on to the importing states. Evidently The Commission was not prepared to extend this logic to the revenue that CST would fetch. The result is that origin based taxation has come to be regarded by the states as their legitimate right with little regard for the consequences in terms of interjurisdictional conflict it generates and the harm it causes to the economy by impeding the flow of trade in the economy.

These problems would be less acute had the states used their sales taxation powers to levy the tax only on retail sales, as in Canada and U.S. This is what was recommended by the Indirect Taxes Inquiry Committee (the Jha Committee) of 1976. But administrative problems stood in the way and so the sales tax systems emerged as a predominantly single stage levy usually at the first point. Proposals for a harmonized, destination based VAT have not found wholehearted acceptance yet.

No doubt there are acute problems in operating a VAT in a federal country where the powers of taxing internal production and trade are divided between the Centre and the states but solutions can be found, if there is conviction and will. The way Canada is going about it provides useful lessons. The section that follows seeks to highlight the lessons that would be relevant for India.

III. Sales Tax Harmonization in Canada

Like in India, domestic trade is taxed in Canada at two levels- federal and provincial. For many years - since 1920 until its abrogation in 1991 - a manufacturers' sales tax (MST) was levied by the federal government while the provinces had their sales tax at the retail level. Instituted originally as a turnover tax at the rate of 1 percent on a broad base (exempting only basic foods, animal feed, coal and exports), the tax applied to all sales except at the retail level. In 1924 the tax was converted into a single stage levy collected at the manufacturing level and emerged as a major revenue source for the federal government. As of 1990, the

year preceding its demise, the MST contributed about one sixth of the total federal tax revenues, more than the corporate tax , and about one-third as much as the personal income tax. (Iqbal, 1994.)

a. Problems with Manufacturers' Sales Tax (MST)

Although it was operating as an apparently painless source of revenue to the government - since it remained invisible to consumers - the MST had come under attack almost right from its inception. . Experts held that it violated every canon of a good tax. Its flaws were said to be numerous and were extensively documented. Principally these were:

- narrow base, covering only about one-third of total consumer expenditure;
- complex and artificial distinctions drawn between commodities, and between commodities and services, generating frequent disputes and law changes;
- tax cascading resulting from the application of the tax to many business inputs;
- competitive distortions caused by the exclusion of retail sale from its purview and the practice of splitting advertising and marketing functions from physical manufacturing operations;
- problems in dealing with value of proprietary right goods, branded goods, sole distributorships and sale by manufacturers to related marketing agencies. (Poddar & Harley, 1989).

The distortions caused by the factors mentioned above were much too serious to be ignored. Various methods were devised to remedy the ills, such as introduction of notional values, "marginal manufacturer" rule, selective shift to wholesale level and so on. Because these did not remove the deficiencies adequately, proposals were mooted for a general shift of the point of levy to the wholesale level and promulgation of rules whereby a person selling goods produced by a manufacturer to whom he is related would be deemed to be the manufacturer of the goods sold by him. Proposals were also put forward to delimit the deduction for marketing and distribution costs to what could reasonably be attributed to the sale of manufactured goods. However, impelled by the intractability of the problems and compulsions of global competition, the Federal government decided to replace the MST with a value added tax named the Goods and Services Tax (GST). Announced in 1989, the GST was brought into operation from January 1, 1991.

b. The Goods and Services Tax (GST)

The GST which replaced the MST in Canada in 1991 is a multi-state sales tax operated on the invoice-credit method and collected at each stage of trade. It is a destination based tax levied at the rate of 7 per cent on the consumption of domestically produced goods and some services, while goods and services exported to non-residents are not taxed. Exports are zero rated and so are certain commodities viz., basic groceries, agriculture and fish products, prescription drugs and medical devices. Charities, non-profit organizations as also municipal services, universities, schools and hospitals - the "MUSH" sectors, as they are called, - are partially zero-rated (that is, can claim a rebate for a portion of the tax paid on their inputs). The exemption limit is $30,000 in terms of annual taxable sales. Small businesses (having sale of less than $200,000) can avail of a "quick method" of assessing the tax liability whereby they can charge the normal 7 per cent GST on sales but remit a lower amount to the government based on a formula.

Though introduced as a replacement for a tax that was widely regarded as severely flawed viz. the MST - and the reform took place after 50 years of effort and recommendations by successive expert panels - the GST had a most hostile reception among the people in Canada and the resentment persisted well after the tax came into operation. So much so that the Liberal party which came to power in 1993 made an electoral pledge to abolish or replace it. However, the tax had started yielding substantial revenue - over $ 17 billion (about $ 15 billion net of refunds), and the country had incurred the start-up costs which a new tax invariably entails. Yet the continued resentment against it - and the election pledge - led the new government to ask the Standing Finance Committee of Canada's House of Commons to suggest alternatives. That Committee presented its report in June 1994.

c. Recommendations of the House of Commons Finance Committee

After examining a large number of people - experts, taxpaying individuals and representatives of business, the Committee found enough reasons for the dissatisfaction with the GST as it was designed. The main flaws identified by the Committee are:

- Narrow base, resulting from the exclusion of a number of goods and servces

from the base (only about two-thirds of the consumer expenditure came under the tax);

- Complexity caused by exclusions based on minute commercial differences among commodities;

- Lack of harmony between federal and provincial tax systems. Operation of two parallel systems of consumption tax, each with its own taxable bases, rates, formulae for tax calculation and reporting requirements, made life difficult for people in general and businesses in particular.

There was also a general perception that the GST had led to the proliferation of the underground economy at least people's perception went that way even though there were other contributory factors (such as overvalued currency). (House of Commons, Finance Committee, 1994.)

The Committee felt that most of the problems could have been avoided had the federal government pursued the proposal put forward in 1987 for a harmonized federal-provincial VAT instead of going in for an independently operated VAT at the federal level. That idea was abandoned because of lack of agreement with the provinces. The Committee, after considering 20 different alternatives took the view that only a National Value Added Tax integrating all Canadian sales taxes - both GST and the provincial sales tax - was the answer to the problem raised by the GST and simultaneous operation of provincial sales taxes. Among the alternatives which figured prominently before the Committee, one was the Business Transfer Tax (BTT) - a subtraction method VAT - and a personal expenditure tax. Because of their complexities, none of these found favour with the Committee.

Building on the recommendations of the House of Commons Committee the federal government proposed in October 1994, a 12 per cent integrated VAT with the objectives of securing:

- fairness for consumers;
- simplicity for businesses;
- federal-provincial tax coordination; and
- reduced overlap and duplication.

Key features of the proposals are:

- a single lower rate of tax (12% - 5% federal, 7% provincial);
- A wide, common base - with exclusion of only basic groceries, prescription drugs and medical devices.

The proposals envisaged that the credit for GST which was available to low income taxpayers would be maintained at the present level. However, to recoup the revenue loss from the reduction in the tax rate, the federal government wold impose a flat tax of not more than 1% on personal taxable incomes; and raise excise duties so that the price of goods like alcohol, motor vehicle fuels and tobacco would not change. Further, more flexibility would be allowed to the provinces in the personal and corporate tax fields. The national VAT would allow full credit for all input taxes paid by businesses. However, this would be phased over a 3 year period and the revenue from the partial ITCs would be passed on to the provinces under a revenue-sharing formula. The federal white paper putting forward the proposals anticipated that the integrated VAT would make no difference to the average tax burden for the Canadian families but would have a wholesome effect on GDP growth and lower prices. (Department of Finance, Canada, 1994.)

As was to be expected, the reaction of the provinces to the federal proposals has not been favourable. The reservations stem frcm several factors, principally, the following:[7]

- A uniform national VAT would impair the provinces' fiscal autonomy. There are no other alternative tax sources which could make up for the loss of revenue from sales tax. More room for raising the personal income tax - as has been suggested by some as a possible option - is not going to be of much help as the level of income taxation in Canada is already high compared to other OECD countries particularly USA. Enhancing the payroll tax - also advocated by some economists to compensate for surrendering sales taxation to the federal government also does not seem to be acceptable to the provinces and the people as that would kill jobs, it is said.

- Provincial sales tax rates vary widely from zero in Alberta to 12 per cent in New Foundland. In this background, a single national rate applicable uniformly in all provinces simply cannot be contemplated, especially when their preferences regarding public spending and requirements vary. The government in Alberta has already indicated that it would protect its citizens from any national levy. Finance Ministers of Saskatchewan and Manitoba too have expressed strong reservations about a national levy. (Cook 1995, Freeman 1995.)

- The changes will not benefit the consumers. For the overall rate cannot be much lower than 15 per cent if the same amount of revenue is to be raised. Otherwise the revenue loss from input tax credit which would have to be allowed under the proposed national VAT cannot be made up. It is estimated that business now contributes about one-third of provincial sales tax revenues in some provinces (e.g. Ontario).

- The new tax will not find any taker if, as is the position now, it is posted on the bills - for then the "cash register stock" will persist.

The "sticker shock" can of course be avoided, if only the prices printed on the bills are made tax-inclusive and there is no constitutional limitation on the province's powers to legislate for the inclusion of the tax in the price. But the other fears would remain, as discussions with officials in the Ministry of Finance in Ontario confirmed. The October proposals of Ottawa clearly did not represent a consensus. The national tax would, it is apprehended by the provincial authorities in Toronto, inevitably raise the tax on several commodities and services.

That apart, for various reasons Ontario would like to have control over the base itself. According to provincial officials, the question of revenue allocation under a national VAT remains to be resolved. Will the revenue be shared on the basis of a formula or will it proceed by tracking every taxable transaction? Then there are issues of structural changes under a national VAT - who, for instance, will decide what? In the event of any rate increase, how would the additional revenue be shared? The officials also felt that the cost of collection will not be low. In fact, even though the number of taxpayers under GST is almost half of those paying PST, in Ontario the cost of collection is four times higher for GST. In the event of integration of the two taxes, questions will arise as to how the cost of administration would be shared. There was also concern about the deployment of provincial revenue department personnel. What will happen to the staff engaged in running the PST in Ontario?

Some of the concerns expressed by the provincial government officials related to transitional problems. These can perhaps be minimised if the integrated national sales tax is administered by the provincial government and the federal share remitted to Ottawa as and when collected. That according to them, would be a more efficient arrangement because the provincial governments are more experienced in handling retailers and would be in a better position to administer an integrated national VAT.

The idea of having the national VAT administered at the subnational level, that is by the provinces acting on behalf of the federal government, does not seem to have many takers among experts.[8] The objective of simplicity, it is feared, will not be achieved if businesses have to deal with ten different provinces while paying their tax. Also, zero rating and monitoring of cross-border sales would be a problem if the tax was administered by the provinces.

c. *GST-PST Harmonization - Quebec Model*

Those who favour decentralized administration of VAT cite the harmonization of GST and PST that has taken place through the system that has been operating in Quebec.

Strongly opposed to any federal intrusion into provincial tax autonomy, Quebec nevertheless went along with the federal government in implementing VAT but with both the taxes - viz. GST and Quebec sales tax - transformed into VAT administered by the provincial tax authorities. This experiment in harmonization drew sharp comments from experts since there were many points of difference between the two taxes, not only in the rates but also in the base. The procedure - e.g. filing requirements - also differed. "If all other provinces were to follow a course of action similar to Quebec, businessmen would be faced with a nightmare of increased tax complexity" (Mintz, Wilson and Gendron, 1994).

In order to meet the criticisms and make it easier to comply, the Finance Minister of Quebec announced a number of measures in his budget for 1995-96, aimed at simplifying the system by aligning the QST with the GST, notably the following:[9]

- application of QST uniformly to all stages of production of goods and services;
- refunding of full amount of QST on purchases made by businesses;
- eliminating the concept of non-taxable supply; and
- standardizing the reporting periods.

Even with all these measures, whether the system will get fully harmonized in the sense that the base would be identical is not all that clear. In any event, the Quebec model is unlikely to be accepted by businesses or its people as the simplicity will depend very much on agreement between the federal government and the provinces to have a common tax base if not uniform rates. The failure of decentralized administration of VAT in Mexico - leading the Central government to take over its administration - illustrates the weaknesses of subnational implementation of a tax like the VAT.

Reference may be made in this context to the system of VAT operating in the European Union, with member countries administering their VAT based on a common (though not exactly identical) pattern laid down in the Sixth Directive of the EEC. The VAT

in Europe is destination based whereby sales to countries outside the Union and also from one member country to another are zero-rated while imports are taxed. The system operates on a computerized information system and frauds do not seem to be a problem. However the costs of administration and compliance of the present arrangements in the EU are believed to be highly burdensome particularly for small and medium sized enterprises and so the proposals for operating the harmonized VAT system by having the tax levied in the country of origin with rebates allowed in the country of destination and the revenues allocated through a sharing mechanism are receiving attention once again although they were put aside earlier (Michie, 1995, Terra, 1994).

Adoption of the European system whether in its present form or with the levy origin based but revenues allocated destination-wise would require the federal government to vacate the internal trade taxes field completely. That in turn would call for a radical restructuring of federal-provincial fiscal arrangements, which is not a feasible option at least for the present.

d. Viable Options

Given that neither the provinces nor the federal government would be prepared to forgo the power to tax sales completely, the search for alternatives to GST has to focus on schemes that envisage levy of sales tax by both levels of government. As repeatedly emphasised in this context the two basic criteria for choosing between alternatives are: simplification and harmonization.

The simplest and least costly alternative which finally emerges as satisfying these criteria and also appear to be practicable is to reform the GST itself to make it simpler and fairer and harmonised with the provinces instead of going in for radical change(Bird, 1994a). This would avoid the start-up cost of a new tax (since GST is already in place). This will require negotiations between the federal government and the provinces for working out a harmonized sales tax regime. While urging the federal government to be flexible or allow room for selected exemptions and respect provincial autonomy, advocates of this approach underline the need to conform to the following parameters:

- Only one agency should administer the tax (e.g. the federal government or a joint federal provincial agency);

- **There should be no cascading of taxes on business inputs;**
- Administrative rules should be on the same lines as those for GST.

(Mintz, Wilson and Gendron, 1994).

A model for possible agreement, allowing the provinces to have differential rates on a uniform tax base negotiated by federal and provincial governments is provided in the House of Commons Finance Committee report. While endorsing this approach Mintz and Wilson (1994) would allow for not only flexibility in the provincial rates but also in the base so that the tax bases are set according to a national norm with some variation for goods or services that are primarily sold to consumers at final stages (e.g. burial services, books and magazines).

Mintz and Wilson also suggest that the national sales tax could be "enhanced" if either of the two following schemes were adopted: a joint VAT or a joint federal VAT - provincial RST, referred to as "the open architecture tax system".

Under the joint VAT, both federal and provincial governments would levy VAT on businesses like the GST. Inter-provincial sales would be zero-rated by he province of origin, as under the European system at present. This would have a number of advantages but would require simplification of the tax by eliminating zero-rating and all exemptions as well as partial exemption of particular items, improving the treatment of MUSH sectors by granting full rebate for tax paid on inputs rather than having differential, and increasing the small trader exemption (The last measure, it is recognized, might reduce the neutrality of the tax but would make for a great deal of simplicity, it is argued.)

The alternative national ST is a joint federal-provincial sales tax with the federal government levying a VAT and the provinces, a retail sales tax. This alternative also would carry several advantages, it is claimed, especially by allowing greater autonomy to the provinces to negotiate exemptions for specific goods and services. This seems to be the preferred alternative of Mintz and Wilson.

What will be the outcome of the debate and deliberations on the replacement of GST in Canada is difficult to predict. As Bird has said, while there are many possible alternatives for the GST, none is clearly superior on all criteria and the choice will depend on one's

perspective in evaluating which criteria are most important in meeting the government's objectives (Bird, 1994a).

Simplification and harmonization, the two prime objectives in the quest for a replacement for the GST, would no doubt be secured best by a NST as recommended by the House of Commons Committee. But for reasons noted above - primarily, its undermining effect on the fiscal autonomy of the provinces - that seems to be a non-starter. However, a good second best would be a joint VAT to be administered federally but allowing flexibility to the provinces in setting their rates and the base in consultation with the federal government with regard to certain exemptions. From discussions with fiscal experts in Canada and officials at the provincial level one gets the impression that this alternative has the best chance of getting accepted. The Conservative government that came to power in Ontaria, the most populous and prosperous province in June 1995, appears to be inclined to go along with the federal government in harmonizing its RST, if their concerns about autonomy and revenue are accommodated. What the federal government does to honour its election pledge - viz. to replace the GST within two years of its coming to power (and they assumed office in November 1993) and action promised in the Budget due in February 1996 - will be watched with keen interest and not merely in Canada.

IV. Lessons for India

What the Canadian experience clearly confirms is what experts have long averred viz. that no country has yet been able to work out a satisfactory way of operating sales taxes independently at two levels of government (Bird, 1994b). Integration in some form is essential. Canada may find a solution ultimately in a joint VAT to be administered by the federal government on a broadly agreed common base but allowing flexibility to the provinces in the matter of rates. That alternative is not available in India under the existing Constitution.

For with present assignment of tax powers in the Constitution, the Centre cannot go beyond the manufacturing stage in commodity taxation. In fact, in terms of the relevant entry in the list enumerating the Centre's powers and functions the Central government can levy only duties of excise on production and manufacture of goods in India and the way this has been interpreted by courts makes it more restrictive in its amplitude than even the MST

that operated in Canada before the introduction of GST. The states on the other hand are unlikely to agree to part with the most potent of their tax powers viz. tax on the sale and purchase of goods. It is also amply clear that they will not be agreeable to part with CST unless assured of compensating revenue Tax harmonization in India is thus much more problematic than in Canada.

Given the political realities and sensitivity of the states regarding their autonomy, one solution that readily comes to mind is to require the Centre to vacate the internal trade tax field (except for taxation on a few big revenue yielding items like tobacco, alcohol and petroleum products) and allow the states to tax sales within their territories without any restriction, but in a harmonized fashion. For the Centre to withdraw from domestic trade taxation, it will be necessary to review the entire gamut of Centre-state fiscal relations for that would reduce the Centre's revenue to such an extent that it will not be able to make the equalization transfers that it provides at present. A form of dual VAT is the only viable option as in Canada. But again, the central issue is how to harmonise the system and, equally important, what to do with taxation of inter-State trade?

a. Possible Options for Sales Tax Harmonization in India

Looking at the ills of the present system, it would appear that the remedy lies in moving towards a destination based system of sales tax which the Constitution had clearly envisaged. That predicates a harmonized system of value added tax modelled on the destination principle.

To repeat, such a VAT is levied best at the national level. But as Canadian experience shows, that option is not open to a federation where the subnational governments derive a major portion of their tax revenue from the sales tax. Whether sales taxation should be assigned to the states or provinces is a moot question on which experts differ (Bird, 1993). But given the existing constitutional position, it is neither feasible nor desirable to divest the subnational governments of this major source of revenue. In the Indian case (unlike in Canada) one cannot even visualise this alternative - that is, transferring the sales tax powers entirely to the Centre - as a viable option, without a major shift in the assignment of functions and financial powers among the Centre and the states. On the other hand, it is not possible to get all internal trade taxation powers vested in the states and have only state VATs

replacing both union excises and sales taxes. In Canada, that would require introducing sales tax in states where there is no sales tax like Alberta and a regime of very high rates in some provinces. In India too similar problems would be encountered by the states.

What seems preferable in a federal government is a concurrent VAT at two levels of government - both Centre and the states - but integrated in the sense that the base will be laid down at the national level while allowing the states to fix the rates.[10] The states can have flexibility in determining their base too but departures from the national base should be kept to the very minimum and decided in consultation with the Centre.

In India such a regime would also require a constitutional amendment inasmuch as it would require extending the tax powers of the centre to go beyond manufacturing and sharing the tax base with the states in consultation with them. The base should cover both goods and services. The states too should be allowed to levy their sales tax (in the VAT form) on the same base at rates to be decided by them depending on their revenue needs and preferences but subject to a floor agreed to by all states. According to rough estimates, a VAT levied at the rate of not more than 20 per cent on a comprehensive base could fetch the same amount of revenue as the Union excises and sales tax taken together (NIPFP, 1994).

With a concurrent VAT, the tax would be charged at a consolidated rate by the vendors on the bills but deposited to government account under two heads: Union and the states, the account may be maintained by the banks. For inter-state sales there could be two options: (i) such sales can be fully zero-rated by the supplier in the state of origin and the buyer would be liable to pay VAT on the entire acquisition in his/her state on first sale in the state of destination ("deferred payment"); (ii) supply can be zero rated only in respect of the state VAT and rebate granted for the Union VAT on subsequent sales. The second alternative would have the advantage of providing an incentive for the buyer to report the purchases in order to get the rebate for the Union VAT paid in the state of origin.

Yet another alternative for the treatment of inter-state sale could be to charge a tax at not more than 2 per cent on inter-state sales in the state of origin, to be rebated in the hands of the importing dealer against tax due on his sale and pool the revenue so realized for distribution among all states on an equitable basis.[11]

A variation of this alternative would be to allow the state of origin to charge 2% on inter-state trade and retain one-half of the revenue. The other half would be pooled for allocation among the states by a formula (Bagchi, 1995). Inter-state supplies or sales to unregistered dealers or even transfer on consignment should be treated as sale to unregistered dealer. This procedure would be a via-media for zero-rating and may be more acceptable to the states and also help enforcement.

Though desirable, it is not absolutely essential for the administration of a concurrent VAT to be located entirely at one level. Some of the more intricate functions of administration such as auditing and exchange of information can be with the Centre and while the routine ones such as registration, assessment and monitoring of filing and payment of tax can be entrusted to the states. The Centre can of course help with the administration in states which are weak or where no sales tax is currently in vogue (e.g., in some of the north eastern states). The Quebec experience, though not very well received so far in Canada, shows that some sharing of administrative responsibilities may be possible. Many of the problems encountered in the Quebec model had their origin in the lack of harmony in the base of the GST and the QST. These problems can be avoided with a truly harmonized base.

A third option would be, as referred to earlier, for the Centre to vacate the internal trade tax field altogether and replace the existing system with harmonized state VATs levied on the destination principle (the Centre could of course levy excises on a few items like petroleum and tobacco).Exports and inter-state sales would be zero-rated (or the via media suggested above can be in place) while imports and inter-state sales taxed on equal footing. This is the recommendation of NIPFP report as the long term solution. But an essential feature of this scheme is the zero-rating of inter-state sales. Experience so far however shows that moving towards removal of sales tax on inter-state sales is not going to be easy in India without the Centre's active involvement and that requires some stake of the Centre too in the tax.

Considering the various options, it would appear that the only viable long- term solution would be the second alternative, that is, a concurrent VAT on more or less uniform base and at rates to be decided by the states subject to a floor. The tax will be administered, principally by the Centre, but with participation by state sales tax agencies in some of the functions. Participation of the states in mobilising savings through post offices in India

provides an example of how collaboration between the Centre and the states can work. That would accommodate the requirements of fiscal autonomy of the states as also the revenue requirement of the Centre and bring about integration of the trade taxes.

What comes out loud and clear from the Canadian experience is that domestic taxation of commodities at two levels cannot be carried on entirely independently. Ultimately there has to be an integration in some form. The scheme suggested in NIPFP (1994) and also in Burgess, Howes and Stern (1993) for a manufacturers' VAT and the Centre and state sales taxes converted into a destination based VAT can at best be regarded as an interim solution. The slow progress in introducing VAT at the state level and almost total resistance to the idea of abolishing inter-state sales tax corroborates this prognostication. Ways must therefore be explored for possible integration. A prerequisite for success in any such endeavour is an institutional arrangement for sorting out federal fiscal issues on a continuing basis. The achievements of fiscal federalism in Canada are due in no small measures to the dialogue between governments at the two levels over important issues. Such a tradition is yet to be established in India.

Notes

1. By virtue of the residuary entry in the Union List in the Seventh Schedule to the Constitution the power to tax services in general belongs to the Centre. The states can levy taxes only on a few specific services such as on luxuries, including taxes on entertainments, amusements, betting and gambling, stamp duties on documents (excluding those reserved for the Centre) taxes on goods and passengers carried by road or inland waterways and taxes on advertisements other than in newspapers, radio or television.

2. In a recent judgement, the Supreme Court of India has made it clear that for a commodity to be taxable, it must come within the category of "goods" and should be marketable. In other words, it should be movable. The Court has observed, "Goods which are attached to the earth become immovable and do not satisfy the test of being goods within the meaning of the (Central Excise) Act nor can it be said to be capable of being brought to the market for being bought and sold." (S.C. in Quality Steel Tubes vs. COE (1995) 75 ELT).

3. For a more detailed discussion of the infirmities of excises in India see, NIPFP (1994).

4. For a dissenting view, see Sundaram, Pandit and Mukherjee (1995). Misgivings were expressed by some economists about the wisdom of implementing VAT to replace the manufacturers' sales tax in Canada also (e.g. Whalley and Fretz, 1990) but mainly on the ground that the time chosen was not propitious for reform and not so much in defence of the existing system.

5. Times of India, 3 December 1995.

6. This occurs when octroi is levied on inputs like yarn or crude oil coming into an industrial centre defined as local area in a state which are used in manufacturing goods consumed by other states.

7. Some of the points noted here emerged out of the discussions with officials of the Ontaria's Ministry of Finance and Revenue Quebec.

8. Prof. Alan Maslove for instance is strongly opposed to the idea.

9. Budget Speech of Finance Minister, Quebec for 1995-96.

10. This proposal is similar to the model of concurrent VAT suggested by Poddar (1990)?

11. This closely resembles the proposals for pooling arrangement for operating an origin-based VAT in Europe which is advanced by some as a better way to implement destination principle than zero-rating of intra-community sales now in operation under the interim arrangements (Ben Terra, 1994).

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