CHAPTER 2

REVENUE AUGMENTATION, TAX LEVIES AND RATES

1. Tax to GDP Ratio

1.1 Falling tax to GDP ratio in general, and similar trend in respect of indirect tax to GDP ratio, in particular is a matter of serious concern, more so when the ratios are falling in the post liberalization era, since early 1990s, when the expectation was to the contrary. There can be no two views that structural and fiscal policy changes over the last decade have been necessary as otherwise the country would have been isolated in the world economy. However, the falling ratios alert us to the fact that much more need to be done than has been done so far and also that a re-thinking is clearly warranted on certain critical issues if the trend is to be quickly reversed.

1.2 On the subject, it is interesting to study the initiatives taken by countries which were similarly placed as ours in the pre 1990s but which have made significant strides in achieving a higher tax to GDP ratio in the last few years (1996 to 2000), such as Brazil, China and Turkey. The common aspect of the reform process in all these countries was to expand the tax base (focusing on consumption expenditure), rationalize tax structure and improve efficiency of tax administration. An important element in relation to tax structure was to focus on incentives, exemptions & distortions. No doubt India too has followed this general direction but not with the same results.

Trends in tax to GDP ratio in select countries (1996-2000)

	1996	1997	1998	1999	2000
Brazil	11.00	12.00	12.50	14.40	14.80
China 1/	10.20	11.10	11.80	13.00	14.10
Turkey 2/	15.00	19.05	20.21	21.28	22.03

1/ Revenue performance of Centre, Provinces, and municipalities.
2/ Tax to GNP ratio

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Customs Revenues, tax to GDP ratio and average collection rate

Year	Revenue (in Rs. Cr.)	Growth (%)	GDP (in Rs. Crs.)	Tax - GDP ratio	Average collection rate(%) *	Imports as a % of GDP (at market price)	Rev. foregone due to export promotion schemes (Rs. Cr.)
1990-91	20644	N.A.	573444	3.6	74	5.01	N.A.
1997-98	40193	(-)6.2	1522574	2.6	27	12.5	13157
1998-99	40668	1.2	1740935	2.3	23	11.5	15492
1999-2000	48420	19	1929641	2.5	22	12.4	18166
2000-01	47542	(-)1.8	2087988	2.3	21	13.0	21658

* Percentage of total customs revenue to the total value of imports.

Central Excise Revenues and tax to GDP ratio

Year	Revenue (in Rs. Cr.)	Growth in Excise revenue (%)	GDP (in Rs. Crs.)	Tax - GDP ratio
1990-91	24514	5.73	573444	4.3
1997-98	47962	6.56	1522574	3.2
1998-99	59246	11.02	1740935	3.1
1999-2000	61902	16.26	1929641	3.2
2000-01	68526	10.70	2087988	3.3

1.3 As seen, between 1990-91 and 2000-01 the customs revenue to GDP ratio has fallen from 3.6 to 2.3 and the central excise tax to GDP ratio from 4.3 to 3.3. One does not have to look too far to find the reasons for the reduction and some of the reasons are :

(i) The rate of reduction in duty rates (both customs and central excise) has been much higher than the rate of growth of GDP.

(ii) On the customs side, the reduction in rate has not led to higher revenue in view of lower than expected increase in volumes of import.

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(iii) There has been a steady increase in the extent of duty foregone on account of the various exemptions including export promotion schemes.

(iv) On the central excise side the contribution of manufacturing sector in total GDP has declined and whereas contribution of services has gone up, this sector is not taxed comprehensively.

1.4 It is but evident that there is an urgent need to arrest the trend of falling indirect tax to GDP ratio if an impact is to be made on the fiscal deficit. Broadly, this calls for action in two areas of tax policy. First is the tax structure and second is tax implementation. In so far as the former is concerned, the following measures are necessary, which are subsequently detailed in respect of each of the indirect taxes :

(i) Widen the tax base by reviewing and removing to the extent possible the duty exemptions – as a general principle, duty exemptions tend to create pressure groups, increase discretion and do not always ensure benefits reach the target. The exemption, when merited (such as in case of life saving goods and sovereign imports of security/strategic interest) should be replaced by a more transparent method of ensuring the relief to the target group, through budgetary support.

(ii) The types of tax levies should be brought down to the minimum - too many levies create distortion and inefficiencies in administration, raising compliance issues.

(iii) Move towards a maximum number of three rates of duty in Central Excise to be achieved in two years and two rates from present 20 rates in Customs, in stages. Fewer number of rates and moderate rates would encourage compliance, reduce discretion and create an efficient tax administration.

(iv) Expand coverage of Service Tax and integration of Central Excise (goods) and Service Tax legislation - It is the expectation that in the long run the service sector would contribute significantly more to the GDP, and even at present it is the single largest contributor. Therefore, for improvement in tax to GDP ratio the scope of Service Tax must necessarily expand.

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(v) VAT should be implemented to reduce cascading effects of taxes.

2. Customs Tariff and Exemptions

2.1 Multiplicity of Levies

2.1.1 At present, besides the Basic Customs Duty, we have the following levies :

(i) Special Customs Duty (SCD)
(ii) Additional Duty of Customs (CVD)
(iii) Special Additional Duty of Customs (SAD)
(iv) Additional Duty of Customs on Motor Spirit
(v) Additional Duty of Customs on High Speed Diesel Oil
(vi) Exports Duty
(vii) Cesses on Exports

2.1.2 As a policy, multiplicity of levies must be reduced. Accordingly, it is recommended that there should be only three types of duties, viz. Basic Customs Duty, Additional Duty of Customs (or Countervailing duty) and Anti-dumping/Safeguard duties. All other duties should be removed. However, removal of SAD should be linked to implementation of State level VAT.

2.2 Multiplicity of Rates

2.2.1 It has been the avowed objective of the Government to reduce the peak rates of customs duty to the ASEAN levels. This is not merely an attempt to follow the other faster growing developing economies but a pragmatic approach to move towards a modern economy producing efficiently according to its dynamic comparative advantage. To achieve this, India needs a large volume of imports which are necessary for technology upgradation. These imports have largely to be paid for by a high level of exports which require import at world prices. That imports are necessary for exports and the development of an economy is a settled proposition and the answer lies in encouraging imports without quantitative barriers, without licensing, and having reasonable tariffs. However, revenue considerations are known to affect the pace of reduction of tariffs in most countries, especially developing countries which are heavily dependent upon

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indirect tax revenues. But experience of successful trading economies have shown that sheer increase in volume of imports has more than offset the fall in revenues on account of cuts in tariff rates, though there may be a transition period. This has to be balanced by a comprehensive reform of the tax system.

2.2.2 The customs tariff, completely aligned to HSN contains 99 chapters wherein all the goods are classified. Each Chapter contains a number of goods and against each Tariff Heading or Sub-Heading the rate of duty is indicated. As seen, the Customs tariff has continued to remain most complicated even after several years of reforms since 1991. This can be seen from the rates of duty, which are 20 in number (182, 160, 150, 105, 100, 85, 75, 70, 65, 50, 45, 40, 35, 30, 25, 15, 10, 5, 3, and nil). 30% rate is the median rate i.e. the most common rate. Besides some items are subjected to specific duties.

2.2.3 The difficulties in administering such a large number of rates are evident. Importantly the large number of rates lead to discretion which should be best avoided in taxation. Further, it is evident that such a large number of duty rates can only contribute to complexities of clearance procedures. Accordingly, it is the view that a modern tax system should be based upon the minimum number of duty rates. In fact, even at present, the major share of revenue comes from few rates only. Hence, it is necessary to quickly move to the least number of duty rates.

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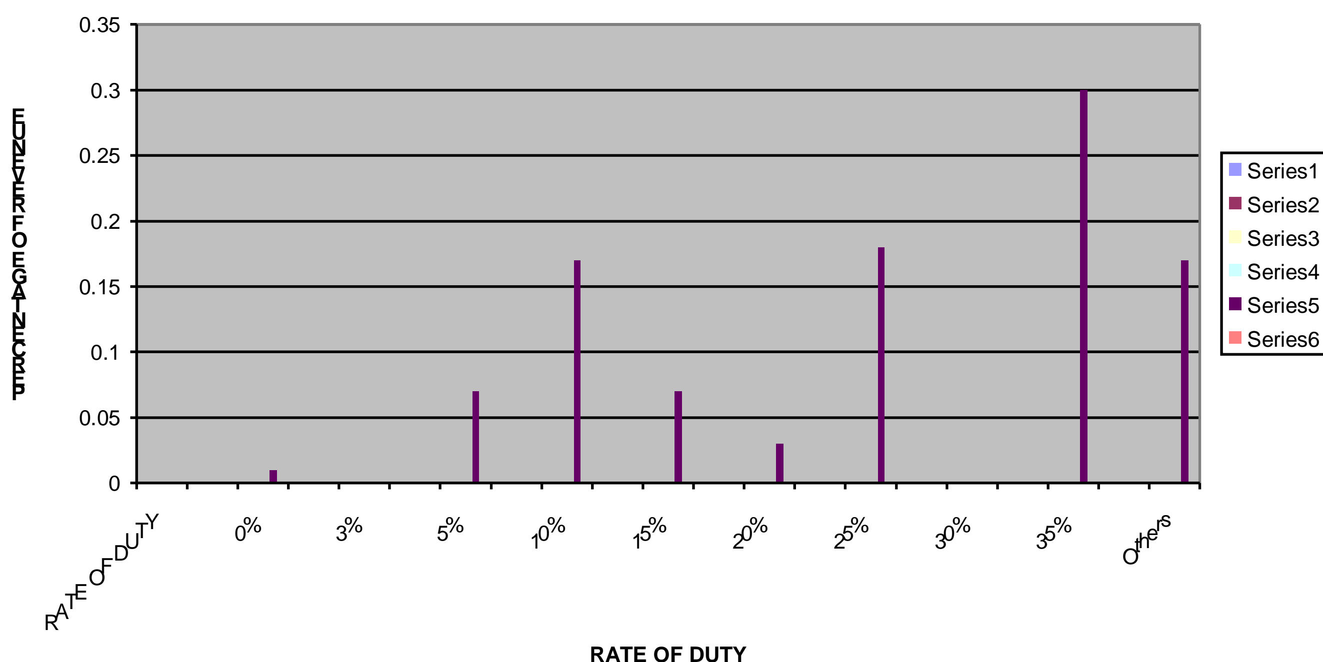
CUSTOMS-RATE WISE DISTRIBUTION OF REVENUE



2.2.4 In this regard, it is the stated policy objective of the Government that by 2004-2005 there would be 2 rates of customs import duties, namely 10% and 20%. Whereas the lower rate of 10% would broadly cover all categories of raw materials, inputs and intermediate goods, the higher rate of 20% is for final goods. At the same time it is necessary to clear the misunderstanding in some quarters that there would be only these two rates and no other. Internationally the majority of the countries have more than 2 rates, though it is also a fact that the endeavour is to have the minimum number of rates as far as possible. Invariably certain de-merit goods have a higher rate and agriculture produce is also subjected to other than the identified one or two rates.

2.2.5 In this direction one approach is to categorize the items in each chapter of the customs tariff as raw material, intermediate goods and final goods and then fix an appropriate rate of duty for each. However, while this may be possible for some items it is not so for others. For instance, steel is both a final good and an input. Another approach could be to fix one rate for one chapter since by and large the items in a chapter would fall in one category. In any case while the approach can be worked out, as regards the number of rates for all items (excluding

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agriculture produce) **the following road map is recommended for the future so that there is no uncertainty in the minds of the investors and industry.**

(i) O% - for items like life-saving drugs, sovereign imports (security related goods etc.) and imports by RBI.

(ii) 10% - for raw materials, inputs and intermediate goods.

(iii) 20% - for final goods.

(iv) Higher duty rate upto 150% for specified agriculture produce and demerit goods.

The recommended rates, as above, are to be achieved by 2004-05.

Having regard to our commitment to reform, it is recommended that for no item should the present duty rate be increased, unless the item is charged to nil duty, in which case a minimum duty of 5% can be imposed.

2.2.6 A word of caution is warranted in the move to the suggested rates of duty. In the event, if the import duty on a particular item is currently high, say, 30% and it has to move to 10% then certainly a sudden reduction to 10% in just 1 year would upset the domestic industry and it would also not be desirable from the point of view of revenue. Thus, certain high rate-high revenue items may require a more gradual move towards 10%. **Hence, it is recommended that as a general policy, the downward revision of duty rates should be in stages of (–) 5% each year.** However, it is quite possible that Government chooses to move to the identified lower rate at a faster pace. All endeavour should be made to move to the identified rates of duty, as above by 2004-05.

2.3 Customs Duty Exemptions

2.3.1 Whereas the customs tariff indicates the peak rate of duty also called the tariff rate of duty applicable on a particular item it is not the case that this is the duty actually leviable when the said item is imported. The leviable duty also called the effective duty is determined in the context of

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the duty exemption notifications, if any, issued in respect of the said item in terms of Section 25 of the Customs Act, 1962. Thus, on account of an exemption an imported item is subjected to a duty lower than that prescribed in the tariff. At times the duty payable may even be nil. The exemptions are generally catergorized as follows :

(i) General exemptions which are non-conditional and can be availed by all importers.

(i) General exemptions which are subjected to conditions such as end-use.

(ii) Ad-hoc exemptions, which are issued in respect of specific imports for security, strategic or charitable purposes - the number of ad-hoc duty exemptions are coming down, no doubt, due to the effect of the legislative change, in 1999, restricting the scope of the exemptions to imports of strategic, secret interest or for charitable purposes. This is a good development.

2.3.2 At present, the exemptions can broadly be placed into the following categories:

(i) Importer specific – e.g., Government (defence and police) etc.

(ii) Project and purpose specific – e.g. training, educational, research, Oil exploration etc.

(iii) Social and health sector/objective specific – e.g. handicapped persons, charitable and social welfare organizations, donations and gifts, medicines, drugs and hospital equipments etc.

(iv) Export related – e.g. samples, packaging materials, durable containers, advance licence, passbook etc.

(v) Sports related – e.g. sports goods, prizes, medals and trophies

(vi) International commitments – There are a number of international agreements that bind customs duties. These include the GATT/WTO bound rates, contractual commitments such as oil exploration contracts, Information Technology

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Agreements, exemption to privileged persons, organizations, authorities and foreigners, preferential areas etc.

(vii) Others – e.g. exhibitions, seminars, or expeditions, re-imports

2.3.3 Whereas the broad categorization of exemptions is possible it is not possible to quantify the items of import which are eligible for the exemption. This is due to the fact that the exemptions have a list of items annexed thereto and the entries are often omnibus in nature.

2.3.4 Any exemption has revenue implication. On their part conditional exemptions invariably necessitate imposition of regime of certification, verification etc., which adversely impact the clearance of goods, result in higher administrative costs, use of discretionary powers, and raise compliance issues on account of misuse. Exemptions are also nothing but a subsidy, and in fact, a discretionary subsidy. Thus, aside from the obvious impact on the tax to GDP ratio, the duty exemptions have undesirable side effects. The fact that exemptions also cause loss of transparency is another aspect of serious concern for the policy makers.

2.4 End-use based exemption

2.4.1 At present, there are a large number of exemptions subject to the condition of end-use, which is sought to be confirmed by the requirement of production of a certificate from a competent authority, usually a Government Officer that the imported goods are meant for the declared use. To illustrate, in case of sports goods the certification would be done by Sport Authority of India and in the case of IT products by the Information Technology Ministry. There are around 33 such certification agencies. There can be no two views that involvement of multiple agencies would only increase the transaction cost besides contributing to delays in customs clearance.

2.4.2 Besides the problems associated with certification, the end use based notifications require the customs to ensure the goods are indeed meant for the stated use. This is invariably accomplished by calling for literature of the imported item. As a result queries are raised and till the literature is produced and perused the goods cannot be released. Thus, the end use based exemption notifications do not facilitate quick customs clearance and also militate against on-line appraisal and clearance of imported goods. Therefore, as the intention is to expedite the clearance of the goods and that too without examination, to the extent possible, the solution lies

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in removing all the end use-based exemptions, which necessitates the calling of literature and certificates from different departments.

2.4.3 On the subject it is increasingly been noticed that there is a move towards removing the requirement of execution of bonds with the customs authorities for the fulfillment of post import conditions. This is a welcome step as it reduces delays in clearances and also transaction costs. However, it is not the case that the bonds are being removed altogether. What is being provided is that such importers must follow the provisions of Customs (Import of Goods at Concessional Rate of Duty for Manufacture of Excisable Goods) Rules, 1996. Invariably this entails the importer to obtain registration with the central excise authorities, followed by execution of bond, filing application for import of goods, maintaining records for verification, obtaining case by case permissions for import etc. Hence, the new procedure is merely a substitute for the system of end-use bonds as instead of the execution of the bonds with the customs authorities the importer registers with the central excise authorities and must satisfy this authority that the goods have been used for the intended purpose.

2.4.4 It is the view that the present procedure is not desirable. Such procedure only increases the contact points and the cost of compliance. On principle it should suffice that customs clear the goods on the basis of the importer's declaration and if misuse is detected on the basis of intelligence or post clearance audit checks, the duty should be recovered along with interest.

2.4.5 As a policy end-use based exemptions must be avoided. However, when this is not possible the customs clearance procedure must provide for the grant of the exemption without insistence upon literature and certification and the customs would reserve the right to carry out a post clearance audit check based upon risk management tools i.e. not as a matter of routine. This is also in line with the best international practices

2.4.6 To sum up, criticizing all duty exemptions would be a simplistic approach. Exemptions do serve a number of objectives by ensuring that the imported goods are not only available but also at less cost. Exemptions also serve to stimulate domestic economic activity by making available a level playing field. However, it is also true that exemptions once granted tend to continue even if the objective has since been met and even if alternative and more transparent mechanism is available for achieving the desired objective. Exemptions tend to distort the opportunity cost and in the long run adversely impact competitiveness. Invariably the exemptions are conditional and

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also impact the pace of clearance on account of necessity of verification process. Overall falling tariffs and India's commitment to bringing down the customs rates of duties to international standards by 2004-05 must also influence the decision whether a particular exemption merits continuance or not.

2.4.7 It is recommended that the grant or continuance of exemptions must be judged against the following criterion :

(i) As a policy, all exemptions must be removed except in case of :

(a) Life-saving goods.

(b) Goods of security and strategic interest.

(c) Goods for relief and charitable purposes.

(d) International obligations including contracts.

(ii) As a general policy, when exemptions are removed but the relief is justified, the targeted beneficiary may be assisted by upfront transparent budgetary support based on a prior stated objective criteria. By such method, the expenditure would be subject to Parliamentary scrutiny and there would be public debate besides CAG audit.

(iii) In case an exemption is justified, it should not be end-use based conditional exemption. However, in the event the end-use condition cannot be avoided, the confirmation of end-use should be done on the basis of selective post clearance checks by using Risk Assessment techniques. It should <u>not</u> be based upon the Customs (Import of Goods at Concessional Rate of Duty for Manufacture of Excisable Goods) Rules, 1996, as the implication in terms of registration with central excise, execution of bond etc. increases contact points and the cost of compliance.

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(iv) **As a general policy, there should be no exemption from Countervailing duty (CVD), which is at par with the duty paid by the domestic manufacturers of similar goods, including in cases where the exemption from basic customs duty is merited. An exemption from CVD places domestic industry (including potential industry) at disadvantage and serves to deter domestic investment in these areas, which is not desirable.**

(v) **Best international practices should be one criteria for determining the requirement of otherwise of an exemption.**

It is the view that adherence to the above principles would widen the tax base, improve the tax to GDP ratio and improve the tax administration.

2.5 **Nature of tax rates - specific versus ad-valorem**

2.5.1 A perusal of the Customs tariff shows that for a few items there are specific rates of duty viz. While the administrative convenience of specific rate is not debatable, these are out of place in an economy seeking to maximize its revenue through buoyancy. A modern tax system should not have specific rates at all. Specific rates also do not allow for buoyancy in revenue on account of price changes. **Accordingly, as a policy there should be a move away from specific rates towards ad-valorem rates.** These findings would also apply to the central excise notifications, to the extent relevant.

2.6 In the light of the above recommendations, the suggested customs duty structure on imports is given in Annexure 'A'. Since agricultural products stand on a different footing, the Task Force has refrained from suggesting the proposed rates and recommends an Expert Group should be set up for the same.

3. Central Excise Tariff and Exemptions

3.1 Multiplicity of levies

3.1.1 At present there are more than one type of levy administered by the central excise department other than the CENVAT (central Value Added tax) duty. These other duties are :

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(i) Special Duty of Excise (SED) - levied under authority of – provision of Finance Act.

(ii) Additional Duty of Excise (AED) – levied under authority of Additional Duty of Excise (Goods of Special Importance Act, 1957) on specified goods, sugar, fabrics and tobacco products.

(iii) Additional Duties of Excise (Textile and Textile Articles Act), 1978

(iv) Additional Duty of Excise (AED) – levied under authority of Additional Duty of Excise (Textile & Textile Articles) Act, 1978 on specified fibres, yarn and fabrics.

(v) Additional duty on Motor Spirit and High speed Diesel – levied under authority of Finance Acts.

(vi) National Calamity Contingent Duty - levied under authority of Finance Act.

(vii) Cess – under various enactments such as Jute Cess Act, Tea Cess Act, etc.

3.1.2 It is well known that multiplicity of levies do not contribute to ease of administration. Invariably separate accounts are to be maintained by the tax payer and the tax collector, which pushes up the cost of compliance. Further, the complexities caused by multiple levies also give rise to errors and disputes. In fact, in cases when an item is subject to more than one levy we often have audit pointing out that one or the other levy was not paid. Even conceptually it is not at all clear why we should continue to have the AEDs, which are basically imposed in lieu of sales tax. So long as this levy continues it would be difficult to move to the National VAT, as is proposed. Accordingly, in order to have a simple administration which has as its advantage reduced complexities and compliance costs, it is desirable that there should not be multiple levies.

3.1.3 It is recommended that as a policy, we should review all levies and have only one levy, i.e. the Cenvat.

3.1.4 An alternative scenario is proposed if for some reason it is not found possible to remove multiple levies at one go. At present, both the tax payer and his counterpart, the tax collector indicate the tax paid under each of the levies separately and subject the same to calculations to

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confirm the correctness of the payment. This system is not conducive to efficient implementation and given the large number of transactions, mistakes can not be ruled out. It appears that so long as the total tax is correctly paid, the tax payer should not be bothered with the task of giving the break up. This is a job strictly for the administrators who have to later divide the tax proceed under various accounting heads. Accordingly, it should be provided that when a product attracts multiple levies only the total levy (i.e. one figure only) should be indicated against the particular item. This amount would be paid and the system should further break it up into the individual heads. This would save the tax payer and the tax administrator the exercise of carrying out all sorts of complex calculations. Of course, one problem in this system would be that at present, under the Cenvat Credit Rules, the credit of a particular duty can be used to pay the same duty on the final goods. Thus, the tax payer must know the element of each duty for this purpose. This can be done by indicating the break up of the total duty (in percentage terms) into its respective heads – in like manner of the Drawback Schedule. As stated, the ideal solution is to have a single levy.

3.1.5 It is recommended that till such time as there are multiple levies, there should be a schedule indicating the total tax payable on a particular product and the system should internally segregate the same into the respective levies.

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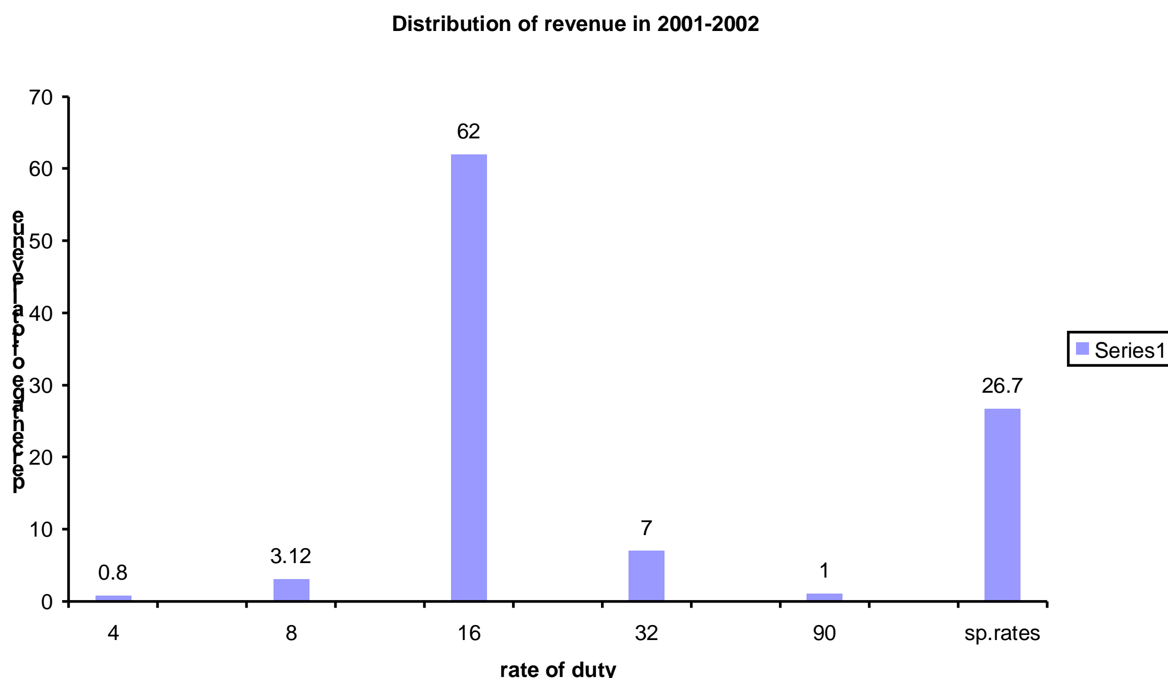
3.2 Multiplicity of Duty Rates



3.2.1 In so far as the multiplicity of rates on the central excise side are concerned, it is appreciated that recently steps have been taken in the general direction to reduce the multiplicity. For instance, the number of duty rates has been reduced substantially, from 11 rates in 1997-98 to a single rate of 16% at present, except in few cases. Whereas a single rate has many advantages domestic economic considerations do not always permit so. Internationally also it is not the practice to have a single rate. However, it is certainly true that the endeavour should be to have as few number of rate of duty as is possible. It is expected that the rationalization of exemptions over the time would also lead to this situation.

3.2.2 It is recommended that the central excise duty rates should be as follows :

(i) 0% would be for life-saving drugs, security related items and the like.

(ii) 8% would be for food products.

(iii) 16% would be for all items.

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(iv) Separate rates for agriculture products.

(v) Separate rates for tobacco and tobacco related products.

3.2.3 As regards the move to 16% duty rate it is the view that the move can not be all of a sudden. The transition has to be staggered to give the industry time to adjust. The availability of Cenvat credit would also act as a buffer whenever duties on inputs and raw materials have to be increased on account of this approach.

3.2.4 Accordingly, **it is recommended that the road map of duty rates should lead towards the identified duty rate (for the product) through a mechanism of (+) or (-) 4% each year, depending upon its current rate of duty.** To illustrate :

Duty rate at 0% or Nil

Year 0 (2003-04) - From 0 % to 4% (without Cenvat) and to 8% (with Cenvat)

Year 1 (2004-05) – From 4% to 8% (without Cenvat) and 8% to 12% (with Cenvat)

Year 2 (2005-06)– From 8% (without Cenvat) and 12% (with Cenvat) to 16% (with Cenvat)

Duty rate at 32%

Year 0 (2003-04) - From 32 % to 28%

Year 1 (2004-05) – From 28% to 24%

Year 2 (2005-06) – From 24% to 20%

Year 3 (2006-07) – From 20% to 16%

3.2.5 This is the general rule. However, it is possible that the Government may move down to 16% even quicker, which would be a welcome move.

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3.3 Duty structure for Petroleum sector

3.3.1 The petroleum sector occupies a very important place in the economy in view of its direct and indirect use in practically every sphere of economic activity but also in terms of its direct impact on the revenues of the Government as it is the single largest source of revenue. At present central excise duty rates on petroleum products vary from 14% to 28% - 14% for HSD and 28% for petrol – with 16% being the rate for other petroleum products. On the customs side the rates of duty very form 10% (crude) to 20% (other petroleum products).

3.3.2 With the dismantling of the Administered Price Mechanism, it is essential to allow the prices of the petroleum products in the domestic market to be determined on the basis of import parity price. Accordingly, the import duty has to be brought down from the present levels. At the same time, as crude is the basic raw material for other petroleum and chemical products there has to be a duty differential varies from nil to a maximum of 5 percentage point In this regard, it is observed that the international practice is that the differential is around 2 percentage points as the value addition is normally around 10-15%.

3.3.3 Accordingly, taking into account all factors including profit margin of refineries, the value addition and need to keep the product prices reasonable for the consumers, **the road map for duty structure on petroleum has to be kept distinct from that of other products and the following recommendation is made :**

(i) A 5% customs import duty differential between crude and its products.

(ii) Year 0 (2003-04) : Basic customs duty - on crude - 10%
- on other products - 15%.

Year 1 (2004-05) : Basic customs duty - on crude - 5%
- on other products - 10%.

(iii) Central Excise duty : 16%

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3.4 Duty structure for Textile sector

3.4.1 The disparity in the central excise tax structure is most evident in the textile sector because of the policy of trying to meet various social objectives through tax rates and exemptions. The duty is summed up as follows :

(i) Yarn duty varies from 8% for cotton yarn to 32% for polyester filament yarn. Other yarns attract 16% duty.

(ii) Woven fabrics and garments and textiles made ups attract duty at 12% (this rate is committed upto 2005).

(iii) Knitted cotton fabrics and knitted garments have the option of paying 12% duty

(iv) Yarns, handloom fabrics and garments and knitted cotton fabrics have a number of exemptions.

(v) Hand processed fabrics are exempt from duty even if power is used for some processes.

3.4.2 The present tax structure with its plethora of duty exemptions distorts the production pattern. However, the levy of duty raises the problem of its administration as the large number of the units engaged in the weaving of fabrics are mostly in the unorganized sector. There would also be the problem of spinners of yarn in the decentralize sector. This can easily be taken care of by putting all unprocessed woven and knitted fabrics as well as yarns under the general small scale sector duty exemption. To continue the exemption for handlooms, the processing of handloom fabrics can be given the benefit of the said exemption. In case a unit processing handloom fabrics is thus required to pay duty, it should be given a transparent subsidy as in the case of hank yarn. However, central excise duty will continue to be leviable on all other processed fabrics. Even fabrics processed without the aid of power or steam should be subjected to duty. With the removal of deemed credit, this will ensure that the units which want to take credit of the duty paid on the inputs would procure their raw materials from the duty paying units. If there is any procedural difficulty because of complexities in textile trade where the traders play a very important role, suitable arrangements may be made to allow the traders to pay duty and get the

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fabrics woven or processed on job work basis. In that case, the traders will pay the duty and take credit. Similar arrangement is already being availed by the garment manufacturers. The textile sector should also be charged to the normal Cenvat rate but since a commitment has been made in this year's Budget that the 12% rate would apply to fabrics, made-ups and garments till February 2005 it is the view that the commitment should be honoured and the normal Cenvat rate should apply after February 2005.

3.4.3 It is recommended that as a general policy the textile sector should be subjected to the standard rates of duty. In view of the commitments already made, the 12% rate may, however, continue till February 2005. The deemed credit facility should be withdrawn forthwith.

3.5 Central Excise duty exemptions

3.5.1 Central Excise duty exemption notifications are issued under the provision of Section 5A of the Central Excise Act, 1944. In like manner to the Customs duty exemption notifications, these also provide relief to the tax payer such that the tariff rate of duty need not be paid and only the concession (or nil) duty has to be paid. A review of the exemptions reveal that over the past 5 years there has been nominal decline in the number of exemptions. However, it is worth noting that the total number of exemptions is not a correct reflection of the number of products being exempted from levy of excise duty. This is due to the fact that one exemption may contain a large number of products spread over a large number of product classifications. For instance, duty exemption notification No. 6/2002-C.E., dated 1.3.2002 is applicable to over hundreds of items, some of which are indicated by their generic descriptions and the actual number of items would be so much more.

3.5.2 It appears evident that monitoring duty exemptions to ensure that these are issued on sound principles and withdrawn when the objective is met is a critical task for the government, which impacts the tax to GDP ratio. However, review of duty exemptions does not appear to be done though the ground realities warranting exemption may have undergone change. Also some exemptions may lead to distorted investment decisions as the industry believes that the exemption will continue *ad infinitum*. It appears that an exemption when issued to meet a specific objective should be reviewed periodically with change in ground conditions. The continuing grant of exemption may not be conducive to efficient utilization of resources. Hence, it is necessary in

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the interest of transparency that when an exemption is issued it indicates the period of its validity with a proviso that changed circumstance may warrant a mid-term review, the periodicity to be mentioned. This would ensure a comprehensive periodic review by the Government which must record the justification for its continuance. It would also put the burden on the beneficiaries to establish the continued justification for the exemptions. This also resolves the problem of promissory estoppel and also ensure transparency and stability.

3.5.3 Taking into account all factors the **recommendation is that the grant of exemptions on the central excise side needs careful consideration and justification based upon the following touchstones**.

(i) **Income elasticity of the product** - an exemption is not justified on items which have high elasticity. In other words, social equity demands that exemption should not be granted in respect of goods which are purchased or used by the high income groups and can be termed as luxury goods. This is not to justify the grant of exemption in each and every case the goods are consumed by the masses. A careful approach is required before grant of exemptions.

(ii) **Cost of compliance** is an important element which would justify the grant or otherwise of the duty exemption - in view of the vastness of the economy and that the tax administrators are spread thin it is desirable that the cost of collection should not be high. Hence, an exemption should be weighed both against the revenue mobilization as well as the cost of collection thereof. In the event, the cost of collection is significant it may be an economically viable decision to grant exemption.

(iii) **International practices** serve as an important input for grant or denial of exemption. No doubt the ground realities and compulsions of other countries may not adequately compare with the situation at home nevertheless tax treatments of goods internationally do reflect the international thinking. For instance, it is a common trait internationally that demerit goods are subject to high tax rates, and the same is done here also. Likewise exemptions to environmental friendly equipment is an international phenomenon and is equally justified at home.

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(iv) Whether an exemption meets the **canon of transparency** or not is an important factor to be taken into account while examining the issue. By and large conditional exemptions run the risk of increase in cost of compliance and inefficient monitoring systems provide scope for misuse. On principle a more transparent methodology is the grant of budgetary support to the activity warranting an exemption. This would ensure accountability, reduce transaction cost, and most importantly lead to periodic monitoring on regular basis. In such scenario the unintended continuance of an exemption would also be ensured against. In other words while granting exemptions on sound principles the scope of extending the intended benefit through budgetary support should first be examined.

3.5.4 Applying the aforementioned tests to the present exemptions the consensus is that a number of duty exemptions can be removed without adverse impact on the industry.

3.5.5 As stated, the general prescription in respect of grant of duty exemption, as indicated in the context of customs duty exemption notifications would equally apply. In other words, it is the view that sound taxation policy demands limited use of exemptions. Further, when exemptions are justified these should not end use based conditional exemption, which cause compliance problems and increase contact points which are best avoided. **Instead of exemptions we should move to a budgetary mechanism for giving the same relief.**

3.6 Small Scale Sector duty exemption

3.6.1 The Small-Scale Sector Industries (SSIs) have been playing an important role in India's economic development in the form of value addition, employment generation, mobilisation of capital, entrepreneurial skills and contribution to export earnings. At present, the SSI sector with over 40 lakh units spread all over the country accounts for nearly 95 per cent of industrial units in the country and 40 per cent of value-added in the manufacturing sector. Its share is as high as 34 per cent in national export and it contributes roughly 7 per cent to the country's total GDP. Yet its contribution to excise revenue is negligible, only of the order of 3.4% of the total excise revenue.

3.6.2 Traditionally, the central excise duty exemption has been used to support the SSI sector. But it has been noticed that over the time the exemption is increasing and today no central excise

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duty need be paid by a unit whose clearances are upto Rs. 100 lakhs in a financial year. Whereas there is no doubt that the smaller units do need the central excise exemption, the flip side is that so long as such a vast sector continues to remain exempted, avoidable distortions are caused, as follows :

(i) The adverse impact on the tax to GDP ratio is an undeniable outcome of the increasing exemption limit for this sector.

(ii) Central excise being a tax at first stage of production, the exemption therefore leads to non-accountal of production which leads to non-payment of all other taxes (Income Tax, Sales tax etc.) and generation of black money.

(iii) Exemption leads to misuse of Cenvat credit by the duty paying (large) sector which procures the exempted goods from SSI sector but wrongly takes credit on basis of duty payment documents generated elsewhere.

(iv) Non-accountal of transactions encourage a cash economy with its own adverse implications.

(v) The exemption gives benefit to units upto a specified turnover after which, duty has to be discharged at the full rate. Therefore, for obvious reasons the units prefer to keep their turnover within the full exemption limit, either by unaccounted removals or by horizontal proliferation. This is not desirable from the point of view of evasion of tax. It also discourages economies of scale.

(vi) Duty exemptions for the SSI sector cause a break in the Cenvat credit chain and would adversely impact the adoption of a full fledged VAT.

(vii) An exemption leads to loss of valuable data which proves counterproductive in respect of dissemination of information, tax planning etc.

3.6.3 In so far as the payment of tax in general is concerned it is important to appreciate that the SSI sector does pay its dues, the sector contributes significantly in the payment of central excise duty on the goods procured from the duty paying sector, payment of income tax, sales tax etc.

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However, the units do not pay central excise duty. The starkness of this simple statement is brought out when we find that a person owning a phone or residential property is on the records of the Income Tax; a person with a turnover of Rs.40 lakhs is subject to compulsory audit by income tax; all such persons pay sales tax and income tax etc. Yet, upto a turnover of Rs. 100 lakhs no central excise tax need be paid and upto clearances of Rs.90 lakhs in a financial year these are not even on the records of the central excise department. The threshold limit for exemption in the developed countries does not exceed Rs.30-40 lakh. It is also the view that the ever increasing exemption limit (from Rs.25 lakhs to Rs.50 lakhs and now to Rs.100 lakhs) has been cornered by the larger of the SSI units and the smaller (tiny and family) units continue to produce at lower levels of output. In fact, being a first point tax non-payment of central excise duty leads to non-accountal of production and income which leads to non-payment of sales tax, income tax, generation of black money etc. Obviously there is something wrong somewhere.

3.6.4 It is the view that as a policy, SSI sector must also pay central excise duty. In fact since they already pay all other taxes there should be no hesitation in paying the central excise duty also. In any case, being an indirect tax, it gets passed on the consumer. Moreover it is the finding that the SSI sector is not averse to payment of central excise duty so long as they do not have to interact with the department. There is a logical reason for this. Since the units are mostly one-man shows dealing with the tax department would lead to loss of man-hours which they can ill afford. This is especially true of the smaller of the SSI units. The bottom line is that it is not the payment of excise duty rather method of collection of the same i.e. harassment by the department which is bothering the SSI sector. Accordingly, what is required is a moderate tax rate and a transparent mechanism to collect the due tax without interaction with the department to the extent possible. At the same time it needs to be appreciated that the present system of collection of central excise may not be administratively able to cope with over 40 lakh units. Hence, while accepting that the smaller of the SSI units need to be kept out of the tax net it is also necessary to evolve a modern system of tax collection which does not encourage interface, contact points and excessive documentation.

3.6.5 The matter of SSI duty exemption was debated at length and the view was that the exemption must be available to only the really small units with turnover of upto Rs. 50 lakhs. Other units must gradually start paying the duty. This is, however, subject to the condition that the central excise procedures improve appreciably and the procedures are small scale sector friendly. In short, the view regarding the Small Scale Sector duty exemption is that the problem in

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payment of duty (by the sector) is basically that the present procedures do not encourage participation and confidence building. Accordingly, there is a need for confidence building measures, which may take some time. In this background, **the following recommendations are made :**

(i) **The exemption should be extended to only small units with a turnover of Rs. 50 lakhs - This would ensure the really small scale units being run mostly with family labour and having low capital investment get the desired support. It will exempt those units whose compliance cost will be significantly high relative to their tax obligations.**

(ii) **The exemption limit for the larger SSI units should be gradually brought down to Rs. 50 lakhs. The gradual downward revision of the limit would give the industry time to adjust. The time frame is suggested, as follows :**

Year 0 (2004-05) – From Rs.100 lakhs to Rs. 75 lakhs.

Year 0 (2005-06) – From Rs.75 lakhs to Rs. 50 lakhs.

However, on reduction of the exemption limit, the unit would have the option of payment of duty at 4% (without Cenvat) on the value of clearance upto Rs. 1 crore. The other option available at present of paying duty at a certain percentage of the normal rate would continue to be available.

It is important to note that the downward revision in exemption is proposed to be complemented by a transparent and hassle free tax collection mechanism, which must be in place from April 2004.

As stated, there was a minority view that the small scale sector needs continuing support of the tax exemption.

(iii) **The duty exemption should be based upon total turnover** - Since the exemption is for a small scale unit, the logical criteria to determine the smallness of a unit is its turnover. It can reasonably be expected that if the turnover is few

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hundreds of lakhs there is really no difference between a small scale and a large scale unit. Accordingly, at present, a unit is entitled to a small scale exemption if the value of its clearances does not exceed Rs.300 lakhs in the previous financial year. This figure is determined after ignoring the value of clearance of exempted goods and goods exported. Thus, if a unit has clearances of Rs.10 crores or even Rs.20 crores it would still qualify for the SSI sector exemption if these are exempted goods! Surely this cannot be the intention of the duty exemption scheme. It is the view that this is a wrong methodology. The central issue is whether a unit is small or not, a factor of its turnover. Thus, the duty exemption should provide for determining the turnover based on value of total clearances including exempted goods. However, in view of the special contribution of the sector towards the overall exports and to encourage exports, it is proposed that the clearances for exports may continue to be excluded for this purpose, as at present.

(iv) **On principle duty exemption for SSI sector should not subsidise consumption of luxury items by the affluent** - Central Excise duty is an indirect tax and is paid by the consumer of the goods. In case of an exemption on the goods, the benefit actually accrues to its consumer. It is the view that consumers of luxury goods (e.g. Airconditioners) do not merit the subsidy extended indirectly to them through the SSI sector duty exemption. Hence, it is proposed that a negative list of such items should be drawn up and the SSI sector duty exemption should be denied to a unit making these items. One yardstick to define a luxury item may be that item which attracts over 24% duty. However, this is only a guideline.

(v) **Declaration of production activity** - At present a SSI unit is required to file a declaration with the Department when its clearances touch Rs.90 lakhs. **It is proposed that with effect from 1st April 2003 a Declaration should be filed by the unit when value of its clearances touches Rs.50 lakhs.** We can simply not have a modern tax system unless there is a data base and proper accountal of all transactions.

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3.7 Extension of SSI sector duty exemption to Matches

3.7.1 At present, the small scale sector duty exemption does not apply to Matches. This sector has over 18,000 tax payers, with an overwhelming majority in the cottage sector located in and around Madurai and Chennai, and only 2-3 large mechanized units. The revenue from Matches is nominal - only Rs.32 Cr. in 2001-2002. Thus, large number of small scale assessees are subject to nominal tax, which is not desirable particularly as it is in contrast to general policy to exempt from excise duty the small scale sector.

3.7.2 Rules 13 and 14 of Central Excise Rules, 2002 prescribe a special procedure for the assessment and collection of duty on Matches (CETH 36.05). This procedure continues on the statute as a unique dispensation for the Match sector. It envisages payment of central excise duty by the method of affixing to each box or booklet a central excise stamp of the value appropriate to the duty. The stamps are printed at Government Security Printing Press, Hyderabad and kept in safe custody at the District Revenue Treasuries or Sub–treasuries wherefrom these are supplied to the individual Match manufacturers. It is the finding that the special duty structure for the Match sector and the special procedure, which is an aberration in so far as the general procedures of central excise administration is not desirable. Some of the common problems which have been noticed are :

(i) The system is inefficient – reportedly, the cost of collection of revenue ranged from 124% in 1998-99 to 68% in 2001-02 - major share being the cost of purchase and distributions of stamps.

(ii) Cost of compliance is high as a tax payer has to shuttle between the Range Office and the Treasury more than once to pay the duty and obtain central excise stamps before effecting clearance.

(iii) The central excise stamps are frequently not available, which dislocates the production activity besides increasing the administrative work on account of Department having to declare ‘Stamp Holidays’.

(iv) The specimen of the labels (of stamps) are approved by the Department, and often it is dragged into disputes of Trade Mark. This is avoidable litigation.

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(v) The Treasuries are under the control of State Government and the Security Printing Press under Department of Economic Affairs, Ministry of Finance. Thus, procedural or other delays at either end affect the collection of central excise revenue.

3.7.3 As a result of the unique tax structure and absence of duty exemption there is, reportedly, wide spread corruption and inefficiency. There can be no sound rationale why the poor unorganized sector is being deprived the advantage of the SSI sector duty exemption. In fact, if there is a case for the SSI sector duty exemption for any item it is the Match sector. Accordingly, it is necessary to clean up the central excise law and bring this sector into the main stream.

3.7.4 It is recommended that :

(i) The small scale sector duty exemption should be extended to Matches - the vast majority of the manufacturers would then be outside the scheme of excise procedure i.e– no registration, no records, no returns and no payment of duty. This would be a relief to the small and cottage sector units.

(ii) The duty structure may be made ad-valorem. Since, the duty would be paid only by the large units (semi-mechanized and mechanized) only the Cenvat credit scheme can be extended. Such step would also clean up the Central Excise Rules as the rules 13 and 14 may be deleted.

3.8 In the light of the above recommendations, the suggested central excise duty structure is given in Annexure 'B'.

3.9 Location based exemptions

3.9.1 In 1999, for the first item in the history of central excise the Government issued two exemption notifications aimed at development of the North-Eastern States. While the intention was laudable it has actually translated into shifting of investment to the North-East from other parts of the country. The long terms effect of the exemption, which is valid for 10 years would be

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to depress the excise revenues for this long period. Another fall out, on expected lines has been the demand from other states for similar exemption. So far Kutch district has been included and the day is not far when other States are also likely to be given the benefit of the exemption. The net result would be the creation of areas of exemption, which is most undesirable from the point of view of any tax administration. Such a move would seriously impact the tax to GDP ratio in the coming years.

3.9.2 It is recommended that there is a need to review the policy of granting exemption based upon location and replace it with subsidy by 2004-2005.

4. Relevant date of Notification

4.1 An important issue relating to exemption notifications, both customs and central excise is the relevant date from which the exemption would come into force. Over time , this has been an area of dispute with some treating the date of issue as the relevant date and others the date from which it is made known to the public. Without going into the legality of the issue, it is the finding that any good tax administration must provide some advance notice to the tax payer before a change is introduced. This has its obvious advantages. In fact, at present the system is that a notification is issued on a particular day and that same day it is placed on the C.B.E.C. web site and comes into force. This is true even if the notification is issued after office hours or late at night, which is usually the case. Reportedly, this situation results in neither the departmental officials or the trade and industry knowing about the notification. As a result, there is invariably an exercise of issue of demand notices (when duty has been increased) and filing of refund claims when duty is reduced). Another fall out of the sudden introduction of the notification is that the automated clearances on the customs side give the wrong results, since the software modification does take time.

4.2 As stated, it is not reasonable to bring into force a notification from the date of its issue as this increases the work load and adversely affects the efficiency of the system. At the same time, it may not be appropriate to give too much time for the implementation of the notification as this may lead to speculation.

4.3 It is recommended that a notification should come into force from the day after the day of its issue. To illustrate, a notification dated (i.e. issued) 1st. December would come into

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force from 2nd December. This would require each notification to contain a suitable clause, till such time as the law is amended.

5. Zero rating exports

5.1 There is a misconception that exports are exempt form central excise duty. This is not so. Exports are chargeable to duty as any other excisable goods. However, in terms of rules 18 and 19 of the Central Excise Rules, 2002 goods can be cleared for exports either on payment of duty under claim of rebate of duty or under bond without payment of duty. Since goods sent for exports are not exempt from duty, Cenvat credit is available on the inputs and capital goods used in the manufacture of such goods.

5.2 In this regard it is seen that the international practice is to ascribe Zero rating to exports. This means that if the goods are exported, the duty payable is Zero. As the goods are technically not exempt, the benefit of Cenvat credit would continue to be available. Zero rating of exports has the advantage that it will facilitate in eliminating all input taxation without the need for any end use based exemption. This of course has to be integrated in a scheme for refund of excise credit quickly.

5.3 It is recommended that from 1st April 2003 exports should be Zero rated.

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