FINAL REPORT

OF THE

TAX REFORMS COMMISSION

19TH October 2001.

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Member Secretary
(From 15-11-2000)

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MAJOR ANNEXURES

CHAPTER I

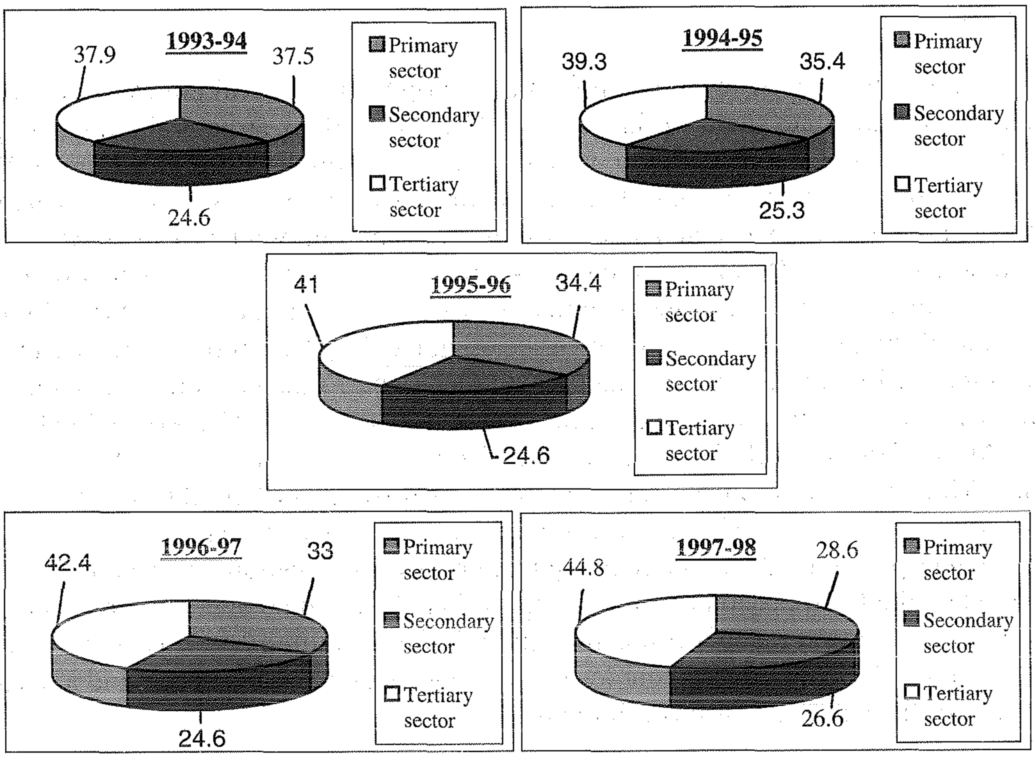
RESTRUCTURING THE TAX STRUCTURE IN KARNATAKA: AN OVERVIEW

Revised sectoral compostion of State Domestic Product

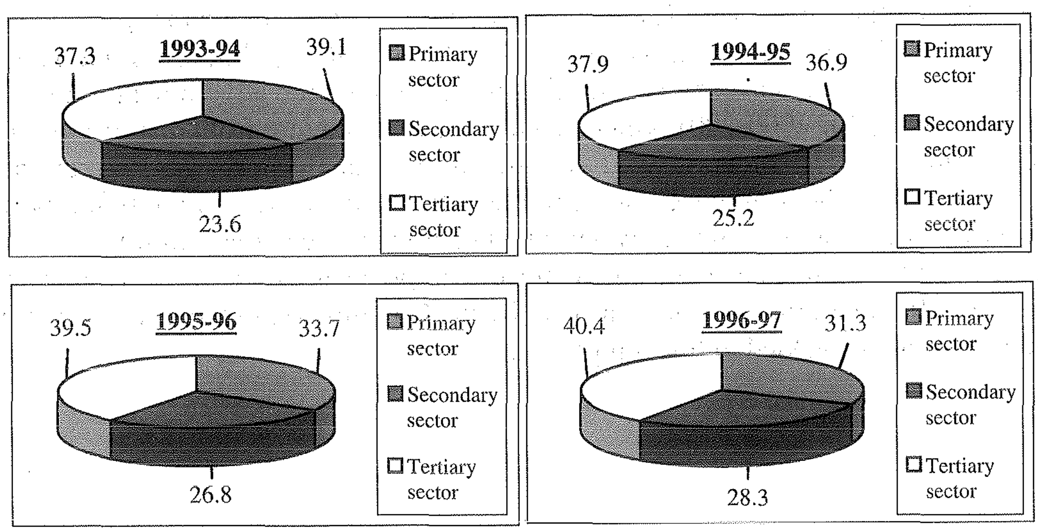
1.4 The first report of the Commission had analysed the sectoral composition of State Domestic Product from 1993-94 to 1996-97-the four years for which final GDP statistics under the new series had been released by the government in the Economic Survey for 1999-2000 (page 11 in Chapter II of the first report). These figures have undergone radical revision in the 2000-2001 Economic Survey, necessitating modification of the two graphic presentations made at pages 11 and 12 of the first report. They may be substituted by the following charts (final GDP data now available for 1997-98 has also been added):

Sectoral composition of NSDP at '93 - '94 prices (%)

Revised



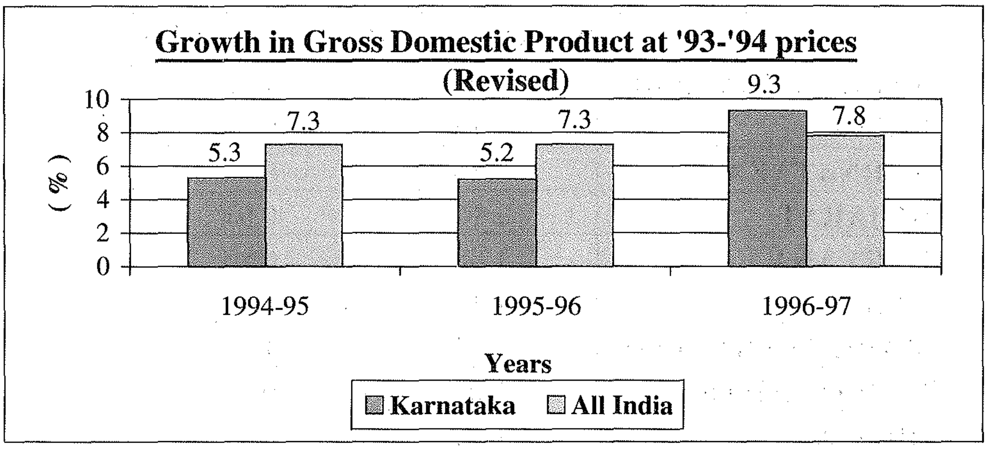
Initial

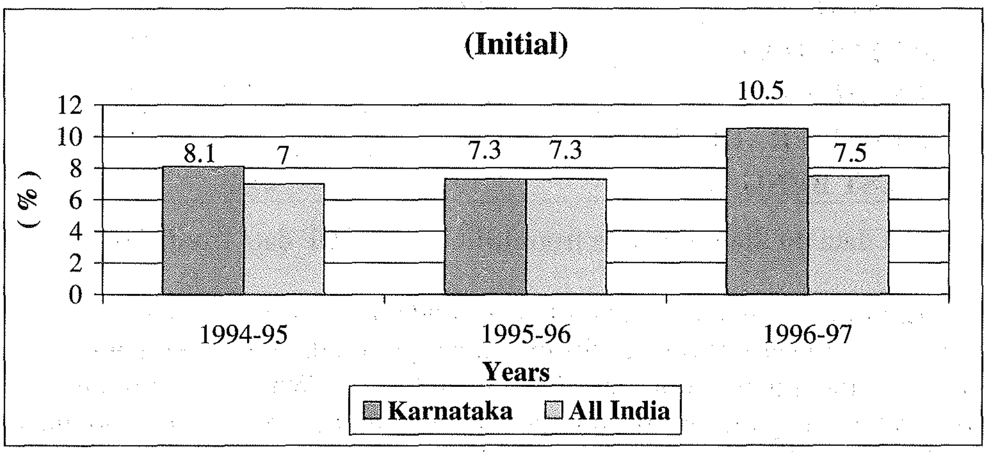


1.5 The revised figures may need to be re-examined, since the share of the secondary sector in NSDP has been indicated as 24.6% for 3 out of the 5 years studied. The new data give a lower share to the primary sector (37.5% instead of 39.1% and 35.4% instead of 36.9% respectively) for the first two years-1993-94 and 1994-95. This builds up gradually to a higher share (33% instead of 31.3%) in 1996-97. In 1997-98, however, the share of the primary sector seems to have dropped to 28.6%. The share of the secondary sector is almost frozen for 4 years with a slight upward movement to 26.6% in 1997-98 (the earlier figure was 28.3% in 1996-97). The main gainer is the tertiary sector whose share goes up further to 42.1% in 1996-97 and 44.8% in 1997-98.

1.6 The revised data indicate an even greater share for the service sector and a lower share for the secondary sector in the State's economy than assumed earlier. Coupled with a higher share for the primary sector, this explains the stagnancy of own tax revenues, which are currently focused mainly on industrial production. It also signals the urgent need to extend the tax base both to the primary and tertiary sectors and supports the case already made out by us in the first report for radical structural reform. The present report focuses on these sectors while considering fiscal tools available at the State level for increasing own tax revenues.

1.7 GDP growth figures at '93-'94 prices presented in the first report also require modification because of changes in GDP figures at both the State and Central levels. The revised picture is given below:





1.8 As against conclusions drawn in the first report, it is now seen that GDP growth in Karnataka was substantially below national rates for two years. It shot up above the all-India figure only in 1996-97. Growth rates have also been generally below the 7% annual target fixed for the Ninth Plan period except in 1996-97 as well as the 7.5% target assumed during the five year period of the Medium Term Fiscal Plan.

Unrealised tax potential assessed

1.9 Delayed reform of tax structures has affected the revenues of almost all States. This is reflected in declining buoyancies. As mentioned in the first report, change in NSDP series from 1993-94 makes it difficult to compute a continuous buoyancy series for the eighties and nineties. Figures derived for the post-1993-94 period alone (using final NSDP data, which is available only up to 1998-99) are likely to be unstable because of the limited number of years covered. For greater accuracy, therefore, we have computed buoyancies for the period 1980-81 to 1992-93 on the old NSDP series and for the longer period 1980-81 to 1998-99 using both sets of NSDP data and employing a dummy variable to capture the shift in 1993-94. The results are given below:

Table I

Buoyancies of own tax revenue

	'80-'81 to '92-'93	'80-'81 to '98-'99
ANDHRA PRADESH	1.01	1.12
BIHAR	1.13	0.79
KARNATAKA	1.14	0.84
GUJARAT	1.17	0.91
HARYANA	1.08	0.83
KERALA	1.17	0.82
MADHYA PRADESH	1.13	1.29
MAHARASHTRA	1.03	0.86
ORISSA	1.32	0.91
PUNJAB	0.96	0.62
RAJASTHAN	1.10	0.97
TAMILNADU	0.30	0.98
UTTAR PRADESH	1.17	0.96
WEST BENGAL	1.19	0.60

Source:- RBI data on State finances from ISEC and NSDP data from CSO

1.10 12 of the 14 major States (A.P. and Madhya Pradesh are the only exceptions) show lower buoyancies for the longer period than for the eighties (buoyancies for the nineties alone should be even lower). What is even more disquieting is that buoyancies have dropped below 1 in these States. In Karnataka, buoyancy has come down from 1.14 to .84. This indicates falling responsiveness of own tax revenue to NSDP growth to the extent that every percentage point of NSDP growth is resulting in less than proportionate growth in tax revenue.

1.11 To avoid misunderstanding, we would like to reiterate here the point made in the first report that fall in buoyancies is due principally to defects in the tax structure, narrow base, proliferation of exemptions and inefficient and inequitable determination of rates and slabs for different productive sectors and classes of taxpayers. Complications in the tax structure create problems for administration. In other words, improvement will depend on both structural and administrative reform.

Consultations and visits of the Commission in connection with the final report

1.12 For firming up recommendations in various areas considered in the present report, the Commission held wideranging consultations with experts and officers. It met formally on 20/2/2001, 13/3/2001, 27/3/2001, 11/4/2001, 12/4/2001, 25/5/2001, 26/5/2001, 27/7/2001, 28/7/2001, 20/8/2001 and 21/8/2001 and held extensive discussions with Secretaries to government and heads of departments on major fiscal matters.

1.13 Leading academic institutions have extended generous support to us in canvassing ideas on knotty problems. A major consultative exercise was organised for the Commission by the Institute for Social and Economic Change (ISEC) which brought together at Bangalore at our request, on 11th and 12th July, national and international public finance experts for a debate on the reform agenda for various State taxes, particularly VAT. The Commission was fortunate in securing the presence and guidance of Dr. Manmohan Singh, former Union Finance Minister to inaugurate the seminar. His perceptive comments on State finances and the reform process set the tone for the debate. The Hon'ble Chief Minister as Chief Guest spared time to share his concerns on fiscal reform with seminar participants. Dr Raja Chelliah encouraged us with his advice and guidance. We are grateful to Prof. Amaresh Bagchi Emeritus Professor at the National Institute of Public Finance and Policy (NIPFP), Dr. Kaushik Basu Professor VKRV Rao Chair ISEC, Dr. Ashok Lahiri, Director NIPFP, Dr. Stephen Howes Senior Economist, World Bank, Dr.S.L.Rao former chairperson of the Central Electricity Regulatory Authority, Dr. Mahesh C. Purohit and Dr. Tapas K. Sen Senior Fellows at the NIPFP, Dr. Kavita Rao Fellow NIPFP, Dr. Hiranya Mukhopadhyay, Macroeconomist, Asian Development Bank, Dr. Errol D'souza, Prof of Economics, Mumbai University, Dr. Arindam Das-Gupta Gokhale Institute of Economics and Politics, Dr. G. Thimmaiah, former member of the Planning Commission, Mr. T.R.Satish Chandran chairperson of ISEC, Dr. Hemlata Rao, Professor, ISEC, Dr. Pranab Sen, Adviser Planning Commission, Prof. Vivek Murthy, IIM Bangalore, Dr. B.M. Srinivas Rao former Director IBM, Prof. Shikha Jha, IGIDR and Prof. N.S.S.Narayana and Dr. Surekha Rao of the ISI whose formal presentations and informal interventions at the seminar have been immensely useful in clarifying major issues relating to State tax reform. Dr. M. Govinda Rao and Mr. H. K.Amarnath (ISEC) at the Institute for Social and Economic Change have generously assisted us in analysis and report preparation. Mr. S. G. Bhat, retired Senior Director of the Planning department, continued to assist us with statistical analysis particularly in the area of agricultural taxation.

1.14 Dr. Mohan Gopal Director, Prof. Jaya Govind and Prof. Shankar Reddy of the National Law School of India took the lead in organising a discussion on

18/5/2001 on judicial stamp duties in which present and retired judges of the High Court, civil courts and the Central Administrative Tribunal interacted with legal luminaries, administrators and legal practitioners to generate consensus on major reform issues. We acknowledge with gratitude the continuing support received from these eminent persons as well as from the former Chief Justice of the Karnataka High Court, Mr. Justice P. Venkatarama Reddy. We are particularly indebted to Mr. Justice R. V. Raveendran, Mr. Justice B.N.Krishnan and Mr. Justice R.G.Desai of the Karnataka High Court, Mr. S. K. Ghoshal of the Central Administrative Tribunal, Bangalore, Mr. M.A.S. Rajan, retired Additional Chief Secretary of the State, Mr. K. Eshwar Bhat, former Law Secretary of the State, Mr. K.R. Chamayya, former Chairperson of the Karnataka Appellate Tribunal, Mr. M. R. Hegde and Mr.H.S.Kempanna, Law Secretaries of the State and Mr. Robinson D'souza, Special Secretary (Law), Mr. A.C.Kabbin, Registrar-General of the High Court, Mr. Ramanna, Principal City Civil Judge, Bangalore, Mr. H. M. Bharatheesh, Additional Secretary (Law), Mr. H.N.Nagmohan Das of the Advocates' Association and S.N.Aswathnarayana, member of the Bar Council who shared their views and suggestions on the reform of judicial stamp duties.

1.15 The Commission benefited greatly from presentations made by experts who willingly and graciously shared their experience and ideas. On 31/7/2001, Dr. Arindam Das-Gupta, Professor at the Gokhale Institute of Economics and Politics, sensitised us to the potential and need for incentivisation structures within tax departments and shared his vast experience in this area. On 5/5/2001, Mr. Valluri Narayan, former Secretary (Investment) of the Government of India and now Secretary of the Central Expenditure Reforms Commission offered us invaluable advice on hurdles that are likely to arise in the movement towards VAT and measures to tackle them. We have drawn on their comments and counsel for framing the recommendations made in this report. We substantially improved our understanding of the problems besetting coffeegrowers at the interaction organised by Ms. Lakshmi Venkatachalam, Chairperson of the Coffee Board on 11/5/2001, at which Mr. Peter Mathias, Mr. I.J.J.Rebello, Mr. H.T. Mohan Kumar, Mr. M. Venkatesh, Mr. G.C.Chandramohan, Mr. Ramesh Rajan, Mr. B.N.Krishne Gowda, Mr. Ashwin Shah and Mr. Ashok Kurien ably represented the industry viewpoint.

1.16 The generous support received from senior policymakers in other States enabled us to understand fully issues related to VAT and State excise in Kerala, Tamilnadu, Andhra Pradesh, Maharashtra and Delhi. We are particularly grateful to Ms. Lalithambika, Excise Commissioner and Additional Chief Secretary, Kerala, Mr. P.V.Rajaram, Development Commissioner and Additional Chief Secretary Tamilnadu, Mr. K.C.Mishra, Principal Secretary (Revenue) Andhra Pradesh, Mr. Vinod Rai, Principal Secretary (Finance) Kerala, Mr. R. Santhanam, Principal Secretary (Finance) Tamilnadu, Mr. Asutosh Mishra, Excise Commissioner, Andhra Pradesh, Ms. Shanta Sheela Nair, Principal Secretary (Home) Tamilnadu, Mr. Ramakrishana Excise Commissioner Maharashtra, Ms. Susan Mathew Secretary (Commercial Taxes and Stamps and Registration) Tamilnadu, Mr. N. Ramesh Kumar, Commercial Taxes Commissioner, Andhra Pradesh, Mr. Vivek Rae, Sales Tax Commissioner, Delhi, Mr. D. Ramakrishna, Inspector-General of Registration Andhra Pradesh, Dr. W. R. Reddy, Special Secretary (Taxes) Kerala, Mr. M. Devaraj, Excise Commissioner, Tamilnadu, Mr. Sanwath Ram, MD TASMAC, T.P. Senkumar MD KSBC, Mr. Sandeep Jain, Deputy Commissioner Commercial Taxes, Tamilnadu and Mr. Manish Gupta Additional Commissioner Sales Tax, Delhi.

1.17 Officers of taxation departments in Karnataka participated enthusiatically in all deliberations of the Commission and spared time and energy to respond to our concerns. We are grateful to Mr. Gopal Reddy, Additional Chief Secretary, Mr. K.P.Pande, Principal Secretary (Energy), Mr. C.S. Kedar, Secretary (Resources), Mr. S.C. Kuntia Secretary (Plan Monitoring Unit, Finance Department), Mr. Kottalingegowda, Transport Secretary, Mr. C.Chikkanna, Revenue Secretary, Mr. R.Suresh, Secretary (Commerce and Industries), Mr. M.N. Vijaykumar, Secretary (Energy Reforms), Mr. Shantanu Consul, Principal Secretary (Administrative Reforms), Smt. Latha Krishna Rao, Member-Secretary of the Administrative Reforms Commission, Mr. V. Madhu, Commissioner Commercial Taxes, Mr. S. Pattanayak, Excise Commissioner, Mr. T. Thimme Gowda, Transport Commissioner, Mr. N. C. Muniyappa, Inspector-General of Registration, Mr. Muralidhar Rao, Special Officer Energy department, Mr. Baligar, CMD, KPTCL, Mr. Ravikumar, Finance Director, KPTCL, Mr. M. Basappa Reddy, Director Mines and Geology department, Mr. Govinda Bhat, Director of Sugar, Mr. Kolhar Joint Director (Industries), Mr. D.N.Nayak, Director Survey and Settlement, Mr. Sadashivaiah, Commissioner Food and Civil Supplies, Mr. Ritish Kumar, Deputy Secretary (Finance) and Mr. Abdul Basith, Director Planning department who have shared their views and responses to reform initiatives. Senior officers of the Transport, Excise, Commercial Taxes, Revenue, Agriculture, Horticulture, Energy, Registration, Statistics and Industries departments have readily cooperated in furnishing information and interpreting data required by the Commission

1.18 Mr. Arumugam and his colleagues at Broadline Computer Systems, who have developed effective computerised systems for managing excise duties and related issues in Tamilnadu, made an extremely useful presentation on e governance to the Commission on 20/4/2001. Mr. N. Biswal, Commissioner of Income Tax, extended assistance in all matters concerning direct taxation of the agricultural sector.

1.19 The Commission was overwhelmed with data and support from companies and industry associations in its quest for practical solutions to thorny VAT and excise issues. We are grateful to senior officers of the Indian Oil Corporation, Mysugar Company, Mysore Sales International, Hindustan Lever Limited, Mangalore Refineries, Renuka Sugars Belgaum, M. K. Hubli Cooperative Sugar Factory Belgaum, Tata Tea, South India Sugar Manufacturers' Association, United Breweries, The Karnataka Brewers and Distillers Association, All India Brewers' Association, Karnataka State Federation of Cooperative Sugar Factories, Karnataka Planters' Association, United Planters' Association of South India, the Hassan District Planters' Association and the Karnataka Growers' Federation Sakleshpur, the All India Coffee Curers' Association, COFIFED and Exporters' Association, the Balur and Kalasa Hobli Coffee Growers' Associations and the Specialty Coffee Association of India who gave us access to valuable industry-specific information. The case studies made by us on the likely impact of commodity tax reform in selected economic segments would not have been possible without this generous support.

Ambit of the present report

1.20 The first report of the Commission had to a large extent completed the analysis of some State taxes-motor vehicles tax, non-judicial stamp duties, entertainment and profession tax. The present report touches these areas only for completing unfinished business and correcting data where required. The first report analysed State excise duties and Value Added Taxation from the macro perspective and with reference to selected issues. The present report rounds off the earlier study and furnishes a further set of suggestions for reforming and managing State excises. VAT has been subjected to closer scrutiny by separating commodity taxation and service taxation. Issues critical to the success of VAT like taxation of inter State trade, have been gone into in this document. Our thrust has been to suggest a workable reform strategy for VAT under existing conditions. Existing taxes at the State level like electricity duty, luxury and betting tax, which are in some measure taxes on services, have been looked at from the point of view of eventual integration with a goods and services VAT. Other areas of State fiscal competence like taxes on agricultural income and royalties on mines and minerals have been considered in depth. Judicial stamp duties that were deferred for study in the first report have also been examined.

1.21 The Commission believes that the reformed tax structure should be administered by innovative and effective e governance. It has, therefore, prepared a macro approach to e governance, which is appended to this chapter, to be used by all tax departments. Our aim is to make widespread and rapid adoption of e-governance affordable and self-sustaining. This will have a timely and significant effect on the government of Karnataka. We recommend, therefore, that the State establish an E-governance Group within the office of the Chief Minister accountable to him or her. It should be headed by a person with strong e-governance credentials, who should take responsibility, against defined targets, of leading the government's efforts in planning, coordinating and attaining pervasive e-governance on an affordable, cost-effective and self sustaining basis. Inter-State coordination and collaborative cost savings should form part of the tasks entrusted to this Group. In addition, specific e-governance measures have been indicated in respective chapters. The special regulatory and fiscal requirements of the Excise department have also been addressed by an indepth study.

1.22 The Commission is grateful to the Hon'ble Chief Minister who has extended unstinted support and guidance in all our endeavours. We hope that our toils will assist government in setting up a modern, effective and productive tax structure.

References:

1) Economic Surveys, Government of Karnataka, 2000 and 2001
2) Medium Term Fiscal Policy, Government of Karnataka, 2001

Annexure

A Cost-efficient Approach to e-Governance

A1.1 E-governance, in the sense of using information and telecommunications technology to deliver governmental activities and services, is no longer a new phenomenon. Trail- blazing initiatives undertaken in some States have sufficiently established the feasibility and attractiveness of e-governance in India. It is also fairly well established, drawing upon the experience of more developed countries, like United States and Singapore, that many areas of governmental activity, especially those touching the citizen, are open to e-governance. Examples are the issue of driving licences, tracking driving offences, net-based customs clearance, electronic filing and processing of income tax returns and automation of social security collections and disbursements. IT companies have been trying to alert us to the numerous avenues for e-governance from their experience in more developed countries.

A1.2 However, while there is reasonable consensus among governments in India on the utility of e-governance and its unique ability to bring government close to citizens, there are few signs of rapid adoption and proliferation. The reason lies primarily in the perception that the technology infrastructure of e-governance (computers and telecommunications) is expensive. The perception is not altogether unrealistic. Any proposal from a department seeking funds for technology infrastructure would be naturally seen as additional expense. Even proposals from departments, which generate revenues for the government, come through as proposals to spend money; they do not indicate hard, measurable returns on investment such as increased revenues, lowered costs or enhanced productivity. As long as the perception and appreciation of e-governance as an expense item persists, the prospects for pervasive implementation will continue to be bleak. However, it would be hard to fault any government in India, given the state of public finances, for casting a wary, conservative eye on proposals which will increase expenses.

A1.3 Thus the slow pace of the spread of e-governance is understandable. Nevertheless, there has been real spread of information and telecommunication technologies into government. E-governance is here to stay, however slow the diffusion. Besides, proper application of technology has the potential to yield increases in productivity by increasing revenues or lowering costs or both. If we accept that e-governance is inevitable, that it furnishes governments with the means to achieve cost-efficiencies and citizen satisfaction, the only impediment to pervasive adoption is affordability.

A1.4 This annexure will set down the design considerations which should define government's approach to pervasive implementation of e-governance. Nine design considerations have been outlined which, taken together, will provide a flexible framework for government. Different governments will accord different relative weights to these considerations and their overall approach will satisfy their unique requirements. Using these parameters, each government can make a shoe that fits it comfortably.

E-governance Is Here To Stay

A1.5 Technology is, in a sense, a one-way street. The initial choice of adopting technology or not is not always available later, since once adopted the use of technology grows and multiplies. Application of computers to work progresses in ever-widening circles. When one regional transport office within the motor vehicles department is computerised it will soon become necessary to computerise other RTOs in the city and eventually offices all over the State. Even within a single office, computerisation of one process quickly creates a felt need to computerise other processes. Backward and forward integration of processes is a major feature of all computerisation in the private sector and in government.

A1.6 The reason is not far to seek. Technology builds in capacity to do more. Its cost is justified by looking at the fresh capacity created to do more work. In the example given above of the motor vehicles department, the widening circle would not stop with computerising all processes in RTOs' offices. Fuller utilisation of the benefits of computerisation in the department can be realised by computerising the police department and connecting the two. Thus computerisation is not an island, it will inexorably compel expansion in an ever-widening circle. Now that Karnataka and other States have embarked on e-governance initiatives, willy-nilly, more processes, more offices and more departments will be computerised.

E-governance is Expensive

A1.7 Three aspects of the use of computer and telecommunications technologies tend to make e-governance expensive. Much of the technology and equipment is not indigenous to India and needs to be imported. Even some of the software like operating systems, database software and applications software (like Lotus Notes and Windows) are from overseas. Technologies are rapidly evolving and becoming regularly and predictably obsolete necessitating technology upgrades or "refreshes". E-governance also demands ever widening linkages resulting in more and more computerisation.

Knowledge Management Is An Essential Complement

A1.8 Knowledge Management (KM) is the method of organising and delivering relevant information and experience to those who need it within a Work Unit-a department, ministry or government as a whole. It depends heavily on computer and telecommunications technologies to structure information and experience and deliver it to the furthest reaches of a Work Unit. By making both information and experience available to all and by facilitating the wide sharing of new experience KM enables movement of the decisionmaking process closer to the citizen. Knowledge Management has been both the consequence and cause of the disappearance of middle management in American business and government.

A1.9 Knowledge Management is an essential complement of e-governance because, without it, e-governance will merely result in doing via the computer what used to be done manually. Mere computerisation of previously manual processes, without restructuring and redesigning them, is known to increase costs and lower efficiency. Knowledge Management procedures compel the Work Unit to give thought to the whys and wherefores of procedures and practices. In this sense, Knowledge Management tends to improve basic governance. It must, however, be noted that in practice full-bodied KM adds to the expense of launching e-governance and is often avoided. This is a somewhat self-defeating exercise because it results in sub-optimal utilisation of the new capacity created by the induction of technology.

E-governance Must Pay Its Way

A1.10 As e-governance is desirable but expensive, it must pay its way. Given the nature of the costs and benefits of computerisation, it will not be possible to ensure that within each department e-governance can break even. Some e-governance initiatives within the State may remain expensive propositions for a long time or forever. Some others like those in tax or other revenue departments (but not only in these departments) may generate surpluses on the e-governance account. Overall, at the level of the State, government can and should aim for an e-governance plan which would at least break even, if not result in surplus. The pacing and phasing of this process will depend on the State's priorities and what it can afford. Even non-revenue departments can begin to think of introducing new fee services, taking advantage of new capacities and capabilities that e-governance initiatives make possible.

A1.11 States need a consistent framework for evaluating e-governance proposals. This Commission recommended such a framework as a part of its first report. The design considerations, which are the subject of this writing, supplement the recommended framework and allow government to take a macro view of its approach to e-governance.
Increased revenues through better collection or new fee services, higher productivity and lowered costs are means to make e-governance pay its way.

Leverage Complexity and Diversity

A1.12 Complexity and diversity are the defining characteristics of government at the level of the State as well as the Centre. The State would serve itself best by developing a unified e-governance plan and assigning priorities inter-ministerially, inter-departmentally and intra-departmentally to achieve and maintain minimum break-evenness during a defined plan period. This makes it easier to provide adequate funds for optimum computerisation. It also brings in the essential discipline of managing to projected costs and returns.

A1.13 A unified plan and prioritisation at the State level allows government to maintain the right balance between its interests and those of the citizen. Frequently the focus appears to settle on citizen satisfaction through citizen visible e-governance initiatives, such as kiosks and citizens charters. While this is not, by itself, objectionable it is not clear whether computerisation within the department should not focus also on attaining higher internal productivities and efficiencies. While popular appeal was essential in the early days to give a fillip to e-governance initiatives, it is time now to adopt a more toughminded approach.

A1.14 The complexity and diversity which characterise India also point to the value of inter-State consultation and collaboration in matters of e-governance. It is possible to visualise division of labour in expertise and costs and sharing of results, applications and experience. Different States could work to create different e-governance applications and even create multiple approaches to the same e-governance issue. There is real scope for significant cost savings and the creation of best-of-breed approaches and applications. Considering that some government issues in India are unmatched elsewhere in size and complexity, it is possible to visualise internationally useable expertise and applications originating from Indian experiments in e-governance.

Employee Education and Motivation a Must

A1.15 Technology enabled human activity depends for its success on the skill and motivation of the enabled person. Training in government departments with respect to computerisation has been frequently confined to training in the operation of computers. Often such training has been limited only to operating staff and not embraced all officers.
Training in computer operation is a necessary but insufficient condition for the success of an e-governance initiative. Even more important is the need to train all employees in the new tools of analysis and decisionmaking that computerisation makes available and in the effective, purposeful use of up-to-date information and knowledge which is now a mere click away

A1.16 It is not always appreciated as much as it should be that fear of, or discomfort with, technology is pervasive at all levels. It is so in the private sector as well as in government. Introduction of e-governance must take explicit cognisance of this aspect of human behaviour and deal with it. Educating employees on the rationale for e-governance and motivating them to embrace it enthusiastically requires a system of behaviour-shaping incentives.

A1.17 It is no less important that each e-governance initiative must document its experience regarding what works and what does not. Such documentation, when widely shared via Knowledge Management in government, results in saving the costs of trial and error.

Governance Leads, Technology Follows

A1.18 E-governance is an exercise in governance, it is not an exercise in technology. Therefore, technology expertise in IT or telecommunications should be on tap, not on top. Expertise in government must take leadership and ownership of e-governance initiatives. The only true measure of e-governance is the degree to which it lifts the quality of governance.

Sell E-governance and Knowledge Management to Citizens

A1.19 It is important that citizens are fully informed and duly educated as to the whys and wherefores of e-governance initiatives. There are many reasons for this. Citizens are the intended beneficiaries and ultimate bearers of cost. Often e-governance initiatives focus on the government-citizen interface through citizen's charters, kiosks and similar exercises. When backed by Knowledge Management or re-engineering exercises, this brings forth new forms and procedures which may visit unavoidable inconvenience and relearning upon citizens. During the early period of an e-governance initiative, interaction between government personnel and the citizen could be less satisfactory than usual because government personnel are learning their way through the new process and discipline even while the expectation of the citizen has been raised. It is important, therefore, to establish a realistic understanding of e-governance and how it works so that it is sympathetically treated in its teething days.

A1.20 As the government does more e-governance, particularly in revenue generating departments, it becomes necessary to encourage or require that citizens who interact with the government, like dealers, do so via the internet or other computers on a network.
Methods of e-governance and Knowledge Management could make governments appear even less accessible, responsive and accountable because of the interposition of machine interfaces and automated processes. Governments, therefore, need to devise ways to ensure that governance wears a human face. In the foregoing and other ways governments will find that a citizenry, which understands and co-operates with it, is a great and essential asset.

E-governance is only as good as Governance

A1.21 E-governance, being merely technology enabled governance, is value independent and amoral. It serves equally, without fear or favour, bad governance as it does good governance. It is important that the implementation of e-governance, including Knowledge Management, compels review of the objectives, procedures and processes of governance. Such implementation affords a timely opportunity to incorporate practices of good governance into the existing system, like transparency, accountability and compliance with the law by citizens and the government. Such practices help the citizen recognise the legitimacy and rationale of governance and improve voluntary compliance.

A1.22 E-governance therefore offers an opportunity to pursue good governance on economical and selfsustaining lines. It harnesses the capacity creating powers of technology to the art and science of governance. It is capable of bringing together government and the citizen and enhancing law-compliant conduct, thereby reducing the cost of enforcement, through a better understanding of the legitimacy and the methods of governance itself. The State can afford to spread e-governance rapidly without undue strain on its already strained public finances.

CHAPTER II

VALUE ADDED TAXATION OF COMMODITIES

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2.1 The erstwhile belief that increase in the proportion of direct taxes (income taxes, corporate taxes etc.) in a country's tax structure is an indicator of economic development has been somewhat tempered by better understanding of the disincentive effects of progressive income and capital taxation on entrepreneurial and risktaking behaviour. Despite successful imposition of direct taxes in advanced countries, the debate on the replacement of income tax by some form of consumption tax has continued (1). Such a reform is expected to foster savings, investment and economic growth. The experience of some developed countries has been that consumption taxes offer a painless, effective instrument for raising substantial revenues from a buoyant and generalised tax base that practically covers the entire population, with minimal distortions in decisionmaking by economic agents. A limited degree of progressivity is also possible through rate differentiation for goods consumed by various income groups. Today, therefore, taxes on consumption account for a significant share of tax revenues even in countries which have a long tradition of successful income taxation.

2.2 Value added taxation has emerged as the most effective mechanism worldwide for levying and administering taxes on consumption. Most countries have adopted the value added tax structure of commodity taxation because of its non-distortionary impact on resource allocation and decisionmaking by economic agents, self-policing nature, revenue productivity, ease of administration and compliance facility. A detailed presentation of the VAT mechanism and its several advantages has already been made in the first report of the Commission. In unitary countries, it is possible to effectively put in
place an economically neutral VAT that is easy to administer and difficult to evade. Federal countries could, however, be faced with special problems while adopting VAT if, under the Constitutional division of fiscal powers between government levels, States are permitted to levy all or some taxes on consumption.

2.3 Table I taken from Bird and Gendron (2001) furnishes the various methods in vogue for taxing sales at two levels of government. As they have noted, five possible methods exist and none is totally satisfactory. These are:
-regional sales tax (U.S. and some Canadian provinces)
-Central sales tax (Germany and Switzerland)
-two distinct tax bases for the Centre and the States (five Canadian provinces, Brazil, India and Argentina)
-dual VATs with harmonised bases and some common rates (Quebec in Canada)
-joint or concurrent federal-State VAT (in three Canadian provinces)

---(1) See for example Sijbren Cnossen "Taxing Consumption: Some Reflections on the U.S. Debate", paper presented in the conference on Monetary and Fiscal Policy, Poverty and Public Policy, held on 17th and 18th January 2001 at the Institute for Social and Economic Change, Bangalore.

Table I

Sales taxes in federal countries

Country	Federal VAT	State sales taxes	Type of State tax
Developed federations			
Australia	yes	no	all VAT revenue goes to States
Canada	yes	yes	some have VATs, some have RST
Germany	yes	no	States share in VAT revenue
Austria	yes	no	States share in VAT revenue
Switzerland	yes	no	none
Belgium	yes	no	none
United States	no	yes	most have RSTs
Developing federations			
Argentina	yes	yes	gross receipts taxes *
Brazil	yes (limited)	yes	VAT (origin base) *
India	no (CENVAT)	yes	most States at producer level (as is central tax)

* States also receive a share of federal VAT revenues.

Source: "VATs in Federal Countries: International Experience and Emerging Possibilities" Richard M. Bird and Pierre-Pascal Gendron in the Bulletin of the International Bureau of Fiscal Documentation July 2001

2.4 For federations in which States are empowered to levy consumption taxes, there could be two major obstacles to the adoption of VAT:
-the relative fiscal powers of national and sub-national governments (this issue arises only when the consumption tax power is shared by both levels)
-the optimal method to tax inter-State trade.

2.5 Federations in which the power to levy consumption taxes is shared between government levels cannot adopt the pure form of VAT which is ideal for unitary countries without centralising tax powers at one level of government. A close parallel to VAT can, however, be developed with a two-tier structure in which Central VAT coexists with State VATs. This results in some overlapping and interpretative and legal confusion at the interface point of Central and State duties, but it is the best approximation to VAT possible in a substantially decentralised federal fiscal framework. Indirect tax reform in India is also generally moving in this direction, but the process has been slow and painful and accompanied by hiccups and backtracking.

2.6 From the point of view of inter-State trade, the ideal State level commodity tax for a federal country is probably a destination based retail sales tax of the U.S. type. Its only handicap is lack of an inbuilt selfpolicing mechanism through capture of data and/or tax at earlier points of the production and distribution chain for goods and services. Because of its range of accounting and coverage requirements, such a tax has not found acceptance even in other developed federal countries; a developing country like ours cannot, therefore, depend solely on a State level retail sales tax.

2.7 Shift to value added taxation, that is engaging the attention of policymakers in Indian States, is the most desirable fiscal reform for the country today. Since commodity taxes (sales tax and related levies) account for three-fourths of the own tax revenues of States, this will result in radical transformation of their tax structures. The magnitude and nature of the contemplated change makes it the most significant event in fiscal federalism since independence.

2.8 Changeover to VAT calls for modification of the nature of Statelevel commodity taxation from the very roots. The impact of commodity taxes, which is somewhat diffused at present, (because of first point taxation, multiple cascading levies, the bar on turnover tax being formally charged to the consumer, origin-based taxation of inter-State trade etc.) will, after the introduction of VAT, clearly fall on the final consumer, although revenue will be realised from different points in the value added chain for administrative convenience, better coverage and control of evasion. When the VAT principle is extended to inter-State trade, the current system of origin-based taxation will be substituted by destination-based taxation; this is a changeover with significant revenue and administrative implications that will transform existing tax avoiding commercial behavior relating to consignments and agency sales. Since VAT calls for credit of tax paid at earlier stages of the manufacturing chain, fiscal incentives for vertical integration will be reduced and economic neutrality restored to the production system. Emphasis on accountbased (as opposed to physical) assessment under VAT will ensure transparency and objectivity; it will also lead to a total makeover of current administrative practices with focus being laid on collating and managing data through online sophisticated scrutiny and validation.

2.9 Given the extent of the transformation required to shift to VAT on a successful and sustainable basis, it is not surprising that "early bird" States like Maharashtra, Tamilnadu and Andhra Pradesh, which took steps on a unilateral basis to introduce crucial elements of VAT into their commodity tax structures, were confronted with enormous interface problems with taxpayers and their own personnel and were forced to withdraw the proposed reform measures within a brief period.

Lessons have been learned from these experiences and the present movement towards VAT is based on consensus building and joint action among States at the level not only of an Empowered Committee of Finance Ministers, but also at the policymaking and operational levels through committees of Finance Secretaries and Commercial Tax Commissioners. These bodies have been engaged in putting together an appropriate VAT package for the Indian context and charting the route or "road map" for attaining the final objective. In our view, decisions on the structure of the Indian VAT and the implementation time frame should not be improvised in the course of implementation of the reform itself, for two main reasons:

-The preferred VAT package should not further distort allocation decisions of economic agents or reduce the revenue productivity of the tax structure. If this happens, taxpayers and governments will be tempted to retrace their steps as has happened in the past and the reform process will be again discredited. It is essential, therefore, to anticipate revenue shortfalls and adverse economic effects and provide "safety nets" and easily enforceable guarantees.

-For every State, the mix of inhouse and inter-State reforms should move in tandem. This is a difficult act to sustain in the absence of effective management and consensus building structures, which engage everybody involved in the exercise all the way up to the legislative level in the Centre and States. Over the last decade, there have been significant achievements in cooperative decisionmaking among States on major issues relating to the introduction of VAT, particularly with regard to floor rates and the removal of industrial incentives. There is some doubt, however, as to whether operationalisation of the commitments made has been as complete and thorough as expected.

2.10 In the Commission's first report, analysis has already been done of the issues to be tackled at the State and national levels while preparing for a suitable VAT under Indian conditions. In this and the following chapter, we will consider in greater detail the options available for smooth transition to VAT for the country and the State and offer suggestions regarding action to be taken as well as supported by the Government of Karnataka to successfully manage the changeover to VAT. In the light of announcements made at the Central and State levels about introduction of VAT in the next financial year, we propose to draw attention to critical unresolved issues concerning the kind of VAT that is appropriate for Indian States as well as the manner and time frame for transition. We will comment on the degree of preparedness achieved at the State and Central levels for moving over to VAT with particular reference to adequacy and sustainability. We will also detail measures that must be taken by States and the Centre (unilaterally and jointly) in advance of the shift to value added taxation.

2.11 Consumption taxes cover taxes on both goods and services. In the country today, service taxation is being done in a piecemeal manner by both the Centre and the States, in accordance with scattered Constitutional references and allocations of powers. The entire issue of service taxation will be looked at in the next chapter.

Constitutional provisions and limitations

2.12 In the Indian federal structure, State and Central governments share the responsibility of commodity taxation under the Constitutional division of tax powers. Broadly speaking, the power to tax goods at the production and distribution stages has been allocated respectively between Central and State governments under Entry 84 of List I (Central list) and Entry 54 of List II (State list) of the Seventh Schedule. The former empowers the Centre to raise excise duties on tobacco as well as other goods manufactured or produced in the country (the only production excises allowed to States are those on demerit goods like alcoholic liquors and narcotic preparations), while the latter empowers States to levy taxes on the sale or purchase of goods other than newspapers.

2.13 In the Constitution itself, there are two main violations of the above broad principle of division of the powers of commodity taxation. Production excises on some demerit goods like alcoholic liquors and narcotic preparations are left to States but those on tobacco continue with the Centre. Secondly, by an amendment introduced at the time of drafting the Constitution, newspapers and advertisements published in them were kept outside the purview of State sales taxation and brought under Central purview. (This was subsequently extended to advertisements broadcast on the radio and television). There is little economic logic in excluding this item from State sales taxation. Article 286 of the Constitution also prohibits States from taxing exports from and imports into the country. While the former is in accord with the destination principle of commodity taxation, the latter is not justifiable in a globalised economy.

2.14 Compulsions for regulating State powers to interfere with inter-State commerce operate in all federations. When sub-national governments are constitutionally empowered to levy commodity taxes, such powers are often interpreted and curtailed to ensure free flow of trade within national boundaries. In India, originally, States had no power to tax inter-State sales, since Article 286 prohibited a State from taxing transactions outside its borders or in the course of import or export. An explanation to the Article, however, indicated that a State is entitled to tax goods delivered within the State even if the sale had taken place elsewhere. The Article also empowered Parliament (not State legislatures) to tax goods transferred in the course of inter-State trade. Interpretational difficulties relating to the tax liability of non-resident dealers making sales outside their jurisdictions led to the Taxation Enquiry Commission of 1953-54 to recommend levy of a Central sales tax, limiting the maximum rate of tax on commodities in inter-State trade and providing for the exporting State to collect and utilise the proceeds. Decisions of the Supreme Court permitting taxation of goods delivered for consumption in a State deprived the State of origin (in which such dealers were registered) of tax revenue, created administrative complexities and facilitated tax evasion through cross-border purchases by unregistered dealers and consumers in the destination State. The Sixth Constitutional amendment of 1956 introduced Entry 92A into the Central list specifically empowering the Centre to levy sales tax on goods in inter-State trade and commerce and limited State powers in this regard under Entry 54 of List II. Article 269 (1) (g) was then inserted to enable the Centre to assign the proceeds of Central sales tax to States. Under the new Article 269(3) and amended Articles 286(2) and (3), Parliament was given power to vote statutes for laying down guidelines for determining the circumstances in which a transaction could be deemed to be an inter-State one. These amendments also made State laws on transactions of goods declared by the Centre to be of special importance in inter-State trade subject to restrictions prescribed by the Centre. In view of these amendments, the earlier explanation under Article 286 was dropped, since Parliament had been specifically empowered to enact legislation to determine whether a transaction had taken place in the course of inter-State trade or not.

2.15 The Central Sales Tax Act was enacted in 1956 in exercise of these powers. The Act determines the *situs* of a sale, defines inter-State sales and regulates such transactions with a view to ensuring that local and out-of-State dealers operate under broadly competitive conditions, exporting States recover some revenue and evasion is checked. To some extent, this also contributed to imparting origin-based elements into the originally envisaged destination-based retail sales tax envisaged by the Constitution with farreaching consequences. States are authorised to levy CST on inter-State sales originating in their territories and retain proceeds within the tax ceiling prescribed by the Centre. Initially, the CST ceiling was 1% of the sale value, but this was progressively increased to 4% over time. Sales to registered dealers are taxed at a low Central sales tax rate (but only if validated by production of the prescribed C form) and those to other dealers at the local rate or a prescribed higher rate (the higher of the two rates). To prevent evasion through consignment transfers, the 46th Amendment of 1982 provided for the levy of a tax on consignments but under the amended Article 286 (3) the levy was subject to conditions statutorily laid down by Parliament. This tax has not been levied since consequential legislation has not yet been enacted.

2.16 The Sixth Constitutional Amendment of 1956 which amended Article 286(3) also enabled the Centre to regulate the maximum tax rate that could be levied by States on selected commodities declared to be "goods of special importance in inter-State trade and commerce". By prescribing a ceiling equivalent to the ceiling laid down for Central sales tax in the CST Act, the Centre was able to substantially harmonise State sales tax rates on these commodities even for intra-State transactions. At present, 13 commodities figure in this list (including textiles, tobacco and sugar for which the power to levy State sales taxes had originally been voluntarily ceded to the Centre through a tax rental). This is again a major violation of the basic principle of division of the commodity tax power between the two levels of government.

2.17 "Declared goods" are a classic example of State sales tax powers getting ceded to the Centre over time. Initially, by a tax rental agreement in 1956-57, States transferred the right to levy sales tax on sugar, textiles and tobacco to the Centre, which then imposed additional excise duties on these commodities and distributed the proceeds among States on the basis of formulae recommended by Finance Commissions. However, the freedom for States to opt out of the agreement was severely curtailed by bringing these goods within the list of "declared goods" so that States which withdrew from the tax rental could not levy tax on these goods at more than one point or at a rate above the CST rate ceiling of 4%. Over time, other commodities were also added to the "declared goods" list.

Table II

Receipts from sales tax -14 major States

(Rs.crs.)

States	85-86	86-87	87-88	88-89	89-90	90-91	91-92	92-93	93-94	94-95	95-96	96-97	97-98	98-99
Andhra Pradesh	761.33	803.20	970.51	1106.70	1237.43	1425.51	1673.63	1849.82	2323.86	2827.24	2954.51	3525.62	4728.35	5251.34
Bihar	388.05	426.01	502.00	581.68	643.85	800.40	940.01	1034.04	1137.49	1121.96	1310.00	1496.40	1567.64	1821.85
Gujarat	690.69	864.50	1020.36	1294.62	1534.57	1739.98	2015.03	2300.58	2771.03	3185.99	3593.36	4025.69	4402.39	4795.84
Haryana	234.35	256.24	314.93	370.56	415.18	494.70	620.30	676.41	768.51	890.08	1055.41	1380.07	1552.69	1599.38
Karnataka	621.74	679.01	817.56	1034.65	1138.12	1382.41	1735.29	1185.64	2410.58	2622.76	3122.79	3709.63	4063.16	4538.30
Kerala	458.42	516.72	599.65	690.41	768.74	897.44	1122.10	1305.59	1533.24	1864.93	2285.96	2772.28	3084.09	3366.62
Madhya Pradesh	419.04	480.50	514.52	614.90	720.39	798.67	947.85	1051.98	1214.06	1309.99	1519.60	1731.25	2056.19	2297.48
Maharashtra	1504.66	1756.48	2046.96	2386.61	2745.27	3174.42	3808.73	4141.20	4740.78	5758.46	6844.32	7290.00	7825.48	8066.61
Orissa	148.35	176.14	206.06	238.34	297.21	354.58	394.16	452.00	514.33	578.09	716.10	893.51	925.08	971.09
Punjab	313.19	377.13	430.82	473.74	537.18	569.72	752.71	807.67	961.18	1195.59	1183.41	1264.50	1401.14	1489.66
Rajasthan	335.35	376.44	450.47	540.26	592.40	653.96	823.92	926.13	1058.14	1184.71	1399.66	1598.85	1826.54	2058.67
Tamilnadu	992.48	1105.09	1242.45	1414.36	1654.98	2088.51	2468.27	2786.74	3281.87	4023.87	5009.03	5714.29	6031.77	6478.33
Uttar Pradesh	734.26	856.90	954.03	1090.22	1337.39	1680.37	1898.46	2021.02	2149.24	2605.43	2966.76	3473.18	3934.94	4457.67
West Bengal	630.19	695.75	832.09	959.34	1067.64	1226.60	1414.83	1622.42	1813.22	2091.18	2447.23	2704.16	2844.31	3117.97
Total	8232.10	9370.11	10902.41	12796.39	14690.35	17287.27	20615.29	22161.24	26677.53	31260.28	36408.14	41579.43	46243.77	50310.81

Source:- RBI studies of State finance of various years furnished by Institute for Social and Economic Change Bangalore.

Revenue significance of taxes on consumption

Table III

Share of sales tax in own tax revenues - 14 major States

(%)

States	85-86	90-91	93-94	95-96	96-97	97-98	98-99
Andhra Pradesh	52.92	53.85	60.63	71.70	72.22	66.47	65.96
Bihar	67.43	70.12	65.06	66.39	66.48	65.58	68.19
Gujarat	64.25	72.50	70.30	67.51	66.37	66.79	62.97
Haryana	46.71	46.25	48.37	48.66	64.40	65.55	51.27
Karnataka	57.81	59.28	63.23	59.21	64.32	63.37	65.36
Kerala	62.75	66.96	65.39	67.58	71.11	68.52	72.41
Madhya Pradesh	50.41	45.51	45.35	43.19	42.19	45.05	44.97
Maharashtra	63.30	62.00	61.60	62.59	62.23	57.04	56.80
Orissa	51.89	53.02	59.81	63.53	66.58	65.07	65.30
Punjab	46.73	44.12	44.71	44.64	46.24	46.02	45.66
Rajasthan	59.25	53.76	54.26	51.26	51.18	50.59	52.26
Tamilnadu	64.13	66.85	68.35	70.04	71.58	69.45	67.31
Uttar Pradesh	56.86	53.14	52.01	54.25	55.08	56.23	56.35
West Bengal	56.08	57.49	62.25	59.21	63.49	62.97	65.31
Total	58.42	58.80	60.02	60.72	62.45	60.90	60.42

Source: Computed on data from RBI studies of State finance of various years furnished by Institute for Social and Economic Change Bangalore.

Table IV

Growth rates of sales tax in 14 major States.

(%)

States	1985-86 * to 1998-99	1990-91 * to 1998-99	1996-97 over 1995-96	1997-98 over 1996-97	1998-99 over 1997-98
Andhra Pradesh	18.08	17.86	19.33	34.11	11.06
Bihar	13.90	9.97	14.23	4.76	16.22
Gujarat	16.64	13.84	12.03	9.36	8.94
Haryana	15.71	16.55	30.76	12.51	3.01
Karnataka	18.58	16.03	18.79	9.53	11.69
Kerala	16.25	18.58	21.27	11.25	9.16
Madhya Pradesh	14.33	14.22	13.93	18.77	11.73
Maharashtra	15.03	13.11	6.51	7.35	3.08
Orissa	15.43	14.80	24.77	3.53	4.97
Punjab	14.38	12.03	6.85	10.81	6.32
Rajasthan	16.30	14.93	14.23	14.24	12.71
Tamilnadu	14.91	16.31	14.08	5.56	7.40
Uttar Pradesh	14.97	13.30	17.07	13.30	13.28
West Bengal	15.10	12.65	10.50	5.18	9.62

*** by regression method**

Source:- Computed on data from RBI studies of State finance of various years furnished by Institute for Social and Economic Change Bangalore.

2.18 The Commission has already commented on the revenue significance of consumption taxes in the first report. Karnataka realised Rs. 4500 crs.from commodity taxation in 1998-99, which is around 65% of total own tax revenues. (Tables II and III). Growth in revenues is also slowing down (Table IV). The State has, along with Kerala and Tamilnadu, the highest tax/SDP ratio for commodity taxation among the 14 major States. (Table V) The per capita revenue from commodity taxation is also quite high (Rs. 887 in 1998-99) (Table VI).

Table V

Tax-NSDP ratios for sales tax (%)

States	85-86	90-91	93-94	97-98	98-99
Andhra Pradesh	5.68	4.57	4.47	5.50	5.10
Bihar	3.14	3.51	3.33	2.98	3.16
Gujarat	5.71	7.20	6.38	5.56	5.40
Haryana	4.05	4.04	4.05	4.65	4.23
Karnataka	6.08	6.73	6.52	6.40	5.95
Kerala	7.05	7.37	6.55	6.44	5.95
Madhya Pradesh	4.03	3.47	3.06	3.38	3.43
Maharashtra	5.69	5.46	4.65	4.46	3.95
Orissa	2.38	3.67	3.19	3.26	3.15
Punjab	3.75	3.40	3.55	3.27	3.11
Rajasthan	4.37	3.58	3.64	3.18	3.57
Tamilnadu	7.25	7.55	6.35	6.23	5.95
Uttar Pradesh	2.98	3.39	2.76	3.02	2.98
West Bengal	3.62	3.89	3.75	3.17	2.94

Old series NSDP data used up to 1992-93

Source: Computed on data from RBI studies of State finance of various years furnished by Institute for Social and Economic Change Bangalore.

Table VI

Per capita revenue from sales tax in 14 major States **(Rs.)**

States	85-86	90-91	93-94	97-98	98-99
Andhra Pradesh	129	216	335	644	707
Bihar	50	94	126	164	187
Gujarat	185	425	643	945	1015
Haryana	162	304	446	813	824
Karnataka	153	310	514	805	887
Kerala	169	310	507	978	1057
Madhya Pradesh	84	140	206	311	349
Maharashtra	215	406	576	884	900
Orissa	52	113	156	264	274
Punjab	171	283	454	612	643
Rajasthan	87	150	230	356	394
Tamilnadu	192	376	565	962	1032
Uttar Pradesh	60	122	148	244	270
West Bengal	104	182	255	372	402

Source: Computed on data from RBI studies of State finance of various years furnished by Institute for Social and Economic Change Bangalore.

2.19 Buoyancies of commodity taxation have come down below 1 in most of the major 14 States in the nineties (Table VII). For Karnataka, it has fallen from 1.25 for the period 1980-81 to 1992-93 to .9 for the entire period of 1980-81 to 1998-99. This underlines the need for radical structural reform of commodity taxation in the State.

Table VII

Buoyancies of sales tax

	'80-'81 to '92-'93	'80-'81 to '98-'99
ANDHRA PRADESH	1.07	1.24
BIHAR	1.12	0.94
KARNATAKA	1.25	0.90
GUJARAT	1.21	0.79
HARYANA	1.08	1.17
KERALA	1.23	0.93
MADHYA PRADESH	0.99	1.25
MAHARASHTRA	1.00	0.75
ORISSA	1.30	1.04
PUNJAB	0.98	0.65
RAJASTHAN	1.02	0.91
TAMILNADU	0.35	0.97
UTTAR PRADESH	1.14	1.09

Source:- Revenues based on RBI studies of State finance of various years furnished by Institute for Social and Economic Change Bangalore.

NSDP from published & unpublished data of Central Statistical Organisation.

Salient features of Karnataka commodity taxes

2.20 There are 2 statutes dealing with commodity taxes in Karnataka apart from the Central Sales Tax Act, which applies to all States. The Karnataka Sales Tax Act of 1957 provides for levy of sales tax, turnover tax and purchase tax. The general sales tax is basically a single point tax levied on first sales made by registered dealers. However, there are several modifications of this principle. Sales by oil companies specified in the Act, for example, are deemed to be first sales only when they are made to persons other than oil companies. Sales of unbranded items to brandholders are again not treated as first sales. In the case of several primary commodities specified in the Third Schedule, the point of levy of the tax is for administrative convenience the dealer's purchase point; whether this is at the first or last point is specified in this schedule. Special provisions for retail sales taxation of the Eighth Schedule, applicable to goods like potable alcohol, have since been omitted (sales taxation of potable alcohol has been discussed in detail in the chapter on excise duties). In operation, therefore, the tax is basically a multipoint levy with a high first point basic rate supplemented by a low turnover tax collected from second and subsequent points.

2.21 Registered dealers alone are permitted to collect sales tax and are liable to credit it to government. Normally, dealers with a turnover of Rs. 2 lakhs have to register with the department. However, dealers who purchase goods from outside the State, including those who handle consignments, and all manufacturers with a turnover of Rs. 1 lakh are expected to obtain registration. Some categories of dealers have to compulsorily register themselves irrespective of turnover limits. These are casual traders, dealers registered under the CST Act, dealers in liquor and jewellery and non-resident dealers with business in the State and their agents, commission agents and millers.

2.22 The general sales tax rate is given in Section 5(1); the existing rate is 10%. The Second Schedule also lists rates applicable to specified goods. Under Section 8A, government has power to notify reductions and exemptions under intimation to the legislature. At present, 10 rates have been specified under the Second Schedule and in notifications. Section 5(4) of the Karnataka Act provides for taxation of "declared goods". Among these goods, Karnataka does not levy sales tax on cereals except barley. Pulses are charged at 2%, which is lower than the prescribed ceiling of 4%.

2.23 The Act itself provides for special treatment of industrial inputs to reduce cascading. Prior to April 2001, the highest rate for industrial inputs (raw material, consumables, components, packing material etc.) used for manufacture within the State was 3%. The term "industrial inputs" has been defined to exclude some items mainly to reduce the incentive for certain kinds of industrial activity; woodbased and energy-intensive industries are not given the benefit of low input tax in the interests of conservation. The lower rate is available only on production of a form (form 37) obtained by the manufacturer from the department and issued by him to the dealer. This procedure has however been modified in the current year's budget. The form 37 requirement has been dropped and manufacturers are expected to pay tax at the normal rate upfront and claim setoff against tax due or get a refund from the department. This measure has to some extent been opposed by dealers on the ground of increase in liquidity (working capital) requirements. A modification has recently been done giving dealers the option of continuing with the old system or opting for the latest amended procedure.

2.24 The KST Act also covers two other levies, the purchase tax and the turnover tax. Section 6 of the Act, which applies to purchase tax, covers transactions in commodities, which for various reasons do not yield sales tax revenue. This includes commodities sold by unregistered dealers, which are not resold in a manner that realises sales tax revenue, that is if they are consumed during the manufacture of a good or consigned to another State for sale. In such cases, purchase tax is collected when the registered dealer makes the purchase and usual sales tax rates are applied to the transaction.

2.25 Under Section 6B, a turnover tax is levied on all registered dealers. This has the effect of a multipoint levy. There are two low tax rates at present: 1.5% on turnovers up to Rs. 10 crs. and 3% on higher turnovers. All second and subsequent dealers, who are not liable to sales tax, are subject to a lower tax rate of 1%. It is important to note that TOT cannot be formally passed on to the consumer as it is expected to be met out of the dealer's own margin.

2.26 Sales tax was being levied on hire purchase transactions even before the 46th Constitutional amendment by treating the date of payment of the last instalment as the point of transfer of the commodity. Consequent on the amendment, the KST Act was modified in 1986. The definition of sale was amended to shift the taxable event to the point of delivery of goods. Section 5-C was also introduced into the Act to permit imposition of tax on the transfer of the right to use goods. This change enabled sales tax to be levied on lease transactions. The Seventh Schedule to the Act also prescribes a tax rate of 4% on 16 kinds of leases.

2.27 Entry tax is levied under the Karnataka Tax on Entry of Goods Act 1979. Karnataka was one of the early States to adopt this levy. The tax was initially conceived as a mechanism to reach textiles, sugar and tobacco, which had gone outside the purview of State taxation because of the tax rental of these taxes by States to the Central government. The levy of entry tax was justified on the ground that revenues would be used to compensate municipalities for loss of receipts from octroi. Levy of the tax in Karnataka was upheld by courts after a lengthy and tortuous legal battle and it became a major source of revenue from 1992.

2.28 The list of commodities in the Karnataka entry tax schedule is 103 but only 21 are subject to tax. The tax is levied on entry of goods into a local area for consumption, use or sale within the area. This means that the tax is not leviable if a good is consumed or sold within the local area in which it is manufactured. The term "local area" which was originally applied only to municipal areas has now been defined to cover the entire State. Broadly speaking, the tax is an additional sort of commodity tax levied on selected commodities, collected by the State government. It is a single point levy to be paid by the first person who causes entry of the commodity. Subsequent distributors of the same product are not liable to tax even if they have moved it to a different local area, provided they produce the prescribed declaration in Form 40.

2.29 Section 3 of the Act fixes a ceiling of 5% on the entry tax rate. The First Schedule indicates goods that can be subject to tax and the Second Schedule those which should not be taxed. Tax rates themselves are determined by government notifications. There are at present 4 rates applicable to different commodities. Dealers are separately required to be registered under this Act. Those registered under the KST Act dealing with goods liable to entry tax are bound to get registered for entry tax purposes. Other dealers who cause entry of taxable goods into the local area with a turnover of at least Rs. 2 lakhs and manufacturers using such goods of value of at least Re. 1 lakh are also required to register themselves.

2.30 The many drawbacks of the existing commodity tax structure of Karnataka have been covered in depth in the Commission's first report. Adverse economic consequences extend from inefficiency and high costs for industry and trade, hindrance to and increased costs for exports, impediments to the free flow of trade within the country and growth of a national common market, inter-jurisdictional conflicts and high compliance and enforcement costs leading to reduction in economic welfare and growth of national product. Some distortions (including those resulting from definitional ambiguities relating to the Constitutional differentiation between manufacturing and sale) may continue to plague commodity taxation in the country, since there seems to be little immediate scope for moving beyond a dual VAT. A properly implemented dual VAT could, however, transform taxes on consumption and the fiscal structure as a whole. In the present chapter, therefore, we have considered the State level VAT structure that is most appropriate for our country with particular reference to areas in which decisions need to be taken or action initiated before introducing value added taxation.

The appropriate State-level VAT package

2.31 We have already referred to cross-country experience, which demonstrates that federations cannot introduce a pure form of VAT without centralising powers of levying and collecting taxes on goods and services in one level of government. This has resulted in federal fiscal systems taking on unitary characteristics while fashioning VAT structures as observed in the case of Germany, Mexico, Switzerland, Austria and Australia. When this happens, the federal principle comes into play only while distributing tax proceeds among States and, rarely, when States take over the administration of a Centrally determined VAT levy.

2.32 The more decentralised Canadian system is not also very similar to the Indian situation, since harmonisation of State and Central taxes has been necessary in only 4 out of 10 Provinces. (Alberta has no sales tax and British Columbia, Manitoba, Prince Edward Island and Saskatchewan levy only retail sales taxes). In provinces which have State level VATs, the tax bases of Central and provincial VATs are concurrent up to the retail point, but in three of the 4-Newfoundland, Novascotia and New Brunswick-the harmonised sales tax or HST is administered by the federal government itself, which eliminates interpretational, data-sharing and other problems. In Quebec, too, administrative simplicity is ensured by bringing the administration of the HST and that of the federal sales tax under a single agency at the provincial level. The Brazilian system of dual VAT comprises a federal tax (IPI) levied on producer prices for industrial products and a general State VAT (ICMS) up to the retail level. All this indicates that we cannot hope to more or less adopt a VAT structure operational in another federation; the most suitable form of VAT for Indian conditions will have to structured carefully to fit unique local requirements.

2.33 The pathbreaking 1994 report on the issues and options for reform of domestic trade taxes prepared by the study team of the NIPFP led by Dr. Bagchi at the instance of the Central Finance Ministry considered in great detail the type of VAT to be adopted (consumption, income or gross product type) and whether it should be based on the origin or destination principles. Since then, there has been agreement on the main conclusion of the report that a destination based consumption type VAT is most appropriate for our country.

2.34 The report also considered three options for introducing VAT: a Central VAT, State VATs and a dual or joint system. It concluded rightly that a Central VAT was ruled out since States would have to surrender a tax power which yielded almost 70% of their revenues, it would reduce the efficiency and accountability that come with fiscal decentralisation and require the Centre to use States to handle collection for which the States would have little incentive unless revenue is distributed on origin basis. States were unlikely to agree to a Constitutional amendment that curtailed their existing fiscal powers so drastically.

2.35 The 1994 report did not favour exclusive State VATs (with special excises on demerit goods retained by the Centre) even if this was in line with the basic public finance concept of fiscal responsibility as such a policy would drastically reduce

Central revenues and call for substantial reduction in Central transfers (and the Central power to equalise the fiscal capacities of States through redistributive grants) or Central responsibilities. The Bagchi report did not support the suggestion both because of the major role that will have to be played by the Centre in redistributive transfers given the range of inter-State fiscal inequality in our country as well as because States are unlikely to move away from existing distorting exemptions, tax structures and origin-based taxation without Central leadership and involvement in trade taxation. Many States do not also have administrative competence to take over indirect taxes. The possibility of a Central VAT collected on behalf of the States and rebated in State VATs (suggested by Purohit-1993) was also not considered feasible for the same reasons apart from problems of cross-system verification and evasion. In a 1995 paper, Burgess, Howes and Stern too have considered the exclusive Statelevel VAT option and pointed out that poorer States would benefit from shift to destination-based taxation under VAT; if this is adopted, the Centre might have to raise funds for redistributive purposes through higher taxes or a Central levy on States based on per capita income. The stand taken in the Bagchi report has also been reiterated in the recent Shome report on Tax Policy and Tax Administration for the Tenth Plan (2001).

2.36 For reasons indicated in the earlier paragraph, the Bagchi report had opted for a VAT levied at both government levels. It considered three possibilities: concurrent VATs on a common base with tax rates set within an agreed band, a Central VAT up to the wholesale stage and revenue at the wholesale level administered and retained by States (as suggested by the Chelliah Tax Reforms Committee) and a Central VAT on manufacturing alongside State VATs on sales.

2.37 The Report rejected the first option because of the likelihood of jurisdictional conflicts relating to administration, compliance problems and Central encroachment on State powers. It did not also support the second dual VAT option, although that would have reduced valuation and tax avoidance (through shifting activities from the manufacturing to the wholesale stage) issues under CENVAT for fear of conflicts of interest between the Centre and the States, difficulties in allocating revenues on intermediate sales among States and incentives to States to offer inducements to manufacturers to make inter-State supplies through intermediate dealers. The Report recognised that the last of these problems could be handled by pooling the tax realised at the wholesale stage and distributing it on origin basis, but it pointed out that coordination between multiple administrations would still be necessary to avoid fraud. Another possibility considered by the Bagchi Report was keeping the Central VAT at the wholesale level low; this has been done in Canada and had also been suggested by the Jha Committee for India. The Report opined that such a solution could be adopted in the long run but there was little likelihood that States would accept it immediately in the light of their experience of loss of revenue in respect of other taxes shared with the Centre. Burgess, Howes and Stern (1995) have also opposed the idea of broadening the base for CENVAT by extending it to the wholesale stage, even if this component is proposed to be administered by States or revenues transferred to them. The proposal of extension of CENVAT to the wholesale level has, however, been revived in a recent paper by Dr. Chelliah and Dr. Kavita Rao, which would indicate that the matter has not yet been settled. The argument advanced is that issue of subsidiary vouchers by registered CENVAT dealers who buy in bulk and sell retail has opened up an avenue for fraud, which can be tackled only by extending CENVAT to dealers at the wholesale stage; the authors suggest that the

Central government should collect this component and distribute it to States on an agreed formula. In our view, since the proposal will evoke fierce opposition from State governments (because of their unhappy experience with Central management of earlier shared taxes) and thus jeopardise the VAT consensual mechanism, it should not be considered for the initial VAT package.

2.38 The feasible VAT solution suggested by the Bagchi report is therefore a dual system independently levied by both levels under the existing Constitutional framework. This would imply conversion of CENVAT into a full-fledged manufacturers' VAT and at the State level, introduction of harmonised destination-based VATs. The Central VAT would set off only Central duties and State VATs State duties. Respective jurisdictions and governments would have to be careful about excluding taxes paid to the other jurisdiction from value assessment of tax bases.

2.39 Given existing constitutional and practical realities and the significance of commodity tax revenues in overall tax revenues for both the Centre and the States, we can only hope at this stage to evolve a close parallel to a true VAT within a dual structure in which Central VAT coexists with State VATs. This is admittedly a second-best solution, under which there will continue to be some overlapping and interpretative and legal confusion at the interface point of Central and State taxes. Nevertheless, it is the best approximation to VAT possible today for two main reasons:

-The federal fiscal framework of the country is substantially decentralised and most States have full-fledged administrative arrangements and procedures for commodity taxation, which have been taken up for rationalisation and harmonisation purposes only very recently. It is inconceivable that States (or the Centre) could be induced to give up their substantial autonomy in this area in the near future.

-There are vast variations in the resource-raising capacities of States. This calls for active Central intervention to equalise fiscal capacities through different kinds of inter-governmental transfers. Commodity tax is a major source of Central revenue, which enables it to discharge the critical equalisation function. As long as such inequalities persist, removal of Central excises is neither feasible nor desirable.

2.40 All parties have agreed that an independent dual VAT system is the only feasible option under current circumstances. From the technical point of view also, it is generally accepted that the eventual objective should be a consumption type VAT which allows input tax credit for both raw material and capital goods; it should be based on the destination principle and use the tax credit or invoice method to compute tax liability.

2.41 The Bagchi report culminated in the constitution of a committee of State Finance Ministers, with Dr. Chelliah as convenor, to look at operational mechanisms for introducing VAT. The committee achieved a broad consensus on reform of existing State sales tax structures by harmonising floor rates, removing exemptions and ending the practice of extending tax incentives for industrial investment. It also detailed measures to be taken for preparing the administration and taxpayers for VAT but could not achieve consensus on the mechanism for taxing inter-State trade. On this aspect, a group of experts and officials under Dr. Parthasarathi Shome was constituted by the Central Finance Ministry and a report prepared in December 1996 incorporating suggestions for eventual transition from origin-based taxation of inter-State sales to destination-based taxation.

2.42 Meanwhile, the movement to VAT proceeded apace. The Committee of State Finance Ministers initially finalised 4 floor rates for sales taxes-2%, 4%, 8% and 12% and the NIPFP also framed a model VAT law and drafted a VAT manual and primer. For operationalising VAT at the State level, an Empowered Committee of State Finance Ministers was set up. Its final recommendations based on frequent meetings have been considered and major decisions related to VAT implementation taken at a conference of Chief Ministers of States on 5/7/2001. It has been decided to introduce VAT in all major States by 1/4/2002 with special category States retaining the option of adopting VAT by 1/4/2003. Committees of State Finance Secretaries and Commissioners have also been working out detailed reform measures at the micro level.

2.43 It must be noted, however, that the VAT which is expected to be adopted in April 2002 will apply only to transactions within the State. A floor rate of 10% has been fixed but States are firming up different revenue-neutral rates. The initial assessment is that it would be high (between 12% and 17%) in southern States which have high tax to SDP ratios and may be low in States like Madhya Pradesh. A lower rate of 4% will be applied to 50 commodities-mainly commodities used by poorer sections. While commodities like sugarcane are to be kept outside VAT, processed salt and toned milk will come under VAT and there will not be separate rates for items sold through the public distribution system. Liquor might be brought under VAT at a special high rate of 20% and petrol, diesel and aviation turbine fuel taxed at a high rate but kept outside VAT (without input credit). Other petroleum products like natural gas, furnace oil etc. will come under the basic rate. 22 commodities (primarily from the unorganised sector) will also be tax-exempt. Lottery tickets will continue to be taxed as at present outside the VAT system. The CST regime for the transition period will be considered in detail in the appropriate section of the present chapter.

2.44 In the context of the forthcoming shift to VAT, we will first consider significant areas of concern on which action can be taken within Karnataka and the degree of internal preparedness for adopting VAT. At the inter-State and Centre-State levels also, four major concerns remain unresolved. These relate to the taxation of inter-State trade, the relative tax room for the Centre and the States within the overall consumption tax structure of the country, other action to be taken by the Government of India to provide revenue support and amend Constitutional and Central statutory provisions and service taxation. We have considered the first three in this chapter and examined service taxation in the following chapter. Each of these matters has also been studied from the point of view of the likely consequences of adopting VAT without tackling them in advance.

Action to be taken by the State to introduce VAT

2.45 Repeated announcements by State governments and State Finance Ministers and Chief Ministers at national conferences and meetings of VAT committees give the impression that States are prepared to move to VAT very shortly. A closer look reveals however that much has still to be done within individual States even in areas which are being closely monitored and repeatedly reviewed. State governments are expected to take action on matters like harmonisation of tax structures and removal of exemptions (particularly tax incentives for industrial investment), before actual adoption of VAT. There are also important issues relating to VAT itself which must be decided, like threshold levels for exemption and composition for dealers, revenue-neutral rates etc.

A Harmonisation of tax structures

2.46 When VAT is introduced in a federal country, harmonisation of commodity tax structures is necessary from the efficiency and equity points of view to eliminate tax exportation and reduce the spillover effects of the tax policies of different jurisdictions. The extent and degree of harmonisation required will depend upon the scope for trade diversion. In the thinly populated vast provinces of Canada, a much higher level of diversity can be tolerated in comparison with the commercially integrated, contiguous States of the Indian heartland. Even within the EEC, tax harmonisation is not total and there is a feeling that a certain degree of tax competition is permissible if not desirable.

2.47 Some awareness about the undesirable consequences of divergent tax regimes had been created even before the liberalisation of the nineties through Statespecific studies. This has become generalised consequent on the issue of various reports on indirect tax reform and deliberations in VAT related committees. Basically, harmonisation applies to tax bases, the number of levies as well as tax rates. State governments have been trying to harmonise bases by creating a common commodity classification based upon the modern classification now used by the Central excise department, which is linked to international practice. The Centre for Taxation Studies at Thiruvananthapuram had been initially entrusted with the task of preparing a common classification. Action is now being taken to align commodity classifications for State VATs with the Brussels classification used by the Central Excise department. Unless this is expedited, it will not be feasible to operate a dual State level VAT within the country, even if the tax is restricted to intra-State commerce. The Commission urges that the preparation of the common classification should be completed very early so that it can be used for training departmental personnel and assisting taxpayers.

2.48 The number of commodity tax levies in Karnataka has been already described in earlier paragraphs. Similar proliferation characterises the sales tax structures of other States too. As we have already seen, this is partly due to the manner in which commodity tax administration has developed since independence, with the Central government appropriating some of the powers of States through mechanisms like goods subject to additional excise duties and "declared goods"; such measures have led to States employing other tax handles available in the Constitution like "entry tax" and "luxury tax". The plethora of levies should be rationalised into a single simple VAT. This has already been agreed to by States at meetings of the Empowered Committee. For Karnataka, rationalisation must commence with merger of the several imposts now on the statute books-sales tax, purchase tax, turnover tax, entry tax and the infrastructure cess-into one common tax with wide coverage, few, moderate rates and no exemptions. The system will benefit enormously from the resultant transparency, simplicity and facility of compliance. In the first report, the Commission had urged that such rationalisation should be done immediately in Karnataka. Further delay can only compound the problem of introducing VAT effectively and successfully.

2.49 In the case of tax rates, the consensus is to lay down a few floor rates and group together commodities which should fall under each rate. A very small list of exempted commodities and a similar small list of goods to be taxed at a "special" high rate outside the VAT structure will also have to be prepared by agreement among States. The Empowered Committee of State Finance Ministers has been toiling since inception to perform this task. Starting from 4 floor rates of 2%, 4%, 8% and 12%, the Committee has now agreed on a single basic rate of 10% and a lower rate of 4% for 50 commodities. There will also be a list of 22 commodities which are exempt from tax and 3 (gold, silver etc.) to be kept under a special rate of 1%. Petrol, diesel and aviation turbine fuel will be taxed at 20% and kept out of VAT (that is, no input credit will be available)and liquor probably taxed at a high VAT rate (with input credit). The Committee has also recommended that States which do not adhere to floor rates when VAT is introduced from April 2002 should be denied Central assistance. How this threat is to be operationalised has not yet been determined although it is being reiterated by the Central government as well as the Empowered Committee. Under the system now adopted by the Empowered Committee, States will have no freedom to go below the prescribed rates for different commodities. Eventually, by welfare-enhancing tax competition, it is expected that the rates of most States will converge towards basic rates. Within a single State, however, this may not immediately result in rationalisation of the commodity tax structure. The fear expressed in the 2001 report of the Advisory Group on Tax Policy and Tax Administration for the Tenth Plan led by Dr. Shome that unless the maximum number of operative rates in States is also determined, some of them may continue with more than one operative rate for a specified commodity category (all above the prescribed basic rate) is very real. It is essential that this does not happen when Karnataka makes the shift to VAT.

2.50 The extent to which harmonisation has actually taken place across major States cannot, however, be gauged solely from commitments made by them at meetings of the Empowered Committee. In Karnataka, there are 10 sales tax rates under the schedule and notifications. In addition, there are 3 graded turnover tax rates depending on the value of turnover of the dealer. Since this a multiple stage levy the tax rate depends on the number of stages through which the commodity is transacted before reaching the final consumer; if most commodities are assumed to pass through three stages, there could be a maximum of 9 TOT rates. Entry taxes are also levied at 4 different rates varying from 1% to 5%. There is also infrastructure cess. When all the levies are taken into consideration, there could be several permutations and combinations resulting in an inordinate number of commodity tax rates in Karnataka. This increases compliance cost, opens up avenues for tax evasion and avoidance, violates the canon of horizontal equity and creates distortions. The situation in other States is not very different. In such a complicated scenario, the tax liability for a commodity is determined eventually by negotiation with the tax department. Even self-assessment cannot improve matters without rate simplification.

2.51 Move to the prescribed floor rates, which have in theory been accepted by Karnataka, has been hampered by fears of revenue loss and perhaps fear of reform itself. Claims are made that floor rates have been adopted, but the tendency is to do only marginal tinkering and retain several additional rates for "special" reasons. Floor rates seem to be used merely as a safeguard against competitive rate reduction, not for rationalising tax rates. To tackle the fears and reservations of States, the Commission had, in the first report, formulated a complete frame of reference for Karnataka, bringing all commodities within the three floor rates of 4%, 8% and 12%, removing exemptions and merging commodity taxes. A special rate of 2% was retained only for bullion, specie and gold ornaments and 25% for petroleum products and alcoholic beverages. We had also pointed out that it was possible to rationalise the commodity tax system with little revenue loss or inequity. The framework suggested by us could be easily adapted to the revised modulated rate structure that the Empowered Committee has now firmed up for VAT.

2.52 Our views on how the transition to VAT should be managed have been discussed further on. Detailed case studies have been undertaken by the Commission on the present incidence of commodity taxes on selected products and the likely scenario under VAT. These are enclosed in the annexure to this chapter. They clearly indicate the unintended economic consequences of the prevailing system. We urge the government, therefore, to undertake the required rationalisation and simplification of the State's commodity tax structure right away to prepare the administration and taxpayers for the VAT scenario.

B Removal of exemptions and tax base expansion

2.53 In Karnataka, as in other States, there are a large number of exempted commodities; some exemptions are user-specific and there are end use exemptions as well. These exemptions complicate the tax system and provide avenues for tax avoidance and evasion. An exhaustive listing of tax-exempt categories under various commodity taxes has been attempted in the first report of the Commission. Those done by statute as well as those notified from time to time have been identified. Keeping in mind the VAT imperative of generalised commodity taxation with minimal exemptions, the exemption list had been pruned and rationalised in the first report. We recommend that the proposed expansion of the tax base by removal of exemptions be forthwith implemented.

2.54 A major source of complexity and distortion in sales tax systems that needs to be remedied is the incentive structure for industrialisation. While the efficacy of sales tax incentives to attract new investments is doubtful, their real cost to the economy in terms of revenue foregone and distortions created has been considerable. This is an important source of distortion since it alters the relative profitabilities of old and new units, different industrial sectors and industries located in different regions. Tax incentives provide undue benefits to industrial units with high value output to capital ratios (processing and packaging, solvent extraction plants etc.). They have also contributed to the high mortality rates of industrial units (particularly small industries) by inducing entrepreneurs to undertake otherwise non-viable projects and manipulate incentive schemes by closing down units after exhausting concessions and start fresh ones.

2.55 Tax incentives for industrial investment have been adopted by most Indian States as also by several developing and developed countries. In Karnataka, such schemes have been operational from 1969. Initially, they were conceived of as refund of tax paid on the purchase of raw material within the State. From 1981, these were replaced by exemptions for the payment of sales tax on sales of goods produced by such industries. Exemption was given subsequently for entry tax payable on input purchases. From 1988, tax deferrals were also permitted. Ceilings were fixed on the extent of benefit available linked to the quantum and period of investment. From 1991 to 1996, the upper limit was relaxed for certain areas. The industrial sectors and locations qualifying for tax benefit have varied from time to time. Industry sizes have also been linked to determination of the entitlement for tax benefits. After prolonged discussion, however, the Empowered Committee of State Finance Ministers has resolved to discontinue the practice of tax benefits for fresh industrial investment and the decision has been implemented by the Karnataka government from 1/4/2000. Industries already availing of the benefit continue to enjoy various kinds of incentives; this poses a major problem for moving over to value added taxation.

2.56 Estimates of commodity tax revenue lost by tax incentives for industrial investment have been made by the department. A recent one puts annual loss at more than Rs. 400 crs.and committed incentives in respect of 41 mega industries at more than Rs. 2000 crs. These figures have been computed by listing out the units which have been approved for incentives and dividing the available ceiling limit for the incentive by the number of years during which the benefit can be claimed. The Commission has looked at the issue in some detail. The initial letter intimating small, medium and large industries of the tax benefits approved and the conditions of approval, (the time limit for invesment, the upper limit for the benefit, the kind of benefit given etc.) is issued by the Udyog Mitra in the Industries department. (For tiny industries, the intimation is sent by district units). Units proposing to invest more than Rs. 100 crs.are kept outside the standard benefit package and specific tax benefits are extended by government on the basis of the recommendation of the High Level Committee of the Cabinet chaired by the Industries Minister. When investment is completed, the unit is expected to apply for the issue of a Fixed Asset Valuation Certificate (FAVC) to the Industries department. For investments above Rs. 100 crs.,this is issued by the Joint Director (Industrial Development) of the Directorate of Industries. For lower value investments, the certificates are issued by districtlevel Deputy Directors who are expected to send copies to the same Joint Director. Functioning units are also expected to file the FAVC with the assessing officer of the Commercial Tax department and obtain his formal approval. Tax returns filed subsequently by the assessee must indicate the extent of the benefit claimed each year. Hence, data is available with the Industries and Commercial Tax departments regarding actual tax benefit eligibility and claims made by units which have commenced production. This information should be compiled by the Commercial Tax department after collecting data from field offices; it should be reconciled with data available with the Industries department particularly for cases in which incentives have been given for expansion and upgradation of industries (where substantial overlap is possible). It is sufficient if the analysis is confined to large and medium industries and mega projects. The departmental MIS should also capture this data on a continuing basis. Once this is done, the extent to which tax benefit claims have already been exhausted by units which have come into production and the size of likely future entitlements can be realistically assessed. This will enable the department to make preparations for handling such commitments when VAT is adopted.

2.57 The major categories of commodity tax incentives offered for industrial investment are the following:
-Sales tax exemption on sale of manufactured goods sold within the State.
-Sales tax deferral on sale of manufactured goods sold within the State
-Central sales tax exemption on sale of manufactured goods sold within the State.
-Central sales tax deferral on sale of manufactured goods sold within the State
-Entry tax exemption on purchase of raw material

-Turnover tax exemption
-Sales tax and entry tax exemptions on the purchase of capital goods

2.58 These exemptions were expected to reduce manufacturing costs and/or sale prices of products manufactured by units entitled to tax incentives and increase their competitiveness in the market. They were geared to enabling such units to establish themselves vis a vis existing producers who had made investments at lower costs in earlier years. The economic effects of such incentives have been dealt with in detail in the Commission's first report. With the introduction of VAT, there is apprehension among beneficiaries that government will go back on earlier commitments. The legal rights of industries availing of incentives require to be thoroughly examined. Apart from legality, however, the economic and practical implications of moving over to VAT need to be studied in greater depth.

2.59 In the case of taxes, like entry tax and turnover tax, which will lose their special identity and become merged in VAT, tax incentives might simply disappear. A similar approach to sales tax itself might not be acceptable even it is deemed to be legal. For sales tax on domestic sales, the choice is between exemption and deferral. The Commercial Tax and Finance departments of different States have been debating the issue while within States, Industries departments are also making their own proposals. Industries who have been given the benefit of deferral, are in fact using sales tax collected from consumers on behalf of government as no-cost working capital and saving themselves interest costs on bank borrowings or margin money. When VAT is adopted, any break in the VAT chain may make it difficult to give tax credit to units which supply inputs to industries which benefit from this incentive. The latter should be required to file tax returns on the basis of which the tax credit claims of their suppliers could be allowed. The net VAT liability of industries availing of deferral could be permitted to be enjoyed by them for the agreed period. Industries benefiting from sales tax exemption are not permitted to collect sales tax from customers today; the tax benefit enables them to sell products at a lower (tax-exempt) price. For easier administration of tax credits for their suppliers, they could also be given the benefit of tax deferral. Industries entitled to CST benefits should also be treated in the same way. It is learned that this is the view taken today by most Commercial Tax departments in States. The Empowered Committee of State Finance Ministers has agreed on discharging the deferral facility on net present value basis.

2.60 Moves are being made, however, to give all industries entitled to tax benefits the right to retain the *gross* VAT amount collected from consumers under the deferral scheme. This is not desirable as it would affect the administration of the tax credit mechanism for suppliers to such industries. It would also imply giving an additional benefit similar to input tax exemption to industries which do not enjoy it today. This would go against the decision of the Empowered Committee to put an end to additional or fresh tax incentives for industries in future. We do not, therefore, support such a proposal.

2.61 Industries entitled to the deferral benefit must be also given the option of adopting the normal VAT regime like the rest of their competitors. We believe that in today's conditions of low and declining interest rates, there would be little incentive for industries to reduce costs by using the tax-deferral mechanism to cut down drawals on working capital limits from banks, particularly since this would make them ineligible for VAT credit on inputs. By keeping the door open for industries entitled to tax incentives to voluntarily move to VAT, it should be possible to phase out incentives even before their regular expiry date. Incentives given for the purchase of capital goods might have to continue for some time till VAT is extended to capital goods.

C. Decisions on major VAT issues

2.62 Decisions are still pending on some critical matters relating to the State VAT structure for Karnataka. The most important is determination of revenue-neutral rates (alongside preparation of an input-output table for the economy).

2.63 The appropriate VAT rate has to be selected for the State in the context of the basic rate floor of 10% laid down by the Empowered Committee. Since, theoretically speaking, VAT implies only change in tax structure, States have been making attempts to arrive at revenue-neutral rates which will ensure that budgetary inflows are not affected by the shift to VAT. It is difficult to estimate the existing effective commodity tax rate because of the complex, non-transparent, multiple rate and levy structure. This is possible only by computing the tax base for commodity taxation. The NIPFP has developed two methods to arrive at the commodity tax base-the consumption expenditure approach and the tax turnover approach. The former estimates the potential tax base while the latter looks at the existing actual base itself.

2.64 The consumption expenditure approach uses aggregate consumption data from National Accounts statistics and adjusts it for exemptions for commodities like agricultural products, services and dealers below the threshold limit. The value of intermediate consumption of taxable goods for the production of exempted items is added back as tax rebate is not available on this component. The tax turnover method uses taxable turnover data available with the department and adds back trade margins of distributors and turnover relating to goods subject to additional excise duty (which do not form part of taxable turnover today) for calculating the revenue-neutral VAT rate. While computing VAT revenue, however, rebate given for taxes paid on inputs is adjusted. The value of goods currently exempted from sales tax and those handled by dealers not subject to tax at present has to be added back to the base and the turnover of dealers proposed to be kept below the VAT threshold excluded for arriving at the VAT rate. Sales have also to be differentiated between local, inter-State (including "consignment" transfers) and international sales. Actual data on local and inter-State sales and estimates of "consignment" transfers must be taken into account to adjust the existing tax base for VAT.

2.65 The NIPFP tax turnover methodology has been used by the Commercial Tax department with minor adjustments to compute revenue-neutral rates for Karnataka. (Annexure I) The major assumptions used in the exercise are the following:
-the share of inputs in taxable local turnover is assumed at 62.5%, based on a study of the operations of 8000 dealers
-10% is added to taxable local turnover to take care of expansion of the tax base when exemptions are withdrawn
-the size of "consignment" transfers is taken as 17% of CST sales turnover based on the dealer study
-input tax is assumed at a uniform rate of 4%

-1% is assumed to be the revenue loss by exempting dealers below the threshold limit from VAT
-10% is assumed to be the value added by extending first point tax to later stages
-credit has been assumed to be spread over five years for capital goods

2.66 Latest estimates of a revenue-neutral rate for VAT in Karnataka are around 13.5%. It must be remembered, however, that with harmonised bases, a single basic rate, an agreed limited list of commodities subject to special rates and removal of most exemptions particularly those for industrial investment, tax competition across States will have a snowballing effect and tax rates converge towards the basic rate. This will enhance efficiency and economic welfare. Existing divergences in inter-State tax structures have not had this effect, due to selective and non-transparent administration of rates and exemptions. Revenue-neutral rates may also need to be computed at the micro level for major productive sectors and assumptions used for macro projections modified on the basis of empirical data. The studies done by us on petroleum products, sugar, potable alcohol and tea, annexed to this chapter, are relevant in this context.

2.67 For policy planning and revenue projections under VAT, it is essential to prepare an input-output table for the State as a whole. Attempts have been made in the past to prepare such tables for econometric modeling in the context of Plan preparation by the Centre and some States. These have been based on industrial data drawn from the Annual Survey of Industries, which suffer from major inadequacies. Fresh tables will have to be prepared so that we get a comprehensive overview of the inter-relationships between sectors before VAT is put in place. For this, the quantities and values of inputs into and output from all major sectors have to be compiled and integrated into a total matrix in which imports and exports out of the system will also have to be indicated.

2.68 The department has made a commendable start by conceptualising the value addition chain through the entire manufacturing and distribution process for any commodity. The theoretical framework gets modified when applied to specific major products, as seen in the studies done by us of selected goods-petroleum products, sugar and potable alcohol and tea. These goods account for 43% of the commoditywise disaggregated tax revenue which accounts for 76% of total commodity tax revenue in Karnataka.

2.69 Production, pricing and distribution controls affect business practices for commodities like petroleum products, sugarcane, sugar (levy and "free sale"), molasses, rectified spirit and potable alcohol. The taxable event also gets shifted for administrative and other reasons as in the case of petrol, diesel and sugarcane. The distribution chain is again not identical for various products. In respect of all commodities, however, broad estimations have to be made based on empirical data, of inventory and manufacturing practices, movements into and out of the State (of both inputs and final goods) and actual commercial mechanisms. In our view, the department should immediately prepare an input-output table by applying its theoretical framework to actual business practices in major sectors to enable it to forecast with reasonable accuracy the revenue outcomes of various policy measures. Such predictions are, however, unlikely to stabilise till industrialists and dealers adjust themselves to the financial and commercial implications of VAT, particulary with respect to inter-State transactions.

2.70 Our study throws light on several core issues relevant to the concept and application of value added taxation in the country. It indicates the incentive-disincentive mechanism operating today in the origin-based, cascading commodity tax structure at the State level. It helps us to identify areas for decision and action and provides fairly reliable estimates of the likely revenue from different tax rates. It can be used as a guide for further similar studies by the department which could be eventually put together to construct a complete input-output table.

2.71 Another important matter on which a decision is still pending is the threshold limit for exempting small dealers and for composition. The 2001 Shome committee has suggested a threshold of Rs. 15 lakhs with a 1% retail sales tax on all dealers below that level. The Empowered Committee is generally agreed on having two thresholds for dealers-one for exemption and another for composition cases. States have freedom to decide the issue. It is essential that a decision is taken quickly on the matter so that the task of educating taxpayers and tax collectors is not seriously affected.

VAT and the inter-State trade issue

2.72 An essential precondition for introducing VAT is an unbroken taxation chain on all transactions from the manufacturing to the retail point. We have already seen that this is not possible in India because different stages-production as distinguished from distribution and sale-of the chain are taxed by different government levels. In federations in which commodity taxation is done wholly or partly at the subnational level, the distribution chain is also interrupted when goods move between States. There is no perfect answer to this problem if we wish States to retain their powers to levy and collect commodity taxes. In this section we will examine the major solutions that have been suggested for handling this issue so far with their advantages and drawbacks.

2.73 In the first report, the Commission has already explained why the incidence of commodity taxation should fall on the final consumer so that there is no distortion of economic activity. Such a destination based tax was indeed contemplated by the Constitution but (as indicated in earlier paragraphs) this is not the kind of commodity tax that we have today in our country. The extensive Constitutional amendment of 1956 introduced the origin principle into the State level commodity tax structure and led to imposition of the Central sales tax on inter-State transactions. Unfortunately, the cascading effect of CST was not contained by limiting the tax rate to the 1% recommended by the TEC of 1953-54 on sales to registered dealers. In the quest for revenue, the maximum permissible rate was raised progressively to 2% in 1963, 3% in 1966 and finally to today's ceiling of 4% in 1975. State governments now levy Central sales tax on inter-State sales originating within their territories and retain the proceeds within the cap prescribed by the Centre. The upper limit was meant to ensure that States do not export high tax rates to consuming States and yet realise revenue from sales of goods originating within their frontiers. (The CST rate could be less than 4% if the normal sales tax rate for the commodity is lower).

2.74 A distinction is made between sales to registered and unregistered dealers under CST. The former kind of transaction gets the benefit of the 4% rate, (when the normal rate is higher than 4%) if the exporting dealer produces a form called the C form, which is obtained from registered dealers in the importing State (who collect it from departmental officials) and furnished to the exporter at the inter-State transaction point. Sales to unregistered dealers of goods other than "declared goods" are subject to tax in the State of origin at the higher of two rates-the local rate or10%. However, if the rate for the good is lower in the importing State, it would be advantageous to the exporter to sell it as an unregistered dealer in the importing State. For "declared goods", sales to unregistered dealers are subject to double the normal rate but this requirement can again be circumvented by the exporter passing himself off as a local dealer. Since inter-State sales levied at less than 4% do not require C forms, they do not get recorded and this could lead to revenue loss in the importing State.

2.75 Apart from the scope for tax avoidance mentioned above, CST administration is beset with administrative problems for the department as well as the taxpayer. Despite the C form requirement, various exemption provisions as well as general tax avoidance have made monitoring of inter-State trade a near-impossibility. This has created a situation in which estimates of revenue loss from the removal or replacement of CST consequent on the introduction of VAT have become based more on guesswork than on empirical data. Dealers operating across States also face departmental harassment in obtaining the requisite quantity of C forms on time.

2.76 CST like intra-State taxes adds to the cascading effect of commodity taxation today. A major stumbling block in the changeover to VAT at the inter-State level is the scope available for exporting States to curtail the tax room of importing States. Since the existing commodity tax structure is biased towards the origin principle, a predominantly producing State has so far been able to raise revenues from early stages of the production and distribution chain and shift tax incidence to consuming States. Several studies of "tax exportation" by States of origin are available which highlight the fiscal obstacles that have hampered the development of a common domestic market in India. There is again the problem of valuation of inter-State sales similar to transfer pricing problems for income tax; since inter-State sales tax is not rebatable, dealers in both States are encouraged to undervalue.

2.77 "Consignment" or "branch" transfers are extensively resorted to by dealers to get around the CST hurdle. Sale consequent to a "consignment" implies transfer by the manufacturer/dealer himself or his agent out of own premises in a State other than the State of origin. This adds to costs since it implies transport of goods by the exporter to the importing State and provision of local storage facilities. It could also encourage uneconomic location of production units for components used in an industry. "Consignments" again provide avenues for evading sales tax in the State of origin by routing goods back and selling them in the State of origin or selling them in the destination State to an unregistered dealer. Tax authorities do not treat a transaction as a consignment if goods move across State borders against specific orders. The consignor does not pay commodity taxes in the State of origin nor the CST; for tax purposes, he is on par in the consuming State with the local dealer. The case studies in the annexure provide interesting examples of CST induced behaviour.

2.78 Commodities which are transacted in a finished form through the hands of dealers in more than two States (that is apart from the State of origin and the consuming State) could be subject to either CST, consignment or a combination of both. If different segments of the transaction are handled through CST alone, tax liability could be substantially increased. Consignment transfers may not be feasible at more than one stage unless the dealer is a large distributor with multi-State operations (the example of tea which has been studied by us in the annexure). A fourth possibility today is treating such a good as a "transit" commodity with the intermediate dealer managing movements between producers and final consumers without physically handling the product. If a satisfactory mechanism for levying VAT on inter-State transactions is put in place, however, dealings across States could be handled purely in response to market demands without having to make allowances for tax-induced distortions. Cascading goods could go through a chain of purchase and resale in several States or meet the stringent requirements prescribed for treating them as goods in transit. The benefits that would accrue from simultaneous introduction of VAT on intra-State and inter-State transactions could thus be enormous.

2.79 The extent and nature of the aberrations created by the present system of commodity taxation have already been referred to earlier. The case studies annexed to this chapter also give ample proof of micro-level tax-induced distortions on inter-State transactions. In the first report, we have expressed the apprehension that the existing sub-optimal system may be replaced by a worse one if VAT is confined to transactions within States. Several options have been explored at the level of official committees for managing commodity taxation of inter-State trade when the intra-State VAT is in place and during the transition period before inter-State VAT is introduced. Care must be taken while choosing the appropriate mechanism to ensure that it does not generate perverse tax-induced incentives for procuring inputs from within States, even when this is not the most cost-efficient alternative or lead to fresh methods of distorting commercial transactions or accounting for commercial transactions and spawn further perversities.

2.80 Cascading also affects the prices of goods meant for export. In principle, such goods are not subject to State sales taxation. Under a provision of the CST Act dating from 1976, the last sale or purchase preceding the export is also "deemed to be in the course of export" provided it took place after and for complying with the agreement or order for export. To benefit from this interpretation, exporters must purchase against confirmed orders only; disputes are common about what can be considered a penultimate sale. The above provision does not, however, completely remove the tax suffered by exported goods, since taxes paid earlier on in the distribution chain are "embedded" in the product; this results in increase in the cost prices of exported goods and affects export-competitiveness. Duty drawback cannot be completely computed in such a system nor can the destination principle, that is the norm in international trade, be applied. Input tax exemption is also given only to exporters themselves not to manufacturers who go in for direct exports.

2.81 From the point of view of long term sustainable reform, the additional effort required to hammer out a consensus on the management of value added taxation of inter-State trade at the commencement of VAT itself appears justified. Such an effort will help to bring to the fore the apprehensions of tax-exporting States, identify feasible mechanisms for providing safety nets in the transitional period and draw forth commitments from the Centre for meeting revenue gaps. It will also compel all players to make administrative arrangements for sharing and validating data. Even proponents of an intra-State VAT are, however, apprehensive that attempts to achieve agreement on inter-State VAT could lead to postponement of the introduction of the tax itself. They also fear further delay on account of the time and effort required to put in place administrative arrangements for inter-State coordination. Although, because of systematic persuasion over a decade, States are beginning to accept the need to shift from origin-based to destination-based taxation, there is justified apprehension about substantial loss of revenue for some States when the change takes place; so far, no agreed mechanism has been evolved to provide a safety net in such circumstances. In addition, it appears that a clear concept of the most appropriate technique for managing an inter-State VAT in the Indian context has not yet been formulated by economists and policymakers.

2.82 On the positive side, resistance to destination-based taxation seems to have been substantially diluted as States have become sensitised to the distortions induced by the origin principle of commodity taxation. Even States which earn substantial revenue from CST are increasingly inclined to admit that returns due to them for the use of facilities provided to manufacturing units should not be realised from cascading levies. They are also becoming aware of the indirect benefits (including increase in revenue) that they will derive from faster economic growth resulting from a more efficient fiscal system. In any case, origin-based taxation will be difficult to sustain in an increasingly liberalised and integrated economy.

2.83 At the implementation level, after reports by two special committees (the Shome committee of 1996 and the NIPFP committee of June 2000) and lengthy discussions in groups of policymakers at different levels, the debate on State VAT has only got marginally beyond designing an intra-State VAT. The 5th July 2001 meeting of State Chief Ministers has suggested some procedural amendments under the Central Sales Tax Act as a pre-condition for reducing CST rates. This is still being considered by the Centre. Other critical issues-the form of inter-State VAT to be introduced, management of inter-State alterations in revenue realisations, the time frame required for preparing for inter-State VAT and distortions likely from premature implementation of intra-State VAT-are still to be examined. Lack of focus or direction on such a crucial matter can seriously damage industrial and commercial activity at a time when the country is already at grips with fears of recession and global competition. We propose, therefore, to examine these fundamental matters and indicate concerns that must be faced immediately by all States and the country as a whole. They relate to the revenue implications of VAT on inter-State trade, existing options for introducing VAT on inter-State transactions and transitional issues.

A. Revenue implications of VAT on inter-State trade

2.84 Assessment of the revenue loss likely to be sustained by tax exporting States is generally done by looking at the Central sales tax that will be foregone when inter-State VAT is introduced. The shares of major States in CST revenues in recent years is given at Table VIII. Producing States like Gujarat, Haryana, Maharashtra, Punjab and Tamilnadu get more than 10% of commodity tax revenues from CST and so too do States like Bihar and Madhya Pradesh (the last two States derive substantial revenue from taxes on coal and steel respectively). Karnataka also derives close to 10% of commodity tax revenues from CST. Uttar Pradesh, Rajasthan and Kerala seem to be less dependent on CST for commodity tax revenue.

Table VIII

CST revenues as a percentage of commodity tax revenues

States	1994-95	1995-96	1996-97	1997-98	1998-99
Andhra Pradesh	17.07	17.62	15.44	13.18	8.55
Bihar	22.83	0.00	21.85	22.56	18.40
Gujarat	16.21	15.45	14.83	15.40	15.64
Haryana	33.41	42.75	28.91	31.66	30.24
Karnataka	19.28	7.71	3.75	5.25	9.88
Kerala	8.65	7.30	6.12	5.29	8.13
Madhya Pradesh	18.88	20.19	17.91	18.21	16.72
Maharashtra	16.90	16.86	17.08	16.33	16.55
Orissa	0.08	0.00	0.00	0.00	0.00
Punjab	19.18	17.01	20.01	19.72	17.43
Rajasthan	5.75	5.85	6.12	6.31	6.52
Tamilnadu	13.84	14.47	12.08	17.79	11.35
Uttar Pradesh	0.00	5.01	4.09	6.02	4.09
West Bengal	19.16	17.41	15.97	11.68	9.10

Source: Computed from data drawn from RBI studies of State finance at the Institute for Social and Economic Change Bangalore

2.85 Receipts of Central sales tax, however, only offer a partial and inadequate indication of the relative financial implications of moving over to destination-based inter-State VAT. Removal of inter-State tax distortions could significantly alter current commercial practices like "consignment" transfers and agency sales and substantially modify purchase and sale decisions of manufacturing concerns. It is impossible to forecast how inter-State trade will look when existing commodity tax-induced distortions are eliminated. Nevertheless, we have made some attempt to identify net tax exporting and importing States and estimate exports and imports by comparing shares of individual States in commodity tax collections with those in overall consumption using data drawn from the 1999-2000 NSSO survey of household consumption in India (55th round) deflated for a year-along with (as yet unpublished) data from the National Accounts Statistics for 1998-99 relating to net purchase of goods and services by the government (allocated Statewise according to GDP shares). (The methodology is taken from Rao & Vaillancourt 1994 and Rao and Sen 1996). The final picture that emerges is given in the accompanying table. (Table IX).

Table IX

Consumption Shares, Tax Shares and Effective Tax Rates 1998-99

	Household Consumption	Government Purchase of Goods	Total Consumption	As % of Total Consumption	Commodity Tax Collections	As % of Total Commodity Tax Collections	Difference Between Commodity Tax and Consumption Shares	Effective Tax Rate	Tax Exported	Tax Exported by Commodity Tax Collections
	Rs. lakhs	Rs. lakhs	Rs. lakhs	Percent	Rs. lakhs	Percent		Percent	Rs. lakhs	Percent
Andhra Pradesh	4645422	163710	4809131	7.82	525134	10.39	2.57	10.92	130043	24.76
Bihar	4609243	162759	4772001	7.76	182185	3.60	-4.15	3.82	-209856	-115.19
Gujarat	3642075	112029	3754104	6.10	479584	9.49	3.39	12.77	171168	35.69
Haryana	1695852	57071	1752923	2.85	159938	3.16	0.32	9.12	15928	9.96
Karnataka	3710342	119215	3829558	6.22	453830	8.98	2.75	11.85	139215	30.68
Kerala	2967611	106850	3074461	5.00	336662	6.66	1.66	10.95	84082	24.98
Madhya Pradesh	4213493	147117	4360610	7.09	271049	5.36	-1.73	6.22	-87194	-32.17
Maharashtra	7099153	243081	7342234	11.93	806661	15.96	4.03	10.99	203465	25.22
Orissa	1665339	77680	1743020	2.83	97109	1.92	-0.91	5.57	-46088	-47.46
Punjab	2091963	102728	2194692	3.57	148966	2.95	-0.62	6.79	-31337	-21.04
Rajasthan	3621684	109281	3730964	6.06	205867	4.07	-1.99	5.52	-100648	-48.89
Tamil Nadu	4734473	195522	4929994	8.01	629557	12.46	4.44	12.77	224537	35.67
Uttar Pradesh	9648979	362191	10011170	16.27	445767	8.82	-7.45	4.45	-376694	-84.50
West Bengal	5044015	170791	5214806	8.48	311797	6.17	-2.31	5.98	-116622	-37.40
Major States	59389643	2130024	61519667	100.00	5054106	100.00		8.22		

National Sample Survey household consumption data (55th round) deflated for a year have been used with unpublished National Accounts Statistics data for 1998-99 relating to net purchase of goods and services by the government (allocated Statewise according to GDP shares) in line with methodology adopted in the NIPFP working papers of M. Govinda Rao and Francois Vallancourt " Subnational Tax Disharmony in India: A comparative Prespective" (April 1994) and M. Govinda Rao and Tapas K Sen "Fiscal Federalism in India: Theory and Practice" Macmillans New Delhi, 1996

2.86 States like Maharashtra, Gujarat, Tamilnadu, Karnataka, Andhra Pradesh and even Kerala seem to be net tax exporters with estimated percentages of exportation to commodity tax collections going beyond 35% for Tamilnadu and Gujarat, beyond 30% for Karnataka and close to 25% for Maharashtra, Andhra Pradesh and Kerala. These States are likely to suffer radical revenue reductions when there is a shift to destination-based taxation, while net importers like Uttar Pradesh and Bihar should enjoy increased revenues. This will form part of other revenue related issues accompanying the shift to VAT which will be considered further on in this chapter.

B. Options for managing VAT on inter-State trade.

2.87 As indicated earlier, delay in moving to VAT on inter-State transactions in our country is not due merely to administrative inertia, the extent of inter-State coordination required for effectively running an inter-State VAT or fear of radical change and revenue loss. The major difficulty is lack of clarity among academics and policymakers about the most appropriate form of inter-State VAT for Indian conditions. This is indeed the core issue connected with VAT in federal countries in which the power to levy commodity taxes is exercised fully or partly by subnational governments.

2.88 There are no close parallels to the current Indian situation in other decentralised federations like Canada and Brazil. In Canada, there is zero-rating of VAT on inter-Provincial transactions but because of reasons indicated earlier, there is little similarity with Indian conditions. In Brazil, taxation of inter-State commerce is based on the origin principle, that is, the importing State gives credit for tax paid in the exporting State on inputs. There is also some modulation of the tax rate on inter-State sales for redistribution purposes. Pointers for an Indian inter-State VAT could, however, be drawn from the manner in which the European Economic Community is tackling similar problems within the confederation. This will be considered in detail further on.

2.89 The search for an optimal solution to the problem of taxing inter-State transactions under VAT has been on for some time. Various proposals have been mooted in academic papers and many ideas tossed around among practitioners in conferences and meetings of empowered and working committees over the last decade. An appropriate choice for India should satisfy the following requirements:
-it should not be susceptible to evasion by a break in the VAT chain
-it should not be cumbersome for the administration and the taxpayer
-there should be inbuilt collection incentives for the importing and exporting State to make the tax easily enforceable
-it should be fairly easy to manage while shifting to a full-fledged VAT

2.90 Some of the other requirements for a suitable inter-State VAT suggested by Keen (2001) like provincial autonomy in rate setting, minimising "game-playing" by States and identical compliance requirements for inter-State and intra-State taxation may not be so critical in the current Indian context since the first two are likely to be achieved by enforcing the decision to implement floor rates and abolish tax incentives for industrial investment and the last may not be a major difficulty for Indian businessmen who are in any case accounting separately for intra-State and Central sales taxes today.

2.91 Suggestions under discussion for the most suitable inter-State VAT mechanism for federations fall broadly into three groups: the zero-rating method, the clearing house approach and the intermediate tax approach. Each of these is discussed briefly below with reference to the four tests mentioned earlier.

a) Zero-rating taxes collected in the State of origin

2.92 The procedure that is easiest to implement from the administrative point of view is zero-rating taxes paid in the State of origin when transactions relating to inter-State trade are made. Zero-rating which can be done unilaterally by individual States implies both that no payment of tax on the inter-State transaction and refund of tax already collected by the State of origin at the inter-State transaction point. Inter-State transactions would thus be taxed in the same way as exports. This was the procedure recommended in the 1994 Bagchi report as well as in the1995 Burgess, Howes and Stern paper. The European Economic Community has been using a similar mechanism since 1993. The dealer is expected to produce account-based proof of despatch of goods to the registered purchaser. In the 1994 Bagchi report, it was suggested that zero-rating should be available only if tax is pre-paid in the State of destination and proof of such payment produced in the State of origin. This was also recommended in the form of a "purchase tax" by Purohit (2000, cited in Bagchi 2001). It is now generally accepted, however, that this would not be practical as it would cause considerable harassment by locking up dealers' funds for long periods of time and might not prevent fraud. It may not also be feasible to make tax refund conditional on receipt of goods in the importing State and subsequent sale (as is normally the procedure for intra-State VAT transactions). Sales to unregistered dealers or final consumers across State borders will probably have to be charged to the State of origin at the normal local rate. This could result in some cascading and inequity in the case of "consignment" transfers, which may not be eligible for input tax credit.

2.93 The advantage of the system is its administrative simplicity since there is no need for a clearing house with all that it entails in terms of expense and management (unless it is decided to extend input tax credit to "consignment" transfers too). There is again no need for States to collect revenues on behalf of one another and pass them on either to a pool or to the consuming State. It also gives both importing and exporting States a financial stake in monitoring inter-State trade. The major drawback of the procedure is the scope for tax evasion since the VAT chain is broken and exporting firms could pass off intra-State sales as inter-State sales and escape VAT on the transaction as well as claim false refunds. In one sense, transitional arrangements would be less onerous in the absence of a clearing house or inter-State fund movement. On the other hand, foolproof information and verification systems will have to be set up to the extent possible or there could be substantial revenue leakages, which would drain State revenues and discredit the VAT system itself. Technological innovations available today may permit implantation of electronic devices to authenticate vouchers issued by dealers for inter-State transactions and records maintained by them in this regard. These could be verified both when monthly returns are filed as well as when random checks are made. Whether such arrangements can be effectively installed in our country when they have not yet become operational in the EEC is to be considered. Unless provisions are made for the inter-State component in data processing systems at this stage itself, it might be difficult to overhaul them to provide for integration of the intra-State and inter-State components in future. From the point of view of dealers also, the current requirement of separate accounts for inter-State and intra-State transactions will have to continue.

b) Tax credit by consuming States and clearing house arrangements

2.94 The zero-rating method used in the EEC from 1993 was meant to be a transitional arrangement. From the eighties itself, the ultimate objective of the Community was to shift to a system of tax credit by the importing State for VAT paid to the exporting State; the exporting State was expected to credit such revenues to a pool from which funds would be routed to the exchequer of the consuming State through a clearing house mechanism. This called for elaborate administrative machinery and uniform tax rates throughout the Community. It was necessary to choose an appropriate revenue sharing formula for pooled funds since it was not practical to settle mutual compensation claims of member-countries on the basis of invoices as originally contemplated by the EEC. There was no incentive for consuming States to check the veracity of rebate claims of importing dealers if they were to be fully compensated from the common fund. In the final analysis, there was also no authority which could compel a member-country to fulfil its payment commitments to the common fund.

2.95 For these reasons, a variation was proposed by the EEC in 1996 (called the Common System of VAT) with a uniform rate for all intra-EU transactions, a single registration point for dealers and revenue sharing among States on the basis of aggregate consumption data. This has not yet taken off since it would deprive member-countries of the freedom to set tax rates. The change would not also remove some of the other disadvantages of the tax credit method like the disincentive for consuming countries to improve tax collections. A further variation was suggested by Keen and Smith (1996, cited in Keen 2001) called Viable Integrated VAT or VIVAT, under which there would be a uniform tax rate for transactions between registered dealers (that is for intermediate intra-EU sales alone). While this would have to some extent restored the fiscal autonomy of member-countries, it would still require a clearing house, managed perhaps by a higher body. Dealers would then have to distinguish not between inter-State and intra-State transactions but between transactions with registered and unregistered dealers.

2.96 If a similar system is introduced in our country, there might even be apprehension that the State of destination may not give credit for tax paid elsewhere or that the State of origin might not credit revenues realised at earlier points to the common pool. The distribution formula cannot be based on trade data which will be too voluminous to keep track of, particularly if there is substantial rate differentiation among States. Consumption data is also not reliably and regularly available. NSS surveys are conducted only at 5 year intervals and results published after a time lag of one to two years; their results do not tally with those generated by the National Accounts Statistics. Some proxy for trade or consumption would have to be employed like shares in sales tax collections. In both the clearing-house and zero-rating approaches, "consignment" transfers would be treated as inter-State sales if the consignee branch is registered as a dealer in the State in which it is located and if the transaction between the consignor and consignee branches has all the legal ingredients of a sale. If these conditions are not fulfilled, sales consequent on "consignment" transfers will be eligible for input tax credit (that is credit for tax paid to the State of origin) only under the clearing house system. But with tax rates bunched close together after adoption of floor rates, there would be less incentive for sale to unregistered entities under an inter-State VAT.

c) Levy of an intermediate tax on inter-State transactions

2.97 The third possibility is levy of a "stand alone" or "compensating" VAT (CVAT) on inter-State sales, preferably by the federal government with zero-rating of the VAT of the State of origin. This is line with the suggestion made by Ricardo Varsano for Brazil and modified by McLure (in 2000, cited by Bagchi, 2001). The tax would be levied at a rate not lower than the lowest VAT rate in any participating State (McLure suggests levy at the weighted average of State rates to eliminate artificial incentives for exporting or importing as well as for fraud.). Varsano, unlike McLure, had restricted the tax to sales to registered dealers. If it is extended to unregistered dealers (that is to sales to final consumers), it would be necessary to share revenues realised on some formula-the final one suggested is the share of States in all-States' sales tax revenue after correcting for differences in tax rates among them.

2.98 The CVAT was proposed mainly to offset the possibility of fraud that is the chief risk attached to simple zero-rating. It is meant for a dual VAT situation in which the federal government is expected to collect this impost alongside its own federal VAT and thus ensure that inter-State transactions do not escape taxation. Varsano in fact described the system as the "little boat model" as the idea was to transport the State tax across the border on board the little boat-the federal tax! The VAT administered by Quebec also maintains such a "paper trail" (NIPFP-VAT primer 2001) by providing for a single administration (in this case the Provincial government) to collect both federal and State VATs. McLure, however, has conceived of the CVAT as a separate tax collected along with the federal VAT. Under this arrangement, zero-rating of the inter-State sale continues but the transaction is subject to CVAT which is collected by the importer from the exporter. From the point of view of the interphase between State and Central VATs, McLure's proposal requires uniform definition of tax bases (but not uniform tax rates) for State and federal VATs and uniform laws and administration.

2.99 CVAT restores the VAT chain and provides some shelter against fraud since refunds/credits continue. Collection incentives are strong if the tax is handled within a single administration, preferably the federal government, but formula based revenue sharing is unavoidable as also differentiation between intra-State and inter-State transactions by dealers.

2.100 Bagchi (2001) has suggested modifying this concept by introducing a federally managed inter-State VAT (ISVAT) levied by the Centre at the minimum floor rate of State VATs using its Constitutional authority to tax inter-State sales (now exercised for enacting the CST Act). The State of origin would not give tax refunds to the exporting dealer. There will also be no refund but taxes paid in the State of origin will be set off while levying ISVAT. At the next stage of sale in the consuming State, the local tax will apply. Only in rare cases, where the tax liability (value added multiplied by the tax rate) in the importing State is less than ISVAT liability, there may be case for a refund to the exporting dealer. To avoid the need for dealers to handle two administrative departments, Bagchi has opposed McCarten's suggestion that ISVAT should be administered by the Centre and McLure's suggestion of administration by a consortium of States. He has instead proposed that administration should be retained with the State of origin as is the case for CST today. Gross ISVAT revenue (which in effect implies all VAT revenue earned on the commodity at various sale points) would be credited to the ISVAT account and collections would be shared among States on the basis of shares of VAT revenue in the total. Bagchi opines that the Centre may not have a problem in ensuring prompt remittance of ISVAT revenue to the Centre by States given the substantial level of fund outflows from the Centre to the States on various accounts. He cites the relative promptness with which income tax deducted at source is today credited and suggests stringent penalties for recalcitrant States. He also recommends an incentive being offered to them in the form of collection charges of around 1% of the tax collected (which might in some sense be interpreted as a partial return to the origin principle). Bagchi suggests that rebate should be given by the importing State net of this charge. Administrative requirements for ISVAT would be more onerous than under zero-rating since accounts have to be audited and revenues shared. Direct remittances of ISVAT to the Central kitty could be made every month by collecting banks and payments identified and accounted for separately as is done today for CST and State sales tax. Dealers would need to continue with separate records of transactions subject to ISVAT and VAT.

2.101 The local rate would be charged on unregistered buyers and sales consequent on "consignment transfers; there would also be no change in the manner in which accounts are maintained. The scope for tax competition and cross-border shopping would be limited after floor rates are imposed. The availability of tax credit would in fact encourage unregistered dealers to obtain registration which is a major advantage of VAT.

2.102 Such an impost would prevent fraud by preserving the VAT chain. It would offer an incentive to the importing State to improve collections by auditing and other methods since revenue-sharing is based on tax collections. By maintaining ISVAT at the floor rate, dealers cannot acquire goods without paying VAT at the lowest rate.

d) Recommended solution for inter-State VAT

2.103 We have considered the three major mechanisms available for an eventual inter-State VAT with their advantages and drawbacks. The zero-rating method, even if it breaks the VAT chain, can be easily adopted by a single State. This could create a snowballing effect and influence neighbouring jurisdictions to move over to a similar system. It does not also require setting up an elaborate inter-State or Central monitoring agency. Nevertheless, substantial preparatory work is essential particularly to access data relating to registered dealers in destination States, since the system is susceptible to evasion and fraud. The method has been adopted in the European Economic Community where it has been working with substantial success. The major objection to the European system that dealers have to maintain separate accounts for inter-State and intra-State transactions will not arise in the Indian context since traders are already doing this for CST today. The final form of inter-State VAT will zero-rate sales made between registered dealers in different States, but sales consequent on "consignment" transfers or those made to unregistered dealers will be treated like local sales to final consumers without the benefit of zero-rating.

2.104 To ensure smooth transition to inter-State VAT, a networked information system must be developed for online sharing of inter-State data on registered dealers and their transactions. Agreements are necessary with concerned States for ensuring the authenticity of transmitted data and there should be provisions for excluding States, which do not rapidly furnish reliable information. Technological innovations available today could be utilised for electronically verifying vouchers and dealers' records when monthly returns are filed and during random checks. A procedure that could be used for the purpose has already been indicated to the Commission and could be examined by the Commercial Tax department. Provision should be made for the inter-State component in data processing systems at this stage itself to avoid problems when inter-State VAT comes into effect. To deter evaders, we also recommend a higher selection percentage of audit cases in respect of dealers with inter-State transactions and severe penalties for evaders.

e) Transition to inter-State VAT

2.105 Ideally, management of the transition to inter-State VAT should be tied to the preferred solution for tackling the taxation of inter-State trade. Policies and procedures used in the interim period should also be carefully selected with an eye on the two major concerns of evasion and revenue loss. Suggestions have been made regarding transitional mechanisms by different committees. The Shome committee on taxation of inter-State trade recommended reduction of tax on inter-State sales by a percentage point every year, its extension to "consignment" sales of registered branches, transfer of half the CST to a pool to be shared on a formula based on consumption, rebate by the importing State initially at half the CST rate to be gradually increased to full rebate and taxation of sales to unregistered dealers at local rates. The 2001 report of the Tax Policy Advisory Committee for the Tenth Plan headed by Dr. Shome suggests a slightly different approach which combines input tax credit for inter-State sales by the State of origin with input tax credit for sales consequent on"consignment" transfers by the destination State side by side with abolition of CST.

2.106 Since a decision has already been taken for adopting an intra-State VAT at the initial stage, these recommendations require to be suitably altered. Phasing out Central sales tax or modifying it, replacement of the origin principle by the destination principle for taxing inter-State sales and setting up administrative arrangements for data sharing, zero-rating and input tax credit will all be conditioned by the manner in which commercial transactions adapt to the preliminary stage of imperfect intra-State VAT. How taxation-induced "consignment", branch and agency transfers are likely to evolve in the interim period will also have to be considered. Provision of fund support to help States tide over transitional revenue shortfalls is important too; this has been separately considered in later paragraphs.

2.107 The Empowered Committee of State Finance Ministers has made certain suggestions for handling inter-State trade under the intra-State VAT regime. It has recommended that to avoid fraud no input credit should be allowed on inter-State purchases on which CST has been paid in the State of origin. On inter-State sales, however, it is proposed that local tax paid at the time of purchase should be credited against the CST liability but on goods sold by "branch" transfer, credit would not be available. Other amendments have also been proposed to the CST Act, particularly with respect to transactions taxed at rates lower than the 4% ceiling, which are likely to escape declaration to the department. These decisions could have serious implications on the evolution of commercial behaviour in the transitional period.

2.108 The experience of two northern States (Punjab and Haryana) and the Union Territory of Delhi with limited "zero-rating" on inter-State transactions offers us useful pointers on how traders are likely to behave when intra-State VAT is adopted. These areas have highly interdependent commercial relationships, since products manufactured by units in the two States are consumed largely within the capital or transferred to other regions through resellers in Delhi. For some years, the three governments have been using procedures under existing sales tax laws to facilitate inter-State commerce. Inputs imported into each of the jurisdictions for local manufacture are exempted from sales tax, on production of the requisite form. Inter-State sales are liable to CST at 4% in the State of origin. However, dealers usually avoid CST by making inter-State movements on "consignment" or "branch transfer" basis. Such transactions are not taxed in the exporting State. "Consignment" transfers of inputs used in the importing State for manufacture also escape taxation in the importing State if the prescribed form is produced. Only sales made to final consumers are taxed at the rate applicable in the consuming State. Effectively, therefore, origin based sales taxation has become destination based in the three northern States. Goods handled by "re-sellers", which account for a substantial component of the business in Delhi, are subject to a low rate of 2%. This helps to keep tax incidence down and encourages dealers in the capital to exploit their locational and infrastructural advantages to play a major commercial role within the national common market.

2.109 Introduction of intra-State VAT is on the whole being welcomed by both traders and the administration in Delhi. The department admits that removal of CST could result in "loss" of around Rs. 800 crs. of CST revenue (25% of current sales tax revenue). How much of this is derived from the transactions of "resellers" is not known. The department, however, anticipates increase in domestic business and economic growth (and eventually revenues) through better compliance. For businessmen, the attraction of VAT lies in elimination of the present form-filing requirement for input credit. With VAT, however, their working capital requirements will increase since tax has to be paid while purchasing inputs. The administration views this as a distinct advantage since revenue would accrue at an earlier point in the distribution chain, there is less scope for evasion and compliance will improve with reduction in departmental harassment through use of forms. Businessmen are also apparently looking forward to reduction in their interaction with administration. In any case, basically, dealers will conduct business in more or less the same manner as at present. On the whole, we seem to be looking at a "win-win" situation for taxpayers and tax collectors.

2.110 The Delhi experience indicates that "consignment" transfers could offer a fairly painless method of moving from origin-based to destination-based commodity taxation. Even in the past, fiscal experts (unlike State governments) have not in general been critical of "consignment" transfer, since they did not view it as a loophole for revenue leakage; to them it seemed a logical method of preserving the common market within national boundaries. For sound economic reasons, they had consistently opposed the Constitutional amendment permitting the imposition of consignment tax. The tax was not operationalised also because of protests from major Central public undertakings dealing in basic essential raw materials and major consuming north-eastern States. Their opposition held up consensus on the issue of whether States or the Centre should be empowered to determine tax exemptions. The Central government wanted to retain control over essential goods but States argued that tax exemptions should be given by them as done under the Central Sales Tax Act.

2.111 The experience of Delhi and its commercially integrated neighbours seems to indicate that under an intra-State VAT, the existing "consignment transfer" mechanism might be used to reduce tax incidence on inter-State sales since full input credit would be available on local sales. Formal inter-State purchases would continue to be subject to CST but manufacturers may resort more and more to "consignment transfers" to avoid CST. "Consignment transfers" can, however, be allowed statutorily only if depots are maintained by the producer or his agent in the State of destination and sales made out of such depots. This may result in sub-optimal distribution mechanisms particularly for manufacturers who do not have sales values large enough to justify such arrangements for purely commercial reasons. All distributors may not, therefore, shift to "consignments" and those subject to CST will necessarily suffer a higher tax incidence. Intra-State VAT may also become less onerous for inter-State transactions if low CST rates are charged on "resellers".

2.112 With intra-State VAT, therefore, we might move gradually to a new equilibrium level with an imperfect commodity tax regime for inter-State transactions built around the practice of "consignment" transfers. Such transfers would more or less be similar to destination-based taxation of inter-State commerce. Goods subject to CST and sales to "resellers" may suffer a slightly higher tax incidence and continue to suffer from cascading. The overall result may not then be worse than the present situation. However, further effort would be required to move forward to true inter-State VAT, particularly since it will imply reversion to CST from "consignment transfer".

2.113 We suggest, therefore, that when intra-State VAT is introduced, "consignment" transfers should be relied on to painlessly convert origin-based taxation of inter-State trade to destination-based taxation. The CST rate should be simultaneously reduced to 2% to facilitate "reselling" across States. Over time, this should result in most inter-State transactions being done on "consignment" basis and stabilise destination-based taxation. When a decision is taken to shift to zero-rated inter-State VAT, an option could be given for dealers to shift to inter-State sales from "consignment" transfers by offering them input tax credit. It appears, however, that the Empowered Committee is proposing to encourage CST based transactions in the interim period itself by permitting dealers to avail of input tax credit against CST liability. In our view, this is not desirable as it would not serve the main purpose of inducing States to move to destination-based taxation. We recommend that Karnataka takes the matter up in the Empowered Committee and suggests modification of the present proposal.

2.114 The economic role of moving to destination-based commodity taxation and mitigating the residual cascading and distortive effects of intra-State VAT played by "consignment" transfers in the transition period should be recognised by States. This should be reflected in the manner in which "consignments" are treated under intra-State VAT. When the final shift to inter-State VAT occurs, definitions of what constitutes "sale" for tax purposes should also be satisfactorily modulated to enable (if feasible) transfers between branches of the same company registered in different States to be treated as inter-State transfers. To a large extent, such preparation will enable the residual tax cascading on "consignment" transfers to be reduced to the minimum.

2.115 The procedure for inter-State transactions needs to be rationalised and simplified. It is essential to eliminate the C form requirement for sales to registered dealers, which causes considerable harassment and generates fraudulent practices. In the interests of encouraging the growth of a national market and building up a VAT constituency, it is hoped that at the initial stage itself, the form requirement will be dispensed with. It appears that an amendment in this direction is being processed at the Central level.

The "tax room" issue: harmonising Central and State taxation

2.116 Substantial professional expertise has been invested over the last decade in sensitising States to the need for reform and achieving consensus on methods of harmonising sales tax structures. This has pushed to the background the need for concurrent reform of Central excises to convert them into a true federal VAT. The 1994 Bagchi report and the Jha committee report had stressed the need to widen the Central tax base to include all commodities, provision of full credit for taxes paid on consumables and capital goods and rate rationalisation (applying not more than 3 rates, apart from non-rebatable high rate excises on goods with negative externalities). The 2001 Shome committee report on Tax Policy for the Tenth Plan has listed out the amendments that must be introduced for transforming Central excises into a fullscale CENVAT. Unfortunately, State VATs are now proposed to be introduced without clarity about the corresponding reform required in CENVAT-its objectives, methods and time frame. Specific Central excise duty rates, which are not justifiable on economic grounds, continue to be used to control evasion arising out of under-valuation of inputs. These duties cause distortion as they are focused on product characteristics mentioned in the law and affect producer choices in favour of untaxed items.

2.117 Delaying CENVAT reform can have adverse consequences for trade and industry. In several matters, a common framework has to be laid down for commodity taxes at both levels. An issue that arises in this area is that of harmonising Central and State VAT structures and sharing the commodity "tax room" between both levels. Even if substantial freedom is given to each government, without mechanisms for continuing coordination, serious distortions could arise to the detriment of economic agents. Experiences to date of cooperative fiscal federalism in other overlapping areas (motor vehicles legislation and taxation, royalties on minerals etc.) have largely been within a scenario of overall Central initiative and control. Tax bases in such cases have been Centrally determined and rates subject to Central approval. For levies like profession tax, limits to State taxing powers have been put into the Constitution itself. The dual VAT cannot be operated on such a basis; neither can the Central tax room be left open-ended. We have attempted to assess the combined commodity tax incidence in some of the studies enclosed in the annexure to this chapter. In the case of sugar, for example, levy of the general VAT rate of 10% could lead to increase in overall tax incidence unless Central excise rates (and the Central "tax room") are reduced. In our view, there should be a broad overall tax rate ceiling for both levels on most commodities, which can be modified only after consultations among all players.

2.118 In the interests of simplicity and transparency, it would be advantageous for taxpayers if the commodity groups subject to different rates in Central and State VAT statutes are broadly similar. Definitions, threshold limits and exemptions may require standardisation to some extent between Central and State VATs. The manner in which coordination between the Centre and the States should be ensured and administrative arrangements required for the purpose put into place has also to be clearly sorted out before a true VAT comes into effect at the Central and State levels. We recommend that the State government take this matter up urgently with the Central government since the benefits of VAT cannot be fully reaped by manufacturers and dealers without CENVAT reform.

Other action to be taken by the Central government

2.119 For introducing a nationwide VAT, the role of the Central government is not restricted to modifying the structure of Central excises. There are significant statutory and constitutional changes which can only be undertaken under Central initiative apart from overall leadership and guidance as well as provision of financial support during the transition period. These will be briefly indicated in the following paragraphs.

a) Statutory amendments

2.120 The legal framework for a national VAT is being discussed today purely in the context of State laws co-existing side by side with an independent Central law. From the long term conceptual and practical perspective, however, it may be necessary to consider a Central framework statute under which States and the Centre will be bound to move towards VAT within a system of prescribed rates and practices. Unilateral introduction of VAT by a single State is doomed to failure as experience has already indicated. It is not clear whether most major States are willing and ready to make the transition at the appropriate time. Maharashtra, Andhra Pradesh, Madhya Pradesh, Uttar Pradesh and West Bengal have been professing their readiness to shift to VAT, while States like Gujarat, Tamilnadu and Kerala have been more reticent. This is another worrying factor, since it may not be practical under the present institutional dispensation to expect the Central government to actively discipline States which do not change their systems. Coordination at the level of inter-State committees in which the Centre is also a participant may not be sufficient to bind all parties to implement consensus decisions. Central intervention by legal methods which are cleared by States is desirable to ensure that different governments do not withdraw from the VAT process after commencement. We recommend, therefore, that the State government pursues this initiative at the national level.

2.121 All committees and experts as well as many States have rightly sought rationalisation of existing Constitutional anomalies in sharing the power to levy commodity taxes. These have already been indicated in earlier paragraphs and are not being repeated here. An area in which full rationalisation is unlikely to take place before 1st April 2002 is that of additional excise duties and "declared" goods. Opposition (or reluctance) by some States and lobbying exercises have resulted in the decision to permit States to tax "declared" goods at 4% at multi-point basis. A final decision was expected to be taken at the Central level on the three commodities on which additional excise duties are levied at present by the end of September. This must be expedited and existing anomalies rectified while introducing State level VAT in April 2002. The prohibition of State taxation of goods imported into the country under Article 286 of the Constitution also requires immediate amendment; this again was scheduled for a decision by end September.

b) Leadership and guidance in the reform process

2.122 We have already pointed out the action that must be taken at the Central level to draft a countrywide framework statute for VAT. This must be supplemented with effective institutional mechanisms for continued coordinated functioning of all governments. Existing arrangements like the NDC and the Inter-State Council may not suffice for constant interaction on administrative and procedural matters. Many innovative methods have already been developed within the country since independence to manage other tax statutes with Centre-State ramifications. The Empowered Committee is only considering setting up a secretariat in New Delhi; it has not yet moved towards demanding a policymaking organ for continuing consultation between both government levels on VAT issues. In our view, this is not sufficient. We suggest that the institutional foundation for managing a functioning VAT should be put on the agenda of all State and Central governments.

2.123 Another major Central responsibility relates to the "tax havens" that have developed today in Union Territories. These have undermined efforts made by States to improve their tax effort; they have also been responsible for undesirable retaliatory fiscal measures like entry taxes on motorcars. Despite repeated reminders, the Central government has not yet taken a firm position on the matter. Government of Karnataka must press ahead with demanding conformity by Union Territories to consensus decisions of the Empowered Committee relating to basic VAT rates, removal of exemptions etc.

c) Financial support for dislocation of commodity tax revenue

2.124 Dislocation of revenues is inevitable while shifting to VAT in any country. For Karnataka, this could arise from removal of cascading through input tax credit and rationalisation of the existing five levies into one. These matters are being taken into account while determining revenue-neutral rates under VAT. Such dislocation is exacerbated in a federation like ours by the required shift from origin-based to destination-based taxation as this will substantially alter the relative revenues of States. A fall-back fund to take care of such contingencies is unavoidable while introducing State VATs.

2.125 The Shome committee on inter-State trade had suggested setting up a Central fund to meet net revenue losses suffered by States. Every year actual collections of CST were to be credited to the fund on a monthly basis after deducting amounts payable to States as tax devolution. Losses suffered by States as estimated by them were to be intimated to the Centre every month and reimbursed by the Centre. At the end of the year, they would be certified by the AG and adjustments made.

2.126 The 2000 NIPFP committee, however, concluded that States could raise additional resources when VAT is introduced if they are also simultaneously empowered to tax some services. It estimated the annual amount required to be provided by the Centre for compensating States during the first two years of VAT at 25% of the present CST revenue at Rs. 1250 crs. The actual requirement could be less than this amount since several commodities are subject to CST rates below 4% often to promote exports. It opined that revenue would in any case go up due to reduction in exemptions, removal of competition and introduction of floor rates, addition of value added up to the retail point, better administration and compliance, improvement in computerisation and information systems and even increase in the "tax room" for States.

2.127 In our view, a fund or resources arranged to manage the transition to VAT must be operated to induce States to agree to what is in the best interests of the economy. The problem is how to insulate States against revenue loss without draining the Centre's own strained resources. In the long term, States, as a whole must be given access to productive additional revenue sources. Compensatory tax sources (or grants) to offset immediate revenue losses on account of CST reduction/abolition will also have to be found at once. State governments are demanding compensation from the Centre as the price of CST abolition and the Centre has committed itself to working out the expected revenue loss and the manner and quantum of compensation in consultation with States. The only satisfactory solution appears to be enabling States to levy service tax concurrently with the Centre and inducing them to use this fiscal tool to fend for themselves. This will be looked at in detail in the next chapter.

Governance and administration

2.128 A major concern while implementing VAT is e-governance. The framework for e-governance has been proposed in the Commission's first report and general principles underlying e-governance presented in the annexure to Chapter I of the present report. These will have to be operationalised while introducing VAT from April 2002.

2.129 We have already noted that VAT can be administered only as an account-based levy. It calls for continuous and quick processing of data provided regularly by taxpayers in their returns. The tax must, therefore, be based on a well-developed information base, electronically and efficiently managed. Self-policing is fundamental to value added taxation since it depends for its success on voluntary compliance by taxpayers. E-governance or the application of information and telecommunications technologies to the delivery of governmental activities and services must thus become the backbone of VAT not merely to improve the quality of governance *vis-à-vis* citizens but for running the tax system itself. VAT affords a historic opportunity for government to design an effective e governance structure, which will also contribute to the highest levels of citizen satisfaction.

2.130 Not infrequently, approaches to e-governance remain at the level of computerisation. In other words, computerisation which is merely the vehicle or "enabler" tends to become the central focus. This pushes the aims, quality and economics of governance to the periphery so much so that e-governance ends up being just an exercise in technology. To maintain focus on the main issues in VAT, it is necessary to work out the governance tasks of the department. This gives administration an opportunity to engineer or re-engineer basics and prepares it to use the tools, techniques, power and information which technology puts in its hands. Procedures can be looked at afresh without the burden of experience of current commodity tax administration. The approach to VAT e-governance may be informed but not guided or pre-judged by experience with existing taxes and earlier approaches to computerisation may inform but not guide the VAT approach to computerisation.

2.131 To develop procedures and statutes for managing VAT, the Commercial Tax department has set up seven groups, each headed by a Joint Commissioner to work on different fronts-formulation of policy and laws, tax base determination, operations (forms and audit), human resource development, MIS support and communications. A consultant has also been taken on board to handle governance and training issues Computerisation has already been done of many of the existing systems through the National Informatics Centre since 1996. The project was envisaged to be implemented in three phases and cover 13 divisions and 255 circle offices. In the first phase, 4 divisions and corresponding circle offices located at Bangalore were computerised. In the second phase, computerisation was undertaken in offices in Mysore, Dharwar, Mangalore and the mofussil areas of Bangalore. The third phase has, however, been kept on hold in view of the proposed changeover to VAT. Computerised modules extend to preparation of a master data base for dealers, filing of annual returns, tax collection and reconciliation with bank accounts and generation of crucial MIS outputs like Demand Collection and Balance statements, registers etc. The system captures data online from operations and is not based on batch processing. 170 outputs have been developed from the collected data. Check post computerisation has also been started as a turnkey project since last year. Connectivity has already been established through modem among Bangalore-based offices. The system is managed by 5 officers deputed from the NIC and 2000 departmental personnel have been trained to run it. Existing systems will, however, need to be substantially transformed when applied to VAT management. We propose in this section to briefly highlight some issues that may have to be kept in mind while developing mechanisms for effective VAT administration.

2.132 To engage the department in a dialogue on e-governance and make it more productive and effective, the Commission prepared a framework document and invited comments. Three layers were visualized. The first or operational layer covers 6 basic tasks-compliance, processing returns, assessment, demand and collection, refunds, enforcement and inter-State relations. This layer lies at the interface between government and the citizen; it is the layer closest to the public. Inter-State relations are placed here because they are crucial to the administration of a nationwide VAT system. (even State-specific implementation or regional implementation could make inter-State relations crucial at the level of exchange of operational information or smoothing out processes).

2.133 The second or planning layer, was visualised to consist of 6 tasks-administration, training and motivation, productivity, fraud control, citizen access and citizen satisfaction. The last two tasks were visualised at this level because the scope of access and measures of satisfaction are planning functions even though their effects would be felt at the operational layer.

VAT E-GOVERNANCE FRAMEWORK

Compliance	Processing	Assessment, Demand, Collections	Refunds	Enforcement	Inter State Relations
Fraud Control	Department Productivity	Department Administration	Training & Motivation	Citizen Access	Citizen Satisfaction
Economic Data	Sizing of Tax Base	Increasing Revenue	New Powers	Inter Departmental Co-operation	Technology

2.134 The third or strategic layer was seen as comprising 6 tasks-the collection of economic data, assessing the tax base, increasing revenue, empowerment, inter-departmental co-operation and technology. This layer is focused on the emergence of a VAT department to assess the tax potential and its growth and chart its course in terms of revenue projections, collection and improving compliance. To do these tasks as well as for fraud control, training and motivation or increasing departmental productivity additional powers have to be given to departmental officials at various levels.

2.135 Under each task, it is necessary for the department to list out its activities as well as those which need to be computerised, problems foreseen in introducing and implementing VAT, transitional issues while moving from sales taxes to VAT and issues which need to be resolved before a comprehensive view on e-governance can be taken.

2.136 Maintenance of a dealer data base and facilitating registration are the basic preliminary tasks that will have to be handled on the computer. In the Commission's first report, we have already discussed how a 12 digit number should be generated for maintaining the dealer data base. A decision is under way in the Empowered Committee regarding adopting income tax PAN numbers for VAT administration to facilitate data exchange across States. Whether this no. itself should be adopted or whether another no. should be derived from it for VAT purposes may have to be finalised. Numbers might then have to be generated for dealers who are not income tax payers and arrangements made to enable them to be allotted PAN numbers within the income tax system. The link with income tax should not also become a disincentive for dealers to opt for VAT.

2.137 The existing data base of around 2 lakh dealers (of whom 1.5 lakh are taxpayers) will have to be ported to the VAT system and numbers generated for fresh applicants. Simple forms will have to be prepared and registration facilitated by opening outlets and even kiosks in departmental field offices and offices of industry associations; online registration could also be considered. The registration procedure is yet to be finalised; it should be kept as simple and direct as possible. The application form may need to mention the legal and economic status of the applicant and the commodity handled by him. Proof of place of business may need to be appended. The applicant's signature could be stored for further recognition purposes when he subsequently files returns and other papers with the department. Data reported by dealers could be validated online using one or two cross-verifications with other reliable databases like registration with the Registrar of Companies, bank account number, passport, driving licence etc., but departmental inspections or security deposit requirements should not be enforced as pre-requisites for registration. Central excise dealer numbers should also be noted where applicable. Registration certificates should be automatically issued and rectification or modification of the original data permitted only to selected persons. The scope and motivations for fraudulent declarations should be considered and the circumstances in which registration should be cancelled laid down.

2.138 Security measures using bio-metric methods must be used to prevent pollution or tampering with this basic data base. Parallel servers can provide back-up facilities and a template used to prevent corruption by viruses. Selected sub-sets of the data base (not original applications) should be accessible to departmental officers concerned with returns as well as those concerned with investigation, intelligence and audit. The basic dealer application may in rare cases be downloaded under strict controls by those concerned with appeals. Within the department, decisions have to be taken regarding the department and the officers who should be authorised to receive and verify registration applications and maintain the data base up to date.

2.139 Finally, data mining interfaces and connectivity are required with the Central income tax and more importantly with the Central excise department. Some interface with the external world of taxpayers and others will have to be established through an interactive web site. The persons from other departments who should be given access to data must be clearly specified. This should be limited to few authorised persons. Erection of adequate firewalls to secure critical data and meet other secrecy requirements is a major requirement. Most important is the link that has to be established to data bases in other States which is essential to confirm the registration authenticity of dealers to whom sales are made across States. This is a critical area for evasion and fraud if zero-rating is adopted for inter-State trade since input tax credit will be given at the point of despatch of the commodity before it is actually sold. A dedicated web-server with the required data subset should be used for this interface. The system should envisage more than one area of checking for greater reliability. The dealer master base can be used to generate taxpayer master files which can be fed with data received from returns regarding tax liability and payment.

2.140 The commodity classification data base must also be maintained on the computer. It is therefore essential to finalise it quickly and adopt it definitively. Dealer exemption and composition thresholds must also be decided early to develop appropriate registration certificate issue software and operational linkages. Goods kept outside VAT may also need to be identified and linked to the data base to keep track of inputs and outputs entering into their manufacture and distribution.

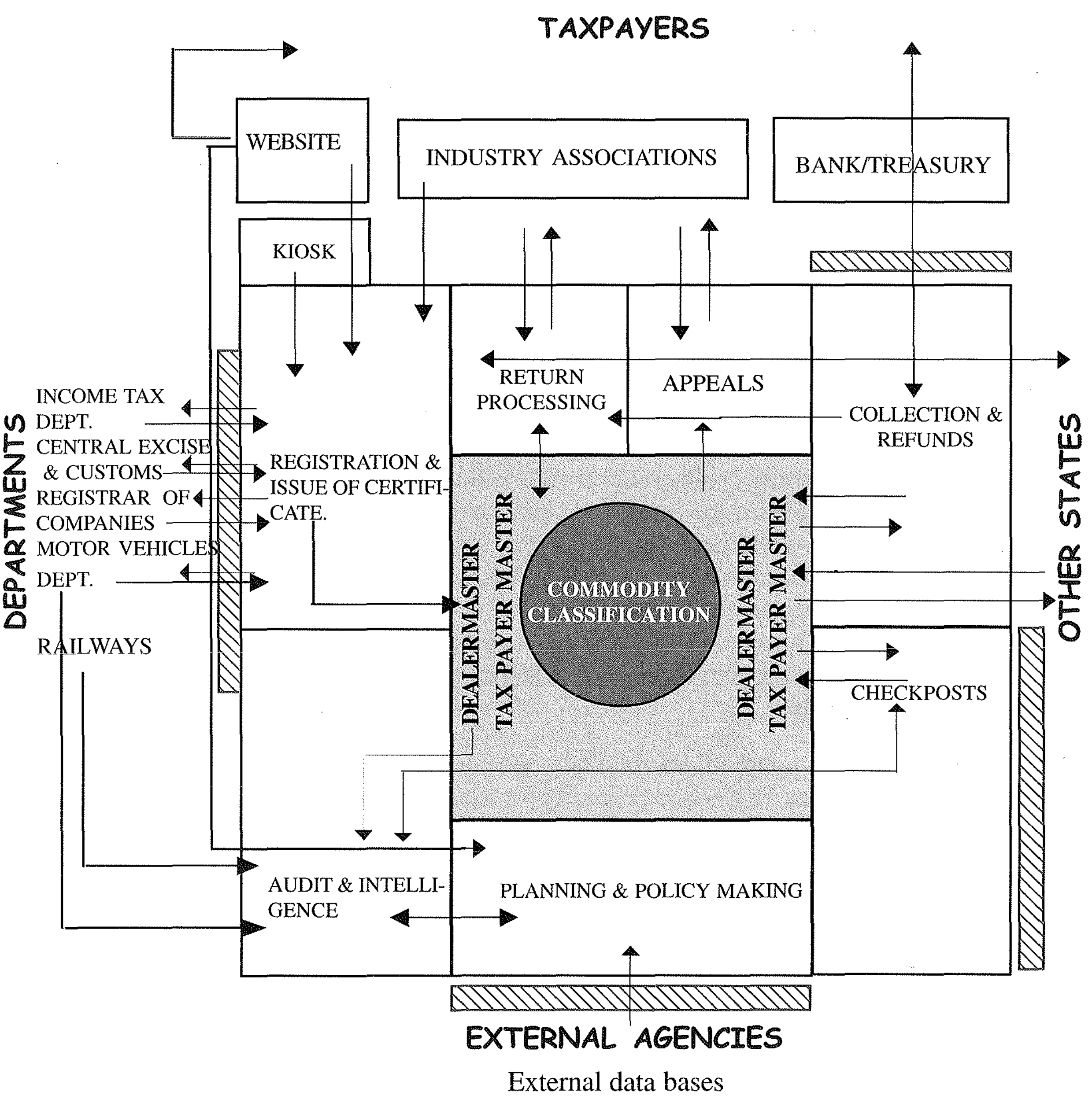
2.141 Various forms under VAT have also to be designed. The invoice form to be used under VAT is a critical item. It must be simple and contain basic essential data. There is no need to duplicate information already stored in the computer or statistics that can be derived from such information except for one or two items for validation purposes. The items suggested for inclusion in the form by the Shome Committee on Tax Policy and Tax Reform for the Tenth Plan (2001) are the name, address and VAT number of the taxable person making the supply, the nature of the supply (the type of supply, the type of goods or services and the quantity supplied), the time of making the supply, payment made for the supply, VAT due, the name, address and VAT no. of the taxable person supplied, the date of issue of invoice and the serial number of the invoice (with identification of the printer). The invoice must also be drafted looking at trade practices and after interacting with dealers and manufacturers. How credit sales should be treated as also quantity discounts will have to be examined. The treatment of "adjustment sales" should also be determined. Invoice authentication by security seals or electronic methods should be looked at.

2.142 Returns filing should be permitted to be done directly into the system and even online. The Central Excise department has already developed such a mechanism which is being test run before implementation. Returns could also be scanned for easy capture of data into the system. The return form should be carefully designed keeping in mind essential requirements only. Certification by a Chartered Accountant should not be insisted upon for monthly returns-whether and how audited accounts should be annually sought has to be decided. As far as possible, no additional documents should be sought as attachments to monthly returns. Automatic issue of notices to taxpayers and penalty determination could also be done on the computer for non-registration or non-filing of returns. It is important to decide on the manner in which input tax credit can be claimed every month. Should actual tax paid during the month be set off against actual tax due or should the tax paid on large one-time purchases be set off in instalments over months? These are matters on which decisions must be taken before the system can be designed. How return monitoring and validation should be managed-in a centralised or decentralised manner, for example- and by whom should also be decided. It could be perhaps done by a nominated officer for each jurisdiction, who should be made responsible for notifying defaulters to others.

2.143 The manner of processing returns should be direct and simple under VAT. The parameters to be used for validation should be firmed up. The few critical internal (within the return itself) computerised validations to which all returns should be subjected must be identified; on no account should these be left to individual officers or original taxpayer documents demanded for scrutiny; neither should there be local inspections or visits at this stage. Whether returns could be also validated with reference to other external information and linked data bases must be determined. Information furnished in returns should be validated with that received from the treasury relating to tax payment. Only returns randomly selected through pre-determined criteria put into the computer should be subjected to audit.

2.144 Audit is usually done on the basis of accounts as well as physical inspection. The audit function should be substantially strengthened and streamlined under VAT. It should be largely officer based with hierarchies fixed only for supervision and guidance. Quotas should be fixed of the percentage of returns under different categories that will be subject to audit. Selection should be based on risk indicators modulated on the likelihood of evasion and fraud in different sectors. The selection criteria should be kept secret and changed only by intervention at very senior levels. Once a list of cases for audit is generated, the audit queue should not be disturbed at the discretion of the officer doing the audit; in fact, the next case for audit could be generated only after the earlier one is examined. Selection software will, therefore, have to be developed with great care. Sectors allotted for audit to different officers may even be rotated from time to time. Supervisory officers in the audit department should determine in detail the procedure to be adopted for audit. This should be based on examination of documents in different phases-the next stage of examination by calling for additional documentation from the taxpayer should be adopted only on the basis of *prima facie* specific irregularities or doubts raised by the earlier stage of analysis. Measures should be adopted to incentivise the audit function, with the initial eligibility for incentives and the kind of incentive determined from computer-generated data linked to both quantity and quality of performance and taxpayer feedback. Audit must involve verification of documents checked and recorded at border check posts. The audit section may need to have connectivity with departments and agencies outside the Commercial Tax department. These might have to be identified along with the level at which such connectivity should be established.

SYSTEM FOR VAT MANAGEMENT



KEY

Interfaces & firewalls

Secured data bases within department

Divisions within department

Outside world.

2.145 Tax collection procedures should be streamlined as done for other taxes. Payments should be as far as possible through banks through drafts, checks etc. Refunds and tax credits should also be managed on the computer. Detailed procedures for bank reconciliation have already been worked out within the department.

2.146 The Intelligence Wing should also have access to relevant data within the department as well as from the check post for effective functioning. Price and consumption information from external sources would also be critical for this division. Coordination may be required with data from the Motor Vehicles department and the railway transport and freight handling departments, as also with the Central excise department. Appropriate connectivity should be established for the purpose.

2.147 MIS data of different kinds must be generated for continuous monitoring of key variables indicating performance efficiency. Existing computerised outputs should be adapted to VAT requirements. An area that could be given more attention is processing taxpayer data to identify trends and behaviour and use this for further investigation and eventual policy change. Data mining systems need to be installed to facilitate such analysis. Much closer interaction between the Commercial Tax and Planning departments would enable reliable data to be generated on critical macroeconomic indicators for the State. Data bases available from external sources (like those relating to product prices at the national and regional levels) which could be of help must also be accessed and made available to concerned departments as also to planners. A departmental web site would permit interaction with the public and with taxpayers. Apart from online registration, it could also provide information on tax policy, VAT practices, commercial and industrial trends and a chat room for clarification on tax matters.

2.148 VAT puts a premium on voluntary and correct compliance. The design of VAT administration must be devised primarily for those who are law- abiding. Foolproof methods of identification of the taxpayer and verification of decisional parameters like turnover, input taxes paid, refunds claimed, etc. are difficult to establish in Indian circumstances. A principal challenge to the design of an e-governance approach lies in devising means for cross and multiple, albeit quick, verifications of key facts online. This may in turn require a large multiplexed information system network. It will also be necessary to require taxpayers to adopt modern, electronic, business practices such as the keeping of verifiable records accessible from the government network, online filing of tax returns and electronic funds transfer. VAT, especially nationwide, will be IT intensive. The depth of IT penetration into VAT implementation requires as its complement similar IT penetration into the business of taxpayers and cross linkage to validate voluntary correct compliance.

2.149 Given the large share of commodity tax revenues in State and Central revenues and the impact of such levies on all economic agents, it is no wonder that implementation of a proper VAT is developing into a litmus test of the strength of co-operative federalism in the country. Existing complications in State sales tax systems and lack of a clear position on issues like the treatment of inter-State trade and service taxation indicate that premature attempts to enforce VAT might result in half-baked implementation. Careful planning, design, scheduling and education are pre-requisites for successful adoption of VAT. Nevertheless, we have tailored our recommendations to the requirements of the intra-State VAT that is proposed to be introduced in the coming financial year in such a manner as to ensure that the eventual objective of a dual VAT on inter-State and domestic sales is achieved with minimum difficulty. VAT on goods must over time be extended to cover capital goods. In the very long run, it might even have to evolve into a single VAT administered at either the State or Central level.

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Annexure I

Computation of Revenue Neutral VAT Rate
(Source : Prepared by Shri. V Madhu Commissioner of Commercial Taxes)

98-99 **Rs. crs.**

	1. CST- 4% 2. No services 3. Inputs in CST sales rebated 4.	
	Input Tax on Consignments not rebated	
A	**Total Revenue for the year**	
	I. KST	3733.53
	ii. CST	531.44
	iii. Share in ADE	189.00
	vi. Entry tax	273.13
A1	Total	4727.10
A2	Less Tax on Petrol, Diesel, ATF, Jewellery &IMFL	1228.00
A3	**Net (A1-(A2)**	**3499.10**
	Taxable local TO	**37760.39**
	Less:TTO on Petrol, Diesel, ATF, Jewllery&IMFL	7374.10
B	NET Taxable local TO	30386.29
C	Inputsin B (62.5%of B)	18991.43
D	Input tax in B(4% of C)	759.66
E	**Taxable local TO net of input tax(B-D)-**	**28145.30**
	Reduction of Tax base due to removal of tax cascading@5	
E1	**Addition of services:**	**0.00**
	Share of TO:	
	a.in Primary Consumption commodities(%)	
	b. in other commodities(%)	
	c. TO (Primary consumption commodities)	0.00
	d. TO(other commodities)	0.00
F	Broad basing due to withdrawl of	
	exemptions(10%of E)	0.00
G	Total taxable local TO(E+F)- goods only	28145.30
H	Inter-state sales TO(CST/0.04)	13265.39
I	Consignment transfers(17% of H)	2255.12
J	Input tax in H(4%of 62.5/100timesH)	331.63
K	**Total TO(G+H-J)**	**41079.06**
L	Inputs qualifying for VAT rebate	9872.39
	(29/100times(K-25%of E)	0.29
M	Plant and machinery for VAT rebate(0%)	173.07
N	***Av Single rate of VAT(%): TO based***	***13.50***
	a. VAT for primary consumption commodities	
	a. VAT for other commodities	
O	Tax on local TO liable to VAT=G*N/100	**3799.62**
P	Tax rebate on L=(L+M/5)*N/100	1337.45
Q	Net revenue(O-P)	2462.17
R	VAT on sugar, textiles, and tobacco	189.00
S	TO Gain from capturing value added in multistage	
	taxation (10% of (1-62.5/100)of G	1055.45
S1	VAT gain from S=(N/100)*S	142.49
T	Revenue loss due to raising of the threshold	
	limit to Rs 3 lakhs p.a (1%of Q)	24.62
T1	Tax from CST at 4% at tax base reduced by 5%	504.87
	Add Revenue from Jewllery	29.05
	Add Revenue from IMFL	160.60
U	Total revenue under VAT(Q+R+S1+T1-T)	3494.50
V	Gain in revenue under the proposed State VAT	
	(U-A4)	**-4.60**
	GDP state	81276.00
	Share of Services sector in GDP(%)	43.90

Assumptions overleaf

General Assumptions

1 The NIPFP formula is marginally modified to local requirements

2 The turnover of 4% goods proposed under VAT is 17% of taxable TO available under VAT

3 Petrol, Diesel, kept out of VAT

4 The input- output ratio is 1:1.6; 62.5% of value at manufacturers' level constituted of inputs

5 Input imports are 47%, 25% of goods are imported and sold,the consignments are about 17% of interstate and exports

6 Capital goods are rebated over 5 years and they taxed at RNR

7 Set off is given for tax on inputs in interstate trade and exports

8 Present Exemptions are unlikely to be withdrawn

9 ADE & Declared goods are assumed to fetch same revenue after transfer to States

Annexure II

COMMODITY TAXATION OF PETROLEUM PRODUCTS, SUGAR, POTABLE ALCOHOL AND TEA

A2.1 The study undertaken in this annexure throws light on several core issues relevant to the concept and application of value added taxation in the country. It indicates the incentive-disincentive mechanism for taxpayers operating today in the origin-based, cascading commodity tax structure at the State level. It helps us to identify areas for decision and action and provides fairly reliable estimates of the likely revenue from different rates. It can be used as a guide for further similar studies by the department, which could be eventually put together to construct a complete input-output matrix.

A2.2 The case study presents a textbook case of the distortions created by the existing structure which would disappear when VAT becomes operational. In Karnataka, there is a plethora of commodity taxes each with its own logic. The sales tax, for administrative convenience, is levied at the first point. To capture value addition at later points and items which escape the first point levy for whatever reason, there is a turnover tax applied to the wholesale level that cannot be billed to the purchaser. A earmarked infrastructure cess is also levied; it is generally piggy-backed on the sales tax. An entry tax follows; it is imposed on landed cost at the wholesale level. Finally, to bring items which are not taxed at earlier points and are despatched on consignment basis, there is also a purchase tax in lieu of the sales tax. The case study furnishes us with ample ammunition to attack the existing perverse structure of multiple levies.

A2.3 The overlapping, cascading and inequitous nature of the current system which can be remedied by introducing VAT is revealed throughout the analysis. For example, sales tax and related levies are sometimes computed on ex-depot cost and sometimes on landed cost giving rise to interpretational ambiguities and perverse economic incentives. When VAT comes into play, however, dealers can choose transport arrangements for commercial reasons alone, since value added that is not taxed at one level can be covered at the next. The levy of entry tax is not uniform on all products. Vertically integrated units, like sugar factories with distilleries (and blending units), are not liable to tax when molasses moves to distilleries and rectified spirit to blending units but this is not the case with autonomous production points. VAT would be economically neutral under such circumstances.

A2.4 Managing the tax systems of different States and the interface between them seems to be a major tax-planning exercise for dealers and manufacturers today. In our analysis, we have been able to observe at close quarters some inter-State transactions of large companies (petroleum companies and those dealing in tea) which have nationwide operations and those of smaller units functioning within the confines of the State. Apart from the well-known trade-off between inter-State sale and consignment dispatches, there are some amusing distortions induced by the current methods of taxing inter-State trade (as for example, the practice of procuring and transporting cylinders for LPG bottling across States because the incidence of Central sales tax is less than the cumulative incidence of local taxes). Even in the case of agency transfers, levies like the purchase tax provide counter-incentives to bill transactions as inter-State sales, as is clear from the example of petroleum products sold from the MRPL refinery through HPC. Given the extensive commercial activity that is taking place across State borders at present, this suggests the desirability of opting for inter-State VAT alongside intra-State VAT from the very beginning of the reform process.

A2.5 The plethora of commodity tax rates still applicable within a sector is most apparent in the case of diesel. There are exemptions for fishermen, reductions for industrial inputs and a special rate to induce a large consumer (the Railways) to make purchases within the State (the bait has not been attractive enough to effectively reduce trade diversion). For some of the products considered, like sugar or LPG, the dual rate is a direct consequence of the dual pricing method used to subsidise essential goods for public distribution. The OCC procedure of loading tax revenues realised from sale of petroleum products by production units back into the price charged on domestic consumers of such States also introduces distortions that have various implications. Since such mechanisms are targeted for early removal, the general VAT rate could be imposed on all sales.

A2.6 The major exemption, however, relates to those extended to encourage industrial investment. The study has led us to assess the likely impact of VAT on such incentives in the case of MRPL. It is evident that the effect of many of these incentives will be neutralised when there is a shift from origin-based taxation to commodity-based taxation. There may not, therefore, be need to make a frontal attack on incentives given in the past; many of them could be left to wither away over time.

A2.7 For the administration, these micro-level studies indicate the possibility of comparing estimates of revenue expected to be generated from selected commodities with actual realisations. In many areas, there are substantial differences between the two, which highlights the need for close monitoring. Some pointers are also available in our study which could be followed up for assessing inventories across years, movements of products into and outside the State etc. which could be useful while preparing the final input-output table.

A2.8 On the whole, our study shows that the shift to VAT would be revenue-neutral, even with tax credits. The general VAT rate is taken as 10% for the purposes of analysis and options for a lower rate (4%) have been examined for articles of general consumption like kerosene and sugar. Potable alcohol and petroleum are treated as goods whose consumption needs to be controlled; they may not thus be subject to a normal VAT regime. Alternative mechanisms have been suggested for these commodities, which will not affect the basic advantage of VAT as a non-distorting levy that is difficult to evade. Where our suggestions are different from those proposed by the Empowered Committee of Finance Ministers, the implications of both alternatives have been examined to the extent feasible.

A2.9 Some attempt has been made throughout the study to assess the combined incidence of Central excise and State commodity taxes and the "tax room" appropriated today by each level. Interesting interface problems between the levies have also surfaced, particularly in the case of petroleum products where it appears that to some extent Central excise is being extended to the wholesale level. Central excise itself needs to be made fully VATable and converted from specific to *ad valorem* duties across the board.

A2.10 Service tax aspects have been highlighted mainly with reference to electricity duty payable on value addition. Data on such areas could be refined and used for completing the input-output table for the State to facilitate introduction of VAT on services. Bringing VAT on capital goods into effect is a long-range plan which is not examined at this stage.

A2.11 It is hoped that the study will promote further mapping of the economy and lay the foundations for assessing the revenue and economic effects of different VAT alternatives.

SUGAR AND POTABLE ALCOHOL

A2.12 In this section, we have looked at how VAT will impact on the production and distribution chain running from sugarcane to sugar, molasses, rectified spirit and two varieties of molasses-based potable alcohol-arrack and Indian Made Liquor. The variety and nature of the products covered make it possible for us to focus on core areas which will be subject to reform when VAT is introduced. Sugarcane is a major agricultural commodity, which is almost totally marketed on a commercial basis. Sugar is a staple item of household consumption, which is widely distributed. Molasses is a by-product in the production of sugar, a substantial quantity of which is used in the manufacture of rectified spirit. Both molasses and rectified spirit are intermediate goods in the manufacturing sector. Spirit (either in its crude form as rectified spirit or further refined as neutral spirit) is the main ingredient in the manufacture of potable alcohol in the form of country liquor (arrack) or Indian Made Liquor (IML). The detailed study of this sector enables us to examine matters like taxation of essential commodities and agricultural products, tax credit for industrial inputs and the taxation of demerit goods. Since most of these products are today subject to quantitative, pricing and other regulatory controls, data on the volumes and values of intermediate and final goods at various points of the value addition chain is readily available.

A2.13 Three types of annual cycles are used by the different agencies that collect and process data. The Directorate of Sugar maintains statistics on the basis of the sugarcane year (October to September), figures of the Excise department relate to the excise year (July to June) and budgetary figures are based on the financial year (April to March). Since sugarcane arrivals at sugar factories taper off by May, sugar production figures for a sugarcane year can be linked with excise year data for molasses with little error. Although we have valued sugarcane using sugarcane year prices, the value of sugar at different points of the distribution chain and tax realised are computed on financial year basis. The production cycle of potable alcohol (starting with molasses) is based on excise year figures and tax revenues on the financial year.

SUGARCANE AND SUGAR:

Table I

TAXATION OF THE SUGAR SECTOR

(Quantities in lakh mts.)		1998-99	1999-2000
Cane crushed-obtained from the Director of Sugar		131.08	145.14
Value of cane crushed at price approved for Mysugar used as the norm for the sector (Rs.crs.)	@ Rs. 865/mt for both years	1133.84	1255.48
*Purchase tax (estimated-Rs.crs.)**	*@Rs. 65 & Rs. 50 respectively*	*76.12*	*84.07*
*Purchase tax (actuals-Rs.crs.)**		*39.18*	*47.49*
*Road cess (estimated-Rs.crs.)**	*@ Rs. 10/mt*	*13.11*	*14.51*
*Road cess (actuals-Rs.crs.)**		*6.74*	*7.65*
Value added during production/mt. (deducting Rs. 50/mt.purchase tax & Rs. 10/mt. road cess for average recovery rate in State)		(Rs. 10180- Rs. 9250) 930	(Rs. 11230- Rs. 9250) 1980
Sugar produced obtained from Director of Sugar		13.7	15.38
Quantity reserved for levy }	@40:60 & 30:	5.48	4.61
Quantity reserved for free sale}	70 respectively	8.22	10.76
Ex-factory value (on averages of 2 govt. notified rates for levy sugar)	@Rs.10180/mt & Rs.11230/mt	1394.66	1727.17
Quantity of levy sugar released for sale from Chief Sugar Directorate.		3.4	4.47
Quantity of free sale sugar sold in yr from Chief Sugar Directorate.		7.07	8.13
Excise duty to Central government for levy sugar (estimated in Rs.crs.)	*@ Rs. 170/mt*	*5.78*	*7.60*
Cess to Central government for levy sugar (estimated in Rs.crs.)	*@ Rs. 140/mt*	*4.76*	*6.26*
Additional excise duty to Central government for levy sugar (do.)	*@ Rs. 210/mt*	*7.14*	*9.39*
Excise duty to Central government for free sale sugar (do.)	*@ Rs. 340/mt*	*12.019*	*13.82*
Cess to Central government for free sale sugar (do.)	*@Rs. 140/mt*	*9.898*	*11.38*
Additional excise duty to Central government for free sale sugar (do.)	*@Rs. 370/mt*	*14.847*	*17.07*
Exfactory value/price of levy sugar/mt. after tax (Rs.)		10700	11750
Exfactory value/price of free sale sugar after tax on Mysugar's rates(Rs.)		14031	13746
Value of free sale sugar after tax(Rs.crs)		992.00	1117.55
Value of levy sugar after tax (Rs.crs.)		363.8	525.23
Weighted average value after tax		12949	13038
Value of sugar after tax (Rs.crs.)		1356	1643

Quantity of levy sugar released for		2.35	2.5
sale within State from Chief Directte.			
Quantity of levy sugar released for sale outside State from Chief Directte		1.05	1.97
Quantity of free sale sugar sold-in St. -outside State		5.15 1.92	5 3.13
Wholesale value of levy sugar sold in State calculated at prices fixed by department (Rs.crs.)	@Rs.11300/mt & Rs.11890/mt respectively	384.2	531.48
Retail value of levy sugar sold in St. calculated at prices fixed by dept.(Rs. crs.)	@Rs.11400/mt & Rs.12000/mt respectively	387.6	536.4
Wholesale value of free sale sugar sold in St. at price indicated by My-gar for sector (Rs.crs.)	@Rs. 14330/mt & Rs. 14045/mt	738.00	702.25
Retail value of free sale sugar(Rs.crs)	@Rs.15000/mt	772.50	750
Entry tax estimated at 1%		*7.23*	*6.87*
VAT revenue @ 4% on free sale sugar alone		30.9	30
VAT revenue @ 10% on free sale sugar alone		77.25	75
VAT revenue @ 4% on levy sugar & 10% on free sale sugar		92.75	96.46
VAT revenue @ 4% with levy		46.4	51.46
VAT revenue @ 10% with levy		116	128.64
VAT revenue @ 4% on sugar when levy is lifted (prices assumed to be those for free sale sugar)		45	45
VAT revenue @ 10% on sugar when levy is lifted (prices assumed to be those for free sale sugar)		112.5	112.5
Total present tax revenue to State (a) (actual purchase tax collected + estd. entry tax revenue)		53.15	62.01
Total present tax revenue to State (b) (estd. purchase tax & entry tax revs.)		96.46	105.45
Estd. present tax revenue to Centre**		54.44	65.52
Combined effective tax rate on sector (a) with actual purchase tax realisns. (b) with estd.purchase tax realisns.		9%(4.6% for St) 13%(St.-8%)	10%(4.8%-St.) 13%(8%-St.)

** Purchase tax & road cess due have been computed on the basis of actual figures of cane crushed & recovery rates-tax realisations are lower due to arrears reliefs given by government for ailing sugar factories and deferrals for fresh investments.

** Additional excise duty is treated as a component of Central tax revenue.

Table II

COMMODITY TAX PER METRIC TONNE OF SUGAR

(Rs/mt.)	**'98-99 (free sale)**	**'98-99 (levy)**	**'99-2000 (free sale)**	**'99-2000 (levy)**
Sugarcane price approved for Mysugar (normative)	865	865	865	865
*Purchase tax**	*65/50*	*65/50*	*65/50*	*65/50*
Road cess	*10*	*10*	*10*	*10*
Post-tax sugarcane price*	925	925	925	925

Ex factory cost for levy sugar adopted as base price (average of 2 major government notified rates)	10180	11230

Central excise	*340*	*170*	*340*	*170*
Central cess	*140*	*140*	*140*	*140*
Additional excise duty	*370*	*210*	*370*	*210*
Weighted average ex-factory price before tax**	12207		12305	
Ex factory price after tax	14031	10700	13746	11750
Weighted average ex-factory price after tax**	12949		13038	
Wholesale price***	14330	11270	14045	11870
Weighted average whole-sale price****	13371		13320	
Retail price***	15000	11400	15000	12000
Weighted average retail price****	13872		14000	

*Entry tax*******	140	x	137	x
Tax collected:	850	520	850	520
by Centre				
by State	75/60+140	75/60	75/60+137	75/60

VALUE ADDED-SUGAR/mt

(Rs.)

While converting cane into sugar(a)***	930	1980
While converting cane into sugar(b)***	2957	3055
At wholesale level	422	282
At retail level	501	680

* There are two specific purchase tax rates linked to recovery rates of sugar from sugarcane. The tax rate of Rs.5O applicable to the average recovery rate in the State for the year has been used for computing the post-tax value of sugarcane.

** The weighted average ex-factory price of sugar has been calculated on quantities of levy sugar allotted for sale in the State at prices notified by the Central Directorate of Sugar and quantities of free sale sugar permitted to be sold from factories in the State by the Central Directorate at prices obtained by Mysugar. This has first been computed post-tax and then worked back to get the pre-tax weighted average ex-factory price of sugar.

*** Wholesale and retail prices for levy sugar are those fixed under departmental norms, those for free sale sugar have been obtained from sugar factories. Differences in value addition at the wholesale level between the years are due to the practice of subsidising wholesalers out of a separate acount for losses incurred in handling levy sugar. Under value added, (a) refers to value added taking the cost of production of sugar & (b)to weighted average pre-tax ex-factory price.

**** Weighted average wholesale and retail prices have been computed on estimated quantities of free sale sugar consumed within the State and actual quantities of levy sugar allotted for sale in Karnataka,

***** Wholesale margins depend on retail prices fixed by government for levy sugar; when these are inadequate to cover approved handling and transport costs, the difference is subsidised from a separate account. Entry tax liability will have to be adjusted against the value added for free sale sugar.

A2.14 Sugarcane is subject to allocational restrictions and sugar to distributional and price controls. It is thus possible to access much of the data relating to production, valuation, distribution and the existing tax burden required for computing VAT on these commodities from official sources itself. These are analysed in Tables I and II.

A2.15 The Sugarcane Control Order of 1966, issued under the Essential Commodities Act, authorises government to issue orders attaching sugarcane growers to sugar factories. They are expected to take their produce only to allotted factories. Sugar factories execute annual contracts making commitments about the quantity of cane they plan to crush during a season. In the present analysis, estimates of sugarcane production made by the Agriculture department have not been adopted for computing value added because of doubts rcgarding data reliability. Instead, monthly returns received from sugar factories by the Directorate of Sugar regarding sugarcane arrivals and crushing have been relied upon.

A2.16 A State Advisory Price for sugarcane was being fixed by the government till 1996-97, but this has been stopped subsequently in obedience to a court order. At present, the Central government fixes a Statutory Minimum Price (SMP) for minimum support price operations for sugarcane. The State government also approves the price to be adopted for purchasing sugarcane by the public sector Mysore Sugar Company; this price tends to become the ruling price in the market for the season.

A2.17 The State levies ***a purchase tax on sugarcane*** at two specific rates linked to sugar recovery rates (the rates are differentiated for recovery rates above and below 10.5%). Purchase tax is paid by sugar factories on each metric tonne of cane purchased. There is also a specific ***road cess*** per tonne of sugarcane purchased, which is earmarked for road development in sugarcane growing areas. Collections made against these two levies for a year are available from the Commercial Taxes department. Both levies were based on *ad valorem* rates for a short period before 1995. Table I indicates that actual purchase tax collections were around 50% of estimated revenues in 1998-99 and 1999-2000. This is due to arrears in tax payment, specific government orders converting tax dues into interest-free loans as a measure of assistance to ailing sugar factories and tax incentives in the form of exemption and deferment for fresh investment.

A2.18 The purchase price of sugarcane accounts for around 80% of the production cost of sugar; other inputs and consumables like chemicals, packaging etc. are negligible in value. As for utilities (water and power), consultations with sugar factories indicate that bagasse generated as waste in the process of sugarcane crushing is adequate to fully cover the energy requirements of the industry. Backup diesel generating sets are maintained for startups when stoppages occur; these provide not more than 4% to 5% of the total power utilised for sugarcane crushing. KPTCL power is rarely utilised by the sector. Very little electricity duty is therefore likely to be paid by sugar factories and claimed as credit when VAT on services is introduced at the State level.

A2.19 Sugar factories produce sugar as the main product, molasses as by-product and bagasse as waste. Technical ratios can be computed for sugar production since recovery rates are reported by factories to the Director of Sugar. Normally, 4% of the sugarcane crushed is expected to be realised as molasses. Bagasse is mostly recycled within sugar factories for power production; it is very rarely sold.

A2.20 The sugar output for each crushing season is available from the Directorate of Sugar. At present, under the Sugarcane Control Order, part of the sugar produced is compulsorily reserved at the factory level for release as levy sugar to the Public Distribution System as per quantities and price specified and in the manner indicated by the Directorate of Food and Civil Supplies of the State government. The rest is free sale sugar, which also can be released only as permitted by the Central government.

A2.21 Generally, two major selling prices are being fixed annually by the Central government for two regions of the State for levy sugar sold by sugar factories. (There is also a third rate, which can be ignored since it is applicable to only one factory). Averages of the two prices have been applied to estimated quantities of levy sugar and the value thus computed treated as the basic cost of production of sugar.

A2.22 Karnataka is surplus in sugar production. The quantities of levy sugar allotted to the State from its own sugar factories are available from the Chief Directorate of Sugar of the Department of Food and Civil Supplies of the Government of India and those released for sale within the State from the Directorate of Food and Civil Supplies. For the years under consideration, there is substantial carryover of stock from year to year. Quantities carried over differ in respect of levy and free sale sugar, due to differences in control and pricing mechanisms. The Chief Directorate of Sugar of the Central government has furnished figures relating to allotments made from sugar factories in Karnataka out of levy sugar for sale within and outside the State. These have been adopted for our calculations in preference to the slightly lower figures of releases available from the State Department of Food and Civil Supplies for reasons of consistency. Although the Chief Directorate has figures of releases of free sale sugar from the factories in Karnataka, they are not differentiated between sales within and outside the State. There are likely to be some movements of free sale sugar across State borders, which are not fully captured by these figures. Actual consumption within the State has been estimated using data of household consumption from the NSSO for 1999-2000 which are around 1 kg./month per capita. When applied to population figures for the State for 2001, household consumption comes to around 6.33 lakh tonnes. This has been rounded off to 7.5 lakh tonnes to take into account consumption by manufacturing and processing units.

A2.23 There is a strong feeling in the sugar sector that the procedure of earmarking part of the sugar produced for distribution as levy sugar will be abandoned by the Central government in the coming season. Although no formal commitment to this effect has been made and no preparations begun for changing the current policy, the existing low percentage share of levy sugar in total production (15%) and restriction of the issue of levy sugar only to ration cardholders below the poverty line give credence to the belief that distribution and price controls on sugar will disappear very soon.

A2.24 At present, there is a specific ***Central excise duty*** (AED) and a specific ***cess on sugar***. There is also a specific ***additional excise duty in lieu of State sales tax***. Originally, additional excise duty was a tax rental by States in favour of the Central government and the revenue realised was expected to be distributed to States on criteria determined by Finance Commissions. After the 80th Constitutional amendment, which came into effect in 1996-97, AED has become part of Central revenues out of which a fixed share is distributed among States. Figures are not readily available regarding revenue raised through AED on sugar in Karnataka, but the levy will have to be given up when VAT is brought in at the State level. There are different rates of Central excise duties and AED for levy and free sale sugar, but the rate of cess is the same. The ex-factory value of free sale sugar has been calculated on the basis of the average post-Central excise price obtained by Mysugar during the year and this has been used to calculate the post-tax weighted average value of sugar. The value obtained has then been worked back to obtain the pre-tax ex-factory weighted average value of sugar.

A2.25 Distribution mechanisms are different for levy and free sale sugar. Ex-factory and retail prices for levy sugar are notified by the State Department of Food and Civil Supplies after they are fixed by the Central government. Wholesale and retail margins and the principles on which transport charges can be levied are similarly notified. Since levy sugar is sold at a uniform retail price, Deputy

Commissioners of districts are empowered to calculate permissible transport costs for wholesalers; if these cannot be met within the available margin, the difference is reimbursed to them as a subsidy from a separate account-the Sugar Equalisation Fund. A similar mechanism operates in respect of levy sugar allocated from factories in Karnataka to other States. For levy sugar, there is one wholesale and one retail level. The retail prices and margins fixed annually for levy sugar have been adopted for calculation of value added in the distribution process.

A2.26 No commodity tax is payable in respect of sugar (levy or otherwise) sold within or outside the State, since there is no Central sales tax on sugar and States themselves cannot levy sales tax on sugar because it is subject to AED. Entry tax is levied on sugar by some States, including Karnataka, but levy sugar is tax exempt.

A2.27 In the case of free sale sugar, ex-factory sales are made to distributors who make further sales to wholesalers within and outside the State. Retail sales of free sale sugar are through large grocery shops or supermarkets as well as through smaller shopkeepers. Thus, there is an additional distributional level in the case of free sale sugar as compared to levy sugar. Due to non-availability of data, however, only prices and value added for the wholesale and retail levels have been computed on the basis of information furnished by sugar companies. These have been applied to quantities estimated as consumed within the State.

A2.28 *Entry tax* is levied on free sale sugar when it enters a local area. The tax was initially introduced by some States like Karnataka to raise revenues from commodities for which the power to levy and collect taxes had been rented to the Central government (through additional excise duties), since they felt that adequate revenues were not being raised by the Central government itself for distribution among States. In 1998-99 and 1999-2000, entry tax was being collected from sugar factories themselves (not from dealers) for administrative convenience; hence, transport cost does not form part of the tax base for computing entry tax. Entry tax is levied on *ad valorem* basis at 1% of the turnover for sugar consumed within the State, but there is no entry tax on sugar consumed within the local area in which it is produced (the latter quantity may not be substantial). Entry tax collection figures are not generally available commoditywise particularly when it is collected from dealers who deal in several items. The unit incidence of entry tax has been computed on estimated revenues realised from estimated sales of free sale sugar within the State.

A2.29 During the period considered, therefore, there was only one State level tax on sugarcane-purchase tax (including road cess)-and one on sugar-entry tax. Both taxes were being collected from 30 odd sugar factories. At present, only purchase tax is being collected from factories and entry tax is being collected from registered dealers.

A2.30 Sugar is an input in the manufacture of various other products. The extent to which sugar is used in confectionery and related industries will have to be estimated to allow for tax credits that will be claimed when a general VAT is introduced.

Major issues arising out of the analysis:

A2.31 The study of VAT on sugarcane raises the controversial issue of sales taxation of agricultural commodities. Since sugarcane is a commercialised agricultural product that is almost totally marketed through sugar factories, there is a case for collecting VAT at the normal rate of 10% at the purchase point. This will in any case be credited againstVAT payable on sugar sold by factories.

A2.32 As for sugar, several rate scenarios are possible and a final decision should depend on continuation or otherwise of the levy mechanism. If levy is lifted, adoption of the normal tax rate of 10% is desirable; if levy continues, there may be a case for a lower rate of 4% on levy sugar or even zero-rating on this component. Some possible revenue scenarios have been projected in Table I. Present indications clearly point towards early lifting of distributional and price controls for sugar. Revenue likely to be realised from VAT on sugar when this happens has been estimated using current retail prices for free sale sugar, though these could change when levy is lifted. VAT realised from the sale of sugarcane will be claimed as tax credit by sugar companies. The overall picture that emerges is as below:

'98-'99

VAT scenarios (Rs.crs.)	Projected revenue	Revenue realised		Difference	
		(a)	(b)	(a)	(b)
Levy sugar exempt, 4% on rest	30.9 }	53.15	96.46	-22.25	-65.56
Levy sugar exempt,10% on rest	77.25 }			24.1	-19.21
4% on levy sugar, 10% on rest	92.95 }			39.8	-3.5
4% with levy	46.4 }			-6.75	-50.06
10% with levy	116 }			62.85	19.54
4% without levy	45 }			-8.15	-51.41
10% without levy	112.5 }			59.35	16.04

'99-2000

VAT scenarios (Rs.crs.)	Projected revenue	Revenue realised		Difference	
		(a)	(b)	(a)	(b)
Levy sugar exempt, 4% on rest	30	62.01	105.45	-32.01	-75.45
Levy sugar exempt, 10% on rest	75			12.99	-30.45
4% on levy sugar, 10% on rest	96.46			34.45	-8.99
4% with levy	51.46			-10.56	-51
10% with levy	128.64			66.63	23.19
4% without levy	45			-17.01	-60.45
10% without levy	112.5			50.49	7.05

(a) with actual purchase tax realised (b) with estimated purchase tax revenue

A2.33 The most desirable tax rate is 10% overall if levy is lifted or 4% on levy sugar and 10% on the rest (if levy continues). Since current tax incentives (in the case of purchase tax) will also go (they could be replaced by an explicit budgetary subsidy if necessary), there should be some increase in revenue with the introduction of VAT. Tax credits claimed by industrial users of sugar could come to around Rs. 16.8 crs. (computed at 10% on difference between household consumption figures of sugar for Karnataka and other consumption estimated earlier) ; hence, the overall picture should be broadly revenue-neutral. It must be noted that there might be some underestimation of revenue currently raised from the sector since figures are not readily available regarding additional excise duty attributable to this item, which will have to be given up when VAT is introduced.

A2.34 Central excise duties will, however, continue even when VAT is introduced. This raises the issue of the combined incidence of commodity taxes as a whole on the sector and questions relating to the "tax room" available for each government level. Existing effective tax rates on the sector are given below:

'98-'99

Current effective tax rate (%)	State taxes	Central taxes	Both
(a) using actual purchase tax realisations	4.6	4.4	9
(b) using estimated purchase tax revenue	8	5	13

'99-2000

Current effective tax rate	State taxes	Central taxes	Both
(a) using actual purchase tax realisations	4.8	4.2	10
(b) using estimated purchase tax revenue	8	5	13

A2.35 Even though sugar is treated as an essential commodity, the current tax incidence is between 9% and 13%! If the VAT rate is fixed at 10% the effective rate would go up if the Centre's tax incidence continues at 5%. Central excises will also eventually have to move to the value added mode of *ad valorem* taxation with setoffs for excise payments made on inputs and services. The Empowered Committee of State Finance Ministers has apparently decided to keep sugarcane outside VAT and levy 4% on sugar.

A2.36 There is again the question of a Statelevel VAT on services. We have already noted that tax credit may not be required for duty on energy used by the sector, but there will be other services subject to the State VAT for which sugar factories would be eligible to claim credit. Coverage of the Central VAT will also have to extend to services.

A2.37 The shift to VAT on sugar is likely to substantially increase the number of dealers whose returns have to be scrutinised, since distributors, wholesalers and retailers will all come within the VAT chain. At the wholesale and retail level, however, sugar is likely to be only one of several grocery items handled by dealers who will be required to file returns on many other products within the threshold limits prescribed for presumptive taxation and exemption. The availability of VAT credit on inputs should act as incentive for dealers to opt into the system. Even today, for levy sugar alone, there are 275 wholesale and 20390 retail dealers in the State! The department could examine whether dealers of this size are already filing returns.

A2.38 At present, since sugar is subject to AED and not sales tax, there is no CST on inter-State sales. Entry tax is leviable on sugar imported into the State, but this is not an issue at present as the State is surplus in sugar production. When VAT is introduced by zero-rating inter-State sales, VAT realised at earlier stages in respect of sugar sold to other States will have to be refunded at the point of inter-State sale so that the product enters the purchasing State devoid of VAT. Administrative requirements for validation of refund claims will also have to be made to operate such a system. If the clearing house mechanism is used instead, appropriate arrangements will have to be made to compute net payments to the State but this will be done at the macro level on the basis of shares of commodity tax revenue in all States commodity tax revenue.

MOLASSES:

Table III

TAXATION OF POTABLE ALCOHOL

Molasses

Quantities in lakh mts. values in Rs.crs.		**'98-'99**	**'99-2000**
Production for sugar year	From Directorate of Sugar	6.73	5.81
Production for excise year	Excise department	5.3	7.09
Releases:	do.	4.85	6.87
-to distilleries		3.14	4.65
-to cattle feed producers		1.29	2.17
-export outside State		0.42	0.05
Value of molasses released for use within the State	estimated from basic prices of molasses used by Excise dept. for fixing arrack prices (Rs. 900 and Rs. 400/mt.)	39.87	27.28
Central excise on sales	estimated on releases at Rs. 500/mt.	24.25	34.35
Central excise on sales within State	estd. on releases within St. at Rs. 500/mt.	22.15	34.1
State sales tax(estimated)	10% of post-Central excise value of sales within State	6.202	6.138
Cess on sales tax(estd.)	5% (on 10%)	0.3101	0.3069
*Turnover tax (estd.)**	3% of post-Central excise value of sales within State	1.8606	1.8414
State sales tax (actual)		3.28	2.21
Cess on sales tax(actual)		0.02	0.11
Turnover tax (actual)		0.55	0.61
Central sales tax on	on value estimated	0.2352	0.028
sales outside St. (estimd.)	at local sale price		
Central sales tax (a/cs.)		0.13	0.08
Ex-factory post-tax sales value **		65.32	63.7
*Entry tax (estimated)****	4% of post-tax sales value adding normative transport cost assessed for arrack by department	2.57	2.93

* Since turnover tax is not expected to be billed to the buyer, it is assumed to be part of the pre-Central excise price used by the Excise department for arrack pricing.

** Since there could be several reasons why actual tax realisations are different from estimates, actual realisations have been adopted

*** Molasses produced by sugar factories with attached distilleries are treated as not liable to entry tax as it is assumed that all the molasses is being used inhouse.

A2.39 "Excisable articles" defined in Section 5A of the Excise Act are subject to quantitative and allocative controls. Information is therefore available with the Excise department regarding quantities of such goods released for various purposes. Molasses is not an excisable good and there are no quantitative controls after the repeal of the Molasses Control Order of 1961 issued under the Central Industries (Development and Regulation) Act of 1951. However, the practice of seeking releases from the department for purchasing molasses continues in Karnataka. 4% of the sugarcane crushed is expected to be normally realised as molasses. The quantities obtained through sugarcane crushing for different sugarcane years are available with the Director of Sugar; figures are also collected by the Excise department from sugar factories for the excise year. We have relied on the latter, since they are likely to be more in line with tax revenue data maintained by the Finance department. Quantities of molasses released to distilleries and cattle feed units as well as for export have also been taken from the Excise department.

A2.40 The value of molasses produced by sugar factories has been computed on the basis of prices used by the Excise department for costing arrack. These are derived from actual prices obtained by sugar factories for molasses sold in the concerned years.

A2.41 As molasses is not treated as an excisable good subject to State excise duty, it is liable to Central excise duty at a specific rate of Rs. 500/mt. ***State sales tax*** is also levied at 10% of the value of molasses including excise duty. The sales tax rate was raised to 20% from 1/1/2000, but for the sake of convenience, 10% has been assumed for estimating tax for the entire period. A ***cess*** of 5% is also being levied on the sales tax amount apart from ***turnover tax*** (since we are dealing with large units, the relevant rate of TOT would be 3%). Estimated and actual figures of the three State taxes have been given in Table III. Reasons for the substantial differences between the two may require further examination. Since TOT is not expected to be billed to the buyer, although it has been computed on the post-Central excise ex-factory value of molasses consumed in the State, it is not added on to this price while computing the landed cost of molasses as input for rectified spirit.

A2.42 There is also an ***entry tax*** at 4% on the post-tax value (including cess but excluding TOT which is assumed to be covered in the cost of molasses). No entry tax is leviable on molasses used by integrated sugar factory cum distillery units; molasses produced by such units has been excluded for estimating entry tax revenue on the assumption that it is all likely to be used inhouse (which may not be totally the case). Since entry tax is levied on the value of the good at the point of entry into a local area, the tax base includes the transport cost, which does not form part of the base for sales tax and turnover tax. Transport charges assessed by the Excise department for input costing of arrack have been added on to the post-tax ex-factory value of molasses for estimating entry tax revenues. As noted earlier, in the case of sugar, actual realisations of entry tax are not readily available in the case of molasses also.

A2.43 Since molasses is an intermediate product directly transferred from sugar factories to distilleries, VAT realised at the sale point is likely to be fully credited against tax charged on rectified spirit. The value of molasses as input for the manufacture of RS has been computed using estimated (not actual) figures of entry tax, sales tax and cess, but turnover tax has been excluded for reasons mentioned earlier.

RECTIFIED SPIRIT:

A2.44 Rectified spirit and its further variants-neutral and extra-neutral spirit-are excisable goods for which allocation and distribution are controlled by the State Excise department. Technical ratios have been prescribed for quantities of RS expected to be realised from three grades of molasses-I, II and III-under Schedule A of the Karnataka Excise (Regulation of Yield, Production & Wastage of Spirit, Beer, Wine or Liquors) Rules of 1998 at 220, 200 & 180 bulk litres. Estimations have been made at Table IV of the quantities of rectified spirit expected to be realised from molasses released to distilleries within the State for 1998-99 and 1999-2000 using the technical ratio of 220 bulk litres of RS applicable to Grade I quality molasses. While actual realisation figures are slightly higher than expectations for 1998-99, there is substantial divergence in the second year, which needs to be further probed.

Table IV

TAXATION OF RECTIFIED SPIRIT-PRODUCTION POINT

Quantities in lakh lts., values	in Rs.crs.	'98-'99	'99-2000
Production for excise year (estimated)	Estimated on technical ratio for first grade at 220 litres/mt.	690.8	1023
Production for excise year (actual)	from Excise dept.	715.48	767.6
Releases:	Do.	700.63	794.55
-for potable alcohol		584.19	650.46
-other industrial uses		71.64	94.09
-export outside State		44.8	50
Landed cost of molasses for manufacture of RS (including transport and entry tax)	Do.	70.12	70.10

A2.45 Rectified spirit is refined to produce neutral spirit, which is used in the manufacture of Indian Made Liquor (IML) in blending units. Unrefined RS is used to produce country liquor or arrack in the two public sector undertakings (MSIL and Mysugar). Neutral and extra-neutral spirit are converted into denatured spirit (DNS) and made non-potable for release for industrial purposes. Data is not available to compute value addition at the point of refinement of RS into NS/ENS and conversion into DNS, since the Excise department treats all releases of spirit under the general head of RS. However, higher prices are realised for NS and ENS than for RS, which reflects the value addition to some extent.

A2.46 Like molasses, RS is an intermediate product, released for the manufacture of potable alcohol and other industrial products within the State and exported for similar purposes to other States. The tax regime differs with the use of the product. There is no Central duty on the production of RS, since it is an excisable product, subject only to State excises under constitutional provisions.

A2.47 Molasses accounts for around 70% of the production cost of RS. The value of other inputs used in producing RS is negligible, as also that of consumables like furnace oil, coal etc. used to generate steam. Consultations with sugar factories indicate that half a unit of power is required to produce a litre of RS. Distilleries attached to sugar factories use bagasse-based power and only have emergency diesel generation facilities as backup. Energy likely to be drawn by this sector from the KPTCL can be computed to estimate electricity duty that could be claimed as tax credit under the VAT on services. Water is also a major utility used by the sector; the quantity required is ten times the quantity of RS produced. At present there is no tax on water as a service.

A2.48 The landed cost of molasses for the manufacture of rectified spirit has been computed at Table IV by adding transport cost at normative levels fixed by the Excise department while determining arrack costing and estimated entry tax on the landed value of RS.

A2.49 The tax regimes for rectified spirit and prices obtained can be broadly bifurcated into two. In the case of country liquor (arrack), which only two public sector institutions (MSIL and Mysugar) are licensed to blend, government annually fixes the retail sale price; it also notifies the issue price from blending units to distributors while taking up annual auctions of vending rights. It further negotiates processing charges to be paid to the two licensed blenders of arrack. To ensure that supplies of rectified spirit are available to them at reasonable prices, it informally negotiates with manufacturers of RS and determines the rates at which MSIL and Mysugar will purchase spirit from them. These rates are likely to change in the course of the excise year while the issue price and the retail price remain constant. Sufficient margins are therefore provided for likely increases in RS during a year while fixing issue and retail prices. MSIL and Mysugar, however, only retain the margins permitted to them and remit the difference, if any, to government. Hence, for rectified spirit used for the manufacture of arrack, the average annual price at which spirit was purchased by MSIL has been used to determine values.

A2.50 The three other uses of spirit-for IML, industrial use and export-are likely to be in the form of neutral spirit which is a more refined (and therefore dearer) product. This component is therefore being costed at the rate indicated by distilleries during discussions.

Table V

TAX REGIMES FOR DISTRIBUTION OF RECTIFIED SPIRIT

'98-'99 quantities in lakh lts., values in Rs. crs.		potable alcohol				other industrial uses		export	
		Arrack		IML					
		estimated	actual	estimated	actual	estimated	actual	estimated	actual
Releases		320.3		263.88		71.64		44.8	
Pre-tax value of RS (after issue fee)	on rates given by MSIL for arrack&private distilleries for others	50.03		47.5		12.9		8.96	
Issue fee (per lt)	at Re.1(3 for expts.)	3.2	N.A.*	2.64		0.72		1.35	
State sales tax	at 20%	10	10.35**	9.5		2.58		x	
Cess	5% of 20%	0.5	.25**	0.48		0.13		x	
Turnover tax	3%	1.5	1.74**	1.43		0.39		x	
*Entry tax****	4%							x	
Central sales tax	4%	x	x	x	x	x	x	0.36	0.07
Post tax value(excl. entry tax)		60.53		57.48		15.61		9.32	9.03
'99-2000									
Releases		338.07		262.39		94		50	
Pre-tax value of RS (after issue fee)	on rates given by MSIL for arrack&private distilleries for others	49.02		41.98		15.04		8.5	
Issue fee (per lt)	at Re.1(2 for expts.)	3.38	N.A.*	2.62		0.94		1	
State sales tax	at 20%	9.08	11.29**	9.5		2.58		x	
Cess	5% of 20%	0.49	.54**	0.48		0.13		x	
Turnover tax	3%	1.47	.97**	1.43		0.39		x	
*Entry tax****	4%							x	
Central sales tax	4%	x	x	x	x	x	x	0.34	0.39
Post tax value(excl. entry tax)		58.59		51.96		17.75		8.84	8.89

* The Excise department has actual totals of issue fee collected for all uses including price differential paid for arrack.

** Only totals for all uses are availiable, these are lower than totals of estimates (22,.93 and 4.9 resp for '98-'99 and 21.16, 1.1 and 3.29 for '99-2000)

*** Not estimated since it is not leviable on blending units attached to distilleries.

A2.51 There are State excises as well as sales taxes on rectified spirit. Under the Excise Act, R.S. is subject to a specific issue fee for all uses, but there is a higher fee rate for exported RS. As for commodity taxes, RS exported from the State is liable to ***Central sales tax*** at 4% paid to the State of origin; that used within the State is subject to ***State sales tax*** (20%) and ***turnover tax*** (the applicable rate is 3%), ***cess*** (at 5% of sales tax) and ***entry tax*** at 4%. There is again a difference of taxable events as sales tax and related levies (excluding entry tax) are computed on the post-issue fee value and entry tax on the landed value at the blending unit (that is after transport cost). Estimations have been made for all levies except entry tax, although this could also be done by using actual data relating to production from blending units attached to distilleries, which do not pay entry tax. Actual tax collected is available for all levies except entry tax but it is not differentiated between different uses of RS (except for CST on exports). This could also be computed by the department. Actuals tend to be generally lower than estimates. Sales tax generates around three times the revenue generated by issue fee, because of higher rates and its *ad valorem* nature. Because higher prices are realised for NS, total values of RS used for arrack and IML tend to be roughly the same. Quantities issued for other industrial uses fluctuate; to some extent this depends on the extent of evasion.

POTABLE ALCOHOL: ARRACK

A2.52 There are two broad categories of molasses based potable alcohol produced and distributed in the State:
-country liquor (arrack) which is manufactured by the two public sector undertakings- Mysugar and MSIL-and released to successful bidders in auctions of vending rights conducted by the government at prices determined by the government and
-Indian Made Liquor (IML), which consists of various brands of gin, brandy, whiskey and rum (this is distributed through licensed wholesalers and retail outlets)

Table VI

TAXATION OF POTABLE ALCOHOL - ARRACK

		'98-'99	'99-2000
Quantities in lakh lts., values	in Rs.crs.		
Sales to distributors	from Excise dept.	882.79	886.83
Pre-tax value	Do.	102.75	103.94
Excise duty (estimated/lt.)	at Rs. 13.58&Rs. 17	119.88	150.76
Excise duty (actual)		118.8	143.92
Post-tax value(on actual ED)		221.55	247.86
Retail value	at minimum rate(45& 50)	397.26	443.42

A2.53 In the case of arrack, there is almost no carryover of stock from year to year. Hence releases authorised by the Excise department have been taken as equivalent to quantities sold. These have been valued at prices notified by the department before tax. Specific State ***excise duty*** is collected on quantities drawn by contractors; the minor difference between estimated and actual collections are due to inter-year payment adjustments alone. Since there is an annually notified price range for retail sale of arrack, the retail value of arrack is computed on the lowest price for the year. Excise duty on arrack generates substantial revenue for the State. There is no other commodity tax on arrack.

A2.54 Rectified spirit accounts for around 85% of the production cost of arrack. Power is not a major component and there are expenses on sacheting and bottling as well as on water. These can be easily computed from data maintained by the two public sector undertakings that blend arrack to project the interface with other sectors for preparing input-output tables and assessing credit that will be claimed on electricity duty and similar charges.

POTABLE ALCOHOL-INDIAN MADE LIQUOR (IML)

A2.55 Since we are only looking at RS based IML, this analysis is confined to whiskey, brandy, rum and gin, not to malt-based or grape-based varieties like beer and wine. It is difficult to make accurate computations for the sector as there is a widespread belief that duty is evaded by various methods like under-reporting production to the Excise department and using "seconds" to lower the average selling price. In Karnataka, IML is sold in the open market to licensed wholesalers and retailers. For these reasons, the quantities and values assumed by us can only be treated as approximations based on departmentally stipulated conditions relating to pricing and taxation. There is also substantial brand differentiation within the sector. Discussions with manufacturers, distributors and officials indicate that a substantial portion of the turnover of the sector is accounted for by varieties of whiskey and rum selling at retail values of between Rs. 200 and Rs. 400/litre if duty is paid and between Rs. 100 and Rs. 250/litre if duty is evaded. The quantities reported to have been sold by the department are likely to be affected by unreported cross-border movements of non-duty paid IML. For our analysis, the indicative basic price of Rs. 250/case assumed by the Excise department has been applied to quantities reported as produced and sold by the department; these are clearly underestimates.

A2.56 In the production of IML, rectified spirit accounts for around half the cost and packaging for around 5%. There is substantial water and power requirement. Energy is basically drawn from the KPTCL with backup inhouse arrangements. This could be computed for drawing up input-output tables and assessing likely VAT credits.

A2.57 ***State excise duty*** **and** ***litre fee*** were charged on IML along with commodity taxes ***(sales tax, cess and turnover tax)*** in the years under consideration. There is no entry tax on IML. The manner of calculating tax incidence of various levies is shown at Table VII. Excise duty at a specific rate is first levied and sales tax, cess and TOT charged on the post-excise duty value, after which a specific litre fee is computed. In the case of exports, the excise duty is at a much lower rate than for local consumption (Rs. 2.50/litre as against Rs. 45/litre). Excise duty and sales tax alone are levied on sales to the defence department but rates are lower than for other sales.

Table VII

TAXATION OF POTABLE ALOCHOL -IML

Quantities in lakh lts., values in Rs. crs

	'98-'99				'99-2000			
	Local sales		**Exports**		**Local sales**		**Exports**	
	Civil	**Defence**	**Civil**	**Defence**	**Civil**	**Defence**	**Civil**	**Defence**
Sales	155.88	56.37	169.59	120.08	183.37	24.48	208.03	86.22
Pre-tax value at minimum value of Rs. 250/case fixed by Excise department	43.29	15.67	47.11	33.36	50.94	6.8	57.79	23.95
Specific excise duty (estd.)	*70.14*	*8.46*	*5.93*	*1.2*	*82.51*	*3.67*	*5.2*	*0.86*
Post-excise duty value	113.43	24.13	53.04	34.56	133.45	10.47	62.99	24.81
Sales tax and CST (60% on local civil & 4% for d-efence-estimated)	68.058	0.9652	2.1216	1.3824	80.07	0.4188	2.5196	0.9924
Cess (5% of 60% estd.)	3.4029				4.0035			
Turnover tax(3% estd.)	3.4029				4.0035			
Litre fee(at 10 & 20 resp. estimated)	15.59				36.67			
Post tax value (estimated)	200.481	25.0952	55.1616	35.9424	254.19	10.8888	65.51	25.8024
*Excise duty (actual)**								
*Sales tax & CST(actual)**	260.29		7.6		211.19		7.27	
Cess (actual)	N.A.							
Turnover tax(actual)	N.A.							
Litre fee (actual)					37.91			
Wholesale value before tax **	210.51				266.89			
Sales tax (estimated)	48.89				58.06			
Cess (estimated)	2.44				2.9			
Turnover tax(estimated)	2.11				2.67			
Wholesale value after tax	261.84				327.85			
Retail value before tax	274.94				350.8			
Sales tax (estimated)	27.49				35.08			
Cess (estimated)	1.37				1.75			
Turnover tax(estimated)	2.75				3.51			
Retail value after tax	303.8				387.63			

* Commodity tax actuals apply to recoveries made at all points of the distribution chain. They are not available in a disaggregated manner. Separate figures for excise duty & litre fee are available only for '99-2000; excse duty figures apply to wine and fenny also.

** Commodity taxes are computed at the wholesale level by deducting the turnover that has suffered tax at the preceding point and excluding litre fee. Margins at both wholesale and retail level are in line with assumptions made in the first report of the Karnataka Tax Reforms Commission while estimating evasion on IML-Annexure XI

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A2.58 As regards inter-State movements, only negligible exports of molasses are officially recorded. In the case of RS, exports account for 5% to 6% of the production. Departmental data does not indicate any import of molasses or rectified spirit. There could be however entry of RS which goes undetected. Imported RS used as an input for industrial use is not liable to sales tax. A greater share of the IML produced in Karnataka is exported than consumed within the State. Recorded entries of IML into the State for '98-'99 and '99-2000 for civil consumption were 22.36 lakh litres and 13.2 lakh litres respectively. Non-defence imports are permitted only through a public sector undertaking-MSIL.

A2.59 IML is retailed within the State through licensed wholesalers to two retail channels: "wine-shops" or retail outlets and hotels, restaurants, bars and clubs. There was no further excise duty or litre fee during the years considered, but at both wholesale and retail levels, sales tax, TOT and cess were being levied on the turnover value at that stage after deducting turnover already subject to commodity tax at the preceding point as well as litre fee. Turnover tax is levied at 1% after the manufacturing stage. Distribution margins assumed at the wholesale and retail points are in line with those taken for estimating tax evasion on IML in the first report of the Tax Reforms Commission (Annexure XI of Chapter V).

A2.60 Surprisingly, the difference between actual and estimated revenues is not very different for excise-related levies and commodity taxes. Commodity taxes also yield at least 50% more revenue than excise levies. However, it should be noted that arrack rentals which are the most important source of excise revenue for Karnataka have not been treated as a tax for the purposes of this analysis.

A2.61 The present decision of the Empowered Committee seems to be to apply VAT at a high "special" rate of 20% with VAT. (There could then perhaps also be an additional specific excise duty which is not rebatable). The VAT component alone should yield Rs. 61 crs. to Rs. 78 crs. from IML. If arrack is also brought under this regime, a further Rs. 79 crs. to Rs. 89 crs. could be realised. In all, commodity taxes on the sector should yield between Rs.140 crs. to Rs. 170 crs. of revenue. Against this, actual realisations on commodity taxes from the sector (excluding entry tax and countervailing duty on IML for which data is not available) come to Rs. 284 crs. and Rs. 235 crs. for the years under consideration. (Estimated figures are much higher.) If the complex existing system is replaced by a rational and simplified VAT there will be fall in the existing incidence of commodity taxation. This could be compensated by increase in the excise duty. There will also be tax credit claims for liquor used in the hospitality industry. However, VAT could act as an internal control on evasion in the sector.

Major issues in taxing the manufacture and distribution of molasses based liquor

A2.62 The above analysis throws light on several critical issues concerning general commodity taxation as well as the taxation of demerit goods. The complexity of the existing tax structure is noticeable. It must be noted that there is specific Central excise duty on molasses since it is not an "excisable" commodity. At the State level, there are at least four commodity taxes-sales tax, turnover tax, entry tax and cess-at different stages and three specific excise levies-an issue fee on RS, excise duty alone on arrack and excise duty and litre fee on IML. Sales tax is a first point levy, TOT is used to capture later stages of value added, cess is earmarked for infrastructure development and entry tax is an additional impost which covers value added up to the wholesale level. Our analysis clearly reveals the perverse tax incentive for vertical integration inherent in the levy of entry tax itself, since entry tax is not payable by composite production units. (This is apart from the incentive arising out of cascading itself). There is also a difference between the tax bases of other commodity taxes and that of entry tax; the latter is computed on landed cost not ex-factory value. It is not clear whether users who take ex-depot delivery could exclude the transport charge component from the tax base; if so, there would be further equity and perverse incentive issues.

A2.63 There is a fair amount of evidence that lack of adequate coordination between the sales tax and Excise departments and data analysis within departments themselves are resulting in lower tax recoveries. Technical ratios statutorily prescribed seem to be met at the macro level only for the recovery of sugar from sugarcane; there are large variations between estimates and actuals in one of the years considered at least for the production of molasses as well as of spirit. This could of course be due to differences in annual cycles among the data sets used by us or estimation errors; nevertheless, it is worth further examination at the macro and micro levels, since there are major implications from the evasion point of view. There are also several areas in which both departments could disaggregate and examine data that is already available in the interests of better management. Some of them have been pointed out at different points of our analysis. Data-sharing between departments is essential too better administration and control of the sector as a whole if commodity taxes and excise duties are both imposed on the sector.

A2.64 Pointers have been given on estimation of tax credits of electricity duty paid for drawing energy at different points of the production chain when VAT is introduced on services; these could be used to generate input-output tables for the State. Water is a major utility consumed in production, but this is not subject to tax today. Whether it should be brought under service taxation requires study. Other services like transport would also be eventually liable to service tax. Current anomalies with regard to computing entry tax should disappear when VAT is levied since transport costs that are not captured at the wholesale stage would be included in the base for retail taxation.

A2.65 Our analysis has also identified the areas in which energy consumption independently billed by the KPTCL could be used to trace doctoring of capacity utilisation figures by distilleries and blending units to detect evasion.

A2.66 Central sales tax is collected on all exported items and issue fee at a higher rate charged only on export of RS. This component will disappear if VAT is introduced on potable alcohol. Imports are subject to CST paid to the State of origin as also to its excise duty regime. In Karnataka, imports are subject to countervailing duty, which equalises the incidence between duty liability within the State and that already discharged to the State of origin. Although imports are canalised through a public undertaking, data is not readily available on duty realised, but it could be gathered if required. Whether and how consignment transfers of IML take place and tax incentives in this area need further examination. However, it must be noted that official data on consignments is available with the Excise department since all movements of "excisable goods" are regulated by permits. Excise duty is also collected on consignment transfers since they apply to the production stage.

A2.67 The number of dealers to be tackled if VAT is introduced will not increase substantially even if arrack is subject to VAT since retailers are large contractors who have bid for exclusive vending within the district. As for IML, commodity taxes were being collected up to the retail level till very recently. In '99-2000 there were 304 wholesale outlets and 3798 retail outlets as well as 3640 hotels, restaurants and the like with licenses to vend IML. Collection from earlier intermediate levels of production is restricted to a few distilleries, sugar factories and blending units.

PETROLEUM PRODUCTS

A2.68 In Karnataka, petroleum products account for 31 % of the revenues from commodity taxation in '98-'99 (Annexure II of the First Report of the Tax Reforms Commission-12th February 2001). This applies only to that component which can be disaggregated among commodities, that is around 76% of total revenues. The manner in which commodity taxes should be applied to the sector is generally determined by revenue considerations as well as by the imperatives of energy conservation. Possible options would include value added taxation with input credit at a rate somewhat higher than the normal rate or an excise type levy with no credit. Since the sector has been subject to substantial pricing and distribution controls, State level consumption taxes are being collected from the few (mainly public sector) companies engaged in production and distribution. Data is available from these agencies for computing quantities handled and product values and tax realised at different points of the chain. The manner in which the current tax mechanism operates for different products has been detailed below with particular reference to two years (1998-99 and 1999-2000). An attempt has also been made to highlight some issues that arise in the context of value added taxation.

Existing pricing and distribution controls

A2.69 Petrol, diesel, kerosene and LPG are called "formula products" or Administered Price Mechanism (APM) products (the list included Aviation Turbine Fuel-ATF-till 2000-2001). Other products are called Free Trade Products (FTP). Petrol and diesel are governed by the Motor Spirit and High Speed Diesel (Regulation of Supply and Distribution and Prevention of Malpractices) Order of 1998 issued by the Ministry of Petroleum and Natural Gas of the Central government under the Essential Commodities Act, under which only oil companies authorised by the Centre are permitted to distribute these products. Kerosene is governed by the Kerosene (Restriction on Use and Fixation of Ceiling Price) Order of 1993 of the same Ministry, which provides for government control of distribution of kerosene through the public distribution system and outside (the "parallel marketing system"); only the former is subject to price controls. LPG is also governed by a similar order-the Liquefied Petroleum Gas (Regulation of Supply and Distribution) Order 2000-issued by the same ministry; here again there is price control only for distribution for domestic use. In 1997, Government of India has notified that price controls will be lifted with effect from April 2002.

A2.70 The major petroleum products are at present being distributed mainly by the four oil companies -IOC, HPC, BPC and IBP. Most of the kerosene that is "parallelly marketed" is routed through these companies themselves. In the case of LPG some multinationals have entered the distribution system, but they have targeted supplies only to commercial purchasers and the quantities involved are quite insignificant. The major FTP product in the market is furnace oil. Large industrial consumers sometimes purchase imported furnace oil directly from private sector suppliers, but here again, IOC sources indicate that this is not in large quantities. For all practical purposes, therefore, figures of petroleum products marketed by the major public sector oil companies can be adopted to assess consumption.

A2.71 The Oil Coordination Committee (O.C.C.), set up under a Government of India resolution of 1975, determines, on behalf of the Central government, gate prices for refineries and ex-storage prices for distribution companies in respect of APM products on the basis of import parity. The ex-storage price is on ex-depot basis for kerosene, which is supplied to the wholesaler from this point. In respect of petrol and diesel, however, it includes transport cost also (the O.C.C. fixes the principles on which transport cost is to be determined) since these products are delivered by the companies themselves to retailing pumps. Excise duty, sales tax and other local taxes are added on by approved distributing companies. Retail margins are also regulated. This means that although there is no system of equated freight, distributors could incur higher than normative costs in some regions and lower costs in others. These have to be absorbed within the pricing structure. To cope with cost increases, oil companies also seek increase in normative rates and reimbursement from the oil pool account. At present there is some degree of cross-subsidisation, since petrol prices are fixed using margins within which shortfalls incurred on products like kerosene can be accommodated. Subsidy may not totally disappear with removal of the oil pool account in April 2002. LPG is expected to carry a 15% subsidy and kerosene a subsidy of 33%, but this will be met through specific budgetary allocations.

A2.72 Because of the regulated pricing and distribution mechanism (except for non-PDS-that is imported-kerosene and non-domestic LPG), most of the information required for mapping value addition in the distribution of petroleum products in the State with reasonable accuracy can be obtained from public sector oil companies. Data pertaining to production has been made available by the only petroleum product producer in Karnataka-MRPL-which is in the private sector.

Production and distribution in Karnataka

A2.73 Figures of consumption of major petroleum products distributed through the four oil companies are given at Table VIII. They are petrol, diesel, kerosene, furnace oil and LPG. In 1999-2000 diesel accounted for close to half the volume and value of petroleum products consumed in the State. In the same year, petrol accounted for close to 9% in terms of volume and value wise, for more than 21% of the consumption in Karnataka. With increase in diesel prices, the relative shares of the two commodities in the value of consumption have been altered; overall they account for over 70% of the value of consumption in the State. Kerosene consumption seems to be on the decline. Furnace oil consumption, basically as an industrial input, is steadily increasing-in 1999-2000, it accounted for around 7% in terms of values and over 11% in terms of volumes. LPG consumption is also on the rise.

Table VIII

Petroleum products consumed in Karnataka

Product	1998-99				1999-2000			
	Volume	Value in Rs crs.	% volume	% value	Volume	Value in Rs. crs.	% volume	% value
Petrol	354965	1177.62	8.64	24.74	380639	1268.92	8.61	21.62
Diesel	1976545	2226.16	48.11	46.78	2138066	2958.65	48.39	50.42
Kerosene	534598	168.27	13.01	3.54	538975	175.31	12.20	2.99
Furnace oil	446651	280.00	10.87	5.88	494249	447.44	11.19	7.63
LPG	264797	275.40	6.45	5.79	312354	345.43	7.07	5.89
Others	530707	631.62	12.92	13.27	554260	672.24	12.54	11.46
TOTAL	**4108263**	**4759.07**	**100.00**	**100.00**	**4418543**	**5867.99**	**100.00**	**100.00**

* Unit rate net of taxes applicable for sales in Karnataka computed on the basis of returns filed by the oil companies with the Commissioner of Commercial Taxes has been applied to quantities imported into the State (as per data supplied by oil companies) which has been subjected to CST in the originating State.

A2.74 Shares of the four companies in sales of petroleum products in Karnataka are given at Annexure IX. I.O.C. appears to be the major distributor, accounting for 52% and 64% of diesel and kerosene respectively; these are two of the "formula products" subject to price regulation. In respect of diesel, BPC and HPC account for more than 20% of diesel sales, but the share of the former is only 13% in the case of kerosene sales. Sales are more evenly distributed among the three major companies in respect of petrol-IOC accounts for 38%, BPC for 31% and HPC for 25%-and LPG-the shares of the 3 companies are near 40% each for IOC and HPC and 20% for BPC. IBP has only limited sales of petrol, diesel and kerosene in Karnataka.

A2.75 MRPL is the only petroleum product manufacturing unit in the State. It manufactures all petroleum products (including "formula products") except lubricants. The breakup of petroleum products despatched by MRPL is given at Table X. MRPL's despatches have been stabilising over time and the company is yet to reach full projected capacity utilisation levels. Our analysis is confined to data relating to 1998-99 and 1999-2000. This indicates that the share of diesel in the total volume of MRPL production has been increasing as also that of FTP products. This could be partly due to technical reasons and partly to the existing system of price controls with low margins for kerosene sale. MRPL is producing more diesel than consumed in Karnataka and close to twice the petrol consumed in Karnataka. MRPL's kerosene production appears to be coming down to levels below the consumption requirement of the State, the reasons for which may have to be understood. Its production of furnace oil is, however, higher than the State's requirement. LPG sales are fairly stable. On the whole, production levels of MRPL are higher than the consumption requirements of Karnataka.

Table IX

Shares of different companies in sale of petroleum products in Karnataka

1998-99					
ITEM	COMPANY	VOLUME in mts	VALUE in Rs. crs.	% share in volume	% share in value
Petrol	IOC	133101	441.57	37.50	37.50
	HPC	89595	297.24	25.24	25.24
	BPC	111121	368.65	31.30	31.30
	IBP	21148	70.16	5.96	6
TOTAL		**354965**	1177.62	**100.00**	**100.00**
Diesel	IOC	1039561	1170.85	52.59	53.17
	HPC	396870	422.75	20.08	19.20
	BPC	482539	543.48	24.41	24.68
	IBP	57575	64.84	2.91	3
TOTAL		**1976545.00**	**2201.92**	**99.99**	**100.00**
Kerosene	IOC	341360	107.46	63.85	63.86
	HPC	115555	36.37	21.62	21.61
	BPC	68041	21.41	12.73	12.72
	IBP	9642	3.04	1.80	2
TOTAL		**534598.00**	**168.275**	**100.00**	**100.00**
Furnace Oil	IOC	313883	196.77	70.27	70.28
	HPC	98775	61.92	22.11	22.11
	BPC	33993	21.31	7.61	7.61
	IBP	0	0.00	0.00	0
TOTAL		**446651**	**280.00**	**100.00**	**100.00**
LPG	IOC	97978	101.90	37.00	37.00
	HPC	98778	102.73	37.30	37.30
	BPC	68041	70.77	25.70	25.70
	IBP	0	0.00	0.00	0
TOTAL		**264797.00**	275.40	**100.00**	**100.00**
Others	IOC	439196	511.45	82.76	80.97
	HPC	67367	77.99	12.69	12.35
	BPC	23522	40.01	4.43	6.33
	IBP	622	2.18	0.12	0.34
TOTAL		**530707.00**	631.62	**100.00**	**100.00**

1999-2000					
ITEM	COMPANY	VOLUME in mts.	VALUE in Rs. crs.	% share in volume	% share in value
Petrol	IOC	143000	476.57	37.57	37.57
	HPC	96391.00	321.23	25.32	25.32
	BPC	118252	394.08	31.07	31.07
	IBP	22996	76.63	6.04	6
TOTAL		**380639**	1268.51	**100.00**	**100.00**
Diesel	IOC	1117538	1546.45	52.27	52.27
	HPC	429197	593.92	20.07	20.07
	BPC	525999	727.88	24.60	24.60
	IBP	65332	90.40	3.06	3
TOTAL		**2138066.00**	2958.65	**100.00**	**100.00**
Kerosene	IOC	342343	111.36	63.52	63.52
	HPC	116641	37.94	21.64	21.64
	BPC	70265	22.85	13.04	13.03
	IBP	9726	3.16	1.30	2
TOTAL		**538975**	**175.31**	**100.00**	**100.00**
Furnace Oil	IOC	364800	309.04	73.31	69.07
	HPC	80829	86.42	16.35	19.31
	BPC	48620	51.98	9.34	11.62
	IBP	0	0.00	0.00	0
TOTAL		**494249**	**447.44**	**100.00**	**100.00**
LPG	IOC	124256	137.32	39.78	39.75
	HPC	124519	137.61	39.36	39.84
	BPC	63570	70.26	20.35	20.34
	IBP	0	0.00	0.00	0.00
TOTAL		**312354.00**	345.43	**100**	**99.93**
Others	IOC	427208	523.23	77.08	77.83
	HPC	90121	92.83	16.26	13.81
	BPC	36181	53.58	6.53	7.97
	IBP	750	2.60	0.14	0
TOTAL		**554260.00**	672.24	**100.00**	**100.00**

Table X

PETROLEUM PRODUCTS DESPATCHED BY MRPL

	1998-99 Volume (mts)	1998-99 Value (Rs.crs.)	1998-99 Share in volume-%	1998-99 Share in value-%	99-2000 Volume (mts.)	99-2000 Value (Rs.crs.)	99-2000 Share in volume-%	99-2000 Share in value-%
Petrol	694671	207.57	18.77	16.21	647224	264.03	14.11	14.43
Diesel	1611314	752.22	43.53	58.74	2437268	1054.54	53.13	57.64
Kerosene	545409	119.70	14.74	9.35	412880	159.31	9.00	8.71
LPG	100215	81.30	2.71	6.35	107869	122.99	2.35	6.72
Furnace Oil	555157	66.72	15.00	5.21	599927	68.75	13.08	3.76
Others	194450	53.09	5.25	4.15	382543	159.95	8.34	8.74
Total	3701216	1280.60	100	100	4587711	1829.57	100	100

A2.76 "Formula products" manufactured by MRPL are sold to HPC and IOC (small quantities in the latter case) in line with O.C.C. pricing norms. In the absence of alternative distribution systems, MRPL prefers to route other products too through the HPC network, although direct sales can be made to bulk customers also in small quantities. Thus, three systems of sale operate for MRPL today: "formula products" sold through HPC, "non-formula products" sold through HPC and direct sales of non-formula products.

Tax structure for production and tax benefit given to MRPL

A2.77 A comparison of the normal tax structure for the production of petroleum products for direct sale as well as for sale through HPC with that operating today for MRPL (which has been given tax benefits as an incentive for industrial investment) has been made at Table XI. Tax benefits have been given to MRPL for two phases of industrial investment. Under the first phase, the benefit extends for 11 years from the date of starting production, which is March 1996. Under the second phase, the benefit is for 14 years from the date of starting production (October 1999).

A2.78 In the normal course, inputs used in the production process-mainly imported crude and additives-are subject to entry tax in Karnataka. Additives are imported from outside the country and other States; they are also procured locally. Additives procured locally are subject to Central excise, State sales tax and turnover tax. Those procured from other States are subject to Central excise and Central sales tax. Inputs used in the manufacture of additives are also subject to relevant State and Central commodity taxes including entry tax (where applicable.). Under the first phase of investment, MRPL has not been given any entry tax benefit, but under the second phase, entry tax on imported crude is tax exempt and there is no cap on the amount of exemption that can be claimed by the company. At present, therefore, all additives (purchased locally or otherwise) are subject to 2% entry tax. Information could be gathered regarding actual entry tax realisations on inputs for further analysis.

Table XI

CONSUMPTION TAX STRUCTURE FOR PETROLEUM PRODUCTS-PETROL AND DIESEL

I. AT STAGE OF PRODUCTION: The only producer is MRPL

Existing situation			Existing situation with VAT	
Without tax concessions	**With tax concessions**		**Without tax concessions**	**With tax concessions**
Entry tax on inputs (mainly imported crude & additives)	Entry tax on additives bought within and outside State. (Crude is tax exempt from October 2000 for the second phase of the project)		Vat on inputs will be credited against VAT on products (Inputs from other States will be freed of VAT of those States at the point of entry for imported inputs, imports duty will be paid but VAT of intermediate States will be zero rated).	
(Since additives are manufactured products, after production, locally produced additives are subject to Central excise, State sales tax and TOT; additives bought from other States are subject to Central excise and CST. Inputs used in the manufacture of additives are also subject to relevant taxes, including entry tax)			Central excise on inputs will not be credited against State VAT but it will be credited against a Central VAT when such a levy is introduced.	

Table XI (contd.)

CONSUMPTION TAX STRUCTURE FOR PETROLEUM PRODUCTS-PETROL AND DIESEL

II. AT SALE POINT BY MANUFACTURER TO DISTRIBUTOR: Sold through HPC & directly to consumers

Existing situation				**With VAT**			
Without tax concessions		**With tax concessions**		**Without tax concessions**		**With tax concessions**	
(a) Products sold through HPC	**(b) Direct sales**	**(a) Products sold through HPC**	**(b) Direct sales**	**(a) Products sold through HPC**	**(b) Direct sales**	**(a) Products sold through HPC**	**(b) Direct sales**
Central excise duty when lifted from bonded warehouse				Central excise duty when lifted from bonded warehouse (with credit for Central VAT paid on inputs if there is Central VAT)			
Turnover tax on sales		Turnover tax &/or CST exemption/deferral up to specified limit-MRPL now avails of CST deferral, hence turnover tax is now being paid on sales.		VAT on sales?	VAT on sales	VAT on sales	VAT on sales
No sales tax at the State level since sales between notified petroleum companies are tax-exempt	Karnataka sales tax for local sales		Karnataka sales tax for local sales	Refund of VAT paid on inputs when sales made outside State			
Central sales tax when sold for consumption outside Karnataka				No CST when sold for consumption outside Karnataka			

A2.79 The commodity tax liability at the point of sale of petroleum products for distribution is different not only between local sales and exports; it is also different between direct sales and sales through oil companies (mainly HPC). In view of the regulated, cartelised distribution system for petroleum products in place today in the country, provisions have been made by States in sales tax laws exempting sales between petroleum companies from tax. The second proviso to Section 5(a) of the Karnataka Sales Tax Act stipulates that only sale by an oil company to a person who is not an oil company will be deemed to be a first point sale liable to tax. Explanation II to this provision also names the four public sector oil companies and MRPL as beneficiaries of this section. When controls are lifted and fresh companies enter the market in April 2002 too, some cartelisation of distribution might be inevitable in the petroleum sector to take advantage of economies of scale of distribution through the vast network that has been built up by public sector units over the country. Some private sector players may, however, prefer to build alternative networks to enable them to break into the existing customer base and increase market shares in competition with older entrenched players. It is not clear at this point of time how things are likely to develop when liberalisation takes place.

A2.80 In the absence of a provision in the Central Sales Tax Act comparable with those in the KST Act cited above, sales of petroleum products by MRPL for consumption outside the State (both to HPC and direct sales) should in the normal course have been subject to CST at 4% (CST accrues to the State of origin). For the first phase of investment, however, MRPL has been given a total tax benefit of Rs. 40 crores/year (without carryover) in the form of exemption of turnover tax and/or deferral or exemption of CST (the company can choose the kind of benefit it prefers). For the second phase of investment, the tax benefit ceiling has been raised to Rs. 250 crs./year.

A2.81 In Karnataka, sales between oil companies are exempt from sales tax but not from turnover tax. In the normal course, therefore, all "formula" and "non-formula" products sold by MRPL through HPC for consumption within the State should have been liable to turnover tax but not sales tax. While availing of the tax benefit given in the first phase, MRPL initially availed of both TOT exemption and CST deferral, but from 1999-2000, it has been paying TOT and setting off its tax benefit against CST deferral. This is probably for accounting purposes to reduce MRPL's corporate tax liability, since TOT is booked as expenditure and CST deferral as contingent liability. MRPL can sell"non-formula" products directly to users although it has not done so during the years under consideration. When this is done locally, KST will be charged but when such sales are made to other States, MRPL can claim the benefit of Central sales tax deferral. Direct sales would normally be made to final users not to resellers. State sales tax is collectable if "non-formula" products are thus sold for use as intermediate goods for further production. Direct sales are also made by HPC after collecting State sales tax on such sales. Since HPC's prices for direct sales would be higher than prices on direct MRPL sales, sales tax revenue realised at this point would be higher than at the point of MRPL's direct sales. For "non-formula" products, market demand determines retail prices, but there is some degree of cartelisation.

A2.82 However, there appears to be a distinct tax incentive for MRPL to make direct sales outside the State because of the CST benefit in preference to direct sales within the State, which are liable to KST. There is also an incentive to make sales outside the State through HPC by availing of the CST deferral benefit till the limit fixed for such deferral is reached. Since MRPL has chosen to take the CST deferral route, the tax benefit will not result in reduction of the retail sales price.

A2.83 Under normal circumstances, for the consumer outside Karnataka, if MRPL had chosen tax exemption and not deferral, at the inter-State sale point, in effect, CST would have been zero-rated. For "formula" products, the benefit for MRPL would have been increase of its market share by reducing prices and thus increasing sales, as under existing controls, there is no leeway for increasing the sale price for "formula" products. For "non-formula" products, if MRPL had chosen the exemption route, there would have been scope to appropriate some of the tax benefits. The extent to which the manufacturer, the distributor and the consumer would gain from the tax benefit will then depend upon market forces. However, the effect on the consumer is diluted by an adjustment made in the O.C.C. pricing formula for taxes charged on petroleum products at the production point. This is factored back into the price charged on such products consumed within the State. One consequence of this is that "tax exportation" through CST is eliminated. There is also reduction of the "tax room" for the State of origin which has to lower its domestic commodity taxes to ensure that inter-State differentials in retail prices are kept at a manageable level.

A2.84 By preferring deferral to exemption, MRPL has retained the tax benefit for itself and increased its cash flow; the tax proceeds become similar to an interest-free loan; the opportunity cost for MRPL is the marginal interest cost for working capital. From the petroleum pricing point of view, therefore, since the principles on which the retail sale price is to be fixed have been laid down by the O.C.C. for "formula" products, the company has planned its tax liability in such a manner as to utilise to the maximum the benefit available. However, CST benefit can be availed of only on sales made outside Karnataka; hence, there is a distinct incentive for MRPL to bill sales outside the State to HPC till the maximum amount of available benefit is reaped. In any case, because of OCC price adjustments, HPC and the customer outside Karnataka are not affected by CST levied or deferred/exempted in Karnataka. If price and distribution controls are removed and MRPL and others have to operate under competitive conditions, the incentive structure could change and MRPL might adopt a different choice of tax instrument within the range available under the present package to increase or sustain its market share. This could happen in a demand driven market.

A2.85 MRPL's products are bought by HPC for sale within and outside the State. MRPL has a distinct incentive to book sales on CST basis up to the limit for which tax benefits are available, since it would give them additional liquidity in terms of deferred tax. From HPC's point of view, in the absence of the OCC price adjustment, a CST sale would have added 4% of CST to the sales tax rate of the consuming State and also led to cascading. The sales would then have increased the final price of the product if the sales tax rate of the consuming State plus the CST rate had been lower than the sales tax rate in Karnataka. With OCC price adjustment, however, this does not happen today. HPC has a choice of transferring the product as a consignment which is a practice frequently resorted to for most goods to avoid paying CST. However, under Section 6 of the Karnataka Sales Tax Act (which is replicated in the tax laws of other States), dealers and manufacturers who have not paid tax for any reason on taxable products purchased by them are liable to pay purchase tax at the local rate if they make despatches on consignment basis. This would mean in the case of petroleum products a higher liability than by the payment of Central sales tax. A lower rate of 4% purchase tax has been notified by the State government for diesel.

A2.86 Table XII shows the share of MRPL in the different petroleum products consumed in Karnataka. Although the company's production of petroleum products is higher than the consumption needs of Karnataka, part of MRPL's production is being exported to other States. This must be due to technical and geographical constraints, as MRPL's production facilities are located in a corner of the State at Mangalore and parts of northern and eastern Karnataka could perhaps be supplied at a lower cost from outside the State. Such supplies will continue even after VAT is introduced and many of the effects of MRPL's tax incentives neutralised. Although today MRPL has an incentive to bill sales to HPC outside the State to take advantage of the CST incentive, HPC is likely to maximise local sales, other costs being the same.

Table XII

PRODUCTION OF PETROLEUM PRODUCTS BY MRPL

1998-99					
(In lakh mts.)	DIESEL	PETROL	LPG	KEROSENE	FURNACE OIL
Production	16.31	6.72	1.00	5.30	5.44
Despatches	16.11	6.95	1.00	5.45	5.55
(a) Within Karnataka	11.14	2.21	1.00	2.09	1.59
(b) Outside State	4.59	4.18	0.00	3.25	3.81
Total	15.73	6.40	1.00	5.34	5.40
Closing Stock	0.59	0.33	0.00	-0.04	0.04
Share in local consumption (%)	56.36	62.36	40.45	39.04	35.59
1999-2000					
(In lakh mts.)	DIESEL	PETROL	LPG	KEROSENE	FURNACE OIL
Production	24.46	6.25	1.09	4.01	7.09
Despatches	24.37	6.47	1.08	4.13	6.00
(a) Within Karnataka	11.15	2.55	1.08	1.94	1.01
(b) Outside State	12.87	3.61	0.00	2.19	4.83
Total	24.02	6.16	1.08	4.13	5.84
Closing Stock	0.43	0.09	0.01	-0.12	1.25
Share in local consumption (%)	52.15	66.97	34.84	35.91	20.43

A2.87 Introduction of VAT will substantially erode MRPL's tax incentive structure. All inputs, imported or local, will be subject to State VAT, which will be credited against VAT levied on petroleum products produced and sold by MRPL. There will be no entry tax on inputs used by MRPL. Central excise duties, which are uniform across the country, will be paid on inputs-imported and local-and not credited against State VAT. (If they are replaced by a Central VAT, there could be credits of Central VAT against Central VAT itself depending on the production chain).

Table XIII

COMMODITY TAXES ON PETROLEUM PRODUCTS DURING PRODUCTION (MRPL)

quantities in mts;values in Rs.crs

	'98-'99				'99-2000			
	Crude	**Additives**			**Crude**	**Additives**		
	(Imported)	(Local)	(Inter-St.)	(Imported)	(Imported)	(Local)	(Inter-St.)	(Imported)
Input values (before entry tax)	2004	12	611	649	4444	22.5	143	89
Entry tax on additives alone (locally bought additives also bear Central excise, State sales tax & turnover tax; inter-State purchases bear Central excise & Central sales tax-the latter paid to State of origin)	x	59			x	91.6		

A2.88 At the point of first sale of manufactured products, instead of State sales tax and turnover tax on local sales, there will be VAT, which might have to be levied on both sales between petroleum companies and direct sales. In the case of sales outside the State, there will be no CST; instead, VAT paid at earlier points will be refunded, the sales tax of the consuming State will be levied and revenue from this impost will accrue to that State. Hence, MRPL will not be able to avail of the CST incentive, which, in effect, means that the company will have to raise working capital finance at market rates, instead of using CST collected as an interest-free loan. Additional tax liability on this account will be offset by reduction in the erstwhile tax liability on entry tax and TOT. There will also be liquidity requirements for making upfront payments of VAT on input purchases since tax credit can be claimed only at the later stage of sale of petroleum products. Under the intra-State VAT that is now proposed, the intention is to convert sales tax and CST deferrals to exemptions on net present value basis.

A2.89 MRPL's manufacturing activity is fully run with internally generated power. It does not pay electricity duty since captive generation is exempt from duty. Whether a VAT on services would be applicable to such power may need to be examined. This would apply also to water consumption, which is not subject to tax today. Other services used in the manufacture of petroleum products would also be liable to service tax, which could be credited on VAT payable on finished products.

Tax structure for the distribution of petrol and diesel

A2.90 The tax structure in respect of petroleum products varies not only with the nature of the product and its different uses, but also with reference to whether it is subject to price controls or not. Petrol and diesel are being considered together since there is similarity in distribution mechanisms and limited substitution in use (for transport). However, diesel is primarily an input into the industrial and transport sectors so that if it is brought under the value addition concept, much of the tax realised would have to be credited.

A2.91 Central excise duty rates for petrol and diesel were being levied on *ad valorem* basis at the commencement of the periods considered. For petrol, the rate was 32% up to 10/10/99 and for diesel it was 16%. After that date the basic duty was reduced to 16% for petrol and 12% for diesel. A specific additional duty of Rs. 1000/kl.was also imposed from 2/6/98 and for diesel from 1999-2000. The present practice is for MRPL to transfer its product to the bonded warehouse and bill HPC or other distributors. Excise duty is billed and paid by the company that actually makes the sale to the user, locally or outside the State, when the product is released for this purpose on the value of the sale and all movements between companies prior to this event is treated as movements under bond. For oil companies this postpones the payment of excise duty to the moment of actual sale either to a user or to a retail pump. However, since movements between different distribution points add to the product cost, this also increases the quantum of excise duty charged and converts it under some circumstances from a tax on ex-factory value to one on wholesale value. The practice, however, is useful to ensure that transfer prices between companies are not manipulated to reduce duty incidence. The existing distribution mechanism provides for HPC as the principal distributor to formally account for almost all the production of "formula products" done by MRPL and transfer it (without actual movement) to other oil companies as required with further storage, transport and/or release being borne on their account. Inter-company transfers among the public sector companies are subjected to price adjustment under OCC criteria and all direct purchases by users are charged similarly. The only cost benefit for direct users is with regard to the retail margin provided for the retail pump.

Table XIV

TAXES ON PETROLEUM PRODUCTS SOLD BY MRPL (to mainly HPC)

(Rs.crs)	'98-'99								'99-2000							
	Formula Products				Non -formula Products				Formula Products				Non -formula Products			
	Diesel	Petrol	Kerosene	LPG	Furnace oil		Others		Diesel	Petrol	Kerosene	LPG	Furnace oil		Others	
					direct sales	to HPC	direct sales	to HPC					direct sales	to HPC	direct sales	to HPC
Ex-factory value before tax	752	207	119.7	81.3	x	66.72	x	52.39	1053.54	264.03	159.31	122.99	x	68.75	x	177.58
Central excise duty and additional	87.58	135.73	2.99	9.32	x	12.8	x	9.86	210.25	185.27	1.12	8.16	x	9.55	x	23.22
Central excise duty																
Ex-factory value after tax	839.6	342.73	122.69	90.62	x	79.52	x	104.78	1263.79	449.3	160.43	131.15	x	78.3	x	200.8

A2.92 Table XIII indicates the tax incidence for different petroleum products at the point of billing by the producer (MRPL) to the main distributor (HPC). The ex-factory value before tax of quantities released from the warehouse as indicated by MRPL and actual excise duty paid have been put together to arrive at the post-excise duty value for different products. As we have seen earlier, the State is supplied with petroleum products not only from MRPL but also from refineries outside the State belonging to public sector oil companies who also distribute imported products. Such transfers when they are made for distribution through retail pumps are on stock transfer basis, which has the effect of making them liable only to the commodity tax regime of the consuming State. However, when direct sales are made to users in Karnataka, CST is paid to the State of origin; this figure has been captured in Table XV under C form purchases. This quantity will under VAT be liable to tax within the State while transfers made from Karnataka to other States which now yield CST will be taxable by consuming States.

A2.93 Petrol is being distributed by direct sale and through retail pumps. Direct sales are made to consumers who are willing to take a full tanker load and have storage facilities and explosive licence. These could be industries, departments like defence and undertakings of the State or Centre like road transport corporations or railways. The tax regime applicable to each category depends upon differences in the schedule, but the price at which sales are made is charged to retail pumps that is net of dealer's commission.

A2.94 There has been some discussion regarding the applicability of turnover tax and cess to transactions between petroleum product distribution companies. Apart from this, sales tax and entry tax are not chargeable to such transactions, even when the product is physically moved from HPC's storage point by other oil companies to their storages since sales tax is not leviable on sales between oil companies and entry tax is not leviable on transactions in which transfer or delivery of product does not take place. State commodity tax liability for distribution commences therefore with the stage of sale of the product to the retail pump or directly to the user. The different regimes in place for petrol and diesel are given in Table XV (the normal rate for local sales is highlighted).

A2.95 There is only one tax rate for petrol, as there is no special rate for industries or recorded direct purchases from outside the State (under Form C). As for diesel, the following sales tax regimes existed during the years under consideration:
-Fishermen were exempted from sales tax based on indents issued by the Fisheries Directorate
-By a notification of 31/3/1995, diesel sold to the Electricity Board was charged sales tax at 4% subject to production of a declaration from the Board. From 31/3/1997, this rate has also been applied to diesel sold to industries as consumable and for use in captive power generation.
-Sales of diesel to the railways was brought under a special rate of 8% from 15/6/99, since purchases were being made from outside the State by paying CST to other States.
-The normal sales tax rate for petrol in '98-'99 and '99-2000 was 22% and for diesel it was 20%
-On direct inter-State purchases from outside the State, CST at 4% is paid to the State of origin.

Table XV

TAXES ON PETROL & DIESELSOLD TO PUMPS

Quantities in mts.values in Rs.crs.

	'98-'99						'99-2000					
(the normal tax rate has been highlighted)	**Petrol**	**Diesel**					**Petrol**	**Diesel**				
	Sales within State	**Sales within State**				**C form* purchases**	**Sales within State**	**Sales within State**				**C form* purchases**
	22%	0%	4%	8%	**20%**	4%	**22%**	0%	4%	8%	**20%**	4%
Quantities sold	356359	N.A.	193679	N.A.	1623165	159700	380765	16555	196983	5648	1759582	159296
Value before tax	1182.31	Do.	212.62	Do.	1833.77	179.88	1268.94	24.74	269.92	8.47	2435.05	182.17
Entry tax	23.65		0.59		4.85	N.A.	25.38					N.A.
State sales tax	265.31		8.52		367.28		284.75		10.8	0.68	487.01	
Cess/kl	12.57		2.2		19.04		13.43	0.06	2.38	0.07	16.03	
*Turnover tax**	36.18		3.22		23.09		38.83	0.31	26.99	0.83	24.35	
Value of sales to pumps	1483.84		223.93		2224.94		1592.5	24.8	283.1	9.22	3517.26	
Retail value**	1487.96		2665.89				1596.79					

* Turnover tax is not chargeable to the purchaser and is not added on while computing post-tax value.

** Retail margins fixed for pumps have been added to sale values of oil companies to estimate retail values; these have been added to estimated values of quantities imported from outside the State. The values apply to all tax categories

A2.96 Sales tax in the case of these products is computed on the post-transport value that is landed value (including it appears entry tax) since transport is generally arranged by the seller. Turnover tax is also computed on the same lines. (It was reduced from the normal rate of 3% to 1% for diesel from 16/5/98). There is no such problem with cess, since it is a specific duty at (Rs.100 for diesel and Rs. 250 for petrol). Entry tax is in any case always computed on the landed cost (2% for petrol; for diesel it was 2% up to 16/5/98 after which it was exempted). Commoditywise data regarding entry tax is not readily available but entry tax is payable on C form purchases. The purchase tax payable under Section 6 (referred to above) by oil companies on diesel was reduced to 4% from 14/5/98. Cess and TOT are also levied on purchase tax. Around Rs. 15 crs. were annually realised in 98-99 and 99-2000 as purchase tax and around Rs. 3 crs. as cess and TOT.

A2.97 Retail sales of petrol and diesel are made through pumps. Pump owners are treated as commission agents of distribution companies and all or part of the infrastructure used by them is treated as an asset of the petroleum company itself. At present, although the commission is added on while selling the product to the final consumer, State sales tax and cess are collected on the price net of commission. There is no retail tax liability as turnover tax is not leviable on second and subsequent sales through a notification. When VAT is introduced, it will have to be computed from a large number of retailers on the final sale price including commission, which has administrative implications. There is also some trade diversion on account of purchases made by the Railways from outside the State to avoid entry tax and TOT levied in Karnataka which do not exist in neighbouring States.

A2.98 There has been substantial debate as to whether and how VAT should be levied on petroleum products. Clearly, the tax regime will have to be different for different items. In the case of petrol and diesel itself, there are divergent views on the relevance of a full VAT with credit for taxes paid at earlier stages. In our view, since consumption of these products requires to be restrained in the interests of energy conservation, it is desirable to subject these commodities to a high special rate of 25%. This is similar to the approach adopted by the Empowered Committee of State Finance Ministers. On the issue of whether credit should be given to tax paid at earlier stages, a possible alternative is to levy a non-creditable retail sales tax on petrol by treating all sales as final consumption and allowing VAT-type credit for diesel which is widely used in industry as input (for captive generation of power) and in the service sector for commercial transport. The scope for evasion of RST (in the absence of VAT) may not be high as long as present controls continue. Since these are likely to be soon removed, the matter may have to be further reviewed. The Empowered Committee seems to have decided not to bring both products under VAT credit at this stage.

A2.99 If petrol is subject to a retail sales tax, it might have to be collected from several retailers. There were 1049 pumps of oil companies in the State in '99-2000. This administrative issue could also be handled by collecting tax from the petrol companies but charging it to the retail value. Such a tax would yield in the case of petrol Rs.375 crs. and Rs. 400 crs. This is around Rs. 40 crs. more than the revenue realised today from this product on account of various State level commodity taxes today. Since a substantial component of the tax realised from diesel is likely to be claimed as credit when VAT is instituted, we have not estimated the revenue that can be realised if diesel is subjected to VAT with input credit.

A2.100 Petrol and diesel are also major inputs into the transport sector. Under a full-fledged VAT on goods and services, VAT paid on these items will have to be set off against the service tax on transport (a substitute for the tax on passengers and goods transported by road). The likely tax credit could be estimated using figures relating to transport vehicles registered in the State and applying norms regarding consumption of petroleum products.

Kerosene:

Table XVI
TAXES ON KEROSENE DISTRIBUTION

quantities in mts.values in Rs.crs.

	'98-'99		'99-2000	
	Consumer categories		Consumer categories	
	4%	10%	4%	10%
Quantity sold	530067	7388	531504	6904
Ex-depot value before tax	161.32	7.82	165.59	9.56
State sales tax	6.45	0.78	6.62	0.96
Cess on sales tax	0.32	0.04	0.33	0.05
Turnover tax	4.84	0.23	4.97	0.29
Landed value at wholesale point	182.47		186.95	
Landed value at retail point	183.56		188.04	
Retail sale value	200.83		205.36	

A2.101 Kerosene for the public distribution system is allotted to the State by the Government of India on the basis of requirements computed as per ration card entitlement; cardholders with two gas cylinders are not entitled to kerosene on PDS, those with one gas cylinder get less than the usual ration. Kerosene meant for public distribution is sold by oil companies to wholesale agents licensed by Deputy Commissioners (DCs) of districts or the State Directorate of Civil Supplies. DCs attach groups to retailers to each wholesaler and allocate supplies from oil companies to them after determining wholesale and retail margins and prices on the basis of the guidelines laid down by the Central Department of Food and Civil Supplies. Kerosene sold through the Public Distribution System is subject to sales tax at 4%; that through parallel marketing to the normal rate of 10%; there is also cess at 5%of KST. Kerosene is not subject to entry tax. It was indicated by oil companies that the major demand is within PDS and there is negligible "parallel marketing" by them as well as others. The oil company makes deliveries to wholesalers and charges transport and service charges, but these do not form part of the tax base for computing commodity taxes.

A2.102 The tax incidence on the distribution of kerosene is shown in Table XVI. Once kerosene is delivered to the wholesaler, there is no further tax liability, since turnover tax is exempt for second and subsequent sales and there is no entry tax on kerosene. There is a Central excise duty on kerosene at 8%. Since kerosene is primarily consumed by poorer sections of the population there is a case for subjecting it to a VAT rate of 4% as decided by the Empowered Committee. This would generate a revenue of around Rs. 8 crs. per year. The combined incidence of State and Central duties today is around 7% to 8% of which around 1% to 1.5% is on account of Central duties and the rest from State taxes. The revenue is likely to come down by around Rs. 5 crs. to Rs. 6 crs. if VAT is kept at 4%. When price controls are removed also, there may not be much increase in the demand for kerosene.

LPG:

Table XVII

TAXES ON LPG DISTRIBUTION

quantities in mts.values in Rs.crs.	'98-'99 Consumer categories			'99-2000 Consumer categories		
	4%	**10%**	**C form purchases***	**4%**	**10%**	**C form purchases***
Sales		244848	19052	1946	303641	5566
Ex-depot value before tax		251.2	19.56	4.76	332.59	6.15
State sales tax		25.12		0.19	33.26	
Cess on sales tax		1.26		0.01	1.66	
*Turnover tax**		7.54		0.14	9.98	
Ex-depot value after tax		277.58		4.96	367.51	
Landed value at retail point		282.14			382.55	
Retail value of sales including direct purchases by users**		301.79			393.09	

*not charged to customer and hence not added for computing post-tax value

** estimated by adding on permitted dealers' margins for sales done through distributors

A2.103 LPG presents a fairly interesting picture since there is some value addition within the State. It is bottled by the 3 major oil companies within the State. Much of the requirement of cylinders for bottling LPG is manufactured by approved dedicated vendors in Karnataka and other States. At present, they are sold on CST basis (and physically moved too!) to the branches of the manufacturing companies outside the State, although the KST on cylinders is at the same rate of 4% as CST. This is to avoid TOT and cess which are leviable in Karnataka if local cylinders are purchased. Cylinders of other States are bought by oil companies in Karnataka paying CST and vice versa. Cylinders are owned by oil companies and leased to users. For tax purposes, they are treated as capital goods not as packaging. The value added on account of cylinders and the tax regime applicable to them could be computed by the department by obtaining the relevant data.

A2.104 In addition to Central excise duties charged at 8% at the point of sale from the manufacturer, State level commodity taxes-sales tax, cess and turnover tax but not entry tax-are charged at the point of sale to the distributor. Margin fixation is similar to that for petrol and diesel. Sales tax is charged at 10% for domestic use and 4% for industries, cess is 5% on the sales tax and the turnover tax rate applicable is 3%. There is no TOT at the retail point, since this has been exempted by notification. In this case, TOT, cess and sales tax are computed on landed cost that is transport charges are part of the tax base.

A2.105 When VAT is introduced, it is desirable to levy the normal rate of 10% on this item as resolved by the Empowered Committee of State Finance Ministers. This should yield a revenue of between Rs. 31 to Rs. 39 crs (Annexure XVII). State commodity taxes of different kinds today yield a total revenue of between Rs. 35 crs. to Rs. 44 crs. There may not be much effect on revenue if VAT is introduced. Central excises add a further burden of 2.4% to 3% to this item. When VAT is introduced, the number of retailers from whom tax is to be collected could go up. At present, there are 386 distributors in the State. It would be desirable to encourage them to opt for the VAT regime.

Furnace oil

Table XVIII

TAXES ON FURNACE OIL DISTRIBUTION

quantities in mts.values in Rs.crs.	'98-'99 Consumer categories			'99-2000 Consumer categories		
	4%	**10%**	**C form purchases***	**4%**	**10%**	**C form purchases***
Sales	175625	15641	255384	169273	10941	314034
Ex-depot value before tax	111.08	8.83	160.09	159.26	8.85	292.94
Entry tax	4.44	0.35		6.37	0.35	
State sales tax	4.63	0.92		6.63	0.92	
Cess	0.23	0.05		0.33	0.05	
Turnover tax	3.47	0.28		4.97	0.28	

A2.106 This is solely an industrial input which is sold both directly as well as through distributors. The tax regime for direct users is low (4%) since the product is mainly used for captive power generation. Most of the tax collected at present is likely to be adjusted as credit under VAT. The applicable entry tax rate is 2%, the normal sales tax rate is 10% and TOT is levied at 3%. Cess at 5% is also levied on the sales tax. Revenue computations have not been made by us in view of the likely tax credit. The Central excise duty at the manufacturing point is 16%. The Empowered Committee of State Finance Ministers has resolved to levy the basic VAT rate on this commodity. Details are furnished in TableXVIII.

TEA

A2.107 Tea is a commercialised agricultural commodity requiring some degree of processing produced in well-defined regions. Under the existing hybrid origin and destination based sales tax systems, it yields revenue to a few producing States and many consuming States. When a destination based VAT is imposed on such a commodity, revenue yields are likely to shift among States. Major processing and marketing companies have all-India and international operations and sales. This implies large scale inter-State and export movements of goods in raw, semi-processed and processed form. Under the existing legal requirement of payment of Central sales tax on inter-State transactions and scope for consignment or branch transfers, companies minimise costs and maximise profits by managing tax liabilities. It would be interesting to look at whether inter-State transaction methods and accounting procedures will change substantially when VAT is introduced on inter-State sales, particularly since the commodity is not bulky but easily transportable.

A2.108 Data required for this study has been furnished by the two main players in the Indian market-Hindustan Lever and Tata Tea who together account for around half of the tea consumed in Karnataka. For reasons of confidentiality, we are not disclosing information relating to individual companies. Projections for the sector as a whole for the State have been made based on statistics drawn from the two companies, their perceptions about production and market potential and these have been validated by drawing on external indicators available from sector-specific market studies commissioned by individual companies, industry associations or promotional organisations (like the Tea Board), statistical surveys conducted by the National Sample Survey Organisation and similar agencies, where necessary and feasible.

A2.109 Industry practice is to purchase dried tea leaves from estates at auctions. Some tea is also produced in farms owned by the companies themselves. Most of the tea handled by Tata Tea is from their own estates while HLL makes substantial purchases at auctions. Further processing is limited to blending and packaging in sizes suited to the market. The most popular packaging sizes are 250 gms.and 100 gms. Companies have their own processing units at many locations all over the country. Occasionally packaging is outsourced to smaller units. Tea that suits the taste of a major consumer centre is blended and packed at a processing facility close to the centre. It is then transported for sale to the depots of c. & f. agents of the company who in turn sell packaged tea to redistributors (wholesalers) from whom it moves to retailers. Most of the tea is purchased in Assam and Kerala. Karnataka has only negligible tea production in Coorg district.

A2.110 HLL has one processing facility in Karnataka at Dharwar and Tata Tea one at Bangalore. The estimated quantum and value of tea processed by them would account for much of the tea processed in the State. At Table XIX, the quantities of tea exported from and imported into Karnataka by the two companies and the quantum consumed have been estimated and presented. Consumption figures for 1999-2000 have been estimated after considering the following:
-the market shares of leaf tea and dust tea in the State
-making projections from the market shares of Tata Tea and HLL for dust tea and leaf tea (Tata Tea deals almost totally in dust tea in Karnataka)

-estimating the market share of unbranded loose tea
-by adjusting per capita consumption figures for the country of 650 gms.downwards to take into account the lower tea demand in Karnataka and applying it to 2000 census population figures.
-looking at consumption data available from the NSS household survey for dust tea and making estimations from data about the cups of tea consumed in cafes.

A2.111 Information is also likely to be available from the Tea Board on production, movement, inventory and consumption, which could be used for greater accuracy. Market studies done by major players or industry associations could also be accessed.

Table XIX

(1999-2000)

	Quantity (tonnes)	**Value (Rs.crs.)**
Production*	18460	195
Import*	10549	116
Export*	15167	190
Consumption**	27000	378

* Figures pertain only to Tata Tea & HLL who account for half the consumption & much of local processing. Production value is based on values booked by companies, imports & exports are as valued for intra-company transfers

** Computed at an average rate of Rs.14000 per tonne

Table XX

TAX INCIDENCE ON TEA & VALUE ADDED

	Rs.	**Value**
Ex-depot price/tonne before tax	106000	286
Sales tax at 10%	*10600*	*28.6*
Cess at 5% on sales tax	*530*	*1.43*
*Turnover tax at 3%**	*3180*	*8.6*
Ex-depot price/tonne after tax	117130	316
Wholesale price after adding sales margin	124451	336
Turnover tax at 1%	*1245*	*3.36*
Retail price (MRP)	140000	378
Turnover tax at 1% on retail price (MRP)	*1400*	*3.78*
Tax revenue estimated	*16955*	*45.77*
Tax revenue realised		18
Revenue realisable at 10% VAT		*37.8*
Value added at wholesale point	7321	20
Value added at retail point	15549	42
Central excise & cess @ Rs.2.3/kg.	*2300*	*6.21*

A2.112 Inventory carryovers for tea tend to even out across years. HLL has 2 c&f depots at Hubli and Bangalore and Tata Tea has 3 depots at Bangalore, Hubli and Mangalore.

A2.113 The tax incidence on tea can be seen at Table XX. We have assumed an average MRP (retail price) of Rs. 14000/tonne and worked back using margins given and taxes levied to arrive at ex-depot and wholesale prices. Turnover tax is levied at all three levels-on sales by manufacturer, wholesaler and retailer. Since it is not allowed to be billed to the purchaser, it is computed and treated as absorbed within the margin. 3% is the TOT rate for ex-depot sales and 1% for subsequent sales at the wholesale and retail levels. Entry tax is not levied on tea.

A2.114 Estimated commodity tax revenue from tea is around Rs. 46 crs.; actual realizations are around Rs. 18 crs. The difference may to some extent be due to sales of loose and unbranded tea and sales done by smaller dealers. A 10% (basic rate) VAT on tea should yield around Rs. 38 crs.

A2.115 The two major processors and distributors of tea in the country manage inter-State transfers on branch transfer basis. They pay sales tax in the State of origin on tea bought at auctions. These rates are low (between 2% and 4%). There is also excise duty of Rs. 2 and cess of 30 paise per kg paid to the Central excise department at the point of dispatch from the factory to the processing and packing unit. Central excise duties and taxes paid in Karnataka alone account for tax incidence of around 13.75% on tea. The actual incidence is likely to be higher if we take sales tax to the State of origin and taxes paid on inputs used in processing and producing tea.

A2.116 An interesting issue is whether these companies will move over to sales on CST basis when VAT is introduced. Under an intra-State VAT, there may not any change in functioning. When inter-State VAT is introduced, tax paid to the State of origin will have to be refunded; States like Assam and Kerala will lose some revenue on this account. The branches of these companies will be registered as dealers in different States and transfers among them will be accounted for. If the definition of sales is modulated to permit such transfers to be also considered as inter-State sales for the purpose of VAT, input tax credit might be permissible. If this does not happen, transfers that continue on consignment basis will not be eligible for such credit on taxes paid to the State of origin and those paid on inputs used in producing and initial processing of tea at tea gardens. The financial and other implications of such a tax regime would have to be considered by such companies while taking a decision on whether to adopt the consignment or CST route.

A2.117 At the processing point, inputs used are mainly packing material, on which (apart from taxes "embedded" through inputs during manufacture) an entry tax of 1% is also charged. The value of packing material in the final value of processed tea is negligible. Diesel and electricity as well as water are used to a very small extent. Electricity is drawn from the KPTCL. When VAT is introduced, duty paid on such intermediate inputs will have to be set off if the product is sold on CST basis.

CHAPTER III

VALUE ADDED TAXATION OF SERVICES

CHAPTER III

VALUE ADDED TAXATION OF SERVICES

Raison d'etre for a value added tax on services

3.1 A major issue still to be resolved before shifting to VAT concerns service taxation. From the revenue viewpoint itself, exclusion of services from the tax base is unjustified given the predominant share of the tertiary sector in NSDP. We have already touched on the growing importance of this sector at Chapter I of the present report as well as in the first report of the Commission. Only very few specified services are statutorily subject to taxation today. Other services yield some revenue in an indirect manner to the extent that their cost is embedded in the prices of taxed commodities. As long as they are kept outside the tax base, it will not be possible to develop a modern, productive, buoyant and equitable tax structure. We must remember that a comprehensive tax on consumption, which extends to both goods and services, will permit us to lower commodity tax rates and realise increased revenue by extending the tax base.

3.2 There are also compelling economic reasons for service taxation. Both goods and services create utilities and satisfy wants and are used for production and consumption. In the modern world, it is essential to recognise their interdependence in all economic activity. Taxation of goods cannot be divorced from that on services since it is becoming increasingly difficult to draw a distinction between the two. Manufacturers provide services related to goods like training, advertisement, installation and maintenance. But goods by definition are tangible and movable products. Commodity taxation cannot, therefore, cover activities like fabrication and erection, which are integrally linked to several goods. For taxpayers and administrators, laboured legal interpretations are all that separate goods from services, which is a highly unsatisfactory state of affairs. Such differentiation has become obsolete in the globalised economic environment. Failure to tax services leads to cascading and distorts consumer choice by encouraging expenditure on goods at the expense of services and spending.

3.3 The piecemeal taxation of services in the country today violates the canons of equity and neutrality on which a sound fiscal structure should be built. Exclusion of services creates a bias not only in favour of services but also in favour of goods with a high service component or large trade margins (generally luxury goods), encourages producers to push trading functions forward to keep down the assessable value of their products and discriminates in favour of sole distributors, especially those who deal in imported goods, who usually provide a higher level of marketing services with costs embedded in the manufacturer's price. It also discourages standardisation by favouring on site setting up of a plant or building. The resulting unequal distribution of the tax burden affects consumer choices and militates against industrial activity.

3.4 The arguments in favour of VAT on goods apply with equal force to services. If the most desirable method of taxing goods is through VAT, it is also the ideal method for taxing services. Since value added taxation requires setting off tax paid on inputs at subsequent stages, taxes have to be levied on services too and setoffs given to avoid distortions in economic activity.

3.5 In the present chapter, after briefly examining the Constitutional and statutory position, we have considered the principles underlying general service taxation and the manner in which the power to levy service taxes should be shared between the Central and State governments in the context of the proposed VAT on goods. We have also examined in greater detail each of the taxes levied by States today-electricity duty, luxury tax and betting tax-which are akin to taxes on services. Comments on another such tax, the entertainment tax, have already been offered in the Commission's first report.

Constitutional and statutory basis

3.6 Service taxation in the country is based on outdated Constitutional provisions that cry out for reform. Both the Centre and the States enjoy limited powers to tax services in accordance with scattered Constitutional references. There is no reference to service tax *per se* in the Consitution. The Supreme Court did not support attempts made by States to extend the ambit of commodity taxes to goods involved in works contracts, leasing and hire purchase. This culminated in the 46th Constitutional amendment of 1983, which inserted item 29A into Article 366 (a miscellaneous Article to define ambiguous Constitutional terms). "Tax on the sale or purchase of goods" was defined to permit sales tax to be levied on the goods component of a indivisible works contract. The taxable event for transactions like leasing and hire purchase were also clarified by this amendment. However, identification of the goods and services components of works contracts continues to be done by specified allocation formulae in many areas. Such complications would disappear if services were also brought under sales taxation. In general, however, service taxation is treated as falling within the residual power of taxation of the Central government (Entry 97 of the Central list).

3.7 Several areas of service taxation are, however, specified in the State list-these include electricity duty, entertainment tax, betting tax, luxury tax and even tax on passengers and goods carried by motor vehicles. Entry 53 of List II (the State list) under the Seventh Schedule of the Constitution authorises States to levy taxes on the consumption or sale of electricity. Entry 56 extends the power to taxes on goods and passengers carried by road or on inland waterways. Item 62 of the same list covers taxes on luxuries, including taxes on entertainments, amusements, betting and gambling. Such taxes are levied independently under separate statutes with their own procedures, rates and well-established administrative mechanisms. There is substantial disharmony among States in this area in tax structures, bases, rates and exemptions. An added problem is that of the level at which the tax competence is exercised, since levies like entertainment tax have been partly or wholly shifted to local bodies in a few States. Many States have also chosen not to levy a separate tax on goods and passengers carried by road mainly for administrative and taxpayer convenience and have merged the impost with basic motor vehicles tax. Entry 55 of the State list also permits States to tax advertisements other than those in newspapers and advertisements broadcast by radio or television. Apart from local body levies on billboards, there may be little scope for States to levy such taxes. The power to tax the major items excluded from Entry 55 of the State list perhaps forms part of the Central residuary tax power.

3.8 Entry 89 of the Central List also permits the levy of "terminal taxes on goods and passengers carried by railway, sea or air and taxes on railway fares and freights" the proceeds of which were to be distributed among States on principles to be laid down by the Finance Commission (Article 269-d). Such taxes have long been defunct and the compensatory grant given to States has been merged with general grants under the amended Article 269 of 2000 (the 80th Amendment).

Revenue significance of service taxation

3.9 The following tables prepared by Dr. M. Govinda Rao (2001) give an overview of relative State and Central shares in service tax revenue in the country today. He has pointed out that while income from the service sector (excluding public administration and defence) constitutes more than a third of total GDP, indirect taxes collected from the secotr by both governmental levels is only 1% of GDP or 6.6% of total tax revenue. This has been the position since 1985-86, which indicates that the levy of service tax by the Centre in 1994 has not made a material difference in revenue terms. Almost 80% to 85% of service tax revenue is collected by States, even if we exclude revenue from sales tax on works contracts and tax on passengers and goods carried by road (to the extent that the latter is merged with general State motor vehicle tax). Such State taxes are not responsive to NSDP growth and the relationship may even be negative. State governments have in some cases even proposed dropping electricity duty or tax on passengers and goods to provide relief to Electricity Boards and Road Transport Undertakings. Central service tax revenues seem to be positively related to the share of services in GDP but since they account for only one-fifth of overall service tax revenues, this may not significantly improve the productivity of service tax.

3.10 Table II indicates that States generally realise a marginal component of own tax revenues from service taxes. The range in 1998-99 was from .3% in West Bengal to 2.3% in Gujarat. The levies are also unsystematic and unrelated to NSDP growth, which indicates inequitable distribution of the tax burden. In Karnataka, such taxes account for only around 1% of own tax revenues. The contribution of service taxes is higher in Gujarat, Haryana and Madhya Pradesh, perhaps because these States have retained the tax on passengers and goods as a separate levy.

Table I

Revenue from taxes on services in the country

Year	Share of services in GDP	Percentage of service tax revenue to GDP			Percentage of service tax revenue to total tax revenue		
		Centre	States	Total	Centre	States	Total
1985-86	35.56	0.03	1.02	1.06	0.41	11.81	6.17
1986-87	36.34	0.03	1.06	1.09	0.40	11.87	6.20
1987-88	36.28	0.04	1.02	1.06	0.49	11.14	5.92
1988-89	35.45	0.06	1.00	1.06	0.72	11.42	6.03
1989-90	35.85	0.09	0.93	1.01	1.01	10.39	5.74
1990-91	36.24	0.09	0.88	0.97	1.09	10.14	5.64
1991-92	37.48	0.10	0.90	1.00	1.21	10.06	5.72
1992-93	37.91	0.09	0.89	0.98	1.16	10.03	5.78
1993-94	39.61	0.08	0.85	0.93	1.20	9.69	5.98
1994-95	39.82	0.13	0.85	0.98	1.75	9.69	6.08
1995-96	40.91	0.16	1.10	1.26	2.09	12.59	7.67
1996-97	40.69	0.16	0.80	0.97	2.14	9.36	5.98
1997-98	41.36	0.34	0.84	1.18	4.93	9.61	7.70
1998-99 RE	41.11	0.19	0.81	1.00	2.75	9.75	6.66

Note 1. GDP from services is GDP at factor cost from elect., gas & water supply, trade, hotels & restaurants, transport, storage & communication, financing, insurance, real estate & business services and other services

2 Service taxation includes expenditure tax, hotel receipts tax, tax on vehicles, goods and passengers, entertainment tax, electricity duty, inter-state transit duties, newspaper advertisement tax, education cess, taxes on raw jute and betting tax.

Source: National Accounts Statistics and Indian Public Finance Statistics

(The table is drawn from the paper on "Taxing Services: Issues and Strategy" presented by Dr. M. Govinda Rao at the World Bank conference on India: Fiscal Policies to Accelerate Economic Growth at Delhi in June 2001)

Table II

Taxes on services of major States

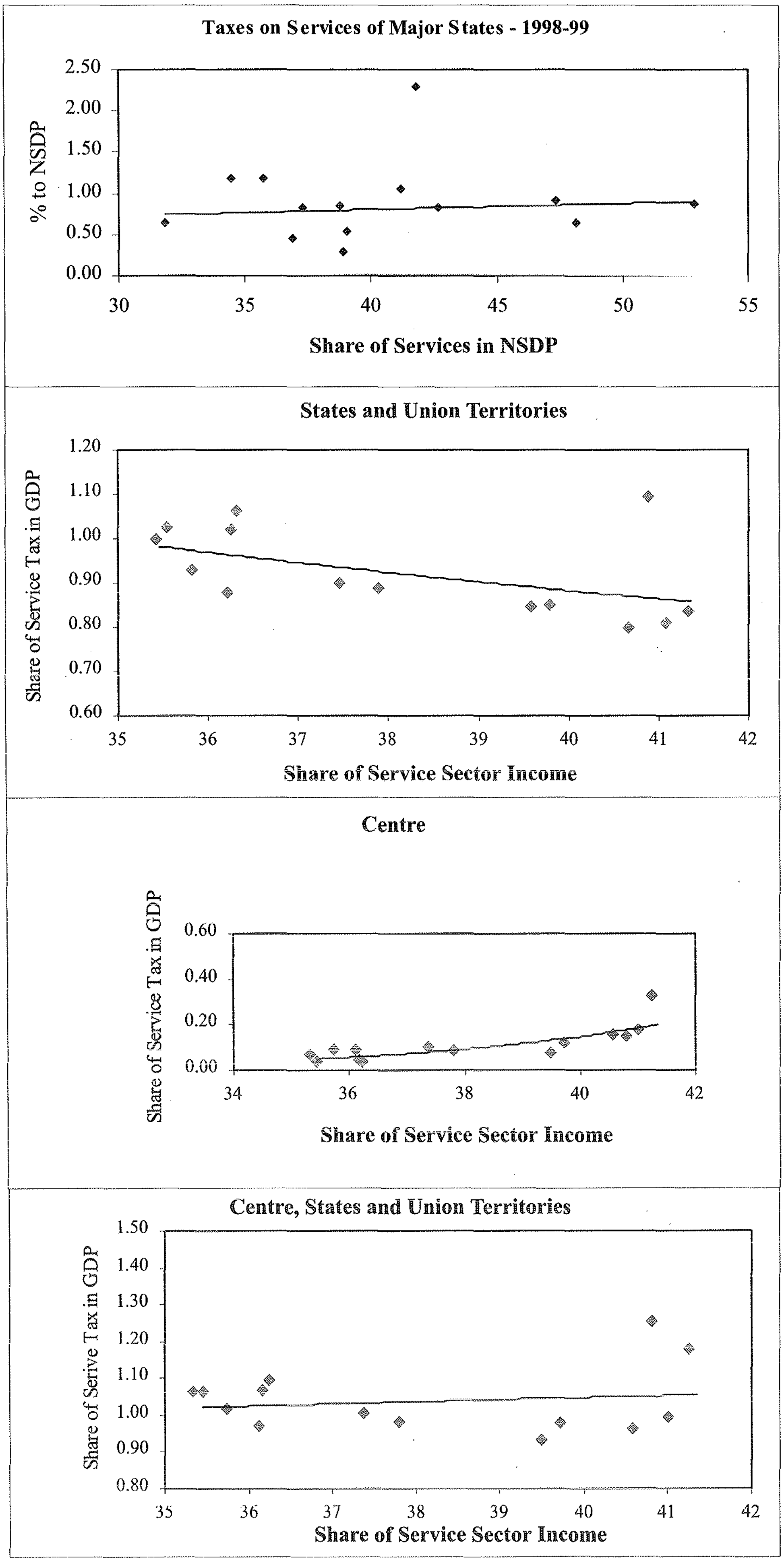
State	1990-91 Per capita NSDP	1990-91 Taxes on services as % of NSDP	1990-91 Share of services in NSDP	1998-99 Per capita NSDP	1998-99 Taxes on services as % of NSDP	1998-99 Share of services
Andhra Pradesh	4733.08	0.85	38.35	13852.90	0.84	42.69
Bihar	2663.11	0.52	24.19	5923.30	0.54	39.00
Gujarat	5900.06	1.74	34.62	18791.63	2.29	41.81
Haryana	7511.48	1.47	29.76	19491.25	1.17	34.43
Karnataka	4606.34	1.72	37.28	15889.03	1.05	41.17
Kerala	4206.75	0.86	35.99	17755.78	0.64	48.11
Madhya Pradesh	4047.96	1.52	29.21	10153.33	1.17	35.71
Maharashtra	7442.02	1.30	41.28	22762.74	0.88	52.82
Orissa	3077.40	1.61	30.86	8718.92	0.84	38.75
Punjab	8318.44	1.03	31.28	20675.13	0.63	31.84
Rajasthan	4198.67	0.95	30.39	11044.58	0.83	37.29
Tamilnadu	4985.18	1.18	41.84	17348.44	0.92	47.29
Uttar Pradesh	3591.68	0.72	33.27	9078.13	0.46	36.84
West Bengal	4673.29	0.82	36.81	13696.37	0.30	38.92

Note. 1. Tax on services includes taxes on vehicles and goods and passengers, electricity duty, entertainment tax and luxury tax on hotels and restaurants.

2. NSDP for 1990-91 is old series

Source: RBI bulletins

(The table is drawn from the paper on "Taxing Services: Issues and Strategy" presented by Dr. M. Govinda Rao at the World Bank conference on India: Fiscal Policies to Accelerate Economic Growth at Delhi in June 2001)



Source: National Accounts Statistics and Indian Public Finance Statistics
(Drawn from the paper on "Taxing Services: Issues and Strategy" presented by Dr. M. Govinda Rao at the World Bank conference on India: Fiscal Policies to Accelerate Economic Growth at Delhi in June 2001)

General service taxation-the current situation

3.11 The Tax Reforms Committee headed by Dr. Chelliah had recommended that a few services should be immediately taxed and if the tax was to be generalised to many more services, it should be merged with the then existing MODVAT on goods. But the Central government has, since 1994, been exercising its residual power to tax services outside the CENVAT system and extending service taxation in an *ad hoc* manner to selected services. Starting with three services-telephones, non-life insurance and stockbrokers-the service tax has been extended to cover 26 items. The current year's budget has spread the net further and added 14 more.

3.12 The Central service tax in its present form is a cascading revenue-raising measure levied at a flat rate of 5%. It is expected to raise Rs. 2800 crs. in the current year. In most VAT debates, there has been discussion of whether and how the tax should be shared with States, but the Central government has not yet responded positively to the idea. The recommendations of the Committee of State Finance Ministers on the introduction of a State level VAT, which have been recently accepted by the conference of State Chief Ministers, also do not extend to giving States concurrent powers to tax services. It is, however, proposed that a Committee of State Finance Secretaries and officials of the Central Finance Ministry should examine the recommendations of the Expert Group on Service Taxation headed by Dr. M. Govinda Rao and those of the Shome Committee on Tax Policy and Tax Administration for the Tenth Plan and furnish their views on the matter by the end of September 2001. In the following section, we will consider the suggestions made by different committees for reform of Central service tax and recommend the approach that could be adopted by the Karnataka government to the issue of the powers of States in respect of general service taxation.

Proposals made over the years for general service tax reform

3.13 The 1994 Bagchi report on trade tax reform drew pointed attention to the economic distortions created by the exclusion of services from taxation and noted that this aggravates the regressivity of consumption taxes. It recommended that some services integral, ancillary or incidental to the supply of goods like installation, works contract and delivery or localised services could be immediately transferred to States. Services predominantly in the nature of consumption or forming a large component of consumption like photoprocessing, cable TV, videofilming etc. could also be taxed by States with rebates allowed only for taxes paid on materials in the transition stage before VAT on services is brought into effect. Eventually, only services with inter-State ramifications were to be left to the Centre.

3.14 The demand for transfer of selected services has surfaced in the recommendations of subsequent VAT committees and in conferences of State Finance Ministers, Finance Secretaries and Commercial Tax Commissioners. The NIPFP report on inter-State taxation of 2000 and the VAT primer brought out by the same institute in 2001 have recommended integration of service tax with CENVAT. They have suggested that the Centre should pass a law levying service tax at a flat rate and the tax should be collected and retained by States. They have also recommended eventual merger of service tax with commodity taxes at the appropriate level over time. In their view, the tax on railway fares and freight should become part of CENVAT and net proceeds from this tax should be distributed among States. The Committee of State Finance Ministers on Sales Tax Reform which had Dr. Chelliah as convenor (1995) included the issue of service taxation in the list of Constitutional changes required for introducing VAT. The Report on Reform of Inter-State Taxation in India of the NIPFP (June 2000) also prepared an illustrative list of services to be transferred to States, which went beyond those ancillary or integral to the production or supply of goods suggested by the 1994 Bagchi committee.

3.15 The Expert Group on the Taxation of Services headed by Dr. M. Govinda Rao set up by the Central government in June 2000 has in its interim and final reports (2000 and 2001) rightly stressed the enormous potential for fiscally induced distortion of economic decision-making by selective service taxation. The Group has opposed selective coverage of services as inadequate, violative of the neutrality principle and resulting in avoidable procedural and legal complications. It strongly advocates comprehensive and general service taxation with a small, clearly defined exemption list. In its view, there should be full input tax credit for taxes paid on both goods and services and exports should be zero-rated (exempted in the transition period) while imports should be taxed as also services provided to foreign nationals and institutions. In the interim period, the Group recommended tax credit only for service tax paid on inputs and introduction of intra-sector credit at a later stage. The Group has suggested comprehensive coverage of services from the current year and integration with CENVAT and completion of the transition to VAT on goods and services by 2004-2005. Above all, the Group, after taking appropriate legal advice, has suggested that the Constitution should be amended to enable both State and Central governments to concurrently levy tax on services while making arrangements to safeguard and harmonise domestic trade taxes. This amendment could be made conditional on States implementing fullfledged intra-State and inter-State VATs with input credits and credits for capital goods within a harmonised rate band, merger of existing piecemeal State level service taxes with VAT and removal of distorting fiscal incentives. Other important issues to be considered for general service taxation are tax exemptions and revenue estimates.

a) Tax exemptions

3.16 The Bagchi report of 1994 had suggested that apart from public interest activities like health, education and social services (which are exempted from taxation in EU, OECD and other countries) and financial transactions, life insurance, housing and government services (in which value added is difficult to measure), all services should be taxed. It pointed out that in New Zealand even government services are taxed.

3.17 The Expert Group on the Taxation of Services headed by Dr. Govinda Rao has also recommended that basic administrative services, those that are meritorious and have significant externalities and those essential for human development and physical progress should be exempted from tax. For administrative and taxpayer convenience, it might also be necessary to keep services in the unorganised sector and small service providers outside the purview of taxation preferably by laying down a threshold limit of Rs. 10 lakhs. The services that could thus be excluded would be public utilities like sewerage and water supply, civil administration, defence, internal security, courts of justice, jails, revenue intelligence, strategic research and development and international affairs. Under the "merit good" heading, all school education up to class twelve could be exempted as also basic health care, preventive medicine and family welfare services. The suggested list of excluded goods is at Annexure I. Dr. Chelliah and Dr. Kavita Rao (2001) note that public administration and defence, "community services" like education, health and welfare and the services of non-profit organizations which do not sell services, a large part of banking and insurance and value generated by owner-occupied houses may not be taxable. Construction in the organised sector can, however, be taxed. Their estimate is that with construction, transport and communication, 5% of GDP from the banking and real estate sectors and 2% from trade and hotels, only about 20% of the GDP from the tertiary sector would form part of the tax base. This would include taxation of railway passenger and freight fares. In their view, since only value added is taxable, about 1 to 1.5% of GDP alone can be added through a VAT on services. The Shome committee (2001) has included public utilities like power generation and distribution, government owned hospitals and labs., government run or aided schools, colleges, labs and welfare organisations, transactions between employers and employees and exported services for which payment is made in convertible non-repatriable foreign exchange in the list of exempted services.

3.18 It is important to note that despite the continuing opposition of the Railway Board, the Expert Group has, in the interests of revenue and neutrality in the treatment of road transport *vis a vis* rail transport, recommended imposition of service tax on all transportation with threshold exemptions only for small transporters. They have suggested that government may also consider exempting freight revenues of essential commodities and passengers travelling by ordinary second class from service tax. They have suggested rationalising service taxation on air transport, which is now subject to inland and foreign air travel taxes.

3.19 When a general service tax is imposed, it might be difficult to differentiate between exempted and taxed components of integrated services while States of destination and origin may not be easily determined for certain types of services. For the former category, the Bagchi Report had suggested adoption of arbitrary rules to identify exempt and taxable components of the same service-health and educational services provided by government and the private sector for example. States would have to come to an agreement on the matter and allocate the tax base for services among themselves as it is now done within the EU. In the case of some services-inter-State transport, telecommunications, advertising, consultancy-the place of origin and destination are difficult to define. Dr. Chelliah and Dr. Kavita Rao (2001) have highlighted the difficulties that could arise in taxing road transport movements across States due to differences between the State of location of the headquarters of transport companies and the place of transport. They have suggested setting up a committee of State Finance Ministers to study the matter and work out an acceptable methodology. The list of tax-exempt services prepared by the Expert Group on Service Taxation using the WTO classification methodology (Annexure I) also illustrates some of these difficulties.

b) Estimates of revenue realisable from VAT on services

3.20 The revenue significance of excluding the service sector from direct taxation has been pointed out by the Shome committee (2001) which noted that a 10% increase in the share of the service sector in GDP today reduces the aggregate buoyancy of tax revenue by .07. Rudimentary revenue estimates from VAT on services have also been made in different studies. The NIPFP Primer and the Institute's 2000 report on inter-State taxation have taken nursing homes, coaching institutes, beauty parlours, sports clubs, film production, software consultancy, lawyers, automobile garages and real estate developers as the tax base and arrived at a figure of Rs. 36780 crs. covering around 2 lakh assessees; by applying a tax rate of 5%, they have made a revenue estimate of Rs. 1839 crs. The Expert Group on Taxation of Services has also prepared tax base estimates using the services of Arthur Andersen and arrived at a figure of Rs. 63675 crs. for sectors like transportation and storage, posts and telecommunications, banking and financial institutions (Annexure II). Kavita Rao (2001) has, however, rightly pointed out that such estimates must be moderated keeping in mind revenue lost on account of input tax credits. These reservations must be kept in mind when we consider the approach to be adopted by the State on the question of a VAT on services.

Suggested approach to VAT on services at the State level

3.21 At first glance, clearing up the legal confusion relating to service taxation before bringing the State VAT on goods into effect may seem an uphill task that could be postponed to a later date. However, economic distortions and administrative anomalies created by continuance of the present inadequate service tax system at the State level indicate that it is essential to integrate, as quickly as possible, general service tax with VAT on goods, subject services to the same range of VAT rates and administer the tax alongside VAT on commodities. As mentioned earlier, this is even more essential from the equity and revenue productivity viewpoints, given the current environment of stagnant or declining industrial activity and phenomenal growth of the tertiary sector.

3.22 There is thus no escape from formulation of a comprehensive statute for an integrated VAT on goods and services at the Central and State levels. A farreaching Constitutional clearing up is essential to lay down the principles for integrating goods and service taxation. The Commission agrees with the view taken by the Expert Group on Taxation of Services that the power to tax services should be enjoyed concurrently by the Centre and the States. Unfortunately, the Central government seems to be dragging its feet on the matter and continuing to approach the service taxation issue from the narrow viewpoint of Central resourceraising. The attempt to view service taxation as a Central resource was even reflected in the composition of the Expert Group on Taxation of Services appointed by the Central government. The committee had no representative from States and its secretariat had been set up within the Central excise department. Although this seriously crippled its ability to forge a national approach to service tax reform (and absorption of service tax within the fold of both Central and State VATs), it is heartening to note that the Group has considered the issue from the viewpoint of the fiscal neutrality of commodity taxation within the federal framework and recommended that service taxation should be done concurrently by the Centre and the States generalised over all services within the overall VAT arrangement. The current initiative to firm up decisions relating to service tax through joint examination of the recommendations made by the Govinda Rao and Shome Committees by a group of senior officials of Central and State Finance departments is a step in the right direction.

3.23 The above approach to service taxation has an added advantage. Service taxation offers the best solution to the compensatory tax source issue, which is a major obstacle in implementing State VATs. If States are given concurrent powers to levy service taxes as an inducement to shift to VAT, exporting States could be reassured about fears of permanent and transitory revenue loss. The current wrangling over Central grants for tiding over revenue shortfalls in tax-exporting States arising from the shift from origin-based commodity taxation to destination-based taxation could be resolved without further strain on the revenues of a cash-strapped Central government. The onus for resource-raising to cover the anticipated revenue reduction will then be placed on States. This is appropriate from the viewpoint of fiscal responsibility and accountability. The measure will also be revenue-productive, since tax-exporting States are likely to be those with a higher share in the consumption of services. A comprehensive integrated VAT on goods and services concurrently levied by the Centre and the States appears to be the ideal formulation for the country today.

3.24 It is encouraging, therefore, that some State governments are moving from seeking powers to tax selected services or sharing Central revenue from general service taxation to demanding concurrent powers to tax services. With the Expert Group on Taxation of Services also strongly recommending such an approach, it is essential to work out the modalities of a common VAT framework as quickly as possible. As pointed out by the Expert Group on Taxation of Services, this cannot be done within the existing Central service tax statute, since it requires alignment of the rates of service taxes levied at the State and Central levels with those accepted for the VAT on goods, harmonisation of exemptions and tax bases and development of administrative practices for accountbased assessment, input credit and data base management apart from constitutional amendments and a common "framework" statute. Since States and the Centre are still not tuned to considering the issue from this perspective, a lot needs to be done to focus the debate, persuade all players and set up working committees to prepare the draft paperwork.

3.25 The Expert Group has suggested drafting fresh Central service tax legislation even for the transition period in the interests of definitional clarity for taxed and exempted services. It has stressed the need to prepare the statute not as an offshoot of Central excise law but in tune with the requirements of a modern service sector. This means comprehensive coverage of all areas apart from goods and immovable property, an *ad valorem* levy and application of the concept of transaction value. Operationally, other desirable principles already mentioned in this and the first report in the VAT context, like self-assessment, non-discretionary functioning, fixed penalties for technical offences, provisions for settlements of cases and advance rulings on substantive issues have also been proposed by the Expert Group.

3.26 We have considered the appropriate framework for VAT on services in Karnataka in the light of the suggestions made by the Expert Group. We strongly support the Group's suggestion of concurrent Central and State VATs on goods and services. We recommend that the Finance and Commercial Tax departments take action right away to prepare for the tax by drafting statutes and regulations, studying revenue productivity and taking decisions on operational issues (covering items like *inter se* input tax credit mechanisms between goods and services, exempted services, return filing, account-based assessment, audit, inspection and appeal). An input-output table for the State's economy should be prepared for both goods and services; while doing this, some of the pointers given in the case studies appended to Chapter II of this report could be followed. Much more work is required to complete the services component of such a report and it is desirable to commence the analysis immediately. Substantial variations in macro figures of tax base and gross tax revenue arrived at in existing assessments of the VAT on services cited above indicate the need for a detailed and comprehensive understanding of the tax potential of the service sector. Net revenue figures must eventually be generated after accounting for tax credits.

3.27 Improved departmental knowledge of service taxation should be accompanied by a concerted campaign to build up support for such a measure among taxpayers and the general public. Under current recessionary conditions, this may not be easy. In all discussions, the department should highlight the two major economic advantages of the VAT on services-simplicity and fiscal neutrality. It should stress the fact that the tax would facilitate exports (through easy identification of the tax component of a product) and improve international competitiveness. It would enable the State to leverage its comparative advantage in the provision of low cost and high quality services and goods.

3.28 The broad framework of the generalised VAT on services in Karnataka should be in line with the rate structure adopted for the VAT on goods; the basic tax rate of 10% should be applied to all services and the lower rate of 4% could be considered for a limited number of selected items. As in the case of goods, for services too, State governments should agree on the items to be taxed at 10% and the few to which 4% should be applied. This agreement should be enshrined within a common national statute enacted by the Central government. Eventually, there should be a single VAT framework law for both goods and services.

3.29 States should also agree on the list of exempted services. The threshold level of Rs. 10 lakhs suggested by the Expert Group seems feasible and acceptable at the State level also. In general, the services listed by the Expert Group on Taxation of Services (Annexure I) in respect to the Central VAT on services could be adopted by the State also. However, we see no justification for exempting computer and related services (item B of 1 in the annexure) from service taxation, since this is *the* growing area of the services sector and putting it in the exempted category would affect the neutrality and revenue-productivity of the VAT on services. Nevertheless, keeping in mind current growth constraints in the area, we suggest levying VAT at the lower rate of 4% on such services at the initial stage. Items A and D at 10 in the annexure pertaining to entertainments and sports should be subject to VAT on services at the normal rate of 10%

since entertainment tax is already being levied on them. We have referred to this in some detail in our first report. Banking and financial services suggested for exemption by the Expert Group may be kept outside the purview of VAT on services, but other similar services like venture capital financing should be subject to tax.

3.30 In the interests of economic neutrality, we concur with the view expressed by the Expert Group on Taxation of Services that VAT should be levied on fares of railway passengers and freight. While dealing with services rendered across State borders, like road transport, courier services etc. the principle of destination applicable to VAT on goods should be applied and similar accounting and collection procedures followed. Where there is difficulty in allocating tax bases among States, appropriate formulae should be devised by agreement among States.

3.31 *Ab initio*, operational methods for the VAT on services should be modern and cost effective. Self-assessment, non-discretionary functioning, fixed penalties for technical offences, provisions for settlements of cases and advance rulings on substantive issues recommended by the Expert Group on Taxation of Services for the Central VAT on services should be adopted at the State level also. Administrative innovations appropriate to service tax include selective audit based on normative parameters evolved on risk basis and compulsory certification by chartered accountants above a pre-determined level of gross receipts. We also strongly suggest that the tax should be administered from inception as an "e tax".

3.32 We have considered the time frame for introduction of VAT on services at the State level. The clock will of course start ticking only from the day on which concurrent levying powers are given to States. We hope, however, that lead time for introducing the tax can be cut short by the department through advance preparation (referred to earlier).

3.33 The Expert Group on Taxation of Services has favoured immediate use of a single Central tax rate till the present service tax is merged with CENVAT. The road map prepared by the Group is as follows:
-extending the service tax base during the current financial year
-introduction of a single basic CENVAT rate, working out modalities for merger with commodity tax and movement to a Central VAT by April 2002
-introduction of a single tax rate, threshold level and input credit mechanism on goods and services by April 2003
-merger of service tax and CENVAT by 2004-2005

3.34 As we have mentioned in the present report as well as in the first report, the ideal situation would be to simultaneously introduce a common VAT on goods and services. The Central government could then have linked concurrent State level taxation of services to changeover to VAT within each State (through adherence to floor rates and removal of tax incentives for industrial investment) as well as in inter-State commerce. However, the decision taken to move to an intra-State VAT on goods alone by April 2002 has reduced the leverage available with the Centre. "Compliance" to VAT conditions by States can now only imply satisfying the requirements for a domestic VAT on goods-that is adherence to floor rates and removal of sales tax exemptions for industrial investment. States which meet these conditions will have to be given the power to levy VAT on services; some other inducement will eventually be necessary to drive them to adopt an inter-State VAT. This may pose difficulties since full acceptance of the destination principle will again alter relative VAT revenue productivities across States. Given our perceptions of how inter-State trade is likely to move under an intra-State VAT (mentioned in Chapter II), such revenue differentials may be controlled through VAT-induced commercial behaviour among dealers. In our view, if preparations begin immediately, not more than a year's time is required after the Constitutional power to levy a concurrent VAT on services is given to States for actual adoption of the tax.

3.35 We have looked at the easiest procedure for quickly transferring the power to tax services to States once a consensus reached on the matter between the two levels of government. The Bagchi report recommended that this could be statutorily delegated to States by the Centre as done today for Central sales tax without waiting for a Constitutional amendment and if the measure met with success, State tax bases could be stretched to cover all services except those specifically excluded. This is also the method suggested by the Shome Committee (2001) which has recommended that the Centre could immediately allow States to tax all services other than financial services (including insurance services), telecommunications, post and communications and transport of passengers by air, sea and rail. In the interim period, collections would go to the Consolidated Fund out of which equivalent amounts could be disbursed to States.

3.36 Delegation of the power to levy and collect CST has been done under Sections 8(5) and Section 9 (2) of the Central Sales Tax Act under which State government sales tax departments have been empowered to assess and collect the tax and fix rates lower than the ceiling limit of 4%. Such delegation may not suffice for operationalising a State level VAT on services, since it would require large scale alterations in existing tax powers of both governments and merger of many current taxes with the general tax. Constitutional amendment seems unavoidable. This will have to be done in such a manner as to permit States to exercise powers to levy VAT on services only after complying with the basic requirements of a harmonised VAT on goods. The amendment must also restore powers to States to tax all advertisements, though the power could be exercised initially only with respect to advertisements on television and radio (to a limited extent).

3.37 In the second section of this chapter, we propose to consider three taxes levied by the State under existing Constitutional powers which have a service tax element- electricity duty, luxury and betting tax. Entertainment tax has already been studied by us in the Commission's first report. We will also comment on the works contract component of sales taxation.

WORKS CONTRACTS

3.38 The general problem associated with indirect taxation of works contracts, leasing and hire purchase has already been mentioned in earlier paragraphs. The present provisions relating to works contracts in the Karnataka Sales Tax Act {Sections 2(t) and 5B} were introduced subsequent to the 46th Consitutional amendment of 1983. They permit sales tax to be levied on the taxable turnover of transfer of property in goods involved in the execution of works contracts at rates indicated in the Sixth Schedule. This implies that only the value of goods involved in an indivisible contract are subject to sales tax. Adjustments are made to ensure that generally tax liability falls only at a single point by excluding goods which have not changed form in the course of the contract and which have not been purchased from registered dealers. Actual labour and similar costs incurred in a works contract are excluded from sales taxation; when these cannot be precisely ascertained, ratios have been prescribed in the Rules to identify the tax base as a fixed percentage of the contract value. Two rates are applicable to works contracts-4% and 10%-differentiated for different kinds of contracts. There is also a provision for composition under Section 17(6) of the Act under which a dealer can opt for payment at the 4% rate applied to the total consideration for a contract. This last provision implies that the service component of the contract is also being taxed but only at the option of the taxpayer and to suit his convenience. Inter-State purchases of goods made at 4% against C form for use in works contracts will result in the contractor losing the option to compound his tax liability for the works contract.

3.39 When intra-State VAT on goods is introduced from April 2002, the segregation of the service element from the amount charged for the contract as a whole will have to continue for determining the VAT liability of works contractors; input credit will also have to be given in respect of the tax paid on goods purchased for contracts. The present composition facility will have to be given up till the composite VAT on goods and services comes into effect. This must be specifically mentioned in the VAT law and sufficient publicity and orientation given for taxpayers. However, when a generalised State VAT on services is introduced, works contracts should be taxed on their gross value at the basic rate of 10% and tax credits given for taxes paid on services and goods used in the contract.

ELECTRICITY DUTY

3.40 Electricity duty is one of the service taxes specifically allotted to States. The power to tax the sale and consumption of electricity figures in Entry 53 of List II (the State list) under the Seventh Schedule of the Constitution. When the combined value added tax on goods and services that we have recommended is introduced, this tax will have to be suitably adapted to fit new requirements. We have considered here the present structure, incidence and revenue productivity of the tax and raised some issues that will arise when it is eventually integrated into the VAT on services. These are bound up closely with the ongoing reform in the power sector that aims at rationalising tariffs on market lines, increasing the number of players (producers and distributors of energy), regulating pricing and efficiency norms through the Karnataka Energy Regulatory

Commission, metering and charging all consumers and modernising administrative and collection procedures.

3.41 In Karnataka, levy of electricity duty is governed by the provisions of the Karnataka Electricity (Taxation of Consumption) Act and Rules of 1959. Tax collections over the years can be seen in Annexure III. Different collection figures are available from the RBI, the Planning Commission's Annual Report on the Working of State Electricity Boards and Electricity Departments 2000-2001 and the Karnataka Power Transmission Corporation. We have adopted RBI figures, since they are based on the Accountant General's final figures and include probably duty collections made outside the KPTCL (in Karnataka, this is by the Electrical Inspectorate). About Rs.140 crs. were raised in Karnataka from electricity duty in 1998-99. Apart from Gujarat, which is raising more than Rs. 1000 crs. from this source, Madhya Pradesh and Maharashtra are raising around Rs. 500 crs. and Rs. 700 crs. respectively from electricity duty. Karnataka's revenue is less than even that raised in Kerala and Tamilnadu, which should be a matter of concern.

3.42 Electricity duty represents only 2% of the State's own tax revenues, while the share is around 9.5% in Madhya Pradesh and over 19% in Gujarat (Annexure IV). More than 7% of the own tax revenues of a State like Orissa comes from this duty. A comparison has been made at Annexure V of revenue growth rates from electricity duty and revenue earned by Electricity Boards from power sales in the 14 major States. (Only power sales for which bills have been raised have been taken into consideration, not power supplied free to special categories like farmers). Ideally, the two should move together. However, there appears to be no relationship between the two in almost all the major States. The only exceptions seem to be Gujarat and to some extent Tamilnadu. This is due to specific electricity duty rates and non-alignment of the duty structure with power tariff slabs. Revenue from the duty has grown by around 10% in Karnataka in the last fifteen years.

3.43 In per capita terms, the incidence of duty as seen in Annexure VI, is around Rs. 27, which is slightly below the figures for Tamilnadu and Orissa; in Maharashtra, Madhya Pradesh and Gujarat the incidence is much higher.

Tax structure and rates

3.44 Specific tax rates per unit of electricity consumed have been fixed under Section 3 of the Karnataka Electricity Taxation Act. Duty rates, which had not been raised between 1985 and June 1996, were doubled in July 1996. Prevailing rates for Karnataka as well as for two other reforming States (Gujarat and Haryana) are given in Annexure VII.

3.45 There are three rates of duty in Karnataka. Industrial and commercial establishments (HT and LT) and temporary supply are charged the highest rate of 20 paise/kwh. There are two rates for water supply connections: 20 paise for high tension and 10 paise for low tension. There are also two rates for domestic connections-15 paise for normal connections and 10 paise for all electric homes. Ordinary domestic connection is only for lighting and there is no connection for a heating load. All Electric Home (AEH) connections include heating load also. It may be noted that although power tariff for AEH connections is higher than for ordinary domestic connections, electricity duty rates for the latter are actually higher than for the former. The 10 paise rate is also applied to lift irrigation schemes and irrigation pump sets of capacities above 10 horse power (apart from LT water supply schemes already mentioned). Haryana too has a specific tariff, which has been uniformly kept at 10 paise, while that in Andhra Pradesh is only 6 paise.

3.46 With integration into VAT on goods and services, the electricity duty structure of Karnataka will also have to fall into the general approved VAT rate schedule. This means movement to *ad valorem* rates, which will ensure stability, convenience for compliance and administration, buoyancy, revenue productivity and transparency. We should make the shift even before VAT is introduced and select a rate or rates as close as possible to likely VAT rates. This will be useful for the consumer and the tax collector. Gujarat appears to have already adopted an *ad valorem* structure, although there are eight rates (5% to 60%). The choices of rates likely to be available under VAT are 4% and 10%. Electricity duty represents close to 5% of the revenue realised from power sales by the KPTCL today. To protect revenue, therefore, we recommend a uniform rate of 5% for all categories of consumers. The 10% basic VAT rate should be applied when electricity duty is merged with VAT on services. The State government should support this stand while negotiating with other States for a common VAT policy for services. Regional perceptions and sensitivities relating to the cost of power should not be allowed to affect selection of the appropriate rate of electricity duty under a VAT on services, since tax credit will be available for all intermediate producers/dealers for VAT paid on both goods and service inputs.

Concessions and exemptions

3.47 Some exemptions from electricity duty are linked to Constitutional provisions. Article 287 specifically exempts electricity sold for consumption to the Central government from tax; it also prohibits taxation of electricity used for construction, maintenance or operation of a railway. This appears to be an extension of the principle of "immunity of instrumentalities" invoked in federal countries to prevent different government levels from taxing one another. The principle should not be extended to commercial operations like the Railways even if they are owned by the Central government. There is a case for appropriate Constitutional amendment and this should be pursued by the State. However, there is little revenue loss for Karnataka on account of this exemption, since electricity drawn for railway traction is negligible. Some of the electricity drawn under the head is being utilised for other commercial and residential requirements of the Railways. Since we have recommended that VAT on services should be introduced for rail transport also, the constitutional protection under Article 287 should be removed for the Railways and input tax credit given.

3.48 The tax tariff notification itself specifies a zero rate for certain consumer categories like the Rural Electrification Cooperative Society at Hukkeri, lighting connections to poorer households under the *Bhagya Jyothi* scheme, irrigation pump sets below 10 horse power, low tension waterworks in village and town *panchayats* and low tension lighting including street lighting. The Hukkeri society purchases HT power at bulk rates without duty. However, it realises duty from consumers at normal rates and remits it to government in the capacity of a "licensee" under the Act under the supervision of the Electrical Inspectorate. When electricity duty is merged with VAT on services, input tax credit will be available to the society in its capacity as an intermediate dealer in power.

3.49 It may not be possible to estimate the revenue that can be realised by removing exemptions for many categories since energy supplied to them is not metred. This is the case with public lighting and Bhagya Jyothi. KPTCL's metering program was programmed to commence from 1st September and be completed in 3 years' time. It is expected to cover all installations below 11 kv., which will mean almost all irrigation pumpsets below 10 horse power. However, the metering contract has not yet been finalised and the matter may be delayed by a month. We recommend that duty should be charged on all consumers as and when metering is completed. When VAT on services is introduced, duty should be charged on domestic consumption for connections given under the *Bhagya Jyothi* scheme. Since this is in the nature of final consumption, there will be no tax credit for VAT paid on inputs. For most of the other categories, however, tax credit will be available if the activity is similar to intermediate production or trading.

3.50 Section 8 of the Act also permits government to notify exemptions. Under this provision, exemption has been notified for captive generation on 18/6/1997. Captive generation refers to power generated by "non-licensees" who either generate power for own consumption or supply it to others free of charge; under the Act, they must pay duty on losses, auxiliary consumption and on energy supplied free to others (they are bound to collect the last from customers and remit it to government). By a notification of 18/6/1997, captive power generation (for self-consumption) has been exempted from electricity duty. The sales tax refund on diesel used for power generation introduced as a part of the 1992 industrial incentive package continues even today. This issue is discussed in greater detail while considering wheeling and banking charges levied by the KPTCL in the following sections.

3.51 We have not attempted to estimate the tax credit that may be claimed on account of electricity duty by different categories of customers when VAT on services is introduced. In the case studies of specific commodities done by us in the annexure to Chapter II, we have referred to this aspect at the micro level. We suggest that the Commercial Tax and Energy departments work together to prepare estimates of net revenue from electricity duty (after adjusting claims for input tax credit). Such estimates can be prepared at the macro and micro levels. Projections of future consumption by different customer categories made by KPTCL to the KERC could be used for macro estimations with correctives drawn from specific sector studies (like the recent ISEC evaluation of the *Bhagya Jyothi* scheme). At the micro level, industry and trade specific assessments can be done when input-output tables are prepared for the economy as a whole (covering both goods and services). Once prepared, such a comprehensive economic map can become an invaluable policymaking tool.

Tax collection

3.52 Licensees under the Electricity Supply Act are expected to collect the tax from consumers and remit it to the government (Section 4 of the Taxation Act); they are entitled to a rebate to cover the collection cost which is limited to 2% of the tax collected. The rebate allowed at present is 1.5%. Licensees other than KEB are expected to file tax returns in prescribed forms to the Chief Electrical Inspector and the Deputy Commissioner; the KEB furnishes reports only to the former authority. An amount equal to the average monthly tax paid in the past 12 months has to be paid by licensees within two months as *ad hoc* payment and the difference between the actual amount received and this figure has to be paid within a month. Non-licensees are expected to file monthly returns and make payments within a month's time by treasury challan or cash. They are responsible for maintaining energy meters, calibrating and testing them once a year and testing transformers in connected position every three years. Detailed inspection procedures of licensees and non-licensees for officers of the Electrical Inspectorate and registers, returns and forms are also prescribed in the Act and Rules.

3.53 The Electrical Inspectorate monitors the collection of duty and its payment to government by all licensees. Apart from the KPTCL this includes entities like the Hukkeri society and third party sales made by other power generators. However, there is no fund transfer on account of duty from KPTCL to the State exchequer, amounts due are adjusted against power subsidy payable to KPTCL for rural electrification and other purposes. Since KPTCL has fairly large arrears of uncollected tariff, it was indicated that duty is set off to government against subsidy on the basis of demand raised, not on the basis of actual collections. As separate accounts of duty are not maintained in respect of low tension consumers, amounts to be paid to government on this account are estimated on the basis of the energy consumed. The Commission recommends that such presumptive adjustments should be given up and electricity duty accounted for on actual amounts collected by KPTCL. When computerisation of KPTCL accounts is completed, this should be possible.

3.54 An issue that will become increasingly important when private power production becomes universalised is the status and mechanism for billing electricity duty. At present, wheeling and banking charges are charged on electricity generated by private producers who use the grid. Since 30/8/2000, wheeling charges are 20% of the energy wheeled and banking charges 2% and the charges are now uniform for all categories of consumers. At present, power generated for captive use is not subject to electricity duty, but duty is charged if it is sold to a third party. We suggest that this procedure may continue till the VAT on services gets stabilised. At this stage, the appropriate procedure for taxing captive power generation under the VAT on services could be developed.

3.55 Transition to VAT on services raises important issues relating to input credit for producers and intermediate consumers. Due to technical reasons, inefficient operation and distortions created by the current exemption and tariff structure, electrical energy in India is a service in which loss of quantity during the distribution process is substantial. The transmission and distribution loss of KPTCL reported to the Electricity Regulation Commission today is as high as 36.5%. This could lead to a situation in which the quantum of energy for which VAT is raised at the bus bar when sold by the generator to the transmitter and distributor would be substantially higher than that actually conveyed to consumers and/or billed to them. The last two figures themselves are today believed to be vastly different due to theft, connivance and administrative defects. In the long run, once power sector reform is well under way, current levels of transmission and distribution losses are expected to come down. They might always, however, remain above 10%, which is still a considerable figure. This will create special problems when electricity duty is merged with VAT on services.

3.56 The chain for the VAT on energy should begin with power generators from within and outside the State. Domestic power producers like the Karnataka Power Corporation (KPC), independent power producers (IPPs) etc. should charge VAT on energy sales to KPTCL and claim tax credits for VAT paid on inputs (goods and services). The transmitting and distributing chain should pass on the VAT and claim similar credits. Consuming intermediate producers and dealers in other sectors will also be eligible for tax credits. Tax incidence will then pass on to final consumers-through electricity duty itself in the case of households or in the form of final goods and services produced by manufacturers and service providers.

3.57 Inter-State transactions between KPTCL and power generators in other States and Central sector generators like NTPC will be treated like those relating to inter-State commerce on goods. The mechanism adopted for goods-zero-rating, tax credit and clearing house arrangements or any other method-will have to be applied to energy sales also. Taxes paid and recovered can then be incorporated into KERC's price fixation procedure under which input taxes are today computed as per current rates and permitted to be charged to customers as a component of the tariff.

Table III

Receipts from betting tax, luxury tax & entertainment tax

(Rs.crs.)

Year	B.T	L.T	E.T
96-97	11.81	31.21	34.2
97-98	9.13	41.08	46.85
98-99	11.78	42.16	56.27
99-2000	11.98	61.87	47.6

LUXURY TAX

3.58 Item 62 of the State list in the Seventh Schedule of the Constitution empowers States to levy taxes on luxuries. The Karnataka Tax on Luxuries enacted in 1979 in exercise of this power is partly a levy on commodities which for statutory reasons cannot be covered under normal commodity taxation (sales tax and entry tax) and partly a levy on services. Luxuries are defined in Section 2 of the Act as commodities or services "ministering to enjoyment, comfort or pleasure extraordinary to necessities of life". The services which actually fall within the definition are enumerated in Chapter II of the Act itself; they are hotel accommodation (lodging charges and all amenities compulsorily chargeable), other separately available facilities like health clubs, beauty parlours, swimming pools, conference halls etc. in hotels and benefits provided by marriage halls.

3.59 In 1997, some commodities were brought under the purview of luxury tax by introducing a schedule to the Act. Up to the current year, these were only tobacco and tobacco linked products. They could not be subject to normal sales taxes because of the tax rental arrangement which has led to the transfer of State fiscal powers to the Centre for the levy of additional excise duties. Unlike textiles and sugar, which also have a similar problem, entry tax cannot be levied on much of the tobacco consumed in the State since most of the consumption is in Bangalore where these items are produced. In the current year, however, silk fabrics and imported electronic goods were also subject to luxury tax but silk fabrics have subsequently been removed from the schedule in July 2001 due to opposition from producers. The tax was imposed on silk fabrics for reasons similar to those applicable to tobacco. In the case of imported electronic goods, however, the intention is to cover items, which are sold in the grey market by dealers who escape sales taxation by claiming that they are holding such products on behalf of owners, not selling them. Since luxury tax falls on stocks not sales, such commodities can also be subject to taxation. Time share is not covered under the tax since ownership is shared by developers of holiday resorts with members of the scheme and annual payments are only in the nature of maintenance charges. Luxury tax is not leviable on goods exported from the State.

3.60 Each taxable good or service has its own tax structure as below:
For hotels, there are three rates: 5%, 10% and 12.5% for those charging from Rs. 150 to Rs. 250 per day, those charging between Rs. 250 to Rs. 400 per day and those charging more than Rs. 400 per day. Marriage halls charging more than Rs. 2000 per day are subject to a 15% tax rate and luxuries provided in hotels like health clubs are charged at 20%. As for commodities subject to the tax, the rate is 4% on tobacco and related products, 20% on gutkha and 12% on imported electronic goods. Silk fabrics were subject to a low rate of 2% for a brief period of three months during the current year. In the case of tobacco which is also subject to entry tax, the luxury tax rate is identical; in the case of silk fabrics, however, the comparable rate for textiles (which is applicable to silk fabrics manufactured in mills or power looms) is 1%. The rate for gutkha is 4% under entry tax and 20% under luxury tax and both are payable since it is a demerit good.

3.61 Luxury tax yielded Rs. 42 crs. in 1998-99 and Rs. 62 crs. in 1999-2000. This is higher than the revenue realised from entertainment tax. It also appears to be an increasingly productive revenue source.

3.62 Tax administration is done by the same officers who manage general commodity tax administration. Taxpayers are expected to register with the department and declare tax liability and make payments every month. The annual registration fee is Rs. 250 but this is collected only from those who are not already registered under the KST Act. Unlike sales tax the luxury tax is levied on stocks not sales. Luxury tax is computed on ex-factory (post-Central excise) value for a manufacturer and consignment value for a stockist. What is returned to the stockist not taxed to avoid double counting. Forms have been prescribed for the maintenance of records, registration and submission of returns. Re-assessment and rectification are permissible within 5 years of the assessment and revision within 4 years. First appeals are handled within the department and second appeal by the Karnataka Appellate Tribunal. Appeal and revision is also possible at the High Court level. Penalties prescribed under the Act are given in Annexure VIII.

3.63 The service and goods components of luxury tax need to be rationalised when VAT is introduced. Goods which are now taxed under this levy can be easily brought under VAT without any need to use the cumbersome entry tax mechanism once "declared goods" and goods subject to additional excise duty are permitted to be taxed by States. They should generally fall under the basic 10% rate and input taxes should be credited. Only tobacco and gutkha should be subject to the higher rate of 20% applicable to demerit goods without input tax credit. In the case of electronic goods, better enforcement and the improved compliance expected from VAT will have to be depended upon to control evasion. For services now under the luxury tax, which will come under VAT, we recommend that hotels charging up to Rs. 500/day should be exempt from VAT, the 4% rate should be applied to room rents between Rs. 500 and Rs. 1000/day and the 10% rate for rooms charged at higher rates. For convention and marriage halls, the exemption should apply to those charging up to Rs. 5000/ day, the 4% rate to those charging Rs. 5000 to Rs. 10000/day and the 10% rate to those charging higher rents. This should also give a fillip to tourists and business customers particularly when the sector as a whole is passing through recessionary days. Health clubs should be charged at the basic 10% VAT rate. These rationalisations could be introduced even during the transition period

BETTING TAX

3.64 The power to levy this tax is also derived from Entry 62 of the State list of the Seventh Schedule of the Constitution. In Karnataka, the tax is levied only on race courses under the Mysore Betting Tax Act which dates from pre-independence days (1932). It is collected through the Bangalore Turf Club and the Mysore Race Club, which are licensed under the Mysore Race Courses Licensing Act of 1952. Two different taxes are levied-the totalisator tax on collections made using totalisators installed and run by the clubs themselves (this method of racing is called the "tote") and the betting tax on collections made by licensed bookmakers. The tax amount is deducted out of winnings before they are paid out by the bookie. There is also a provision for composition with composition rates being determined annually by the government after examining business records. The law limits the tax rate to 25% for both kinds of taxes. At present, rates are differentiated between the two kinds of taxes and also between race categories as below:

	On course	Off course	Gymkhana
Totalisator tax	15%	10%	15%
Betting tax	20%	15%	20%

3.65 Composition rates are Rs. 8 crs. for the Bangalore Turf Club and Rs. 30 lakhs for the Mysore Race Club for totalisator tax only. The "tote" specialises in bets grouped around the outcomes of a number of races taken together. It is computerised and bets are accepted only in cash. There are also a few extension counters for totalisator betting outside race course premises. Betting, however, is permitted only at the race course, it is not computerised and bets are taken only on individual races.

3.66 The betting tax was administered by the Revenue department till January 1982 when it was transferred to the Commercial Taxes department. An officer of the level of Joint Commissioner is entrusted with the task of receiving returns and finalising assessments while inspection functions are delegated to a designated Commercial Tax Officer. Totalisator tax has to be declared and paid up within a week of the close of a race meeting by the club. "Totes" covered under the composition option are expected to pay one-twelfth of the tax amount every month before the 20^{th}. Betting tax receipts have to be similarly reported and paid up by bookies within three days of each racing day through the concerned club. There are 14 bookmakers in Mysore and 30 in Bangalore. Penalties prescribed under the Act are indicated at Annexure IX.

3.67 Revenue from the tax has been practically stagnant at around Rs. 12 crs. for some years. It is believed with some justification that betting tax is evaded by underrecording bets which are physically taken in larger units using hand signals for communication between bookies and bettors. For this reason, as also because of the composition facility for the totalisator tax, the latter yields a higher revenue (Rs. 8.3 crs.).

3.68 The betting tax need not be brought within the ambit of the general VAT on services. It should be treated as a tax on demerit goods subject to a special higher rate of 20% without input tax credit facility. There is also a case for regular annual revision of the composition rate for totalisator tax.

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Annexure I

SERVICES PROPOSED TO BE EXEMPTED

Sr. No. as per WTO	Sector		Sub-sectors / Services
1.	**Business services**	**B**	**Computer & related services**
		a	Consultancy services related to the installation of computer hardware
		b	Software implementation services
		c	Data processing services
		d	Data base services
		e	Other
		C	**Research & Development services**
		a	R & D services on natural sciences
		b	R & D services on social sciences and humanities
		c	Interdisciplinary R & D services
		F	**Other business services**
		f	Services incidental to agriculture and forestry
		g	Services incidental to fishing
2	**Communication Services**	**A**	**Postal services**
			Postcards
			Money orders
		D	**Audiovisual services**
		b	Motion picture projection service (theatres)
3	**Construction & Related Engineering Services**		Rural housing Slum development Lower & middle income group housing
5	**Educational Services**	**D**	**Adult education**
7	**Financial Services**	**A**	**All insurance and insurance-related services**
		a	Life, accident and health insurance services, crop insurance
		B	**Banking and other financial services (excluding insurance)**
		a	Acceptance of deposits and other repayable funds from the public
		b	Lending of all types, including consumer credit, mortgage credit, factoring and financing of commercial transaction.

10	**Recreational, Cultural and Sporting Services (other than Audiovisual Services)**	**A** **C** **D**	**Entertainment services (including theatre, livebands and circus services)** **Libraries, archives, museums & other cultural services** **Sporting and other recreational services**
11	**Transport Services**	**A** **B** a b c d e f **D** **E** **F**	**Maritime transport services** **Oceangoing vessels** **Internal waterways transport** Passenger transportation Freight transportation Rental of vessels with crew Maintenance and repair of vessels Pushing and towing services Support services for inland water transport **Space transport** **Rail transport services** Ordinary second class passenger travel Freight of essential commodities **Road transport services** Freight of essential commodities

Source: Final Report of the Expert Group on Taxation of Services, (2001)

Annexure II

Tax Potential in Services Sector

Segment	Segment growth rates assumed	Potential tax base 1999-2000 (in Rs.crores)
Key sectors		
Transport and Storage		
Land Transport		
Railways	NA	26,393
Land transport-public transport by buses	9.7%	12,674
Pipelines-HBJ revenues to GAIL	0.0%	1,120
Water Transport		
Costal and offshore	2.0%	455
Major ports	13.8%	3,802
Air Transport	NA	297
Services Incidental to Transport	NA	
Storage and warehousing	9.1%	546
Posts and Telecommunications		
Posts		
Postal services	1.9%	1,284
Telegraph services	-04.0%	58
Telecommunications		
Internet Service Providers	NA	102
Cable Operators	NA	52
Banking & Financial Institutions		
Banks	14.6%	9,433
Financial institutions	21.3%	866
Other Sectors		
Construction	NA	
Hotels and restaurants	NA	2,383
Business services	NA	
Education	NA	1,000
Health and medical services	NA	
Media	12.0%	3,210
TOTAL		**63,675**

Source: Final Report of the Expert Group on Taxation of Services (2001)

Annexure III

Receipts from electricity duty in 14 major States

(Rs.crs.)

States	85-86	86-87	87-88	88-89	89-90	90-91	91-92	92-93	93-94	94-95	95-96	96-97	97-98	98-99
Andhra Pradesh	5.24	41.10	28.95	33.28	36.48	40.37	76.90	45.13	46.03	84.12	68.47	70.01	74.67	78.44
Bihar	15.29	17.00	18.05	27.93	19.14	20.52	23.00	25.27	30.00	47.72	57.72	70.57	42.32	67.04
Gujarat	118.31	113.92	113.88	189.61	180.97	187.39	376.33	544.19	465.53	791.21	695.58	900.60	1023.54	1447.17
Haryana	22.40	27.21	27.67	33.36	29.43	34.36	38.49	43.43	39.06	48.00	46.46	35.48	40.53	44.53
Karnataka	47.85	47.97	32.00	42.61	65.07	52.72	76.16	85.85	70.68	69.69	62.52	106.50	140.19	140.25
Kerala	46.27	46.77	37.97	18.36	72.82	30.56	41.15	22.15	44.46	49.99	7.51	46.76	168.56	39.06
Madhya Pradesh	52.82	104.66	120.93	180.90	237.59	231.47	282.23	294.96	286.29	328.91	494.79	516.37	478.29	488.81
Maharashtra	134.79	176.00	173.10	215.47	217.85	277.50	296.35	276.33	336.66	336.68	357.12	403.31	535.64	711.23
Orissa	49.81	60.19	61.12	68.42	33.39	98.75	99.45	97.34	98.46	100.91	121.35	120.06	127.73	110.13
Punjab	40.78	45.61	48.67	53.62	61.76	59.64	60.55	66.34	73.04	87.27	92.87	79.92	37.79	31.90
Rajasthan	19.03	25.60	28.04	25.29	34.08	53.56	53.36	50.13	57.32	74.26	80.34	91.96	88.96	91.87
Tamilnadu	7.89	8.29	9.61	7.61	5.27	6.94	82.95	69.17	78.16	114.41	140.53	150.63	171.42	178.83
Uttar Pradesh	30.80	36.21	41.78	62.00	50.98	53.07	57.13	63.57	56.43	59.69	75.71	78.33	110.89	100.85
West Bengal	36.50	31.82	35.66	31.52	29.33	29.39	138.56	51.83	35.13	22.85	51.56	88.29	136.92	117.36
Total	627.78	782.35	777.43	989.98	1074.16	1176.24	1702.61	1735.69	1717.25	2215.71	2352.53	2758.79	3177.45	3647.47

Source:- RBI studies of State finance of various years furnished by Institute for Social and Economic Change Bangalore.

Annexure IV

Share of electricity duty in own tax revenues

(%)

States	85-86	90-91	93-94	95-96	96-97	97-98	98-99
Andhra Pradesh	0.36	1.52	1.20	1.66	1.43	1.05	0.99
Bihar	2.66	1.80	1.72	2.93	3.14	1.77	2.51
Gujarat	11.01	7.81	11.81	13.07	14.85	15.53	19.00
Haryana	4.46	3.21	2.46	2.14	1.66	1.71	1.43
Karnataka	4.45	2.26	1.85	1.19	1.85	2.19	2.02
Kerala	6.33	2.28	1.90	0.22	1.20	3.74	0.84
Madhya Pradesh	6.35	13.19	10.69	14.06	12.58	10.48	9.57
Maharashtra	5.67	5.42	4.37	3.27	3.44	3.90	5.01
Orissa	17.42	14.77	11.45	10.77	8.95	8.98	7.41
Punjab	6.08	4.62	3.40	3.50	2.92	1.24	0.98
Rajasthan	3.36	4.40	2.94	2.94	2.94	2.46	2.33
Tamilnadu	0.51	0.22	1.63	1.97	1.89	1.97	1.86
Uttar Pradesh	2.39	1.68	1.37	1.38	1.24	1.58	1.27
West Bengal	3.25	1.38	1.21	1.25	2.07	3.03	2.46
Total	4.46	4.00	3.86	3.92	4.14	4.18	4.38

Source:- RBI studies of State finance of various years furnished by Institute for Social and Economic Change Bangalore.

Annexure V

Growth rates of sales revenue from power and of electricity duty in 14 major States

(%)

States	Growth rates of sales revenue from power: 1996-97 over 1995-96	1997-98 over 1996-97	1998-99 over 1997-98	Growth rates of electricity duty: 1996-97 over 1995-96	1997-98 over 1996-97	1998-99 over 1997-98
Andhra Pradesh	45.03	19.47	10.62	2.25	6.66	5.05
Bihar	-33.82	15.67	19.42	22.26	-40.03	58.41
Gujarat	30.54	10.43	21.09	29.47	13.65	41.39
Haryana	22.09	22.55	13.22	-23.63	14.23	9.87
Karnataka	16.93	33.20	0.69	70.35	31.63	0.04
Kerala	-1.67	42.62	31.05	522.64	260.48	-76.83
Madhya Pradesh	29.46	1.09	-1.21	4.36	-7.37	2.2
Maharashtra	23.76	-4.64	16.74	12.93	32.81	32.78
Orissa	-9.60	14.55	18.04	-1.06	6.39	-13.78
Punjab	17.23	14.89	17.66	-13.94	-52.72	-15.59
Rajasthan	20.88	24.12	9.95	14.46	-3.26	3.27
Tamilnadu	7.95	13.50	-12.85	7.19	13.8	4.32
Uttar Pradesh	0.23	20.15	16.42	3.46	41.57	-9.05
West Bengal	-30.41	29.94	6.95	71.24	55.08	-14.29

States	1985-86 * to 1998-99	1990-91 * to 1998-99
Andhra Pradesh	8.18	-0.74
Bihar	12.21	16.71
Gujarat	22.79	23.34
Haryana	4.68	1.61
Karnataka	9.34	10.61
Kerala	1.36	8.56
Madhya Pradesh	16.13	10.96
Maharashtra	11.05	11.17
Orissa	7.80	3.07
Punjab	1.20	-5.36
Rajasthan	13.34	9.13
Tamilnadu	36.49	33.46
Uttar Pradesh	8.37	9.18
West Bengal	9.46	12.28

*** by regression method**

Source : Sales revenue is computed by multiplying average tariffs with quantity of power billed by SEBs for respective years on the basis of data furnished in the Planning Commission's Annual Report on the Working of State Electricity Boards and Electricity Departments 2000-2001. Growth rates of electricity duties have been computed on data from RBI studies of State finance of various years furnished by the Institute for Social and Economic Change Bangalore.

Annexure VI

Per capita revenue from electricity duties in 14 major States

(Rs.)

States	85-86	90-91	93-94	97-98	98-99
Andhra Pradesh	1	6	7	10	22
Bihar	2	2	3	4	7
Gujarat	32	46	108	220	306
Haryana	15	21	23	21	23
Karnataka	12	12	15	28	27
Kerala	17	11	15	53	12
Madhya Pradesh	9	35	41	63	63
Maharashtra	19	36	41	60	79
Orissa	17	31	30	36	31
Punjab	22	30	35	17	14
Rajasthan	5	12	12	17	18
Tamilnadu	2	1	13	28	29
Uttar Pradesh	3	4	4	7	6
West Bengal	6	4	5	18	15

Source: Computed on data from RBI studies of State finance of various years furnished by Institute for Social and Economic Change Bangalore and Planning Commission's projected population figures.

Annexure VII

RATES OF ELECTRICITY DUTY

KARNATAKA CATEGORY	RATE RATE/ UNIT(ps)	GUJARAT	RATE *AD VALOREM*	HARYANA RATE/ UNIT(ps)	ANDHRA PRADESH RATE/ UNIT(ps)
High tension water supply & industrial units, residences & temporary supply	20	Residential-rural (5000 popn.)	exempted up to 250 kwh/yr 20% for others	10 village chaupal exempted	6 irrigation pump sets exempted
High tension lift irrigation schemes	10	Residential-urban	25% up to 40 kwh./mth., 40% on additional units		
Low tension industrial & commercial units & temporary supply	20	LT industrial-services	60% for lighting,others30%		
Low tension domestic supply, non-commercial non-domestic lighting	15	Other industries Halls, theatres and hotels	10% 45%		
Low tension all electric homes	10	HT industrial-services	30%		
Irrigation pumpsets above 10 hp.private horticultural nurseries and plantations	10	Other industries Agricultural	20% 5%		
Low tension water supply schemes of municipalities & State & Central government residential layouts	10	Public water works Temporary connection	exempted 60%		

Annexure VIII

LUXURY TAX-PENALTIES

Offence	Penalty
Delay or default over 10 days	2% interest/month
Illegal or excess tax collection	1.5 times collection
Non-filing of return or non-payment, non-response to notice to furnish data, concealment & when escaped tax is assessed	1.5 times tax
Non-payment of tax or penalty on time	2% interest/month
Non-registration, non-filing of return or monthly statement,non payment of tax or penalty on time, non-maintenance of account, non-issuance of bill and non-response to notice to furnish data	Imprisonment for 6 months and/or fine from Rs. 1000 to Rs. 5000
Carrying on business without security, wilful dishonesty or disobedience and obstrcution of inspection	Imprisonment for a year and/or fine from Rs. 5000 to Rs.25000 & Rs200/day during period of offence
Failure to comply with garnishee (third party) notice	In addition to above,personal liability whichever is less

Annexure IX

BETTING TAX
OFFENCES AND PENALTIES

OFFENCES	PENALTIES
Non-production of accounts	Rs. 100/unaccounted card
Evasion of betting tax	1.5 times tax payable
Non-production of accounts and/ or tax evasion, non maintenance of accounts or false accounting	Imprisonment for 6 months and/or fine
Non-payment of totalisator tax after 10 days	2% interest/month
Any other contravention	Rs. 500

CHAPTER IV

STATE EXCISE DUTIES

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STATE EXCISE DUTIES

4.1 In the first report, the Tax Reforms Commission had outlined the regulation-revenue problem for State excise duties, studied their revenue significance and attempted to analyse the rate structure in the context of the objective of restraining hard liquor consumption. Some suggestions were also made relating to quality control and the merger of sales tax and excise duties. The Commission attempted to estimate the extent of evasion in respect of both country liquor and IML and proposed external indicators for improved regulation and control. In the final report, the Commission will analyse fiscal and regulatory policies that govern the production, retailing and consumption of liquor as well as e governance mechanisms that could increase compliance and restrain evasion.

4.2 The Commission has already noted that in the last decade, States have veered in and out of the prohibition policy. Prohibition is generally introduced in response to demands from the electorate for greater restraint on the availability and consumption of alcohol but it has invariably been abandoned not merely because of steep fall in revenues but also because of the near-impossibility of eliminating the illicit distillation and distribution of alcoholic beverages. The mix of regulatory and fiscal measures adopted by States has not yet succeeded in establishing a reasonably satisfactory and acceptable balance between alcohol availability and restrained consumption. This has resulted in unpredictable and fluctuating revenues from State excises, which are reflected in tax buoyancies (Table I). Buoyancies in most of the major States are much lower for the entire period of the eighties and nineties in comparison with those for the eighties alone. In fact in many States they have dropped to below one. The Karnataka figure is the third lowest after Kerala and Andhra Pradesh.

Table I

Buoyancies of State excise duties

	'80-'81 to '92-'93	'80-'81 to '98-'99
ANDHRA PRADESH	0.98	0.07
BIHAR	1.34	0.99
KARNATAKA	1.03	0.56
HARYANA	1.35	NA
KERALA	0.94	0.59
MADHYA PRADESH	1.28	1.27
MAHARASHTRA	1.21	1.00
ORISSA	1.37	0.75
PUNJAB	1.10	0.74
RAJASTHAN	1.68	1.06
TAMILNADU	1.33	1.59
UTTAR PRADESH	1.51	0.76
WEST BENGAL	-0.27	0.87

Source: Computed at the Institute for Social & Economic Change, Bangalore on the basis of old NSDP figures up to '92-'93 and by using a dummy variable for capturing the shift to new SDP figures in '93-'94 Tax revenue figures are drawn from RBI reports on State finance.

4.3 Karnataka has not resorted to prohibition since the seventies (October 1967), despite being subject to the same pressures as other States. Although the previous government had made an election promise to introduce prohibition, it recognised fairly early that this could exacerbate the regulatory problem and adversely impact State finances. It, therefore, experimented with several methods of reducing liquor availability without actually resorting to public sector canalisation of the wholesale distribution of potable alcohol but was forced to return to the existing (not very satisfactory) auction cum licensing system.

4.4 The Commission would like to reiterate the point made in the first report that the objective of excise duties on potable alcohol should be primarily regulatory. Revenues are realised when fiscal tools are used to restrain consumption and guide it into desired channels but they are incidental to regulatory goals. The effectiveness of excise policy should not be gauged only or even mainly by revenue realisation as this tends to distort perceptions about appropriate fiscal tools and leads to undesired consequences. In principle, the regulatory objective should be pursued through excise duties while the revenue objective could be met through general commodity taxation (VAT). In practice, as later paragraphs indicate, objectives and fiscal instruments tend to overlap.

4.5 From the public finance viewpoint, the major questions to be resolved are the following:
-pitching the tax level at an appropriate level to reflect social priorities regarding control of consumption with an eye on rates in contiguous jurisdictions to prevent trade diversion and evasion through cross-border shopping.
-determining the rate structure and setting rates to discourage consumption of strong liquor without increasing incentives for trading in untaxed products.
-selecting effective physical, account and data based administrative mechanisms to control evasion and ensure compliance

4.6 Non-fiscal issues include the application of regulatory (regulation of the hours and manner of sale and location of sale points, age restrictions, etc.), social and health related measures (counselling and de-addiction for alcoholism). Since they cannot be totally divorced from the fiscal package, our recommendations in this chapter will touch on such matters too.

4.7 Developing appropriate strategies for regulating the consumption of potable alcohol within a liberalised market-determined framework is a major challenge at the State level given the weakness and ineffectiveness of traditional regulation methods based on physical controls. In the Indian context, such controls have extended all the way from managing the quantities of potable alcohol produced to the entire cycle of distribution, retailing and consumption. We will in this chapter first examine the manner in which production and retailing of potable alcohol are regulated with reference to both quantitative and fiscal mechanisms in Karnataka and neighbouring States before focusing on the specific issues in the Karnataka context and suggesting how they could be handled.

Controls on production and production policy

4.8 States enforce capacity controls for distilleries, breweries and blending units by closely monitoring molasses availability and licensing the creation of additional capacity. Many States have not permitted capacity expansion for years because of perceived public disapproval. Time limits on existing licences are extended and licences are, therefore, likely to be traded at a premium. In practice, the production of potable alcohol has not yet been elevated to the respectability of a full-fledged industry, although erstwhile restrictions on credit from development financing institutions have been removed. The export and employment prospects of the sector and its potential as a major agro-based industry are high, particularly since oil companies have initiated efforts to develop alcohol-based substitutes for motor spirit (one such initiative is well under way at Miraj in Sangli district).

4.9 In States, which permit country liquor consumption, production is confined to State boundaries and closely monitored. Spillovers occur mainly in border areas through limited cross-border shopping. The production mechanism in Karnataka, (which alone of the four southern States has a separate regime for country liquor), has been referred to in the Commission's first report. Section 16A (1) of the Karnataka Excise Act was amended with effect from 1/7/93 to restrict the grant of licences for manufacturing and bottling arrack to companies and agencies owned and controlled by the State or a State department. Arrack is blended today only by two public undertakings-Mysore Sales International (MSIL) and Mysore Sugar Company (Mysugar). The Karnataka Excise (Manufacturing and Bottling of Arrack) Rules, 1987 lay down the conditions for manufacturing and bottling arrack (including warehouse licensing), the machinery to be used for manufacture and storage, blending procedures, the price fixation mechanism, quality control and accounting requirements, wastage norms and stipulations for the release of liquor.

4.10 In the case of Indian Made Liquor (IML) and beer, there is scope for import and export of molasses, spirit and final products across State boundaries in the southern States. Tamilnadu and Andhra are practically self sufficient with respect to IML. Tamilnadu is also self-sufficient with regard to beer, but Andhra Pradesh imports more than 40% of its requirement. Both States are not structurally surplus as far as molasses is concerned. Tamilnadu had in fact only 5 distilleries for a long time, while Andhra Pradesh has close to 30. Occasional production increases in molasses are handled in both States by permitting exports. These States also permit molasses and spirit to be exported and imported (mainly from Maharashtra and Karnataka) whenever necessary to take advantage of quality and price differentials. It was stated during discussions with officials that only existing manufacturers are being allowed to expand capacity to some extent, because establishment of greenfield distilleries tends to get politically controversial. In Andhra Pradesh, 90% of the distilleries are attached to sugar factories, which has implications for effective enforcement.

4.11 Kerala, however, is deficit in spirit although blending is done locally by importing extra-neutral spirit from neighbouring States like Karnataka. 90% of the IML consumed in the State is blended in this fashion as also 60% of the beer. Of the southern States, Karnataka alone is a net exporter of IML and beer. Production, import and export figures for these products in Karnataka are indicated at Table II.

Table II

Availability & sales of IML and beer in Karnataka (1999-2000)

(In lakh ltrs.)

	IML	Beer
Production	509.76	977.16
Sales to wholesalers	183.37	552.55
Export	294.86	423.89
Import	13.23	8.15
Availability in State	228.13	561.42
Sales to retailers	282.16	502.94

Source: Excise department

4.12 Our western neighbour, Maharashtra, which is a major producer of sugar, also has substantial molasses surpluses. 5.69 lakh tonnes of molasses were despatched outside Maharashtra in the last sugar year, of which almost 2 lakh tonnes were exported overseas. There is thus potential for diversification and expansion of the production capacity for spirit and IML. With recent growth in grape production, Maharashtra has even become a major exporter of wines, but these are largely sent abroad. Fresh licences for blending country liquor and IML (and for distilleries) have not been given in Maharashtra since 1985. It was indicated by departmental officials that there are 60 pending distillery applications of which 28 are from cooperatives. The official assessment is that there is scope for setting up 15 additional distilleries. Last year, a Cabinet sub-committee had made recommendations for licencing additional production capacity; a decision on the matter is stated to be pending. If this is done, preference is likely to be given to existing licenceholders in the cooperative sector with other applicants been accorded a lower priority.

4.13 The production capacity in Karnataka for molasses and spirit is given below. In 1999-2000, 6.35 lakh tonnes were produced in the State; after adding the opening balance of 22000 tonnes, 7.07 tonnes of molasses were available that year. 3.44 lakh tonnes were drawn by distilleries for manufacturing rectified spirit, 77000 tonnes were released for export and 1.5 lakh tonnes for other purposes. There was thus a surplus of more than 1 lakh tonnes, which should be adequate to run 2 to 3 distilleries. Although the Govt. of Karnataka has not made a formal policy announcement in this behalf, fresh distilling and brewing capacity have been more or less frozen for some years. Information furnished by the department indicates, however, that at least two distillery licences given as far back as 1968 and 1991 have been routinely extended up to date, although distilleries have not been set up and time limits given for project execution have been exceeded long back. 2 fresh distillery licences and a blending licence have also been issued in recent years-2 in 1999 and one in 2001, of which one is in the cooperative sector. Many licencees also seem to have discontinued production. 8 licencees are reported to have not renewed licences after 1997-98, 12 after 1998-99 and 16 after 1999-2000 (these figures pertain to all kinds of production licences).

4.14 There is a case for clearing up the present confused policy regarding issue of licences for setting up distilleries and blending units with reference to the availability of surplus molasses and the utilisation of existing installed capacity. Applications for issuing distillery and brewery licences are not called for at the government level. Those which are received by Deputy Commissioners under the Karnataka Excise (Distilleries and Warehouse) Rules of 1967 are examined with reference *inter alia* to the availability of molasses. A similar procedure is being followed for breweries also. Applications are routed through the Excise Commissioner to government. 7 applications duly recommended are now pending with government.

4.15 The licence structure for distilleries and breweries in Karnataka and some neighbouring States is given at Annexure I. Licence fees have to be paid annually by all licenceholders. This is also a fairly lucrative revenue source. The Karnataka licence fee rate for primary distilleries is much higher than rates in other southern States. Such a high rate has been fixed in the hope of recouping a part at least of the evaded tax through upfrong licence fee collection. The Karnataka government has been raising the licence fee for distilleries and blending units regularly and substantially since 1995-96. The licence fee, which was Rs. 2.5 lakhs for both primary distilleries and IML blending units, was doubled in 1995-96. Two years later, the former was raised to Rs. 6.5 lakhs and the latter to Rs. 7.5 lakhs; the following year the former went up to Rs. 8.5 lakhs and the latter to Rs. 10 lakhs. In 1999-2000, the licence fee for primary distilleries was raised to Rs. 15 lakhs and that for blenders to Rs. 18 lakhs. In the current year, they were again enhanced to Rs. 22.5 lakhs and Rs. 30 lakhs respectively. Brewery licence fees are identical to those for primary distilleries but rates are low for those making draught beer. (Additional licence fee in the nature of a 15% cess is also charged on all licences, except bottling licences, to fund infrastructure development in the State).

4.16 Other southern States have adopted different production licence fee practices. In Andhra and Maharashtra, the fee is graded on capacity basis. In fact, the former State charges as high a fee as Rs. 50 lakhs for blending units with capacities over 40 lakh litres. For breweries, however, although Tamilnadu and Karnataka have made a distinction between bottled and draught beer, Andhra has a single high rate of Rs. 20 lakhs for all units.

4.17 Since licence fees accrue on the number of distillers, blenders and brewers in the State, Tamilnadu with 5 IML manufacturers and 2 brewers does not earn much from this source. Karnataka has today 20 primary distilleries manufacturing spirit, 37 IML manufacturers and 6 brewers. Of these, only 7 are composite units combining distillation and blending. 2 are in the cooperative sector and one in the public sector. There are, therefore, more production units in our State than in Andhra which has 27 IML manufacturers and 4 brewers. Maharashtra has more distilleries than Karnataka. As many as 47 of the 58 distilleries of Maharashtra are attached to sugar factories in the cooperative sector and these account for 75% of the spirit production capacity of the State; 1 is partly owned by government and only 10 are in the private sector. 3 of these 10 are attached to chemical units and dedicated to the production of industrial alcohol.

4.18 The working group of the Confederation of Indian Alcoholic Beverage Companies (CIABC) has suggested that production should be based on market demand and that restrictions to the entry of new players should be removed and monopoly discouraged. It has suggested that adequate time should be given to producers in production licences to build up infrastructure. It has also recommended that licensing policies should be stable over 2 to 3 years and that licences should be valid for a 5 year period. In the view of CIABC, too short a time limit discourages new entrants while too many extensions encourage monopolies. The Excise department has responded to these demands by pointing out that there is no case for quinquennial licensing since licences are being promptly renewed every 3 years and licence fees collected on an annual basis.

4.19 Keeping the above facts and views in mind, the appropriate licensing policy to be adopted for distilleries, blending units and breweries and the licence fee structure suitable for Karnataka have been considered further on in this chapter. Given the significance of molasses based production for Karnataka, we must note that increased inflow of foreign liquor, consequent on the lifting of trade barriers from April 2001, has exposed Indian brands of liquor to severe competition. For the present, this is being handled by the Central government which is trying to equalise the tax burden on imported and domestic products through high countervailing Central duties. (Revenue from these duties is part of general Central tax revenues, a fixed percentage of which is shared with States). Present rates of countervailing duty are the following:
-150% for brands of alcohol in the low price band,
-100% for brands in the medium price band and
-75% for brands in the high price band.

4.20 This is additional to basic customs duty of 100% for wine and beer and 210% for other liquor. In the long run, however, there is no escape from competition. Product upgradation and aggressive marketing are essential if Indian IML products are to hold their own in the market.

Liquor availability

4.21 Apart from States, which have opted for prohibition like Gujarat, other States control the macro availability of liquor to restrain consumption. This is done both by limiting the number of production points as well as by reducing the number of sale outlets. A case is sometimes made out for making liquor available in a fairly extensive manner at reasonable prices to forestall possibilities of illicit distillation and attendant health hazards as well as to ensure lower outgoes from family budgets on an inevitable item of expenditure. This can be done by combining wide retail availability of cheap liquor brands and foolproof mechanisms of quality control. Among the southern States, Karnataka alone seems to have taken this route, but its western neighbour, Maharashtra, has an even more market-based system of liquor distribution and availability. In Karnataka, country liquor continues to be marketed as a standardised separate cheap low end product for the consumption of poorer sections of the population (blue collar workers in urban areas and labourers in rural areas). Adulteration is checked by routing the blending of arrack through two public sector undertakings. Partly for this reason, there have not been cases of mass poisoning of liquor in the State for some time.

4.22 In all States, social effects attributable to indiscriminate liquor consumption like domestic violence, anti-social behaviour, public disturbance and the like have given rise to spontaneous uprisings against liquor contractors. Widespread public opposition to the free availability of liquor throughout the nineties has resulted in severe reduction in the number of sale outlets in most southern States. The effects are most apparent in rural areas. Andhra Pradesh and Tamilnadu have abolished country liquor and cut down drastically on the number of retail sale outlets. Kerala, after a recent tragedy, has strictly regulated liquor sale and routed it through government or cooperative sector shops.

4.23 The effects of these policies are apparent in the relative availability positions of liquor varieties with high and low alcohol content in southern States for 1999-2000 presented in Table III. The inter-State comparison is restricted to "wine shops" or outlets authorised to sell packaged liquor. The table vividly indicates the difference in approaches between Karnataka and other southern States. It is apparent that because Karnataka has continued with the policy of permitting the sale of arrack through several dispersed outlets, the number of sale outlets in Karnataka is much higher than in other southern States and the population served per outlet much lower (although per capita sales are largely comparable). Arrack outlets account for 12000 sale points. Karnataka, Andhra Pradesh and Tamilnadu have broadly similar per capita sale figures, but per capita sales of strong liquor are distinctly higher in Karnataka (because of the wider availability of country liquor). Tamilnadu has higher per capita sale figures for low alcohol varieties, principally beer.

4.24 This point has been highlighted by the Health Task Force of Karnataka, which is rightly concerned with the higher per capita availability and sale of strong liquor in Karnataka. The availability of strong liquor (in Karnataka, this implies country liquor, IML as well as beer above 5% v/v) must be reduced or controlled. By permitting manufacture and sale of country liquor, liquor availability, particularly that of strong liquor, is much higher in the rural areas of Karnataka than in other southern States. With this in mind, we will consider in the following section issues like the ban of country liquor, the procedure adopted for licensing retail outlets and the licence fee structure for retail vending of potable alcohol.

Table III

LIQUOR PRODUCTION AND AVAILABILITY IN SOUTHERN STATES '99-2000

Liquor quantities in bulk lts.

	High alcohol varieties-arrack & IML				Low alcohol variety beer				All varieties			
	Karnataka	Kerala	Andhra	Tamilnadu	Karnataka	Kerala	Andhra	Tamilnadu	Karnataka	Kerala	Andhra	Tamilnadu
Per capita production *	8.91	NA	6.55	6	6.2	NA	1.97	2.21	15.15	NA	8.5	8.25
No. of production points	48	14	27	5	6	2	4	2	54	16	31	7
Per capita sales*	7.46	5.87	6.55	6.5	3.21	1.97	3.54	4.19	10.67	8.16	10.1	10.69
No. of sale outlets	15798	691	6006 **	4069	3798	753	6006	4069	15798	753	6006	4069
Population/outlet	992	17049	3741	4798	4125	13147	3741	4798	992	13147	3741	4798

* computed on males between 15 and 60
** 3434 are in urban areas

Sale outlets do not include restaurants, clubs, bars and the like.
For Kerala, IML production points are only blending units, for Karnataka country liquor is blended in public sector units; these are not inclu

NA = not applicable

Source: Computed on data furnished by State excise departments using population figures from the 2000 census

a) Ban of country liquor

4.25 Other southern States have abolished country liquor as a separate excisable item; only Kerala has very limited sale of toddy. (Our western neighbour, Maharashtra, continues to permit the manufacture and sale of country liquor through licensed dealers). Although this was done to link all spirit-based liquor to better-quality neutral spirit instead of the cruder variety of rectified spirit, the policy measure was accompanied by substantial reduction of the number of rural retail outlets for strong liquor since it went hand in hand with abandonment of the auction system and channelling of wholesale distribution through a public undertaking. In this manner, these States coped with both the public outcry against widespread availability of liquor (especially strong liquor) arising mainly from rural areas as well as the danger of illicit distillation and related "liquor tragedies". Karnataka continues to market a specific cheaper variety of strong liquor in the form of arrack made from rectified spirit, although blending is routed through two public undertakings. The auction system has continued but only for retail vending, not for blending or bottling. There has, therefore, been no move to drastically reduce the number of retail outlets, particularly in rural areas and there has also not been a concerted movement against liquor vending in the State. The Health Task Force too has adopted a pragmatic approach and suggested better regulation of liquor availability at the micro level, not drastic pruning of the total number of outlets.

4.26 We cannot also ignore the fact that rural outlets maintained by contractors who succeed in country liquor auctions are generally product specific. This means that they stock and sell only arrack, which is strong liquor. This considerably reduces the scope for offering a lighter alternative at the same price to the consumer. A total ban of country liquor could result in illicit distillation (particularly distillation that escapes regulation) and lead to "liquor tragedies" unless the ban is accompanied by effective enforcement and inspection. Policy measures to be taken in this area are indicated further on in the chapter.

b) Regulating the number of retail outlets

4.27 For all practical purposes, the number of retail outlets has been frozen in Karnataka from February 1992 onwards. Grant of licence is covered under the Karnataka Excise (Sale of Indian and Foreign Liquor) Rules of 1968. Rule 12 stipulates that in urban areas there could be one outlet for a population of 7500 or fraction over 3500 and in rural areas one outlet for a population of 15000 or fraction over 7500 (census figures projected for the latest year are used to determine the quota available for each taluk). Since quotas were not being fixed nor fresh licences issued, the Court has directed the government to fix quotas in accordance with Rule 12. After considering the matter in depth, the Excise Commissioner has also made a recommendation on the matter to the government suggesting far fewer outlets than permissible under Rule 12. This is now pending with government. If fresh licences are proposed to be granted, the quota available per taluk will have to be publicly notified, applications obtained and processed by Deputy Commissioners and licences issued with the Excise Commissioner's approval.

4.28 Practices in neighbouring States in this connection are worth consideration. In Andhra Pradesh, the number of retail shop licences was frozen for 10 to 15 years. There were around 24000 licensed country liquor shops before prohibition was introduced. When prohibition was removed in 1997-98, the number of shops was restricted to 3211. In 1998-99, a Cabinet subcommittee fixed high licence fees graded on population size and permitted issue of licences to those who were prepared to pay the fees. As a result, the number of shops went up to 10000. There was public agitation and the government attempt to encourage people to surrender licences by raising licence fees. The number of shops is now stated to be 6553. Retail shops are allotted by auction but licence fees are also collected.

4.29 In Tamilnadu, retail vend of alcohol is done through three-year auctions, with a standardised 10% increase in auction amount (privilege fee) in the intervening years. The number of outlets is stated to be around 4181 at present. (Against this, Karnataka has almost 12000 country liquor outlets and 3398 IML outlets, around 4 times the number of outlets in Tamilnadu and 2.5 times the number in Andhra Pradesh. These outlets sell liquor with both high and low alcohol content). In Kerala, after retailing has been recently taken over by the government, the number of outlets is stated to be 235 although it is likely to go up to meet increasing demand. In Maharashtra, from 1973, fresh licences have not been issued although there has been no formal policy announcement to this effect.

4.30 Since existing country liquor auction arrangements in Karnataka provide a large number of outlets for strong liquor alone in rural areas, there is a case for looking at measures for giving consumers a wider choice of softer varieties like beer and wine by improving their availability. (There is also the *inter se* pricing issue, which will be considered further on in the chapter). From the point of view of retail sales, IML licence holders are entitled to sell bottled beer and wine under the CL2 licence issued under the Karnataka Excise (Sale of Indian and Foreign Liquor) Rules, 1968. Under Rule 4 of the Karnataka Excise (Retail Vend of Beer) Rules 1976, licences can also be given for retail sale of beer alone. In urban areas, one such outlet can be licensed for a population of 20000 persons or fraction up to 10000 and in rural areas for a population of 30000 or fraction up to 15000. The licence fee for retail vending of beer was Rs. 10000 up to 1995, when it was doubled to Rs. 20000; this was increased to Rs. 30000 in 1999. Although this was meant for both bottled and draught beer, apprehensions of evasion through misuse of RVB licences for selling IML also and lobbying by IML vendors have led to restriction of such licences to pubs in which only draught beer can be sold in a loose form. Such licences are practically banned so that old ones tend to get transferred in the grey market. Outside Karnataka also, pub licences are issued only in Maharashtra and West Bengal (in Calcutta alone). Pubs are, therefore, not just vending points for beer; they must also provide limited catering services and incur corresponding liabilities and costs.

4.31 Karnataka had tried to tackle this issue, in the last budget, by permitting the sale of beer in supermarkets, which was widely criticised. The Excise Commissioner has indicated that this was done to bring down the prices of beer since it was being sold at high prices in dedicated "wine shops" by retailers who were cornering the sales margin. It was felt that in supermarkets, beer would be more widely available; it would also have to compete with substitute foreign liquors. The expected fall in prices was expected to wean people away from high alcohol content IML, which is being sold even cheaper than beer in "wine shops" now. However, the measure had to be withdrawn due to public opposition.

c) Licence fee structure for vending

4.32 Apart from quantitative control of the number of permitted sale outlets, the licence fee structure is sometimes modulated to restrain expansion of outlets. Retailing is generally done through dedicated "wine shops" or as a component of the hospitality industry in restaurants (including beer parlours and bars) and clubs. In Kerala, liquor retailing has recently been taken over for public sector distribution and in Tamilnadu and Andhra Pradesh, retail licences are being auctioned. (In Tamilnadu, there is no retail licence fee for sale outlets, only a "privilege fee" which is in the nature of an upset price for auction of the outlet, but Andhra Pradesh has a licence fee in addition to the "reserve price" fixed during auctions).

4.33 Officials of Andhra Pradesh indicated that the IML licence fee structure was being used to some extent to reduce the demand for liquor sale outlets. The comparable licence fee structure for retail shops in Karnataka, Andhra Pradesh and Maharashtra is given at Annexure I. This applies only to IML in the first two States, while in Maharashtra it extends also to arrack. Kerala has no retail licences now that retailing is being done by a State undertaking.

4.34 Tamilnadu charges vend fee per case on the public sector wholesale distributing company and Andhra Pradesh siphons off profits earned by the corporation in the form of margin and special privilege fee (the current rate for the margin is 6.75% to 15.75% of sale price for different brands and a further 10% as special privilege fee). Karnataka and Maharashtra continue with a system of wholesale licencing. In Karnataka, one wholesaler is generally permitted for 5 retailers. For areas with population over 20 lakhs, the fee is Rs. 8,25000, while for other areas, it is Rs. 6,75000. Even if this is taken into account, the incidence of licence fee in Karnataka may not be higher than that in Andhra Pradesh although comparison is not easy. It was also indicated that it is now proposed to reduce retail licence fees in Andhra Pradesh on public demand. In Maharashtra, the wholesale licence fee for strong liquor is only Rs. 143000. The licence fee structure for pubs has already been studied in earlier paragraphs.

4.35 Apart from regular retailing, restaurants and clubs which serve liquor are also required to be licensed. Karnataka, Maharashtra and Andhra Pradesh have a licensing structure based on population, while Tamilnadu has aligned its structure on the star rating of the licensee. License fee rates in Andhra Pradesh have been kept high in this area also. The comparative picture is given at Annexure II

4.36 An interesting feature of the Maharashtra policy is the power enjoyed by the Excise Commissioner since 1996 to raise retail licence fees by at least 10%; it was indicated that this is being done regularly. Annexure II indicates that the Tamilnadu licence fee for 5 star hotels is Rs. 4 lakhs, which is double that in Karnataka for the most urbanised group while the highest fee in Andhra Pradesh (for areas with population over 7 lakhs) is as high as Rs. 12 lakhs.

4.37 The availability issue is intimately linked to alcohol content. It is agreed that consumption of strong liquor varieties like IML, arrack and high-strength beer should be restricted, an argument that is frequently adopted by brewers to push through proposals for more outlets and tax reduction. The All India Brewers' Association has been advocating the idea of "beer only" outlets in addition to the existing composite structure for this reason. However, the substitutability of low alcohol content liquor for strong liquor is limited. Sharp reduction of the availability of strong liquor could encourage adulteration and illicit distillation even if cheaper low alcohol varieties are easily available. While there is a case for restraining availability using quantitative restrictions and fiscal measures, the former enhances the discretionary powers of politicians and government officials and promotes rent-seeking, while, from the taxation point of view, it is not easy to determine the appropriate overall tax level.

Tax structure for potable alcohol

4.38 While aligning some of the concerns expressed above to the specific question of liquor taxation, the following issues require consideration:
-discouraging consumption of liquor varieties with high alcohol content by imposing relatively higher rates on strong liquor
-choosing between *ad valorem* and specific rates-the issues involved are discussed in later paragraphs
-managing the interface between the excise component and the general taxation component
-discouraging cross border movements by aligning rates with those in neighbouring States

4.39 These intimately related objectives have been kept in mind while assessing the tax incidence on potable alcohol in Karnataka in comparison with those in neighbouring States and making recommendations for restructuring the excise duty and sales tax mechanisms in the context of the forthcoming introduction of VAT.

a) Assessing tax incidence

4.40 Understanding the incidence of excise duties and making inter-State comparisons is difficult, though not impossible, because of the levy of the usual commodity taxes (sales tax or variants of VAT), licence fees and the like and because of differing distribution structures (sometimes differentiated by product too, as in Karnataka, where arrack vending alone is auctioned). There is also the problem of *ad valorem* duties in Kerala for IML. On the whole, incidence should be assessed by looking at both excise duty and commodity taxation. Licence fees and their substitutes at the wholesale level consequent on nationalisation of wholesale distribution in some States (like the Tamilnadu vend fee and the Andhra Pradesh margin and special privilege fee) are better treated as regulatory levies but auction rentals for arrack are more in the nature of pure tax measures even though they carry a regulatory component also. The privilege fee of Tamilnadu collected while auctioning retail vending may have to be treated as a retail licence fee although it could incorporate a tax element too. From this point of view, two comparisons of tax incidence across southern States have been made at Annexures III and IV. (In the case of Karnataka, the excise duty structure prior to merger of sales tax and excise duty in February 2001 has been compared; tax incidence has not been affected by the change since sales tax has only been converted into additional excise duty). Annexure III relates to excise duties alone while Annexure IV is an attempt to assess the overall tax incidence on a popular IML variety in southern States.

4.41 For the reasons mentioned earlier, the comparisons at Annexures III and IV should be used only for broad judgments. Overall, it appears that the Karnataka duty (excise duty and litre fee alone) on beer is the highest among the southern States with specific duties; the Andhra duty on beer is close behind but Kerala and Tamilnadu have much lower duties. In the case of IML too, excise duty is highest in Karnataka (excluding Kerala which has an *ad valorem* structure), particularly since there is no differentiation based on varieties and price. Even arrack in Karnataka is charged a high duty in comparison with that on IML in the three southern States if per litre auction rentals (discussed further on) are considered, but arrack is not subject to sales taxes like IML.

4.42 Given the different mechanisms employed by States to tax potable alcohol, excise duty structures alone may give a distorted picture of tax incidence. An attempt has therefore been made at Annexure IV to compute tax incidence on a popular IML variety in the four southern States. It must be noted that where wholesale distribution is routed exclusively through public sector undertakings (in Tamilnadu, Andhra Pradesh and Kerala-even retail distribution is nationalised here-as well as in Karnataka for country liquor), the margins generated while managing the costing and pricing of liquor and profits or cushions which are eventually transferred to the government as a component of excise revenue after accounting for permissible operating costs have to some extent been captured under taxes on potable alcohol. In this comparison too, the tax incidence on IML in Karnataka (prior to the merger of sales tax with excise duty in the form of additional excise duty) is seen to be the highest. The incidence in other southern States clusters close together.

4.43 In the case of beer, a listing of excise, import and export duties as well as sales tax and surcharge on mild and strong varieties across States and Union Territories has been made by The Brewers' Voice (the official publication of the All India Brewers' Association) in its April-June 2000 issue (Annexure V). Of 26 governments, Maharashtra alone seems to have an *ad valorem* duty structure. Specific duties range, however, from a high of Rs. 12.18 per bulk litre in Assam and Bihar to a low of Rs. 1.03 in Arunachal Pradesh and Rs. 1.75 in Pondicherry and Mahe. The comparisons may need some rectification since the figure given for Karnataka is exclusive of litre fee of Rs. 1.5. Among the southern States, the lowest tax rate is Rs. 2.5/bulk litre in Tamilnadu, which is probably linked to preventing cross-border movements towards Pondicherry. This is followed by Kerala with Rs. 3, Karnataka with Rs. 4 and Andhra Pradesh with Rs. 5. Rates in major States in other parts of the country are generally far higher. Some States like Sikkim, Himachal Pradesh, Punjab, Rajasthan and Uttar Pradesh differentiate between mild and strong beer. What is noticeable is the substantial difference in tax burden between these two in Delhi, where the tax on strong beer is close to 3.5 times that on lager. This has probably been necessitated by the health, traffic and other hazards associated with the consumption of high alcohol content beer particularly in urban areas. None of the southern States or Union Territories differentiates between lager and strong varieties of beer. The Brewers' Association has also separately indicated that growth in beer consumption has been in strong varieties, which seem to offer better value for money to consumers in terms of intoxicant capacity in comparison with IML.

4.44 All the southern States and Union Territories levy sales tax on beer, with the Andhra rate apparently the highest, though, as we have indicated earlier, incidence can be determined only by looking at distribution methods and the mechanisms adopted to compute tax. Some of the major States-Madhya Pradesh, Maharashtra, Haryana and Rajasthan-do not levy sales tax on beer. In the case of Maharashtra, this is because they prefer to use excise duty as a fiscal tool for taxing potable alcohol instead of sales tax. (It was, however, indicated by departmental officials in Maharashtra that VAT at 20% has since been introduced at the wholesale and retail levels)

b) Sales taxation and excise duties

4.45 Under the Constitution, although alcohol is the only item in which the entire production-distribution cycle can be subject to State levies, historical factors and the exigencies of taxation of a demerit good have resulted in a dual levy mechanism for potable alcohol in most States. Excise duty is levied and managed by the Excise department but alcohol is also subject to the usual range of State commodity taxes administered by the Commercial Tax department (the general sales tax rate on alcohol is among the highest). With value added taxation under consideration in many States, the most appropriate mechanism for taxing liquor will have to be examined in some detail.

4.46 There is considerable overlapping between the two kinds of levies on potable alcohol in most States today. Although excise duty is expected to be a single point (generally specific) levy and sales tax a multipoint (*ad valorem*) one, different States have adopted different mechanisms. Aspects of VAT have also been imported into the sales tax system for potable alcohol by setting off tax paid at earlier points of the chain or netting out the tax base at each taxing point (the tax-credit or invoice method and the subtraction method in VAT parlance). The computations done in Annexure IV for southern States gives a flavour of the way in which tax mechanisms have been applied to IML.

4.47 There is no sales tax on arrack in Karnataka. Sales tax rates in the other southern States for IML also seem to be less heavy than in Karnataka (70% in Andhra Pradesh, 50% in Tamilnadu and 85% in Kerala against our erstwhile rate of 115%). In Tamilnadu, there is a tax of 3% on the manufacturer's price, one at 50% on ex-factory price (including excise duty, vend fee and manufacturer's sales tax) and a "value added tax" at 50% on the selling price to the retailer against which the 50% sales tax earlier paid is deducted. In Kerala, sales tax at 85% is levied on the warehouse selling price (which includes *ad valorem* excise duty at 100% and specific import fee). 85% sales tax is again calculated at the retail point on the retail price (net of sales tax paid at wholesale level) and the difference remitted to government. In Andhra Pradesh, sales tax is levied at 70% at two points (before and after charging the margin of the Beverages Corporation that is at the purchase and sale points of the Corporation) but cascading is avoided. In Karnataka, up to 15th February 2001, sales tax at 115% and cess at 5% were being collected on the basic price plus excise duty and a further sales tax at 10% (without adjustment) on the retail price at the last point. After replacement of sales tax by additional excise duty, the appropriate slab of specific additional excise duty is added to the excise duty and litre fee at the manufacturing point itself. It is clear, therefore, that what is relevant is not just the sales tax rate but the manner in which it is computed. As noted earlier, the comparison done at Annexure IV indicates that the tax incidence on IML in Karnataka is probably the highest among the southern States.

4.48 The continuing complaint in Karnataka is that strong liquor varieties are available cheaper than milder varieties, which explains the undesirable high figure of per capita consumption of strong liquor. The Health Task Force has also pointed this out in its report. The complaint is clearly with reference to arrack, which, as we have already seen, is available fairly freely in the State. In other southern States, due to the abolition of country liquor, the cheapest available strong liquor or IML costs around Rs. 150 per bottle of 750 ml., which is much higher than the maximum price fixed for country liquor in Karnataka (Rs. 85/litre). It is stated with some truth that arrack manufacturers often sell arrack at higher prices (up to Rs. 100/litre) and take advantage of the market. It is not possible, however, to accurately assess the comparative tax incidence on IML, beer and country liquor, since the last is auctioned. When attempts are made to compute auction realisations per litre of arrack consumed as reported by contractors for excise duty purposes (we have done this for 1999-2000), we get an anomalous picture of tax incidence, since the per litre auction rental itself comes to around Rs. 74, which, with excise duty of Rs. 20, is higher than the final approved sale price of Rs. 85 (another confirmation of the widely held belief that consumption figures are doctored by contractors to keep total outflows to the exchequer on rental and excise duty taken together within manageable limits). If consumption figures are adjusted for evasion estimated by us at Annexure X of Chapter V of the first report, the per litre auction rental comes down to Rs. 43 and tax incidence on arrack to around 74%. This is still higher than the current tax incidence on beer (43%) even after adding on licence fees charged on beer outlets.

4.49 A feature of the tax structure commonly applicable in States seen at Annexure IV is the *ad valorem* nature of commodity taxation and the specific nature of excise duty.

Kerala has an *ad valorem* structure for excise duty itself while in Maharashtra, since 15/1/97, an innovative method of duty determination has been in place for State excise duties which is similar to *ad valorem* taxation. The duty and the maximum retail price in Maharashtra are fixed multiples of the basic cost, which has to be declared to the Excise department. MRP is 4 times the basic cost for strong liquor and 3.25 times for soft liquor (except wine which has a longer maturing time and therefore higher holding cost). For strong liquor (country liquor and IML), duty is twice the basic cost, but for mild liquor it is equal to basic cost. There is also an alternative specific duty structure, which acts as a floor rate, since the higher of the specific and *ad valorem* rates is applied. For IML, this is Rs. 125 per proof litre, for country liquor, it is Rs. 45 per proof litre while for beer it is Rs. 16 per bulk litre for mild varieties and Rs. 18 for strong varieties.

4.50 Karnataka has also recently introduced an innovation by "merging" sales tax with excise duty. In reality, there has been no merger; the erstwhile excise duty continues but the sales tax component has been converted into specific "additional excise duty" to be managed by the Excise department itself. Since AED has been retained as a specific tax, a rather messy mechanism of 29 complicated rates have had to be notified for hard IML liquor varieties. This has certainly reduced the number of departments to be dealt with by distillers to one, but it has considerably compromised the canons of simplicity and transparency.

4.51 An added issue relates to the point from which tax is to be collected. Excise duty is recovered when the product is released from the manufacturer's warehouse, but sales tax is payable only after it is finally sold to the consumer. For the administration, the former is simpler to collect and there can be little overt evasion; for the taxpayer, it means that tax is paid upfront before revenue is realised from final retailing. For this reason, the shift to AED in Karnataka has meant earlier and easier tax collection; this has created liquidity problems for distributors who are beginning to cry foul. Realisations of additional excise duty for one and a half months after change in the Karnataka system as furnished by the Excise Commissioner are of the order of Rs. 47 crs. If this is projected for a full year, total realisations would come to Rs. 376 crs., compared to around Rs. 218 crs. actually realised from sales tax and related levies administered by the Commercial Taxes department in 1999-2000 and Rs. 268 crs. in 2000-2001. (We must, however, remember that collections tend to balloon towards the end of the financial year which means that the estimations made above for a full year's collection of AED by the Excise department are likely to be slightly exaggerated). The distinction between excise duty and commodity tax implies that unless departmental data is shared on a continuing basis, one or the other department (generally the Commercial Tax department) might recover less than is due.

4.52 The theoretical position regarding *ad valorem* and specific taxation for liquor has been spelt out in the Guidebook for the Taxation of Distilled Spirits of the International Tax and Investment Centre, which has strongly recommended specific taxation of liquor. Specific taxes are easier and cheaper to comply with and administer, do not discriminate against high-quality, high-priced products, are neutral among imported items coming from different countries at varying exchange rates, and (by keeping prices of high quality prices at low levels) promote product development and discourage recourse to counterfeit products. *Ad valorem* duties have a cascading effect unless they are incorporated within a VAT structure, but (and this is not the line taken in the Guidebook!) they automatically adjust to price changes and are more equitable. The Maharashtra system of excise duty is based on an *ad valorem* arrangement, which is logical and effective. By making excise duty and the maximum retail price fixed multiples of the basic cost and modulating these multiples to differentiate between strong and mild liquor, the transparency and simplicity required for better compliance, reduced evasion and effective administration have been linked to equity and revenue objectives. It was indicated by Excise department officials in Maharashtra that after the introduction of this system in 1997, excise revenues increased substantially through government obtaining a share in profits, which were earlier accruing only to distilleries and blending units most of whom are attached to sugar factories in the cooperative sector.

Concerns and recommendations for Karnataka

4.53 The above analysis helps us to identify Karnataka's special concerns in the sphere of State excise duties. On the one hand, there is surplus productive capacity in Karnataka in the brewery segment. Molasses releases also indicate availability of surplus for distilling spirit. Unreleased surplus molasses if not exported (export figures are low for the State) are an open temptation for illicit distillation with attendant revenue and health implications.

4.54 On the other hand, capacity utilisation figures furnished by distilleries (Annexure VI) are very low. Apart from evasion through unaccounted spirit production, a reason for low capacity utilisation is likely to be distillery and brewery licence fees which are much higher in Karnataka than in neighbouring States. The overall picture for Karnataka (Annexure I) is one of high fees for both brewing and IML distilling, calibrated to discourage smaller producers since the high licence fee is not related to capacity (installed or utilised) as in Andhra Pradesh and Maharashtra. Licence fee represents a fixed cost for the distiller who may renew the licence to prop up the market value of his brand even when he does not break even in the hope of getting a better price when he sells the unit to recover his investment. Continuous increases in licence fees in recent years for mopping up revenues have increased the fixed costs for smaller producers and perhaps induced them to shut down operations. The number of unrenewed licences in recent years has already been indicated in earlier paragraphs. There are informal indications that the availability of many producers encouraged wholesalers to delay payments to producers for supplies drawn on credit and shift orders to newer entrants; this could have led to pressures being mounted on the government from older units to reduce the number of producers through high licence fee levels.

4.55 The combined picture of molasses availability, low distillery capacity utilisation and high licence fees makes it difficult to assess the potential for further capacity addition. Growth in alcohol production need not imply increase in consumption of potable varieties within Karnataka; IML brands could be developed for the foreign market and utilised by petroleum companies when alcohol-linked substitutes for motor fuel are evolved. Regulatory and fiscal policies should be geared to these requirements. The Commission suggests, therefore, that an expert committee should be appointed to look closely into the matter. It should consider the existing molasses surplus and the low capacity utilisation reported by licensed distilleries and determine the potential for utilising surpluses either by adding distilling capacity or by encouraging other alcohol-based production. Installed capacity is not specified in existing licences. It should be indicated whenever fresh licences are given. For existing units, however, the committee mentioned above should fix minimum capacity utilisation levels after obtaining an annual declaration of expected utilisation from each distillery. Distilleries which do not achieve the prescribed minimum levels should be liable to cancellation of licences. They should not also be eligible to acquire fresh licences or run additional units. Frequent random checks of capacity utilisation should be undertaken in addition to implementation of the e governance mechanisms indicated by us in the annexure to this chapter.

4.56 Close examination of relevant indicators could again disclose evasion. Energy consumption captured through electricity bills is a fairly useful indicator to assess the capacity utilisation of distilleries. In the case study on potable alcohol done at Chapter II of this report, we have noted that in Karnataka, this will be useful only at the blending and distillery stages, since earlier stages depend upon internally generated bagasse-based power. Some such pointers have been mentioned in the Commission's first report also. Turnover, profit and investment figures reported to statutory authorities for other purposes could also be used to confirm capacity utilisation figures given to the Excise department.

4.57 In view of the high licence fee structure in Karnataka, we recommend reduction in distillery and brewery licence fees to levels prevalent in neighbouring States. We also recommend making the rate proportional to installed capacity as in Andhra Pradesh and Maharashtra. The expert committee suggested above may also consider if incentivisation mechanisms could be developed for ensuring reasonably accurate reporting of capacity utilisation figures. Unutilised production licences should not be routinely renewed by the department. Licences are issued for distilleries and blending units without specifying the period within which they should be set up. The argument is that revenue can be earned from the renewal of licence fees. We recommend that since licences lead to pre-emption of production capacity, they should be in the nature of letters of intent as done in some States. The time limit for implementation should be specified in licences and extensions should not be given beyond 3 years. Old licenced projects which have not yet been implemented should be cancelled. If it is decided to add to existing distillery capacity, only integrated distillery-cum-blending units should be sanctioned and they should be as far as possible integrated with sugar factories. These measures will help to rationalise the existing system and reduce the scope for evasion.

4.58 We have already noted that because of the continuance of arrack in Karnataka, strong liquor is more widely available here than in the other southern States (Maharashtra might have a similar availability structure). This has of course made strong liquor affordable for poorer groups and reduced the dangers associated with illicit distillation and the possibility of "liquor tragedies". The scope for voluntary shift by consumers to milder varieties is limited by the auction mechanism for country liquor, which encourages arrack-only vending outlets. All this is reflected in much higher population/outlet figures for strong liquor than for beer in Karnataka. The higher figures could also be due to the higher population densities in urban areas since beer is a largely urban phenomenon. Nevertheless, there appears to be little choice of mild liquor varieties for the rural consumer.

4.59 The scope for higher taxation of country liquor is limited since the tax incidence on arrack, by whatever means measured, is much higher than that on beer. It continues, nevertheless, to be much cheaper than beer because of lower manufacturing costs, since in Karnataka and Maharashtra it is based on rectified spirit, not on the costlier, refined and better quality neutral spirit as in other southern States. These States, therefore, seem to have more price effective competition between mild and strong liquor (beer and IML). We must also remember that beer *per se* is not all of the same degree of alcohol content. Strong beer varieties above 5% v/v are substantially intoxicating but the tax structure is not differentiated on alcohol content in Karnataka as in places like Delhi, although urban areas (particularly Bangalore) are subject to the same risks arising from the consumption of strong beer. The Brewers' Association has thus recommended delinking of beer from IML for tax purposes and encouraging "beer only" sale and consumption outlets.

4.60 The most appropriate manner of modulating the availability of strong liquor in Karnataka has been considered by the Commission after noting that:
-banning arrack or insisting on better quality spirit (extra neutral spirit and neutral spirit instead of rectified spirit) could push up the manufacturing cost of arrack and reduce consumption; on the other hand, arrack is today already probably being sold above the official price of Rs. 85 (in Maharashtra the end price is only Rs. 60!)
-reducing the number of sale outlets, especially in rural areas, could result in illicit distillation and "liquor deaths"; on the other hand, the number of outlets is already much lower than permitted under the rules and there is pressure for modification
-further increase in the tax incidence on country liquor will definitely be counterproductive since our earlier analysis offers conclusive proof of underreporting of arrack consumption
-promoting availability of low alcohol content liquors and avoiding arrack only shops may not be possible under the present auction system; it could also invite public outcry as has happened with supermarket sales of beer

4.61 We have considered in depth whether country liquor should be banned in Karnataka to achieve the twin objectives of quality improvement and reduction in hard liquor availability particularly in rural areas. However, keeping in mind the ever-present danger of illicit distillation and liquor poisoning and the issue of alcohol affordability for poorer groups, we do not recommend modification of the existing routing of arrack blending to public sector undertakings and the auction system of country liquor vends. We suggest, however, upgradation of the quality of country liquor by making the use of neutral spirit mandatory and insisting on proper maturation of arrack. This should increase to some extent the end price of country liquor and mop up surpluses now accruing to vendors. It would also reduce the price differential between arrack and beer and help to restrain hard liquor consumption.

4.62 Quantitative restriction of retail outlets has been in place for strong liquor for almost a decade leading to existing permits being traded at a premium. The scope for further restriction is limited at the macro level, but micro concerns should be considered sympathetically. The ban on alcohol retail outlets near tribal areas should be extended all over the State. It could even be considered for other vulnerable hamlets like Lambani *tandas*. It may not be feasible to restrict the number of arrack sale outlets to one per village *panchayat* as this would imply halving the number of existing shops. We recommend, however, freezing the number of sale points in villages, which already have more than one outlet. An early decision may be taken on the policy to be adopted for fixing retail licence quotas and the Rules amended if necessary to pre-empt judicial intervention.

4.63 We have considered the existing licence fee structure for retail vending through shops as well as restaurants and similar places. If availability of mild liquor varieties is improved, drinkers are more likely to move away from stronger brands of alcohol. Licences for exclusive retail outlets for mild bottled liquor varieties may, however, be misused. Evasion could be controlled and availability improved if mild liquor varieties like beer (below 5% v/v) and wine are permitted to be sold along with items of general consumption in large marketing outlets. Government may consider how this could be done in large metropolitan areas.

4.64 The licence fee structure for hotels, restaurants and clubs has also been examined. If it is linked to star category status as in Tamilnadu, the burden might be unduly high for the few high quality restaurants and hotels located outside Bangalore and other big cities which cater purely to limited tourist traffic. We do not, therefore, propose any change in such fees for the present. In the case of clubs, however, there is no justification for the existing low concessional rate; we recommend that licence fees for serving liquor in clubs be increased to levels similar to those for hotels.

4.65 We also recommend increasing the range of choice for consumers of alcohol in rural areas. Liquor varieties with low alcohol content should be promoted to offer competition to arrack. The arrack auction system now in vogue should therefore be extended to cover cheaper varieties of beer with low alcohol content. The two kinds of products should be stocked and sold in common outlets. Under a government notification issued under Rule 15 (3a) of the Bottling of Liquor Rules of 1967, beer varieties below 4.5% v/v are not permitted to be bottled. The notification requires amendment; such low alcohol content varieties of beer should also be brought under the auction system for arrack. The services of an expert external consultant should also be taken to study how auction procedures could be modified so that cartelisation and cornering of bids is prevented.

4.66 We have also considered auction of IML outlets. A view has been expressed that if this is done, producers of IML varieties would form cartels and corner wholesale shops to convert them into exclusive sale outlets for their products. Introduction of the auction mechanism might also create pressures for increasing the number of outlets for strong liquor to increase rental revenue. Auction of IML outlets can, however, control evasion of excise on IML which is so widespread today. On balance, therefore, we recommend auction of IML outlets using the standard mechanism of a reserve price. We also suggest that appropriate auction procedures be adopted to prevent cartelisation of bids.

4.67 The tax structure on potable alcohol should also be modified so that the tax burden can be automatically adjusted to price increases. It should also be progressive as well as heavier for strong liquor varieties. From the conceptual point of view, there is justification for treating liquor like other commodities and bringing it under the normal sales tax (or VAT) regime. Since it is also a demerit good, the consumption of which must be discouraged to some extent, an additional levy (or excise duty) is also justified at the production point. The latter tax could be administered along with other regulatory measures by the Excise department while the former could be part of the usual commercial tax schedule. Such an arrangement might be somewhat cumbersome for the taxpayer, but since excise duty will be restricted to a limited number of producers, tax administration can be simple and costs of collection kept under control. When VAT is introduced, it appears logical to bring commodity taxation on liquor under VAT and apply the "special" VAT rate meant for goods whose consumption has to be restrained (like petroleum products). This component could be managed on *ad valorem* basis while excise duty continues as an additional, specific non-rebatable levy. The VAT rate will be much lower than the erstwhile sales tax rate on liquor. Revenue loss will therefore have to be compensated by high excise duties. The problem with this approach is that it is somewhat regressive since high value products consumed by affluent persons will bear a proportionately lower excise duty.

4.68 The Maharashtra model, which is somewhat akin to an *ad valorem* system, has a better logic since a lower tax rate could be applied to mild liquor varieties which could be sold at a slightly higher profit but there would be a higher tax rate (and lower profit margin) for strong liquor. The equity requirement is satisfied because *ad valorem* taxation ensures that the absolute tax collected from cheap country liquor will be less than that from dearer IML brands. Modulation of the rate structure has, however, been done in Maharashtra using excise duty not commodity taxation. The Empowered Committee of State Finance Ministers on VAT has not yet firmed up its views on the matter.

4.69 We have already indicated in the first report our reservations about the non-transparent, complex additional excise duty mechanism that has since been notified by the Government of Karnataka. The new procedure restricts interaction by taxpayers to a single department and reduces departmental harassment; it may also yield slightly higher revenue by permitting duty collection on the basis of the approved reserve price at the first point of sale by the producer to the wholesaler. To retain some of these advantages and take on board the government's recent approach, we propose to modify to some extent the recommendation made for a dual excise duty-VAT mechanism in the first report. We suggest, therefore, retention of excise duty as a single impost on potable alcohol. However, in the interests of simplicity and transparency, as also for better administration and compliance and the prevention of evasion, we suggest that excise duty should be administered as a multiple of the basic price declared by the producer on which the final sale price should also be determined. The multiples should be fixed differently for mild and strong liquor, which means similar higher tax incidence (in *ad valorem* terms) on country liquor, IML and strong beer and lower incidence on light beer and wine. The structure would be basically similar to the Maharashtra excise duty mechanism. The only beneficial VAT feature that would be lost by taking this route is the possibility of self-policing through input credits.

Controlling duty evasion

4.70 We have already mentioned in earlier paragraphs that if evasion of State excise duties on potable alcohol is controlled not only will there be increased revenue, there will also be reduction in the risk of consumption of adulterated illicit liquor, which has escaped quality controls and could be hazardous to health. The widespread belief that evasion is rampant in the case of duties on potable alcohol has been substantiated by the analyses made in the Commission's first report. We have already estimated evasion of excise duty and sales tax on country liquor as well as IML at Annexures X and XI of Chapter V of our earlier report. These have also been shared with manufacturers and their associations. The Brewers and Distillers Association has responded by indicating a probable figure of evasion of around Rs. 150 crs. alone at Rs. 200 per case on the 72 lakh cases estimated by the Commission. They have contested the estimates of profit margins and overheads adopted in the first report and pointed out that consumption targets fixed by the government are being consistently fulfilled. They have also drawn attention to the dumping of liquor in transit through Karnataka and suggested introduction of a cheaper IML variety to compete with country liquor. They have not, however, indicated the basis for the revised estimate of evasion nor refuted the computations made by the Commission. We are unable, therefore, to accept their viewpoint. We have also received information from income tax authorities about extensive suppression of IML production and marketing of "seconds" by large scale forging of excise labels. A price list for IML products circulated by the Wine Merchants' Association indicates retail prices at levels, which are too low to be sustained without duty evasion. Thus, we do not see any reason to modify the computations and comments made by us regarding evasion of excise duty and sales tax on IML as well as country liquor in the first report.

4.71 Evasion is possible at various points of the production and distribution chain although it is fairly closely regulated as the case study of the sector done in the annexure to Chapter II of this report indicates. "Excisable goods" are defined in the Excise Acts of States and detailed regulatory mechanisms laid out for such products. However, for many States like Karnataka, the control can legally start only with spirit in the case of molasses-based liquor. The earlier stage of production of conversion of sugarcane to sugar resulting in molasses as a by-product and molasses itself are not any longer subject to quantitative controls.

4.72 Most of the sugarcane produced is crushed in sugar factories, which are in the formal sector and are still subject to quantitative and a certain number of price controls (sugarcane farmers are allocated to factories, part of the sugar produced is reserved for distribution through the public distribution system as levy and the release of "free sale" sugar is regulated by government). The two latter controls are likely to be lifted very soon. There are also a large number of sugar factories in the cooperative sector subject to the close supervision of the Registrar of Cooperative Societies; these units are often run by officers deputed from the Cooperation department. All this implies a lower likelihood of escape of unaccounted molasses from such factories for the production of illicit liquor. Smaller *khandsari* units which produce jaggery (brown sugar) are fewer in number and molasses produced by them could go unaccounted. However, this may not be a very significant avenue for evading State excise duty on potable alcohol. We have made suggestions in the annexure to this chapter for administrative measures which can help to keep track of molasses produced in sugar factories and *khandasari* units.

4.73 To manage the utilisation of molasses, controls on distribution had been laid down in the Molasses Control Order of 1961 issued under the Central Industries (Development and Regulation) Act of 1951 but with the rationalisation done in the first phase of liberalisation, this order was rescinded by the Central government. States have been considering whether and how to introduce controls at their end. In Andhra Pradesh it appears that no law has been enacted; the Excise department is also not insisting on permits for transporting molasses. In Tamilnadu, a statute is in force because there has always been a Prohibition Act at the State level and it appears that there is a requirement of a licence; it was also stated by departmental officers that molasses is being allocated by the government. Maharashtra, U.P. and Bihar also have their own Acts prescribing controls on the supply of molasses for industrial purposes. In Karnataka, a draft law for controlling molasses was framed subsequent to the abolition of molasses control by the Government of India but it has not been adopted. Despite the absence of an Act, purchasers of molasses from sugar factories obtain permits from the Excise department to transport it to distilleries and sugar factories continue to report stock movements to the department. As we have seen earlier, due to public opposition, approvals are not being given for setting up fresh production capacity for spirit and surplus molasses is exported to other States or overseas. If fresh capacity addition is not permitted molasses is likely to escape into the unregulated illicit distillation network. This could happen in molasses surplus States like Maharashtra and to a lesser extent in Karnataka. It is desirable to enact legislation similar to that in Maharashtra on the basis of the draft already pending with government. The annexure to this chapter which contains detailed suggestions for e governance in the Excise department gives the minimum feedback required regularly from sugar production units to enable the department to control the escape of molasses from the organised sector. Prescriptions for the maintenance of minimum records of stock and movement and reporting requirements can be legally laid down and official verifications done for molasses only through formal legislation. A Molasses Control Act may be introduced covering these items but it is not desirable to enforce pricing or other distribution controls.

4.74 A major point of the production chain for potable alcohol at which there is unaccounted escape of inputs is when spirit is distributed from distilleries. Rectified spirit (RS) produced by distilling molasses is (in Karnataka as in Maharashtra) used for producing country liquor or further refined into neutral spirit (NS). The latter enters into the production of Indian Made Liquor (IML-mainly whisky, rum and brandy) or is used for other industrial purposes (chemical industries). To prevent diversion of NS and tax evasion from the former to the latter category, it is rendered nonpotable while leaving the distillery by conversion into Denatured Spirit (DNS). It is widely believed that evasion occurs at this stage of the production chain. There is less likelihood of leakage in integrated sugar factory cum distillery cum blending units. This is the case also with dedicated distilleries attached to chemical units. Many distilleries in Maharashtra are of this kind, in Tamilnadu and Andhra Pradesh also composite units seem to be more the norm than in Karnataka, which has very few integrated units and only 3 in the public and cooperative sectors.

4.75 Physical control seems inseparable in controlling evasion of State excise duties. It has however led to rent-seeking on a substantial scale with tentacles extending to policymaking levels. From the point of view of liquor production, such control is exercised (as in the case of Central excises) by stationing an official at the distillery to physically clear all transport of spirit for different uses as well as by checking the movement of spirit on the road or at check posts. Checking mechanisms in distilleries themselves need to be substantially strengthened. The prevalence of evasion despite the presence of officers of the department cannot be glossed over. It cannot take place under the noses of departmental officers without their knowledge and connivance since release orders have to be given by them before spirit leaves factory premises and RS must be converted into non-potable DNS only in the presence of excise officers. The suggestions made in the annexure to this chapter to tighten up administration in distilleries should be implemented to improve the effectiveness of physical controls.

4.76 A common method of evasion is to set up spurious chemical units and divert spirit (without conversion as DNS) for illicit manufacture of potable alcohol. During our visit to Tamilnadu, it was indicated that all licences of chemical units in that State had to be cancelled a year back after inspections revealed widespread misuse. There are around 36 RS based chemical units in Karnataka with a quota of around 24 lakh litres and 22 based on denatured spirit using 3.5 lakh litres. In 1991-92, an expert committee was set up to study the functioning of such units. On its recommendations, the capacity of each unit was fixed and spirit allotment quotas determined at 50% of the requirement. Allocations are now being made only up to these limits. A technical committee headed by a senior professor from the Regional Engineering College Suratkal with representatives of the Industries and Excise departments, the Small Industries Service Institute etc. as members is now functioning to determine the allocation of spirit for new chemical units. There has been increase in allocation of spirit for non-potable purposes in recent years but this could be because of the increased requirements of pharmaceutical units. Deputy Commissioners are expected to conduct regular inspections of such units but no drives have been undertaken in recent years. It was indicated by the Excise department that court orders prohibit entry and inspection of chemical units; the department is only permitted to control the actual denaturing process and the transport of spirit. There are also industries based on rectified spirit, which is not subject to denaturing. All this makes it difficult to prevent misuse of RS/DNS lifted from distilleries ostensibly for use by chemical units. It is essential, therefore, to focus on e governance methods within the distillery itself. We have made some suggestions in this behalf in the annexure to this chapter. We also recommend setting up a Joint Committee of the Excise and Industries departments to regularly review the external indicators available to judge the capacity utilisation and functioning of chemical units. Licences given to units, which are proved to be misusing spirit, should be cancelled.

4.77 Diversion of spirit can also be controlled by specifying wastage and recovery norms for molasses modulated in accordance with quality. The CIABC has suggested that the norm should be for a production of 220 litres of spirit and 2.25 litres of IML from every tonne of molasses. In Tamilnadu, such technical parameters are laid down by an expert group and quality checks done through forensic laboratories. In Karnataka, the Excise (Regulation of Yield, Production and Wastage of Spirit, Beer, Wine or Liquors) Rules of 1998 themselves lay down norms for beer, malt, grape and coconut toddy spirit, wine and rectified spirit. 220 litres of RS have to be produced from every tonne of Grade I molasses, 200 from Grade II and 180 from Grade III. There are no production norms for IML. The commodity study which we have done of potable alcohol taxation in the annexure to Chapter II reveals substantial abnormalities and divergences between expected and actual figures of spirit realised by distilling molasses. The Rules provide for fines to be levied on manufacturers who do not achieve prescribed yields equal to the duty on the difference in yield. It was indicated by departmental officers that such fines have been levied on distilleries.

4.78 Detailed recommendations for better governance in distilleries and blending units have been made in the annexure to this chapter. There is scope for improving existing distillery procedures for accounting for spirit. Conversion ratios for producing spirit from molasses are believed to be conservative and actual recovery ratios are stated to be higher than the 220 litres/tonne of molasses prescribed in the Rules. We recommend, therefore, that the ratio should be reviewed by the technical committee suggested in earlier paragraphs, which is to be established for determining distillery capacity utilisation, by conducting controlled experiments to ascertain actual average recovery rates. The quantity of spirit released from distilleries is recorded at the despatch point by weighing lorries before and after loading and converting the difference in weight into volumetric units by a simple formula. This is a fairly crude mechanism. We recommend that meters should be compulsorily installed at different points of the production chain to automatically record the quantitities of spirit produced. Meters should be fixed at the point at which spirit moves into pipes and also when it falls into storage VATs. They should also be installed at the point where spirit is loaded into vehicles. Calibrations recorded on such meters should be linked to the departmental MIS. The use of every litre of rectified spirit, neutral spirit and extra-neutral spirit as well as of denatured spirit should be recorded on computers so that it is directly available on the PC of the excise officer stationed at the distillery; these PCs should be part of the departmental network and the data conveyed on line to supervisory officers and the Excise Commissioner. The installation of such machinery must be made mandatory by amending Excise Rules. Opinions have been expressed that the quality of RS supplied to MSIL and Mysugar for blending arrack is sometimes doctored and the spirit released by this mechanism routed into illicit channels. We, therefore, recommend that laboratory checks should be mandatorily applied by the two undertakings at the entry point of RS into the blending process.

4.79 Distillery capacity utilisation is an important indicator of evasion. The figures for Karnataka are given at Annexure VI. As mentioned earlier, installed capacity has been indicated by distilleries themselves. Only 7 out of the 20 (1/3d) of the primary distilleries have reasonably acceptable figures of capacity utilisation. In Andhra Pradesh, it was indicated that capacity utilisation in distilleries was around 66%. In Maharashtra, 41 cr.litres of spirit were produced by distilleries against an installed capacity of 55 cr.litres. In comparison with these States, therefore, the Karnataka position is dismaying. It gives rise to the suspicion of significant leakage of spirit, a suspicion that is confirmed by the availability of IML at unusually low prices in the market (discussed above). We have already given recommendations for exercising effective controls on capacity utilisation in distilleries. We believe that auction of IML outlets will also help to control evasion.

4.80 Evasion is also likely at the point of distribution and sale of liquor. Although vending rights for country liquor are auctioned in Karnataka, excise duty is also levied on reported consumption figures. There is, therefore, a tendency for contractors to underreport consumption and reduce excise duty liability so that total outgoes to government are kept under control since bid amounts themselves are fixed and cannot be avoided. High auction rentals are likely to be compensated through lower consumption and excise duty figures. While discussing the combined excise duty-rental incidence on arrack in earlier paragraphs, we have shown how the tax burden per unit of arrack, computed on reported consumption statistics, adds up to a figure higher than the final sale price fixed by government. This is patently absurd; it indicates clearly that reported arrack consumption figures cannot be accepted at face value. Suggestions have thus been made to abolish excise duty and recover the entire revenue through rental itself. However, it is also believed that even non-duty paid arrack is manufactured and sold by successful bidders through regular sale outlets without paying excise duty is likely to meet health and quality standards. Under the auction system, therefore, liquor that is illicitly distilled and sold outside the regulated system is more susceptible to adulteration with poisonous substances. In the case of retail sales of arrack and IML, States use external indicators to informally pressurise distributors to report consumption. In Tamilnadu, retail sales data is maintained shopwise and offtake targets fixed for each shop. Despite this, there are apprehensions that "seconds" are being sold in licensed shops; it was indicated that illicitly distilled liquor is more likely to be sold in parallel unlicensed shops. In Karnataka, consumption targets are fixed by the department using 3 year averages of reported consumption. Nevertheless, as indicated in the Commission's first report, there is strong evidence of evasion of duties and sales tax on arrack and IML.

4.81 Adulteration is also sought to be controlled by close regulation of the packaging sizes and designs of seals used for liquor containers. Under the Karnataka Excise (Bottling of Liquor) Rules 1967, (Rule 15-2) liquor bottles are expected to be marketed in sizes of 750, 600, 500, 375, 300, 250 and 180 m.litres (except for arrack and beer) and 650 and 325 mlits for beer. Country liquor is permitted to be marketed only in polythene sachets of 50 ml.and 100 ml. The CIABC has sought greater freedom for manufacturers to decide packing sizes for vending liquor within the overall limit of 9 litres per carton based on their specific perceptions regarding market preferences and consumer tastes. For easy identification for tax and regulation purposes, the Confederation has recommended three packaging sizes for beer for brands with strengths of 5% v/v, and those with strengths higher or lower than 7% v/v. We have examined the matter in some detail. We do not, however, recommend any major change in packaging rules at present. In our view, sacheting may be continued for arrack vending since there is scope for misuse of bottling contracts.

4.82 Existing Rules in Karnataka stipulate that label designs should be approved for liquor containers by the Excise Commissioner to prevent adulteration and duty evasion. Adhesive labels are mandatory for liquor bottles and there is scope for greater leeway in selecting labels for certain product categories like exported liquor. The Rules also prescribe security seals for containers while holograms are proposed to be introduced from 2002. A fee is collected for approving label designs for IML-it is Rs. 10000 for bottles to be sold in Karnataka, while it is Rs. 250000 for products proposed to be sold outside the State. Labels are also permitted to be manufactured by a single government agency-Marketing Consultants and Agencies (MC&A). Here again, the CIABC has suggested that only regulatory requirements for labels should be specified by the department and manufacturers should otherwise be given freedom to use more than one label and choose their own designs, sizes and colours. The CIABC would also like manufacturers to choose their own designs for seals but is in favour of mandatorily indicating logos, brand names and names of licensees on seals.

4.83 Security devices have not been noticeably successful in preventing evasion and adulteration. Income tax officials have reported largescale manufacture of forged labels by IML manufacturers in Karnataka. Discussions are also going on about introducing other modern tamper-proof identification methods like bar-coding for locating non-duty paid products. Some of these can be duplicated, photographed or scanned. Holograms put on bottle tops cannot also prevent their re-use. Penalties are not prescribed in existing Excise Rules for those caught tampering with security seals. Offenders can only be prosecuted under the relevant provisions of the Indian Penal Code. As a result, there are few complaints and convictions. We recommend that a specific severe penalty should be laid down for this offence in the Excise Act and a high compounding fee levied to deter offenders.

4.84 Wastage norms are also prescribed for quantities of "excisable goods" lost in transport and storage. In Karnataka, the wastage norm for molasses transported by road is 1% while it is 2% for transport done partly by road and partly by rail. When spirit is transported by road, 1% is permitted to be accounted as wastage. A 1% storage loss is accepted in the case of molasses, 3% for spirit used in the redistillation of IML and 5% for bottling and related activities. The CIABC would like wastage norms for transport of "excisable" items to be tied to the distances covered and the time spent on transport-.3% for 100 kms. .5% up to 5 days, 1% for periods between 5 and 10 days and 1.5% for periods over 10 days. We do not propose any modification of existing norms.

4.85 Misuse of transport permits is another method of evasion that is widely used. It can be controlled by measures like computerisation, composite check posts and indication of time limits on permits. At present, a day's time is given for travel within the same city, 36 hours for distances up to 200 kms.and for longer distances, 36 hours for the first 200 kms.and 6 hours for every 100 kms. The CIABC has complained that these limits are impractical, since it takes 3 days to organise transport of labelled goods and arrange for guards, liquor issues are delayed till the evening and there are delays at check posts and in issuing certificates of verification, postal delays in dispatching permits and adverse road and climatic conditions. It has recommended 7 days time for transport and additional time to cope with poor terrain, bad weather and long distances. It also recommends allowing 10 days for an import pass to go through an exporting point and its processing. It suggests a journey time of a day/100 kms.and 20% extra time during monsoons (15th June to end-September). Such generous time limits are not justified and we do not propose further liberalisation of transport permits. Implementation of the recommendations made for better governance in the annexure will reduce delays in obtaining permits and facilitate interaction between taxpayers and the administration.

4.86 It might seem ironic that excise levies on inter-State movements of potable alcohol are (contrary to the canons of public finance) administered as destination-based levies, unlike sales taxes which are origin-based levies (when they ought to be destination-based!) Low export and import fees are charged on RS which is the basic input in liquor manufacture. When IML is exported, however, the importing dealer pays excise duty to the importing State and obtains the import permit, which is used to obtain the export permit from the exporting State. Before AED was introduced on 12/2/2001, CST at 4% was being charged on liquor exports and collected by the Commercial Tax department as in the case of other commodities. This is now being computed as AED and charged on exports in addition to a nominal export fee. It is also being collected by the Excise department. The present fiscal regime under which exporters pay very little tax to the State of origin facilitates evasion through fraudulent accounting of exports. If our proposal for levying an *ad valorem* excise duty as a multiple of basic price is implemented, the principle will have to be extended to imported liquor and exemption extended to exported varieties.

4.87 To ensure that duty-free exported liquor does not find its way back to the State of origin, check posts and other controls are laid down in Excise Rules. The Karnataka Excise Excise (Possession, Transport, Import and Export of Intoxicants) Rules of 1967 and accompanying circulars provide for excise guards to compulsorily escort export consignments of IML up to the destination point when exports are made to Union Territories in southern and western India. When exports are done to Rajasthan, Punjab and Haryana, escort is given to the border check post of the concerned State. Excise guards are provided by Deputy Commissioners of Excise and there is no fee charged apart from the permit fee of Rs. 100. Verification certificates are also expected to be produced from the importing State on receipt of the exported good. 60 and 90 days time are prescribed respectively for exporters to submit such certificates when exports are undertaken for civilian and defence sales. It is learned that there are substantial arrears of unproduced certificates. Instructions have been issued within the department for denying export permits to those who do not produce certificates within 10 days of the time given as also to take deterrent action against offenders. Rules have also been amended from 1st July of the current year, stipulating that exporters should furnish bank guarantees equal to 50% (10% in the case of defence supplies) of the value of exports to ensure that the required certificates are produced. Certain quantities and categories of liquor like toddy, molasses arrack, country beer, foreign liquor, DNS and wine do not require export permits. In Karnataka, MSIL is the only canalising agency for imported liquor. We recommend strict enforcement of existing regulations as well as implementation of the e governance measures suggested in the enclosed annexure to control evasion through misuse of transport permits.

Public monopoly of liquor distribution

4.88 The extent and role of direct public sector intervention in blending varies across States. A statement published in the Brewers' Voice in 2000 (Annexure VII) indicates that public sector distribution has been adopted only in three southern States although the Delhi administration seems to have taken over liquor retailing and Orissa was planning to nationalise vending of potable alcohol. (In Kerala, wholesale and retail vending are done through a public sector corporation). Most northern States follow the auction route, while eastern States continue with licensing. Maharashtra, Goa and Daman have not gone in for auctions as Madhya Pradesh and Chattisgarh have done.

4.89 The pros and cons of licensing retail outlets or auctioning them have been hotly debated by policymakers. Vending rights for country liquor are auctioned in Karnataka, but not the retailing of IML, while in Tamilnadu retail outlets are auctioned shopwise over 3 year periods. (The Tamilnadu policy is likely to be reviewed). In Maharashtra, the auction system is not in vogue, but it being seriously considered. Departmental officers are apprehensive about the possibility of gang wars, particularly in metros like Mumbai, if auctions are conducted although they concede that successful bidders have a greater incentive to prevent illicit distillation (particularly adulteration of the dangerous kind). Theoretically speaking, auctions are expected to promote competition and yield higher revenues. In practice, however, they are often cornered by cartels, who develop mafia-like links with power centers and tax personnel. Sophisticated auctioning techniques to take care of cartelisation have not been introduced for liquor vending anywhere in the country. If licensing alone is used to regulate the number of retail outlets, the discretion of departmental officers and their political backers is increased. When this is coupled with a policy of not issuing fresh retail licences (as is the case today in many States), earlier licences tend to get traded at a premium in a shadow non-transparent market, giving rise to further problems.

4.90 A method that is increasingly being adopted to tackle the enormous leakage possibilities at the spirit and/or final product point for hard liquor is direct public intervention. Karnataka is the only southern State, which has not fully nationalised the wholesale distribution of liquor, but even here there is a substantial presence of the public sector-it has the monopoly of manufacture of country liquor. The Karnataka model is intervention (only in the case of country liquor) at the blending point for manufacturing arrack and releasing it to successful bidders. In Tamilnadu and Andhra Pradesh, public sector corporations do not undertake manufacture; in the former State, liquor is procured and distributed to licensed retailers, while in the latter, auctions are held for IML vending. In Kerala too, public procurement stopped at the wholesale level till recently. In the wake of a recent"liquor tragedy", however, the public sector has entered the sphere of liquor retailing.

4.91 Public sector intervention certainly reduces possibilities of evasion and related health hazards but it transfers the onerous tasks of fixing production levels, product pricing for different brands, inventory management etc., which should be market-determined, to government control. It may increase the already enormous rent-seeking potential of the sector and expose officials and politicians to allegations about motivated price fixation. It has been preferred as the best option to prevent life-threatening adulteration and seems to have succeeded in this objective in Tamilnadu and Andhra Pradesh. The recent Kerala experience shows, however, that public sector intervention at the wholesale level cannot be guaranteed to prevent "liquor tragedies". Such occurrences can eventually be prevented by good enforcement alone. Public monopoly *per se* may not also eliminate evasion, but it can ensure better and earlier tax collection. Sales tax could be collected upfront when retailers lift stocks from the Corporation as in Andhra or paid by the Corporation when it buys liquor as in Tamilnadu.

4.92 We have considered the question of introducing public sector involvement in wholesale liquor distribution. Although this would facilitate revenue realisation to some extent, we do not consider it appropriate for government to assume the role of liquor distributor and take on the responsibility for price fixation, inventory management and other activities, which ought to be determined purely by market forces. Wholesale control is not also likely to eliminate "liquor tragedies" as the recent experience of Kerala demonstrates. We suggest instead improved e governance measures for better administration and a tax structure that would provide some incentive for better compliance. Public monopoly *per se* may not eliminate evasion, but it can ensure better and earlier tax collection.

Administrative issues

4.93 The various regulatory requirements of the Excise department which relate to quantities and values of "excisable goods" procured, processed, transported and sold principally within the chain commencing with molasses and ending in IML or arrack have been discussed in some detail in earlier paragraphs. The detailed study of the potable alcohol sector in the annexure to Chapter II of the present report gives an overview of the working of the sector. Management practices can be substantially improved by computerisation. This has happened particularly in Tamilnadu where the department and the Beverages Corporation have been successfully computerised using the services of an external Total Service Provider. Since we have not recommended public sector handling of wholesale distribution of liquor, we are mainly concerned with the former component although there are elements of the latter which could be usefully appropriated by agencies like MSIL to manage inventories and sales. Vital departmental MIS reports covering distillerywise production, sales, wastage and inventory, blending unitwise inventory and issues of spirit for sale, redistillation and blending and revenue generated at different points are being obtained from the system. We have studied and adapted some of the elements of the Tamilnadu package while making our suggestions for better governance.

4.94 Setting up computerised norms and prescribing a standard computer package to be mandatorily installed in all distilleries from which required data could be directly captured into departmental MIS systems is under consideration in States like Maharashtra where it might be easier to install given the fact that a large number of distilleries are tied to cooperative sugar factories working under substantial governmental regulation. This is also covered in the administrative recommendations made in the annexure to this chapter. They are mainly focused on e governance and linked to computerisation within the department as well as at the major production and distribution points for liquor. Some additional administrative matters which require reform are detailed below.

4.95 In the first report, we had drawn attention to the complex bunch of Rules and regulations that are now being administered by the Excise department. An exercise to rationalise the Excise manual should be undertaken and the simplified structure put on a departmental web site in a suitably user-friendly manner.

4.96 Techniques for managing State excise duties without direct State intervention need to be further developed. Stationing departmental officials in distilleries has to some extent been counterproductive and increased the politicisation of the department. There is a strong case for looking at incentivisation mechanisms to increase departmental commitment to governmental objectives at all levels. Mechanisation and information management certainly need upgrading. In the Commission's first report, we have proposed setting up fully mechanised composite check posts at State borders for the motor vehicles, commercial taxes and excise departments. The last department should benefit substantially from such an exercise since it is at present the least exposed of the three mentioned above to modern management methods. A possible solution is installation of a similar post in distilleries themselves but its effectiveness will depend on the motivation of departmental staff and acceptance by distilleries. Automatised posts should be set up at material despatch points in distilleries and blending units and these should be connected online to the departmental network. It should be made mandatory under the Rules to set up such facilities in production units.

4.97 Apart from check posts, the department has enforcement machinery consisting of 12 Divisional Intelligence Bureaux, 45 subdivisions and 3 sea squads working under 6 Joint Commissioners and one Deputy Commissioner. The unit is headed by an Additional Excise Commissioner. There is a case to increase the powers of enforcement staff who are sometimes exposed to violence when they raid illicit distillation units. We recommend that check posts should be declared as police stations for the purpose of handling excise offences. They should also be provided with better communication facilities. Technical training (in chemical analysis for example) will greatly enhance departmental capabilities. We recommend incorporation of such training in normal departmental HRD programs.

4.98 In addition to the suggestions made in the first report for better quality control, we also recommend the establishment of a modern laboratory for analysing material samples for the department. The Drugs Controller has prepared a proposal for setting up such an institution with the capacity to annually analyse 12000 samples. The cost to government of this unit would be around Rs. 2.5 to Rs. 2.7 crs.

4.99 Some amendments to regulations and procedures should also be considered. Cash collections should be avoided and all fees should be collected through banks. It was indicated by the department that banks are reluctant to handle some fee collections since the amounts involved are nominal. This can be negotiated with banks who are getting business on other items.

4.100 Other regulatory measures should be strictly enforced like driving under the influence of alcohol through random checks using the latest apparatus available like breathalysers and offenders strictly punished through deterrent fines and endorsements on licences leading to eventual revocation for habitual offenders. We have recommended this in the chapter relating to motor vehicle taxes. We also endorse the views of the Health Task Force for prohibiting liquor vending outlets on national highways.

4.101 Members of the Health Task Force have sought funds for research into the effects of alcohol addiction and dissemination and publicity about "safe" drinking by earmarking a portion of excise revenue. At present, government has established a Temperance Board but its activities are not very visible and effective. We recommend ploughback of a small fixed percentage of excise revenue for effectively running the Board and actively involving NGOs and researchers in publicising the adverse effects of liquor consumption. The Board should fund the preparation of appropriate material to be used in school and college textbooks for spreading the message of temperance among young people.

4.102 Section 36 of the Excise Act prescribes penalties for the sale of liquor to persons below 21 years of age but Rule 10 of the Karnataka Excise Licences (General Conditions) Rules 1968 prohibits such sale to those below the age 18. This has created an anomalous situation as there is no specific penalty for selling liquor to persons between the ages of 18 and 21. We recommend amendment of Section 36 of the Act to bring it in line with the Rules.

4.103 Under Rule 4 of the Karnataka Excise Licences (General Conditions) Rules 1968, liquor shop timings have been notified as follows: 9am to 9.30 pm for arrack, 6 am to 9.30 pm for toddy, 9 am to 7 pm for wholesalers, 10 am to 10.30 pm for IML and 10 am to 11.30 for bars and pubs. The CIABC has suggested keeping liquor vends open in rural areas up to 10 pm and in urban areas up to 11 pm. They suggest also that bars in five star hotels should be permitted to remain open till 1 am and restaurants and club bars till midnight. We learn that a Cabinet sub-committee on tourism has suggested that pubs and bars should be permitted to serve liquor up to midnight to encourage tourism. The Health Task Force has, however, expressed apprehensions about the effects of serving alcohol on school and college-going youngsters. The Commission concurs with the views of the Health Task Force and recommends that liquor shops and pubs should be kept closed between 11 am. and 4 pm.

4.104 For administrative convenience and stability, we recommend that all excise licences should have validity for a three-year period. An automatic increase in licence fees of 10% may also be enforced every year.

4.105 In the context of VAT, if a decision is taken to restore commodity taxation on liquor to the Commercial Taxes department and administer them in addition to excise duties, it is essential to establish mechanisms for continuing coordination between the two departments. This responsibility should be undertaken by the Finance department at the Secretariat level and appropriate systems established under the supervision of Secretary (Resources) to counter the tendency of each department to deny the other access to relevant data for enforcement purposes.

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Shri. R. Neelakanta Rao, MD, Amrut Distilleries, Bangalore
Shri. Srinivasa Murthy, MD, K.B.D, Bangalore
Shri. T.S. Narayana Rao, United Breweries, Bangalore
Shri. R.L. Prakash, United Breweries, Bangalore
Shri. Govind Bhat, Mysore Breweries Limited,
Dr. Armugam, MD, Broadline Computers, Chennai
Shri. Shantha Kumar, Broadline Computers, Chennai
Shri. Sanwat Ram, MD, Tamilnadu State Marketing Corporation, Chennai
Shri. T.P. Senkumar, MD, Kerala State Beverages Corporation, Kerala
Shri. Mohandas, Joint Commissioner of Excise, Kerala
Shri. Sudalikannan, Joint Commissioner of Excise I, Chennai
Shri. Rahematulla, Joint Registrar of co-op-societies & MD, M.K. Hubli Sugar factory
Shri. Inghalli, Chief Engineer, M.K. Hubli Sugar factory
Shri. S.M. Patil, Chief Chemist, M.K. Hubli Sugar factory
Shri. Sunkar, Accounts Officer, M.K. Hubli Sugar factory
Shri. Magadum, Distillery Officer, M.K. Hubli Sugar factory
Shri. K.B. Tallikere, Inspector of Excise, M.K. Hubli Sugar factory
Shri. M.R. Bendigeri, Chief Chemist, M.K. Hubli Sugar factory
Shri. Turmuri, Dy. Chief Chemist, M.K. Hubli Sugar factory

Shri. Mukherji, MSIL Sacheting unit, M.K. Hubli Sugar factory
Shri. Karunakar Shetty, MSIL Sacheting unit, M.K. Hubli Sugar factory
Shri. Mohandas Shetty, MSIL Sacheting unit, M.K. Hubli Sugar factory
Shri. Babu Shettigar, MSIL Sacheting unit, M.K. Hubli Sugar factory

Annexure I

License fee structure for production units in some States (Rs. lakhs)

	Karnataka *	Andhra Pradesh	Tamilnadu **	Maharashtra
Primary distillery (for manufacture of spirit)	22.5	Up to 20 lakh litres -3.75 Over 20 lakh litres -5	1	Up to 45 lakh litres Rs.68000 Up to 90 lakh litres Rs.92000 Up to 135 lakh litres Rs.116000 Up to 180 lakh litres Rs.134000 Over 180 lakh litres Rs.182000
IML blending units	30.5	Below 1 lakh litres -5 Up to 5 lakh litres -7 Up to 20 lakh litres -12 Up to 40 lakh litres -25 Over 40 lakh litres -50	4	
Brewery	Bottled beer - 18 Draught beer - 2.4	20	Bottled beer- 0.1 Draught beer-0.5	
Winery	1.50	-		

* There is a 15% infrastructure cess on the licence fee

** In addition there are nominal application and licence fees

Source: State excise departments

Annexure II

LICENCE FEES FOR VEND OF POTABLE ALCOHOL IN SOME SOUTHERN STATES

RETAIL OUTLETS

Karnataka		Andhra Pradesh	
City Corporations		up to 10000 population	-Rs. 250000
-over 20 lakh population	-Rs.135000	10001 to 50000	-Rs. 375000
-other Corporations	-Rs.110000	50001 to 300000	-Rs. 720000
-CMCs-popn.50000 to 3 lakhs	-Rs.100000	300001 to 700000	-Rs. 900000
TMCs-popn.20000 to 50000	-Rs. 75000	over Rs. 700000	-Rs.1080000
Others	-Rs. 60000		

Maharashtra-	IML	arrack
-up to 5000 population		-Rs. 9000
-between 5000 and 10000		-Rs. 15000
-up to 1 lakh	-Rs. 33000	
-between 1 and 2 lakhs		-Rs. 36000
-between 2 lakhs and 10 lakhs	-Rs. 59000	
-between 1 lakh and 10 lakhs		-Rs. 90000
-between 10 lakhs and 20 lakhs	-Rs. 90000	
-over Rs. 10 lakhs		-Rs. 165000
-over Rs. 20 lakhs	-Rs. 118000	

HOTELS AND RESTAURANTS

Karnataka		Andhra Pradesh	
Hotels			
City Corporations		up to 10000 population	-Rs. 250000
-over 20 lakh population	-Rs.200000	10001 to 50000	-Rs. 400000
-other Corporations	-Rs.175000	50001 to 300000	-Rs. 750000
CMCs	-Rs.130000	300001 to 700000	-Rs. 1000000

TMCs	-Rs. 110000	over Rs. 700000	-Rs. 1200000
Others	-Rs. 85000		

Clubs:

-population over 2000000	-Rs. 60000	up to 300000	-Rs. 100000
others	-Rs. 40000	above 300000	-Rs. 200000

Tamilnadu

Liquor possession for non-proprietory clubs:	Rs. 200000
Star hotels:	
-Main bar:	
--5 star	Rs. 400000
--4 star	Rs. 300000
--3 star	Rs. 200000
--2 star	Rs. 150000
Others	Rs. 100000
-Additional bar:	
--5 star	Rs. 400000
--4 star	Rs. 300000
--3 star	Rs. 200000
--2 star	Rs. 150000
Others	Rs. 150000

Kerala

Hotels:	-Rs.1300000
Roof gardens in hotels	-Rs. 25000 (addl.)
Beer parlours:	-Rs. 200000
Foreign liquor clubs:	-Rs. 500000

Maharashtra

Bars	which serve IML	which serve only beer
-up to 1 lakh population		Rs. 33000
-up to 3 lakhs	Rs. 71000	
-between 1(3) and 10 lakhs	Rs. 81000	Rs. 66000
-between 10 and 20 lakhs	Rs. 141000	Rs. 90000
-over 20 lakhs	Rs. 161000	Rs. 112000

-Hotels

-up to 100 rooms	150% of the licence fee based on population
-over 100 rooms	200% of the licence fee based on population

Annexure III

Excise duty structures in southern States (per bulk litre *)

Products	Alcohol Content	Karnataka	Andhra	Kerala	Tamilnadu
Beer	4.5 to 8% alcohol	Rs.4 + 1.5 LF (Rs.5.50)	Rs.5	Rs.3	Rs.2.50
Rum **Whiskey** **Brandy**	75 proof	Rs.45 + 30 LF (Rs.75)	Rs.26.25,Rs.33.75,Rs.48.75 **	100%	Ordinary Rs.48.75 Medium/Premium Rs.63.75
Fenny	75 proof	Rs.45 + 30 LF (Rs.75)	Nil	Nil	Nil
Arrack	65 proof	Rs.20 ***	Banned	Banned	Banned
Toddy	-	-	-	-	-
Rectified Spirit	166 proof	No Duty	No Duty	No Duty	No Duty
Extra Neutral Spirit	167.2 proof	No Duty	No Duty	No Duty	No Duty
Denatured Spirit (not potable)	155 proof	No Duty	No Duty	No Duty	No Duty

* Converted from proof litres

** For different varieties depending on price.

*** If per litre auction rental is added, the figure could be even higher than Rs.60

Proof is a measure of degree of intoxicant capacity; the higher the proof, the greater the intoxication.
L.F is litre fee.

Source: State excise departments.

Annexure IV

Tax liability for IML in southern States (1998-99)

Sl.no.	Tamilnadu	(Rs.)	Kerala	(Rs.)	Andhra Pradesh	(Rs.)	Karnataka **	(Rs.)
1.	Basic price per case *	268.84	Basic price per case (for Rs.100)	100.00	Basic price per case (for Rs.100)	100.00	Basic price / case	250.00
2.	Vend fee	165.00	Excise duty (ad valorem 100%)	100.00	Excise duty (Rs.35 /proof litre)	227.00	Specific excise duty	405.00
3.	Additional sales tax 3%	26.44	Import fee (Rs. 5 / proof litre) @	33.75	Total	327.00	Total	655.00
4.	Total	460.28	Total	233.75	Sales tax 70%	229.00	Sales tax 60%	393.00
5.	Excise duty (specific)	421.20	Warehouse margin 30 %	70.13	Total	556.00	Cess 5%	19.65
6.	Ex-factory price	881.48	Total	303.88	Margin of APBCL (estimated)	38.00	Total	1157.65
7.	Sales tax 50%	440.74	Shop margin 20%	60.78	Sales tax on margin 70%	27.00	Litre fee (specific)	180.00
8.	TASMAC vend fee	18.00	Total	364.66	Total	621.00	Total	1247.65
9.	Total	1340.22	Sales tax 85%	309.96	Spl. privilege fee (10%)	62.00	Assumed wholesale margin (5%)	62.38
10.	Insurance .35%	4.69			Issue price of APBCL	683.00	Total	1310.03
11.	Landed cost	1344.91					Sales tax (60% after deducting tax paid at wholesale level)	285.02
12.	Profit margin 10%	134.49					Cess at 5%	14.25
13.	Additional profit margin	2.00					Total	1609.30
14.	Selling price	1481.40					Assumed retail margin (7%)	112.65
15.	Value added tax 50 %	299.96					Total	1721.95
16.	Wholesale issue price	1781.36					Retail sales tax (10%)	172.20
17.	Retailer's margin 21.25%	378.54					Cess	8.65
18.	Price per case	2159.90	Price per case	674.62	Maximum retail price per case (1.3*683)	888.00	Retail price	1902.80
19.	Price per litre (price per case / 9 ltrs.)	240.00	Price per litre	74.90	Price per litre	98.67	Price per litre	211.42
20.	Tax per litre	159.37	Tax per litre	49.30	Tax per litre	60.56	Tax per litre	164.19
21.	Tax incidence on selling price (%)	63.49	Tax incidence on selling price (%)	65.82	Tax incidence on selling price (%)	61.37	Tax incidence on selling price (%)	77.66

*Monitor brandy (Shiva distilleries, Combatore)
@ Since IML is principally imported
** Before replacement of sales duty by additional excise duty
Source: State excise departments

Annexure V

Excise Duty Structure in States and Union Territories

SL. no.	STATE	EXCISE DUTY				EXPORT DUTY				IMPORT DUTY				SALES TAX	SUR-CHARGE
		LAGER		STRONG		LAGER		STRONG		LAGER		STRONG			
		Per bulk litre	Per 650 ml case	Per bulk litre	Per 650 ml case	Per bulk litre	Per 650 ml case	Per bulk litre	Per 650 ml case	Per bulk litre	Per 650 ml case	Per bulk litre	Per 650 ml case		
1	Haryana	8.00	62.50	8.00	62.40	0.77	6.00	0.77	6.00	5.00	39.00	5.00	39.00	Nil	Nil
2	Himachal Pradesh	6.16	48.00	10.77	84.00	0.50	3.90	0.75	5.85	3.08	24.00	3.08	24.00	15%	Nil
3	Jammu & Kashmir	7.69	60.00	7.69	60.00									30%	5%
4	Punjab	7.70	60.00	10.00	78.00	0.38	3.00	0.38	3.00	3.00	23.40	3.00	23.40	12%	10%
5	Rajasthan	10.00	78.00	15.00	117.00	2.00	15.60	2.00	15.60	5.00	39.00	5.00	39.00	Nil	Nil
6	Uttar Pradesh	5.38	42.00	7.69	60.00	0.50	3.90	0.50	3.90	4.62	36.00	4.62	36.00	26%	25%
7	Chandigarh	3.85	30.00	3.85	30.00					7.69	60.00	7.69	60.00	10%	10%
8	New Delhi	3.48	27.12	12.31	96.00					0.77	6.00	0.77	6.00	12%	Nil
9	Arunachal Pradesh	1.03	8.00	1.03	8.00	0.64	5.00	0.64	5.00	1.28	10.00	1.28	10.00	Nil	Nil
10	Asam	12.18	95.00	12.18	95.00					2.31	18.00	2.31	18.00	Nil	Nil
11	Bihar	12.18	95.00	12.18	95.00	1.54	12.00	1.54	12.00	1.54	12.00	1.54	12.00	25%	10%
12	Meghalaya	8.97	70.00	8.97	70.00	4.44	34.63	4.44	34.63	3.00	23.40	3.00	23.40	Nil	Nil
13	Orissa	10.00	78.00	10.00	78.00	1.00	7.80	1.00	7.80	3.00	23.40	3.00	23.40	20%	10%
14	Sikkim	5.38	42.00	6.15	48.00	0.26	2.00	0.26	2.00	0.77	6.00	0.77	6.00	6%	Nil
15	Tripura	8.50	66.30	8.50	66.30					1.00	7.80	1.00	7.80	Nil	Nil
16	West Bengal	10.00	78.00	10.00	78.00	0.20	1.56	0.20	1.56	1.25	9.75	1.25	9.75	30%	Nil
17	Maharashtra	100% of MC		100% of MC		2.00	15.60	2.00	15.60	3.00	23.40	3.00	23.40	Nil	Nil
18	Gujarat	10.00	78.00	10.00	78.00									45%	10%
19	Goa	9.00	70.20	9.00	70.20									20%	15%
20	Madhya Pradesh	3.08	24.00	3.08	24.00	0.46	3.60	0.46	3.60	10.77	84.00	10.77	84.00	Nil	Nil
21	Daman	3.00	23.40	5.00	37.90	0.75	5.85	0.75	5.85					15%	10%
22	Andhra Pradesh	5.00	39.00	5.00	39.00	2.00	15.60	2.00	15.60	2.00	15.60	2.00	15.60	70%	Nil
23	Kerala	3.00	23.40	3.00	23.40	2.00	15.60	2.00	15.60	2.00	15.60	2.00	15.60	55%	Nil
24	Pondi / Mahe	1.75	13.65	1.75	13.65	1.75	13.65	1.75	13.65	1.75	12.65	1.75	13.65	35%	Nil
25	Karnataka	4.00	31.20	4.00	31.20	1.00	7.80	1.00	7.80	3.00	23.40	3.00	23.40	45%	Nil
26	Tamilnadu	2.50	19.50	2.50	19.50	0.40	3.12	0.40	3.12	3.08	24.00	3.08	24.00	40%	Nil

Source: Brewers' Voice (official publication of the All India Brewers' Association, April-June 2000)

Annexure VI

DISTILLERYWISE PRODUCTION CAPACITY AND PRODUCTION OF RS FROM 93-94 TO 98-99 (in lakh litres)

DISTILLERY	PRODUCTION CAPACITY	1993-94	1994-95	1995-96	1996-97	1997-98	1998-99
GOWRI	90.00	50.72	66.02	71.61	64.90	57.11	64.35
B.T.F.C	54.00	24.75	21.77	18.86	19.91	9.58	12.00
H.S.S.K.N	162.00	86.87	87.38	125.78	45.56	76.18	110.32
SAPTHAGIRI	82.00	73.17	90.55	59.33	53.17	58.21	59.13
CAPCHEM	60.00	0.14	0.00	7.55	0.00	0.00	0.00
DISTILLERS CO.	150.00	7.76	0.00	0.00	0.00	0.00	0.00
MYSUGAR	108.00	72.73	87.49	57.99	46.12	53.56	78.96
I.B.D. BIDAR	54.00	17.13	0.00	19.88	26.30	12.17	8.33
KHODAY	102.00	32.40	62.41	37.58	19.91	19.26	8.82
PAMPASAR	49.00	39.27	37.62	36.73	35.80	35.09	76.32
UGAR	125.00	60.68	74.79	77.21	84.51	81.98	105.79
RAVINDRA	13.50	6.17	3.05	13.82	6.08	7.73	13.43
GEMINI (N)	112.00	41.63	49.08	45.09	31.99	19.44	26.03
MALAPRABHA	60.00	44.20	46.84	58.96	33.71	14.27	27.17
MARUTHI	60.00	4.14	29.22	8.36	5.47	5.92	6.10
SAMSONS	90.00	0.00	9.22	53.83	54.90	59.47	56.18
WILSON	90.00	0.00	0.00	5.22	2.95	4.30	17.25
BRINDAVAN	13.50	0.00	0.00	0.07	0.00	0.00	0.00
S.L.N	90.00	0.00	0.00	6.30	16.29	12.37	22.66
VENKATESHWARA	90.00	0.00	0.00	1.11	17.64	8.72	22.63

Annexure VII

Distribution System for IML / Beer

State	Distribution System
Delhi	Retail by Govt. Corpn.
Rajasthan	Auction mkt.
Uttar Pradesh	Auction / open mkt.
Punjab	Auction mkt.
Chandigarh	Auction mkt.
Jammu & Kashmir	Auction mkt.
Himachal Pradesh	Auction mkt.
Haryana	Auction mkt.
Uttaranchal	
West Bengal	Open mkt.
Orissa	Distribution by Government (to be implemented by 1st January)
Bihar	Open mkt.
Assam	Open mkt.
Meghalaya	Open mkt.
Tripura	Open mkt.
Arunachal Pradesh	Open mkt.
Bhutan	Open mkt.
Sikkim	Open mkt.
Karnataka	Open mkt.
Kerala	Distribution by Government
Tamilnadu	Distribution by Government
Andhra Pradesh	Distribution by Government
Pondicherry	Open mkt.
Andaman & Nicobar	
Maharashtra	Open mkt.
Goa	Open mkt.
Daman / Diu	Open mkt.
Madhya Pradesh	Auction mkt.
Chattisgarh	Auction mkt.

Source: Brewers' Voice (official publication of the All India Brewers' Association, April-June 2000

Annexure VIII

E GOVERNANCE IN THE EXCISE DEPARTMENT

A4.1 We have already noted that existing physical controls like check posts and departmental clearance for denaturing and release of spirit in distilleries are often systematically neutralised by tax evaders. When data from various sources is analysed, there is substantial evidence of excise duty evasion. We have made some estimates of evasion of the duty on country liquor and IML in Chapter V of the first report. In the present report also, we have pointed out the unreliability of the arrack consumption figures reported by contractors, while computing tax incidence. The excise department should itself undertake similar data analysis and validation on a continuing basis to assess the extent of revenue leakage and the points at which it is occurring. This is possible today if mechanised tools of governance like computers are extensively used and connected online. Computerisation will facilitate enforcement of the various regulatory requirements of the department and ensure that permits, licences etc. are issued with minimum fuss and delay. It will also enable operations like auctions to be undertaken with little administrative strain.

A4.2 The systems proposed in this annexure presuppose online management of critical activities throughout the production and distribution process of potable alcohol so that revenue accruals are maintained at expected levels.

Existing levels of computerisation

A4.3 Computers have today been installed only in the Excise Commissioner's office and in offices of Deputy Commissioners of Excise in districts. At departmental headquarters, stand alone computers are being used in the offices of Additional and Joint Commissioners as well as in the Excise Commissioner's personal section. A computer room has been set up under the Joint Director of Statistics where data processing is undertaken through terminals networked by modem. Here, data is entered relating to the department's demand, collection and balance from various sources particularly arrack rentals, the consumption of arrack, IML and beer, revenue arrears, cases booked against culprits and their progress etc. Information collected manually from range offices is put together by Deputy Commissioners of Districts and entered into their computers; these officers furnish computer statements by post or fax in prescribed MIS forms as per the prescribed schedule. This is re-entered into computers in the Commissioner's office and MIS outputs obtained district and taluk wise for use at the head office and by the government.

A4.4 To introduce a comprehensive computerised system in the Excise department, computers must be installed in Joint Commissioners' offices, offices of distillery officers, warehouse officers in MSIL and Mysugar depots and range offices in Bangalore urban and rural districts (which account for much of the State's excise revenue today). These should also be networked through a Wide Area Network. This will ensure online connectivity and facilitate exchange of data as well as expeditious disposal of applications from taxpayers.

A4.5 Since we are proposing online processing of applications of various kinds, it is also essential to maintain a data base of departmental personnel in the following format:

TABLE I

Data base of departmental personnel for the month of ...and year...

Sl.no.	Designation of the officer	Address	Code no.	Name of present incumbent	Phone nos.		
					Office	Residence	Mobile

A4.6 All heads of offices from the State headquarters downwards should be indicated in the data base which should be updated (if possible through the computer itself from transfer orders and joining reports) every month under the Excise Commissioner's supervision. Signatures of officers authorised to take decisions should also be maintained on the computer after authentication.

A4.7 Systems applicable for electronic management of various areas of departmental functioning are analysed in detail in the following sections.

I Molasses production and distribution

A4.8 From the administration's viewpoint, the main objectives of e governance in this area are twofold:
-ensuring that molasses availability reported by producers is in line with technical production functions for sugar and molasses from sugarcane
-ensuring that molasses produced is accounted for either by releases to users-distilleries, cattle and poultry feed producers-or through destruction as permitted by the Excise Commissioner

A4.9 The administration and users are also concerned about ensuring that licences and permits are expeditiously and objectively issued and prescribed permit fees collected. These requirements can be met through departmental computerised networks equipped with security measures, which can also link up to users' computers where available.

A4.10 Molasses is graded according to Indian standard specifications no.IS.1162-1958 as A, B, C and below C (the terms K1, K2, K-3 & I, II, & III are also sometimes used). Sugar factories and *khandasari* units, which produce molasses as a byproduct in the manufacture of sugar, are today expected to maintain accounts of production as well as disposal. Sugar factories send monthly returns of molasses produced to range offices in the Excise department from where the information is passed on to Deputy Commissioners of Excise. The Directorate of Sugar also collects information about molasses and sugar production on a monthly basis along with data regarding sugarcane arrivals at factories. This is also passed on to the Excise department by the Director of Sugar. The Directorate of Sugar also estimates sugarcane arrivals and sugar and molasses production in *khandasari* units at the macro level but this information is not sent to the Excise department. *Khandasari* units are not formally required to furnish data to the Excise department at present.

A4.11 Consumers of molasses-distilleries, cattle feed and poultry feed units-are allotted molasses on an annual basis. Distilleries are expected to send a request for molasses allotment to the departmental official stationed in the distillery with information regarding molasses allotments and lifting during that year and an assurance of supply from the sugar factory or *khandasari* unit. The distillery officer verifies this against the allocated quota and makes his recommendation to the Excise Commissioner who also makes verifications and issues an allotment order specifying the quantity to be lifted and the time given for lifting. Copies of the allotment order are sent to the Deputy Commissioner of the district, the distillery officer, the sugar factory or *khandasari* unit and the distillery. The distillery officer issues the transport permit which is used to lift molasses.

A4.12 When molasses is lifted from outside the State, the transport permit is issued by the concerned Deputy Commissioner of Excise. After the distillery picks up molasses, the load is verified by the distillery officer and taken to stock. The Deputy Commissioner then sends a verification certificate to his counterpart in the State of import for record.

A4.13 When molasses is exported from Karnataka, the factory applies for permission to export enclosing copies of orders received from the concerned distilleries. The Excise Commissioner issues the allotment order to the Deputy Commissioner, the sugar factory and the Excise department of the concerned State. The Deputy Commissioner issues the export permit with copies to the sugar factory, distilleries and the transport operator. When the consignment reaches the destination, the Excise department of the importing State sends a verification report to the DC (Excise) of Karnataka who has issued the transport permit. Applications made by cattle and poultry feed units are processed by district Deputy Commissioners instead of distillery officers but otherwise the procedure of allotment is the same as that for distilleries.

A4.14 Molasses production and availability reported by producers can be validated by maintaining a computerised data base of sugar factories and *khandasari* units and their production capacities. Sugar factories and *khandasari* units should be listed districtwise with income tax PAN and sales tax numbers. Code numbers could be allocated for simpler data processing. Data may not be readily available regarding the installed capacity of *khandasari* units as it is available for sugar factories. It will, therefore, have to be collected from municipal and other records or confirmed on the basis of power consumption billed by the KPTCL or project reports furnished to lending agencies. Information about sugarcane arrivals, crushing operations and sugar and molasses produced should be regularly obtained from the units themselves and confirmed independently through data received from the Directorate of Sugar. The proposed Molasses Control Act should lay down clearly the reporting requirements for production units. A computer program built around the prescribed production functions for molasses and sugar from sugarcane can be used for validating the information furnished by production units at the macro and micro levels. Districtlevel Deputy Commissioners of Excise should be made responsible for maintaining the data base up to date for their jurisdictions. Once a year, the data base should be verified by senior officers at a meeting convened by the Excise Commissioner.

A4.15 Returns should be obtained from molasses producers by directly linking to larger units online where feasible. Sugar factories which do not have networking facilities could maintain a bill book type register in the following proforma.

TABLE II.1

Daily Report of Production, Stock and Issue of Molasses from Sugar Factories

Name and address of the factory Year
Code no.
Date
Volume no. Page no.

Molasses in quintals

Sl.no.	Particulars	Grade A	Grade B	Grade C	Grade < C	Destroyed	Total
1.	Opening balance						
2.	Production						
3.	Degradation resulting in						
(a)	Decrease						
(b)	Increase						
4	Issues						
(a)	Qty. issued						
(b)	Name & code no. of party to whom issued						
(c)	Code no. of permit						
(d)	Code no. of permit issuing authority						
5(a)	Quantity destroyed Code no. & date of Commissioner's order						
6	Closing balance (1+2+3b-3a-4a-5a)						

A4.16 *Khandasari* units should be asked to furnish information in the following proforma:

TABLE II.2

Monthly Report of Production, Stock & Issue of Molasses from *Khandasari* Units

Name and address of the unit Year
Taluk and code no.
District and code no. Month

Molasses in quintals

Sl.no.	Date	Opening balance	Production	Permit no. and date

Permit issuing authority and code no.	Party to whom issued and code no.	Grade	Quantity issued	Closing balance	Remarks

A4.17 There should be three copies of each page of which two should be perforated. The daily report for sugar factories should be filled up and signed (in three copies) by the authorised signatory and the perforated copies sent twice a week to the range officer who should send one copy to the Deputy Commissioner of Excise for scanning and entry into the computer. In Bangalore urban and rural district, range officers should themselves do the scanning. Strict penalties should be imposed for those who do not furnish returns.

A4.18 In the case of *khandasari* units, the entries for a month should be entered in a page and the monthly report sent in the two perforated copies to the range office before the 5th of the succeeding month. Since there are only 34 sugar factories and 17 *khandasari* units, it should be possible to collect complete information regarding molasses with relative ease and speed.

A4.19 When the molasses allocation mechanism is computerised, applications of various kinds could be easily handled through scanning. They should be signed by purchasers and contain the name and address of the applicant and his code number, the allocated annual quota, quantities lifted during the year, the quantity applied for and the name of the supplier. The supply assurance letter should accompany the application. The concerned departmental officer should scan the application. Discrepancies in the application could be identified by a computer program at this stage itself and returned for rectification to the applicant. Applications that are complete would thus be available online for scrutiny by the Commissioner. They could be verified using a computer program and allotment orders printed out automatically serially numbered and dated. Even time limits for lifting could be programmed within the computer. After signature by the Commissioner and affixation of the official seal, the order should be scanned so that it is available online for the concerned DC or the distillery officer who could download the order and dispatch it to the concerned units and officers. Arrangements could also be made for collecting the required fee from the applicant and issue of permits.

A4.20 Data bases should also be maintained locationwise for different categories of consumers of molasses-primary distilleries, cattle and poultry feed units-indicating allotted quotas, PAN and sales tax numbers. Procedures prescribed for primary distilleries to account for molasses stocks are indicated in the following section. In the case of other users, the annual quota fixed for each unit generally remains unaltered for long periods. Units must, therefore, be inspected annually and quotas reviewed by looking at lifting performance. The findings of such reviews should be brought before the annual officers' meeting to be conducted by the Excise Commissioner. Cattle and poultry feed units should also maintain records in registers similar to those prescribed for *khandasari* units and send monthly returns reporting allotment, receipts, utilisation and stocks in a similar manner. The reporting format could be as below:

TABLE II.3

MOLASSES ALLOTMENT, RECEIPT & UTILISATION IN CATTLE & POULTRY FEED UNITS FOR -----(MONTH) & -----(YEAR)

Name of the unit & address Code no........... Taluk........... District...........

(Qunitals)

Sl. no.	Date	Opening balance	Permit no. & date	Designation & code no of permitting authority	Quantity noted in permit for lifting	Quantity lifted	Quantity received at unit	Quantity used	Closing balance

A4.21 The keeping quality of molasses degrades over time. Sometimes poor quality molasses is destroyed under orders of the Excise Commissioner. This procedure too could be run on the computer if networking is done. Deputy Commissioners of Excise should supervise destruction after receipt of permission from the Excise Commissioner. Details of destroyed and degraded molasses should also be mentioned in reports furnished to the Excise department as indicated above. A data base of destruction permissions given by the Commissioner should also be maintained in departmental headquarters listing out order nos.and dates, code nos.of the party seeking permission and his name and address and the quantity permitted to be destroyed.

A4.22 The only excise revenue collected by the State on molasses is a permit issue fee at a flat rate of Rs. 100. This could be kept track of in a database of the type given below.

TABLE II.4

Date	Designation & address of officer issuing permit	Code no. of the officer	Code no. of the party	Permit code no.	Permit fee	Challan no.	Date of payment in treasury

A4.23 The above system ensures that data required from the excise point of view relating to molasses production, stock, movement and degradation as well as information about permit applications, pendency and disposals is captured on a continuous basis. If kept up to date, it can produce accounts for every tonne of molasses produced and released to consumers. Outputs can be derived relating to quantities allotted and lifted for various uses by different types of consumers. The capacity utilisation of production units can be computed on a regular basis as also the revenue derived from transport permits. Information regarding availability of molasses stocks with producers could even be made available to consumers to enable them to plan their lifting schedule in the most convenient manner possible from units located in Karnataka.

II Manufacture of rectified spirit

A4.24 Most of the spirit manufactured in primary distilleries in Karnataka is from molasses and only a small proportion is produced from malt, grapes and coconut toddy. E governance applied to different stages in the manufacture and distribution of spirit will be discussed from the point of view of collection of excise revenue.

a) Molasses accounting in distilleries

A4.25 Distillery officers should maintain on computer a register showing daily receipts, issues and closing balance of molasses in the following format.

TABLE III.1

Daily stock account of molasses.

(quantities in metric tonnes)

Sl.no.	Date	Type of molasses	Opening balance	Lifting from production units		
				Date	Name & address	Code no.
		Grade A Grade B Grade C Grade < C Total				

Lifting from production units					
Allotment order code no.	Permit code no.	Permit issuing authority code no.	Quantity lifted		
			By road	By train & road	Total

Quantity received			Quantity issued for process	Closing balance
By road	By train & road	Total		

A4.26 Under the Karnataka Excise (Regulation of Production etc.) Rules of 1998, the permitted transit loss for molasses during transport from production units to primary distilleries is 1% if transport is done by road and 2% if it is by train and road. The time permitted for transport is also indicated in the permit. The fulfillment of both these requirements can be watched by supervisory officers using the database built up through the above format to derive the two following tables within the excise network.

TABLE III.2

Transit loss in molasses transport

Sl.no.	Sl.no. in earlier table	% age loss for quantity lifted by road	% age loss for quantity lifted partly by road & partly by train	Explanation of distillery if % age exceeds prescribed figures	Action taken by distillery officer if explanation is unsatisfactory

Delay in transit

Sl.no. in earlier table	Date of lifting	Date of receipt	Transport time		Action taken for exceeding prescribed time limit
			Permitted (no. of days)	Actually taken (no. of days)	

A4.27 This information will enable supervisory officers to pull up defaulters and improve administration.

b) Manufacture of spirit

A4.28 The Karnataka Excise (Regulation of Yield, Production etc.) Rules of 1998 prescribe the following minimum production ratios for rectified spirit realised (in bulk litres) from every tonne of molasses for various grades of molasses.

Grade A 220 bulk litres
Grade B 200 bulk litres
Grade C 180 bulk litres

A4.29 Molasses which is below grade C is required to be reported to the Excise Commissioner who will prescribe the minimum production ratio per tonne and the quantity of molasses to which the minimum should apply. A data base of permissions obtained from the Commissioner on each such request made by primary distilleries should be maintained in the computers of Deputy Commissioners of Excise in the following format.

TABLE III.3

Permissions given by the Excise Commissioner for yields of molasses below grade C.

Year................ District....................

Order no. & date	Name of primary distillery and code	Yield per tonne for molasses and quantity requested by distillery.			Permission of the Commissioner for yield and quantity covered by the permission	
		Date	Yield per tonne	No. of tonnes of molasses to be covered	Yield per tonne permitted	Quantity to which yield permitted will apply

A4.30 The daily production of spirit from molasses issued for distillation should be watched in distilleries using the following format.

TABLE III.4

Issue of molasses and prescribed production of rectified spirit (RS)

Sl.no.	Date	Molasses issued in metric tonnes				Minimum quantity of spirit to be obtained
		Grade A (X1)	Grade B (X2)	Grade C (X3)	Grade < C (X4)	Total (Y) (bulk litres)

A4.31 If the quantity of molasses of Grade A is X1, of Grade B X2, Grade C X3, grades below C X4, the minimum yield of spirit to be obtained Y and yield of spirit determined by the Excise Commissioner for grades below C in each case X .com, the total yield of rectified spirit can be calculated by the following formula:
$Y= 220X1+200X2+180X3+X4.Xcom$

A4.32 This can be generated by the computer and entered in the prescribed format.

A4.33 When spirit is manufactured in the stillhouse of the distillery, the distillate passes from receivers in the stillhouse through branch pipes fitted with cocks to receivers in which it is stored on the basis of strength and quality. Stillhouse receivers and storeroom vats are arranged to ensure passage of spirit from receivers to store room vats through closed pipes by gravity or pumping. Each receiver in the still house and each vat in the storeroom (warehouse) should be given a code number with capacity noted against the code. The distillery officer should maintain on his computer a datewise, receiverwise account of production for each type of spirit in the following format.

TABLE III.5

Daily stillhouse production

Name and address of distillery .... Code ....
Year...........

Date	Type of spirit-rectified or neutral	Receiver code no.	Opening balance				Received from still			
			Quantity (ltrs.)	Strength			Quantity (ltrs.)	Strength		
				Hr	Tr	Pr		Hr	Tr	Pr
1	2	3	4	5	6	7	8	9	10	11

Issued to vats in the store					Closing balance			
Vat code no.	Quantity (ltrs.)	Strength			Quantity (ltrs.)	Strength		
		Hr	Tr	Pr		Hr	Tr	Pr
12	13	14	15	16	17	18	19	20

Production			
Quantity (ltrs.) (col.13 + col.17 – col.4)	Strength		
	Hr	Tr	Pr
21	22	23	24

Hr is hydrometer reading, Tr thermometer reading and Pr proof.

A4.34 The computer can be programmed to provide from the above table the actual daily, monthly and annual production of each type of spirit and total production. This can be compared with sanctioned production capacity and capacity utilisation computed. Actual daily production could be compared with expected minimum production in the following format.

TABLE III.6

Actual and minimum prescribed yields of spirit

Date	Minimum prescribed yield (bulk litres)	Actual yield (bulk litres)	Strength		
			Hr	Tr	Pr

% age difference	Explanation of distillery for production below minimum (where applicable)	Action taken

This data in should be reviewed frequently by supervisory officers

c) Issue of spirit to consumers

A4.35 Spirit is consumed by secondary distilleries (blending units), pharmaceutical and chemical industries and educational and research institutions and hospitals. A database should be maintained on the computer of various kinds of consumers and code nos. assigned to each alongside departmental quotas fixed for each consumer. They should also be differentiated by categories among blending units, arrack processors, industries and institutions. PAN and sales tax nos. of consumers should be maintained by Deputy Commissioners of Excise of districts on the computer.

A4.36 For the issue of spirit to IML blending units, the procedure followed is similar to that used for molasses. The IML blending unit submits an application to the Excise Commissioner through the distillery officer for spirit allotment with the letter of assurance of supply from the primary distillery. What has already been lifted during the year against annual quota fixed is examined and scrutiny of the letter of assurance done. The allotment order is issued to the applicant unit and distillery officers of both the primary and secondary distilleries. On this, the permit for lifting is issued (on payment of the standard permit fee) by the Deputy Commissioner of Excise of the district with copies to the Deputy Commissioner of Excise of the district in which the primary distillery is located and the distillery officers of the blending unit and primary distillery.

A4.37 In the case of imports, the allotment order is replaced by a no objection certificate. On receipt of the certificate, an application is sought from the blending unit and permit issued by the Deputy Commissioner of Excise (on payment of the permit fee) with copies to the Deputy Commissioner of the concerned district in the other State, the distillery officers and the transporters of the blending unit. An excise verification certificate is sent by the Deputy Commissioner of Excise to the other State after spirit is received.

A4.38 As for other users, only arrack processing units and pharmaceutical units need allotment orders for which they submit applications through the Deputy Commissioner of Excise in the concerned district to the Excise Commissioner. The procedure of issue of allotment letter, permits etc. is similar to that applicable to blending units. Other users like institutions only need a permit from the Deputy Commissioner of Excise to lift spirit. In all cases, permit fees are collected.

A4.39 If a primary distillery needs a permit for export of spirit to a party, it makes an application to the distillery officer along with a request from the purchaser. This is verified by the distillery officer and recommended to the Excise Commissioner who issues the no objection certificate. Based on this, the primary distillery approaches the Deputy Commissioner of Excise, who issues permits to the purchaser, after collecting the prescribed permit fee, with copies to the distillery officers of both units. When the consignment reaches the other State, an excise verification report will be sent by its excise department to the Deputy Commissioner who has issued the permit.

A4.40 Systems for purchasing spirit are extremely cumbersome, so much so that obtaining legal documents for transit from various office levels located in different places takes considerable time and effort. Computerisation and networking can, however, ensure that these are obtained quickly and easily. The objective should be to ensure that allotment orders, NOCs and transport permits are obtained in a day or two. Even the daily availability of stocks in primary distilleries should be available on the excise network. The blending unit should obtain its assurance of supply of spirit through the network via its distillery officer. A copy of the assurance should be sent by the distillery officer in the primary distillery to his counterpart in the blending unit after verifying the stock position and quotas available and utilised online. Other listed consumers should also be permitted to access online the spirit stock position in a distillery through the distillery officer, Deputy Commissioner of Excise or range officer (in Bangalore urban and rural districts where range officers will also be networked) to get assurance of supply and apply for allotment of spirit. Verifications can also be done online by distillery officers, Deputy Commissioners of Excise and the Excise Commissioner and allotments, NOCs and permits signed and issued to applicants and other concerned persons to facilitate quick movement of these goods and faster revenue inflow.

A4.41 Warehouse (storeroom) operations should be watched in the following format:

TABLE III.7

Receipt, issue and stock of spirit at the warehouse

Name of the primary distillery...................................... Code no...........
Year................ Date...............
Type of spirit.......................

Sl.no	Date	Vat no.	Opening balance				Receipts			
			Quantity	Strength			Quantity	Strength		
			(ltrs.)	Hr	Tr	Proof	(ltrs.)	Hr	Tr	Proof

Issues								
Name of the party	Code no. of party	Allotment order			Code no. of permit issuing authority	Permit code no.	Quantity permitted to be issued	Date of lifting
		Code no.	Quantity (ltrs.)	Expiry date of allotment				

Quantity lifted							Closing balance			
Quantity (ltrs.)	Strength			Name and address of the party lifting spirit	Code no. of the party and date of lifting		Quantity (ltrs.)	Strength		
	Hr	Tr	Pr		Date	Code no.		Hr	Tr	Pr

A4.42 This should enable issue of allotments, NOCs and permits in a day's time. Vatwise and spirit type wise data maintained in the above manner can be used to monitor the performance of the distillery and watch the efficiency of officers at different levels.

d) Further processing of rectified spirit

A4.43 Rectified spirit is further refined into neutral and extra neutral spirit or converted into denatured spirit by adding non-potable chemicals in the primary distillery. For this reason, stock and production accounts must be maintained for each type of spirit. The vatwise record prescribed by us must keep note of this. This must also be done while issuing spirit

A4.44 The denaturing process also requires close monitoring since it is susceptible to evasion. It is expected to be done in the presence of the distillery officer. Quotas for the manufacture of denatured spirit are fixed for selected units by the Excise Commissioner and denatured spirit is only issued against specific permits produced by chemical units. A database of these quotas and permits must be maintained in the computer so that production and issues are continuously validated. In addition, a register must be maintained in the computer to watch the denaturing process vatwise to enable inspection and supervision to be done at higher levels.

e) Revenue realisation

A4.45 Excise duty and litre fee are not collected on spirit. Revenue is realised at the distillery point from issues fee (both domestic and export) for releasing spirit to consumers. Before spirit is lifted, customers get challans countersigned by distillery officers and return them as proof of having paid the prescribed duty. These details should be maintained in a computer-based register of the type given below.

TABLE III.8

Issue fee realisation

Name of distillery...................... Code no.................. Year..................

Sl.no.	Name and address of the party	Code no. of the party	Allotment code no.	Permit issuing authority code no.	Permit code no.

Kind of spirit	Date of issue	Quantity issued (litres)	Strength			Issue fee collected Domestic / Export
			Tr	Hr	Pr	

A4.46 Data relating to licence fees will be inputted by the Excise Commissioner and can be accessed by distillery officers and Deputy Commissioners of Excise. In the case of fees, it will be useful to establish connectivity with the treasury so that payments can be directly recorded. Treasury challans should clearly mention the excise code no. This could be done for banks also when they agree to handle such transactions.

A4.47 For MIS purposes, the computer can be programmed to generate outputs linking duties to be realised against quantities lifted with actual realizations. Revenue collected in distilleries should be maintained datewise online in the distillery officer's computer.

A4.48 Preparation of spirit from raw material other than molasses can also be monitored in the same manner.

III Manufacture and issue of IML

A4.49 IML items normally marketed are rum, whisky, gin and brandy with each distillery having its own brand. IML is a matured blend of rectified spirit, water and the appropriate essence. Each firm has its own formula for essence but the basic product is 100 litres of spirit mixed with121 litres of water.

A4.50 A blending unit has generally the following layout:

<table>
<tr><td>Distillery officer of Excise department</td><td>Entrance</td><td>Chemist of distillery</td></tr>
<tr><td rowspan="2">Bonded warehouse</td><td>Blending warehouse</td><td rowspan="2">Spirit store</td></tr>
<tr><td>Bottling warehouse</td></tr>
</table>

A4.51 The distillery officer notes performance of the following functions:
*receiving spirit and storage in vats in the spirit store
*transfer of spirit from store to vats in the blending warehouse to set the blend
*transfer of liquor from blending room vat to bottling room container and subsequent transfer to bottles kept in cases
*transfer of cases to bonded warehouse
*movement of cases from bonded warehouse for sale to wholesalers and others

A4.52 We will look at different aspects of e governance relating to the processes undertaken in blending units

a) Stocking and storing spirit

A4.53 The most important apparatus in a distillery is the vat or receiver used for storage blending and maturing. An inventory of vats and receivers should be kept on the computer with consecutive code numbers and capacities. Spirit received from primary distilleries is measured in the presence of the distiller or his agent by the warehouse officer. The permit and invoice sent by the primary distillery for spirit should be scanned in the computer and transit loss assessed in the format given below:

TABLE IV.1

Transit loss of spirit in transport from primary distillery

Year........

Sl.no.	Permit code no.	Code no of officer issuing permit	Date of lifting from primary distillery	Primary distillery invoice data			
				Quantity (litres)	Strength		
					Hr	Tr	Pr

Date of receipt in secondary distillery	Days of delay beyond permitted time	Receipts in secondary distillery			
			Strength		
		Quantity (litres)	Hr	Tr	Pr

% loss	
In quantity	In strength (proof)

A4.54 1% loss is permitted under the Karnataka Excise (Regulation of Yield, Production and Wastage etc) Rules of 1998. Action should be initiated in all cases where higher figures are reported without satisfactory explanation and frequent defaults penalised. Similar action should be taken if transport time is beyond permitted limits.

A4.55 The stock register of the blending unit should be maintained on the computer of the distillery officer in the following format.

TABLE IV.2

Stock register of spirit

Name of the unit............. Code no..........

Year..........

Sl.no.	Date	VAT no.	Opening balance (litres)	Strength of opening balance			Receipts (litres)	Strength of receipt		
				Hr	Tr	Pr		Hr	Tr	Pr

Issues for blending					Closing balance			
Vat no. set for blending	Quantity (litres)	Strength			Quantity (litres)	Strength		
		Hr	Tr	Pr		Hr	Tr	Pr

b) Manufacture of liquor

A4.56 As stated earlier, liquor is manufactured by blending 100 litres of 66 OP (over proof) rectified spirit with 121.33 litres of water and the relevant essence in a vat in the blending room for some time. Spirit is pumped from vats containing in the storeroom to the blending room with the permission of the distillery officer. Blending data should be maintained in the following format.

TABLE IV.3

Blending transaction sheet for each vat

Name of the distillery.......................... Code no..........
Blend of liquor.........................
Vat no. in which blending is done..........
Brand name of liquor ....

Date on which blending is set.	Spirit pumped from spirit store				Water added (litres)	Essence mixed Yes/No	Quantity of mixture (spirit + water + essence)	
	Vat no. of spirit store	RS or NS	Quantity (litres)	Strength (proof)			Quantity (litres)	Strength (proof)

Liquor sent to bottling room			Balance after sending to bottling room	
Date on which sent to bottling room	Quantity (litres)	Strength (proof)	Quantity (litres)	Strength (proof)

A4.57 The quantity of mixture of water, spirit and essence should be filled in by the distillery officer by measuring the vat containing the mixture on the day on which it is set for blending. After maturation the quantity of liquor obtained will be slightly less than the quantity set for blending because of maturation losses. Under the Karnataka Excise (Regulation of Yield, Production etc.) Rules of 1998 different levels of maturation losses are permitted varying from 3% for mixtures kept for 6 months to 22% for those stored for 36 months.

A4.58 For X quantity of spirit, Y quantity of water and E of essence, the mixture on the day of blending Z will be as follows:
X+ Y + E =Z

A4.59 With a maturation loss of M for a period D (the loss being MD%), loss will be Z - (Z*MD/100) or Z (1-MD/100). If the vat is emptied after three drawals of durations D1, D2 and D3 the percentage loss will be MD1%, MD2% & MD3% respectively. If Z1, Z2 and Z3 are the quantities drawn after durations D1, D2 and D3, the maturation loss by the day of drawal of Z1 will be ZMD1/100 and liquor left with in the vat equal to Z-Z1 litres. If further drawals D2 and D3 are taken into account, the total loss would be ZMD1/100 +(Z-Z1) MD2/100+(Z-Z1-Z2) MD3/100 and yield of liquor will be Z- (ZMD1/100 +(Z-Z1) MD2/100+(Z-Z1-Z2) MD3/100).

Durations D1, D2 & D3 can be obtained by subtracting from the dates of drawal for the three drawals the date on which blending is set. Percentages MD1%, MD2% and MD3% can be obtained by applying maturation losses prescribed in the Karnataka Excise (Regulation of Yield, Production etc.) Rules of 1998. Quantities drawn on the three occasions Z1, Z2 & Z3 and the quantity set for blending are available we can estimate the expected yield from the three drawals. This can be compared with the actual yield obtained.

A4.60 In a later section we have indicated how bottling room operations should be monitored. We can draw data regarding the number of bottles filled up, sealed and sent to the bonded warehouse after each drawal. The computer can be programmed to calculate the quantity bottled from each drawal.

A4.61 The estimated yield can be compared with the actual yield at the vat point which may be higher than, equal to or lower than the former. This can also be compared with the quantity bottled, which can be either equal to or less than yield at the vat point. If the actual yield is lower than estimated yield, it should be investigated by the distillery officer. Frequent shortages would call for intervention by supervisory authorities. At the bottling point, a shortage of up to 5% is permissible under the Karnataka Excise (Regulation of Yield, Production etc.) Rules of 1998. If during the process of reduction, evaporation, blending, storage, bottling and storage in the warehouse losses exceed 5%, the distillery officer should look into the matter. Frequent shortages should again be investigated at a higher level.

c) Bottling

A4.62 In the bottling room, containers receive liquor pumped from the blending room. These are arranged according to the type and brand of liquor. Liquor is then drawn to fill up bottles of various sizes. Rule 15(2) of the Karnataka Excise (Bottling of Liquor) Rules 1967 prescribe seven sizes of bottles for IML as given below, but the sizes generally used are 750 ml., 375 ml. and 180 ml. These are packed in cases as below:

Bottle sizes:

750 ml –12 bottles in a case
375 ml – 24 bottles in a case
180 ml – 48 bottles in a case

A4.63 The bottles are sent to the bonded warehouse, from where they are issued to wholesalers and others.

A4.64 Bottling room operations may be monitored in the following format:

TABLE IV.4

Bottling room operations

Name of secondary distillery........ Code no...........
Name of the liquor.................... Brand name.......

Sl.no.	Date*	Vat no. in blending room from which liquor drawn	Quantity pumped from blending room to bottling room containers

No. of bottles/ cases obtained, sealed with security labels and sent to bonded warehouse							
Size	750 ml	600 ml	500 ml	375 ml	300 ml	250 ml	180 ml
No. of bottles *							
No. of cases *							

* For each date the number of bottles and cases of each size sent out should be noted.

A4.65 The computer of the distillery officer can be programmed to compute the quantity of liquor contained in bottles sent to the bonded warehouse in terms of litres for all types of liquor and all brands for a day, a month or a year. The actual annual production sent to the bonded warehouse can be set against the installed capacity to compute the capacity utilisation of the blending unit.

d) Issue of permits

A4.66 From the bonded warehouse, cases of various types of IML are issued under different brand labels to wholesalers in the State and defence authorities inside and outside the State as well as to MSIL. Exports are made to licensed parties outside the State and outside India. These transactions take place under permits issued by different authorities.

A4.67 The procedure for obtaining permits is also time consuming:
*Within the district the wholesaler prepares an indent and checks the availability of stock from the distillery officer of the IML blending unit in his district who gives confirmation of availability of stock.
*Then he approaches the jurisdictional range office for the transport permit. In Bangalore urban and rural districts, the range officer himself issues the permit. In other districts the range officer makes a recommendation to the Deputy Commissioner of Excise who issues the permit.
*The wholesaler has to produce the invoice from the IML blending unit for the quantity lifted by him to the range officer when he applies for the next permit.
*The range officer verifies the stock and gives a verification certificate

A4.68 To obtain a permit for lifting IML from another district, the procedure is slightly longer since the permit is obtained from the Deputy Commissioner of Excise of the district where the wholesaler is located. Before the wholesaler goes to the IML blending unit, he has to get his permit endorsed by the Deputy Commissioner of Excise of the district concerned.

A4.69 If an MSIL depot in a district wants to lift liquor from a distillery within the district, the depot manager has to first confirm availability of stock from the distillery officer and approach the Deputy Commissioner Excise for issue of permit. If the IML blending unit is located in another district, a copy of the permit issued by the Deputy Commissioner of Excise of his district will be sent by the permit issuing officer to the Deputy Commissioner of Excise of the district in which the IML unit is located. The MSIL copy has to be got endorsed by the Deputy Commissioner of Excise of the district in which the blending unit is located before liquor can be lifted.

A4.70 The procedure for imports from outside the State done by MSIL is also complicated. The depot officer applies to the Excise Commissioner for permission to import with a copy of the confirmation of liquor availability from the blending unit. The Commissioner's permission is marked to the concerned Deputy Commissioner of Excise, the MSIL depot, the blending unit concerned and the transporter. The depot manager then applies to the district level Deputy Commissioner of Excise for a permit which is marked also to the transporter and the excise officer of the concerned State. After the consignment reaches the depot, the Deputy Commissioner of Excise sends an excise verification report to the other State.

A4.71 IML blending units also undertake exports against export permits. An application for export is given along with the request of the purchaser to the distillery officer, who recommends it to the Excise Commissioner. After verification, the Commissioner gives his concurrence and marks copies of his order to the concerned Deputy Commissioner of Excise, the excise officer of the concerned State and the purchaser. The Deputy Commissioner of Excise then issues the export permit with copies to the distillery officer of the unit, the purchaser, the excise officer of the other State and the concerned range officer. After the consignment reaches the other State, an excise verification report is received by the Deputy Commissioner of Excise from the other State.

A4.72 For sales to the defence Canteeen Stores department from distilleries located in the State, the department sends an application for a transport permit to the distillery officer who issues the permit to the department with copies to the transporter and the excise officer in the department. When liquor is lifted from another State, the application is handled by the Deputy Commissioner of Excise of Bangalore urban district who issues the permit with copies to the transporter, the excise inspector in the department and the excise authority in the concerned State. When liquor is transported to Goa which also falls under the jurisdiction of the Canteen Stores department at Bangalore, the application is handled by a Joint Commissioner in the Excise Commissioner's office. Defence units in districts send their applications to the district level Deputy Commissioner of Excise of their district who issues the permit.

e) Sales from the wholesaler to the retailer

A4.73 After preparing the indent and checking the availability of stock with the wholesaler, the retailer submits an application for a transport permit to the range inspector. The transport permit is issued to the transporter and wholesaler. The retailer produces the invoice of the wholesaler when he applies for the next permit to the range office.

A4.74 When the retailer lifts liquor from another range, he prepares an indent in the prescribed form and checks availability of stock with the wholesaler. He submits an application for a transport permit to the range inspector of excise. The transport permit is issued to the transporter, wholesaler and both range officers.

A4.75 The retailer approaches the range officer of the range where the wholesaler is located, gets an endorsement on his permit and lifts the stock. He produces an invoice for having lifted liquor with the next application for a permit to lift liquor.

A4.76 Procedures for securing allotments and permits are very time consuming and cumbersome. They can be simplified if authentic data bases and signatures of the various players are kept on the computer network. A database of wholesalers with code nos., licence nos. and currency of licence, names and addresses, signatures of authorised signatories attested by the Deputy Commissioner of Excise of the district where the wholesaler is located, the name of the range, its code no., the excise district concerned etc. should be kept in the computer network. The computer should be programmed to delete wholesalers who do not renew licence within the time prescribed. This information will be available to distillery officers of all distilleries, the range officers of Bangalore urban and rural districts, Deputy Commissioners, Joint Commissioners and the Excise Commissioner.

A4.77 A similar database of retailers could be maintained by the Deputy Commissioners of Excise for their respective districts. A database of MSIL and Mysugar depots, with signatures of authorised signatories and warehouse officers of these depots should also be maintained after attestation by the Deputy Commissioner of Excise. This should be maintained up to date. A similar database for the Bangalore Canteen Stores department and similar departments in Karnataka and Goa which come under the same circle of the defence department should be maintained. Here too, the names and designations of authorised signatories and attested signatures should be kept up to date on the computer. Purchasers from outside the State may also be listed by name and address against the concerned State on the data base. Code nos. should also be given to each type of liquor and each brand to facilitate verification of bonded warehouse stocks and stocks with wholesalers and retailers. All databases should carry PAN nos. and sales tax nos.

A4.78 Such databases will ensure that permits can be processed in a day's time if users are given access to the computerised network.

f) Bonded warehouse stocks

A4.79 The distillery officer should maintain on the network stocks, receipts and issues of IML on a daily basis in the following format.

TABLE IV.5

Database of stocks, receipts and issues of IML in the bonded warehouse of the blending unit

Year…..
Name of the distillery…………………
Code no………. Type of liquor code no. ……………
Date………….. Brand code no……………………..

Opening balance

750 ml		600 ml		500 ml		375 ml		300 ml		250 ml		180 ml	
No of btls.	No. of cases	No of btls.	No. of cases	No of btls.	No. of cases	No of btls.	No. of cases	No of btls.	No. of cases	No of btls.	No. of cases	No of btls.	No. of cases

Receipts from bottling room

750 ml		600 ml		500 ml		375 ml		300 ml		250 ml		180 ml	
No of btls.	No. of cases	No of btls.	No. of cases	No of btls.	No. of cases	No of btls.	No. of cases	No of btls.	No. of cases	No of btls.	No. of cases	No of btls.	No. of cases

Issues

Sl. no.	Name of the purchaser & address	Code no (if from Karnataka)	Permit code no.	Permit giving authority code no.

Quantity issued													
750 ml		600 ml		500 ml		375 ml		300 ml		250 ml		180 ml	
No of btls.	No. of cases	No of btls.	No. of cases	No of btls.	No. of cases	No of btls.	No. of cases	No of btls.	No. of cases	No of btls.	No. of cases	No of btls.	No. of cases

Closing balance

750 ml		600 ml		500 ml		375 ml		300 ml		250 ml		180 ml	
No of btls.	No. of cases	No of btls.	No. of cases	No of btls.	No. of cases	No of btls.	No. of cases	No of btls.	No. of cases	No of btls.	No. of cases	No of btls.	No. of cases

A4.80 The system proposed for IML could *mutatis mutandis* be applied to other excisable commodities like beer, fenny and wine.

g) Stocks of wholesalers, retailers and MSIL depots

A4.81 These should be monitored in the following format:

TABLE IV.6

Daily stock with the wholesaler

Name and address of the wholesaler........... Code no............
Year...... Date........

Sl.no	Name of liquor	Brand name	Opening balance (no. of bottles)	Issues		Receipts			Closing balance
				Bill no. Invo-ice no. *	No. of bot-tles	Permit code no.	Code no of permi-tting authority	No. of bottles	(No. of bottles)

* The permit number also may be noted here.

A4.82 This information should be maintained in a register with three copies for each page, two of which will be perforated and the third a hard copy attached to the register. It should be filled up daily and a weekly report sent under the signature of the authorised signatory in two sets, (by tearing off perforated sheets) to the range inspector. The range inspector should send a copy to the Deputy Commissioner of Excise of the district for being scanned in the computer. Thus for each wholesaler the opening balance, receipts, issues and closing balance of liquor will be available online. Mistakes made in computing opening and closing balances by the wholesaler could be rectified by the computer and communicated to the wholesaler for record and improvement. The range officer should use these statements for surprise inspections. The system could be replicated for other distributors like MSIL, the Canteen Stores department and retailers.

h) Revenue realisations:

A4.83 Excise duty, additional excise duty and litre fee are collected at the blending unit when liquor is released to distributors. They are specific levies linked to the quantity and strength of the liquor. It is therefore possible to generate from the computer the tax liability for each issue linked to the lifting of liquor for the three kinds of excise levies. Under the new excise duty regime that is in force from February 2001, additional excise duty liability is linked to the range within which the sale price declared by the blending unit to the Excise Commissioner falls. We should therefore maintain the prescribed AED range as part of the data base on the computer and link it to the price declared for each brand by blending units. The AED rate payable on that brand will then be computer generated and be available to all officers of the department through the network. Provision could also be made when the system recommended by us is adopted to generate the maximum retail price and the excise duty liability for each brand and type of liquor as multiples of the basic price declared by the manufacturer. Actual duty paid can also be compared with the payable amount and the Demand Collection and Balance statement automatically generated at the micro and macro levels at any point of time online from the system itself. Fees are also collected when liquor is exported; this can again be monitored by the distillery officer on the computer. Records of revenue realised could be maintained by the distillery officer permit numberwise in the following format.

TABLE IV.7

Revenue accrual from IML blending units

Name of distillery............ Code no.........
Name of distillery officer.............. Code no.........
Year........

Sl.no.	Date	Permit code no.	Permitting authority's code no.	Invoice no. of distillery	Name and address of purchaser-defence and others	Code no. of purchaser	Code no. of liquor	Code no. of brand	Quantity lifted	Excise duty*	Litre fee*	AED*	Whether exported Yes / No	Export duty

*The computer can be programmed to calculate excise duty, litre fee and AED from quantity lifted and actual realisations against estimated liability can also be compared.

A4.84 Similar database would be maintained for licence fee payable by wholesalers, retailers, MSIL etc by authorities who are authorized to collect but should be brought online on the nearest excise department's computer on network at least once a week if they do not have a computer.

IV Operations related to arrack

A4.85 Arrack manufacture is very simple. One litre of rectified spirit of 66 Over Proof kept with 1.55 litres of water in a vat becomes 2.55 litres of arrack in 15 days. But arrack manufacture is a State monopoly. MSIL and Mysugar are the two government undertakings which manufacture arrack at different centres in the State. Each center caters to one or two districts. They manufacture arrack, sachet it in 50 ml. and 100 ml.packs and sell it to contractors who are successful in the retail vending auctions held once a year. Auctions are held separately for each taluk separately. A single contractor may be successful in more than one taluk also. The talukwise list of contractors is furnished by the Deputy Commissioner of Excise at the beginning of the year to MSIL/Mysugar centres in the district. Based on this, MSIL/ Mysugar sells sachets to contractors, who in turn sell them through shops spread throughout the taluk. The maximum number of shops that can be opened in a taluk is notified in the auction notification itself. To computerise the system, the following databases must be kept online in the Excise department's network.

TABLE V.1

Database of contractors for the year…………………

Sl.no.	Name and address	Code no.	District	Taluk to which applicable	Maximum no. of shops permitted

Note: A contractor who holds more than one taluk, his name will have a different code no. for each taluk.

TABLE V.2

Shop database in taluk……..

Year……… District………………………..

Name of contractor……………… Code no………

Sl.no.	Location of shop	Boundaries	Licence no.	Code no. of shop

A4.86 The performance of the contractor in meeting his revenue and lifting obligations can be watched by Deputy Commissioners of Excise in districts and the range officers of Bangalore urban and rural areas through a computerised performance sheet in the following format:

TABLE V.3

Performance sheet of arrack contractor

(1) Name and address of the contractor (2) Code no…………

(3) Taluk for which vending right operated……… (4) Income tax PAN no. ………..

(5) Sales tax no………

Financial performance:

Deposits made:

A. Before lease agreement

Sl.no.	Type of deposit	Date	Amount
	Earnest money deposit After awarding contract additional deposit towards one month's rent (+ or -) (3) **3 1/10th months** deposit made in: *cash *government securities *other securities *bank guarantees: --name of bank and branch Total		

B. After agreement

(1)licence fee for shops

Sl.no	Maximum no. of shops approved	No. of shops opened	Payment of licence fee for opened shops			
			Date	Amount	Treasury	Challan no.

(2)monthly rent (the due date is the 10^{th} of the month or the next working day the 10th is a holiday)

(a) current payment

Sl.no.	Month	Monthly rental	Date of actual payment	Amount paid	Challan no.	Treasury	Interest	Balance

The computer should be programmed to calculate interest on unpaid rent, even of arrears.

(b) arrears

Sl.no.	Particulars of payment *	Date	Amount paid	Challan no.	Treasury

* will indicate the month for which rent arrears and interest have been paid.

(3)excise duty while lifting arrack

address of MSIL / Mysugar depot....................

Sl.no.	Date	Permit code no. of Dy. Commr.	Quan-tity permi-tted to be lifted (bulk ltrs.)	Quan-tity lifted (bulk ltrs.)	Excise duty due	Paid		
						Amount	Challan no./date	Treasury

Note: The warehouse officer of MSIL / Mysugar should directly transmit this information from his computer on the network to the Deputy Commisioner of Excise.

A4.87 Apart from revenue data, shop sales performance should also be monitored in the following format. This should be counterchecked against consumption figures reported by the contractor for discharging his liability to pay excise duty.

TABLE V.4

Performance of arrack shop

Location of shop... Code no. ....

Taluk......................

Contractor code no.............................

(no. of sachets)

Sl.no.	Date	Opening balance		Receipts			Sales		Closing balance	
		100 ml	50 ml	Permit code no.	Qty. 100 ml	Qty. 50 ml	100 ml	50 ml	100 ml	50 ml

A4.88 This format should be in a bill book type of register and the size of the page should be big enough to accommodate data for a week. There will be three copies for each page, two of which will be perforated and the third a hard copy attached to the register. The register should be filled up in three copies daily and a copy sent every week to the range officer in two sets. Range officers in Bangalore urban and rural district should scan them in the computer; those in other districts should send one copy to the district level Deputy Commissioner of Excise for scanning. The computer could check the arithmetical accuracy of the sheets and correct them. Copies of corrected statements should be made available to shops for record and correction. The computer should also be programmed to convert sachet based data into bulk litres.

A4.89 The quantity of arrack lifted by contractors could be validated against quantities received by shops under each permit.

A4.90 Findings noted during inspections conducted by Deputy Commissioners, range officers and others of licensed shops could be noted in the following register and made available to others for similar verifications.

TABLE V.5

Inspection of arrack shop located at………………… Year……………..

Name and designation of the inspecting officer………………………
Code no. of the inspecting officer……………
Date of inspection…………
Code no. of the shop inspected………………
Code no. of contractor…………..

Sl.no.	Findings (irregularit-ies noticed)	FIR no. & date	Date of filing case	Date of disposal	How disposed convicted Yes / No

A4.91 Every month an abstract could be prepared for each Deputy Commissioner's jurisdiction on the computer to monitor cases pending without FIRs and thosepending in courts for different periods. These will be available to all inspecting and supervisory officers. Raids done at various levels should also be similarly monitored looking at seizures made, cases booked, cases pending, convictions recorded and cases in which evictions have been ordered by courts.

V Monitoring systems for the department

A4.92 So far, we have looked closely at systems that can be adopted within liquor production and distribution units themselves. We have also mentioned the interphase between these units and departmental offices, principally range offices and offices of Deputy Commissioners of Excise. Within the department itself, other systems should be adopted for generating MIS data and monitoring developments at the macro level. By working through an online system, it should also be possible at the State headquarters to identify problem areas before they develop into major issues. Revenue realisations from different sources could also be monitored throughout the year and corrective action taken.

A4.93 The present list of suggestions should be expanded to cover more activities as also other excisable commodities. With reference to the composite check post recommended in the Commission's first report, we suggest that the control room that will be set up at the Excise Commissioner's office should be manned round the clock by officers empowered to compound offences to deal online with vehicles caught committing these crimes at composite check posts. This will substantially increase the effectiveness of these check posts and of the department as a whole. The department may also examine whether the list of compoundable offences should be increased keeping in mind departmental objectives.

A4.94 If online processing of voluminous data has to be done, many documents like application forms, allotment orders, NOCs, concurrence orders, permissions, permits, invoices etc. must be made capable of being scanned. Order and permit formats should also be formatted in advance so that they can be automatically issued with only a few variables requiring entry. Manual keying in should be used sparingly and only in rare cases.

A4.95 The possibility of introducing embedded electronic systems at processing and storage points in production units should be explored. Software can then be developed to transmit vital data to computers from each one of these points relating to the supply and storage of inputs, the outflow of outputs and their storage and distribution. The department should explore the availability of such devices and commission research institutes like IITs and the Indian Institute of Science to develop them. This will enable direct capture of online data from the source to the departmental computer network.

A4.96 Some areas for capturing revenue accruals from production and distribution units for the departmental MIS have been indicated in other sections of this annexure. More exhaustive systems should be developed to develop authentic cash flow systems for the department and for the Finance department. Licence fees paid annually by producers and distributors as well as those paid by those who store excisable goods could be recorded and monitored at the relevant departmental office. A general data base of all allotments, permits, orders, concurrences and NOCs issued by different offices should also be built up online. This should be available to all supervisory points like check posts, distillery officers, raiding parties and inspecting officers. A data base of export verification certificates should also be maintained datewise and this should be closely monitored to ensure that evasion does not take place by passing off liquor sold within the State as exported items.

A4.97 Large payments like auction rentals for arrack are made by contractors who make collections in cash from liquor shops using only small denomination notes. Treasury officers complain of such remittances particularly when they are made at the end of the financial year. All branches of scheduled bank branches particularly computerised ones should be authorised to receive cash, furnish acceptance challans and electronically transfer funds to the State's account in the RBI.

CHAPTER V

STAMP DUTIES
AND
REGISTRATION FEES

CHAPTER V

STAMP DUTIES AND REGISTRATION FEES

5.1 The first report of the Commission focused only on non-judicial stamp duties and deferred consideration of judicial stamp duties to the final report. In the present chapter, we have made an indepth study of judicial stamp duties and taken for analysis up the few items on which we had reserved comments in the first report. Further comments on tax potential

5.2 Detailed comments have been made in the first report on various aspects of the revenue realised from this head of account in the eighties and nineties. This is the most productive of the major own tax revenue sources in Karnataka. The buoyancy of stamp duties and registration fees in the 14 major States is given at Table I. Although buoyancy for the entire period of 1980-81 to 1998-99 is above 1 in Karnataka, it has fallen from the level of 1.36 for the period 1980-81 to 1992-93. Buoyancy levels for the longer period are also lower than those for many of the other major States.

Table I

Buoyancies of stamp duties & registration fees

	'80-'81 to '92-'93	'80-'81 to '98-'99
ANDHRA PRADESH	1.01	1.19
BIHAR	1.44	0.39
KARNATAKA	1.36	1.08
GUJARAT	1.20	1.22
HARYANA	1.11	1.37
KERALA	1.36	0.30
MADHYA PRADESH	1.27	1.42
MAHARASHTRA	1.48	1.24
ORISSA	1.18	0.92
PUNJAB	0.84	0.36
RAJASTHAN	1.34	1.24
TAMILNADU	0.40	0.71
UTTAR PRADESH	1.26	1.02
WEST BENGAL	1.33	0.80

Source:- Revenues based on RBI studies of State finance of various years furnished by Institute for Social and Economic Change Bangalore.

NSDP from published & unpublished data of Central Statistical Organisation.

Duties on some documents on which suggestions were deferred in the first report

5.3 In the first report, the Commission had postponed consideration of duty levels to be imposed on hypothecations, pledges, pawn, unattested pledges and mortgages without possession (para 6.82). We have examined the matter in detail and noted the manner in which duty levels have been shifting over time to adjust to alterations in banking practices. At present, the stamp duty for the hypothecation of movable property is .1% with a ceiling of Rs. 10000, while for pledges which offer a higher degree of security to bankers it is .5% with a ceiling of Rs. 2 lakhs. The Model Act circulated by the Government of India puts hypothecations and pledges on the same footing and applies a uniform rate of .5% with a ceiling of Rs. 2 lakhs to all of them. Unattested instruments are duty exempt in Karnataka and other similar mortgages without possession charged at 3% with a Rs. 3 lakh ceiling. Separate duties do not seem to be specified for both these instruments in the schedules of some other States-Andhra Pradesh, Maharashtra and Tamilnadu. Since bankers are in any case resorting mainly to hypothecations and the transaction is applied to material secured for working capital finance, we recommend application of the recommendation given in the Model Act to both instruments

Extension of the compulsory registration requirement

5.4 In paras 6.49 to 6.53 para 6.103 of the first report, we had made suggestions regarding extension of the compulsory registration requirement to instruments like General Power of Attorney and sale agreements applicable to immovable property by amending the Registration Act at the State and Central levels to control evasion and fraud. Our recommendation regarding extending the ambit of Section 17 and dropping the proviso to Section 49 of the Registration Act to prevent unregistered GPAs from acquiring evidentiary value in judicial proceedings relating to part performance of contracts under the Transfer of Property Act (Section 53A) is being implemented by the Central government. The statute in this connection is pending for Presidential assent. This is a welcome development. The State government should ensure that the amendment becomes law as quickly as possible. It is also necessary to tackle the prevalent practice of transferring ownership without executing a document by making purchasers equityholders in property and shifting only the equity to them which is being used to evade duty on conveyance. We recommend amendment of Section 17 of the Registration Act at the State level to include such transactions under the definition of "conveyance".

5.5 The State has tackled the practice of evading duty on conveyance by using the technique of creating and dissolving partnerships (which have low duty liability and are not compulsorily registrable) by making such transactions registrable. To mitigate the disincentive effects for entities which are developing from firms into incorporated companies for economic and industrial reasons, we may reduce stamp duty and registration fee requirements for firms in which partners continue to hold controlling shares for a minimum lock-in period of 5 years.

Recommendations relating to other matters

5.6 There are financial penalties prescribed in the Stamp Act. Up to ten times the stamp duty due can be levied as penalty for unstamped or under-stamped documents and the document itself impounded. Section 82 also prescribes a penalty of 7 years' imprisonment and fine or both for making false statements but this is rarely enforced. We recommend introduction of a penalty for non-registration of registrable documents since this is the most common evasion technique. The suggestion made in the May 1995 NIPFP report that registration should also be cancelled if affidavits are found to be false may not be enforceable in practice.

5.7 Under Section 72 of the Registration Act there is only provision for a single appeal to the Registrar (D.C.) against an order of the sub-registrar refusing to register a document. We recommend that there should be provision for a second appeal to the Revenue Appellate Tribunal. We also recommend that inspection powers in Section 67B of the Stamp Act should be used to examine the records of developers who are suspected of undervaluing property and evading stamp duty.

Governance and tax payment

5.8 We have drawn attention to the widespread perception about unfriendly, rent-seeking, sub-registrars' offices in the Commission's first report. In recent months, there have also been several newspaper reports about specific instances of illegal gratification in the department. We have already made several recommendations to simplify and rationalise duty and fee structures and procedures. A key suggestion that we would like to re-emphasise is the institution of a system of computerised generation of guidance values, for which, as we have already indicated in the first report, much of the preparatory work is practically complete. Concerted action over a six-month period is all that is required to bring in this radical improvement in the effectiveness and user-friendliness of departmental offices. We reiterate our view that computerisation at the superficial level of scanning registered documents or networking offices to improve MIS data would be inadequate to enhance the performance and image of the department. We hope government will move in the direction suggested in the first report as rapidly as possible in the interests of revenue and better compliance. As soon as this stage is reached, duties on conveyance should be brought down to the levels suggested in the Commission's first report

5.9 A beginning should be made in improving physical infrastructure in sub-registrars' offices. Most of them in Bangalore and other cities are located in cramped, storeyed buildings which are deficient in facilities for both official personnel and the public. We strongly recommend setting up modern offices spread over a single floor with personnel located in glass cubicles set opposite a comfortable public lounge provided with a computerised kiosk at which data concerning tax rates and procedures can be accessed in a user-friendly manner over the internet. Such offices should be provided with telephones and given powers to incur the expenditure required to purchase consumables for computers and take and preserve registered documents.

5.10 The need to fill up departmental posts which are lying vacant should be assessed after working out requirements after computerisation. This is essential since it is widely believed that sub-registrars' offices are being run by outside persons, "recruited", used and paid by departmental officials out of unaccounted earnings. Such persons should be kept out of sub-registrars' offices after the required personnel are put in place. Recruitment rules should be modified to ensure that personnel with computer skills are preferred for appointment.

5.11 As already mentioned earlier, action has been taken to purchase hardware. Some of it is getting installed with NIC support. Software development has commenced along with networking and development of management information systems. We suggest that the general recommendations on e governance made by us in this and the first report be adopted in this department. Some of the comments made regarding computerisation of the motor vehicles department would also be applicable to the Stamps and Registration department. We reiterate our view that regular departmental staff should be trained to use computers and used for managing systems when software development is completed. NIC or other special personnel should not be taken on board for routine computer operations; they may be required only for creating a core systems management group attached to the head office for trouble shooting and handling upgradation and similar issues.

5.12 Routine office management in sub-registrars' offices also requires substantial improvement. No check list is used to confirm that sub-registrars have done the prescribed verifications before registration. No record is therefore available of the manner in which a document has been treated after presentation. This affects transparent working and makes inspections difficult at the micro level. Since it is possible to precisely specify the verifications required to be done by the sub-registrar for each kind of transaction, check lists could easily be prepared and brought into use. It is heartening to note that the IGR has already prescribed an office inspection schedule and formats for conducting inspections. This should be strictly adhered to and closely supervised. There is also no departmental manual listing out procedures and requirements although there is an internal diary containing much of this information. This should be developed into an easily readable manual which can be used by both departmental staff as well as users. It should be made freely available to members of the public and put on the departmental website. It could also be broken down into brochures documentwise and these could be made available at all offices.

5.13 A major area of administration that requires upgradation relates to duty collection through stamps. We have already made extensive recommendations on this issue. For many transactions, there is no requirement of authentication of the document concerned. Payment could therefore be encouraged through agencies which deal with such transactions in large numbers like banks, financial institutions, stock exchanges and insurance companies. For transactions which require authentication, these agencies need to be authorised to "frank" documents on behalf of government. Since 1994-95, the department has been using franking machines in sub-registrars' offices. In Bangalore, at least, they are apparently being used fairly extensively. The Nasik printing press has practically given up printing stamps in small denominations. Stamp shortages add to the distress of taxpayers and encourage rentseeking. The department is planning to furnish franking machines to major institutions like banks etc. Franking machines will be calibrated to handle transactions of up to Rs. 10000 at a time and will pay advance duty whenever machines are recalibrated. Sub-registrars admit that most conveyance documents today are not prepared on stamp paper and duty is paid through bank drafts which are appended to the document when it is presented.

5.14 In the first report, we have already recommended online collection and accounting of duty by most institutions. To this end, officers of the appropriate level should be empowered to endorse documents and accept duty on behalf of the government. This could be routinely done online by financial institutions, stock exchanges, insurance companies and the like. It would, in fact, be a better alternative to stamps than franking. It would also remove the harassment and delay created by frequent visits by the personnel and clients of such institutions to sub-registrars' offices. Appropriate verification mechanisms could be prescribed for departmental officers using documents and occasional physical checks. This would eliminate the need for stamps, franking machines and even methods like pass-books and revolving credit accounts which have been suggested in various reports and thoroughly modernise duty collection. Safeguards could be incorporated and powers granted to institutions made liable to withdrawal if they are found to be evading levy and collection of duty. We also recommend abolition of adhesive stamps as a means of collecting duty.

5.15 No-objection certificates demanded before registration of conveyance deeds add to the lack of transparency and delay in registration. These relate to violations of "public policy" under other statutes which are expected to be identified and prevented when deeds are registered (under Section 22A of the Registration Act). NOCs sought at present pertain to prohibited land transfers-lands granted by government to Scheduled Castes and Scheduled Tribes, confirmed to tenants under the Land Reforms Act or to *inam*holders under Inams Abolition Acts, lands notified for acquisition by the government or the Bangalore Development Authority as well as non-alienated or *gramthana* lands and surplus lands or sales to non-agriculturists violating the Land Reforms Act. In urban areas, it appears that only a formal *affidavit* is taken from the presenter of the document, while in rural areas, the document is referred back for verification through J forms to concerned departments. To avoid delay, the practice in rural areas is for the presenter to obtain the required certificates upfront and present them along with the document to the sub-registrar. Measures to reduce such harassment must be explored as it is at the root of non-transparent, user-unfriendly departmental functioning. Whether affidavits and strict penalties for false declarations could substitute for the NOCs could be considered. However, removal of such requirements may need to be made contingent on feedback from concerned departments on documents registered. In any case, wide publicity should be given to prescribed procedures, their rationale, exemptions and NOC requirements through a citizen's charter in which time limits for registration and avenues for grievance redressal are indicated.

5.16 Accounting for duty collected and MIS pose special problems in this department. We have already discussed them in detail in the first report. Online transactions could substantially improve data collection mechanisms and our understanding of the revenue productivity of different documents. For the present, it is preferable, as suggested by the IGR, for the Finance department to collate data relating to drafts collected by sub-registrars for stamp duty and registration fee payment obtained from sub-registrars' offices and information regarding sale of stamps furnished by district treasuries to arrive at a reasonably accurate estimate of revenue realised. This could be reconciled with the Accountant-General's office from time to time.

5.17 A major area of reform is facilitating the issue of *khatas* and mutation after a transaction is completed. At present, this is tackled afresh by appropriate authorities with considerable harassment of citizens. In urban areas, it is handled by the local

body while in rural areas, the revenue department is entrusted with the task. The only link between registration and *khata* issue is transfer of intimation of registration to the appropriate authority. Even this is rarely enforced. We do not recommend automatic issue of *khata* after registration by the sub-registrar himself, since the department may not be fully aware of local requirements. There should however be provision for online intimation of registration to concerned *khata* issuing authorities. Since the revenue department and municipal bodies are themselves getting computerised, provision should be made for such interaction when systems are developed. Till something akin to the Torrens system of title insurance in introduced in the country, the sub-registrar's office may only be required to advise visitors to obtain encumbrance certificates before registration and ensure the genuineness of the title to property. Agencies granting lands like local bodies, BDA etc.should be formally authorised to collect stamp duty and registration fees and exercise delegated powers to register documents on behalf of the department. This should be done after they are linked online to the IGR's network and systems are developed for transferring data relating to formal title to property for use by both parties.
Other statutes administered by sub-registrars and District Registrars

5.18 From the e governance point of view, this is an area of considerable public interaction. District Registrars are authorised to register, reconstitute and dissolve partnerships, trusts and societies under the respective Acts. Apart from stamp duty collected by them, they also charge a renewal fee from societies as well as fees for the issue of certified copies. Here again, we must consider how the procedure could be simplified and insulated from harassment and rentseeking.

5.19 A major activity of the sub-registrar that touches the lives of many citizens is his function as the Registrar of Marriages. Marriages conducted under the Hindu Marriage Act and the Special Marriage Act are registered by the sub-registrar, but those under the Parsi Marriage Act are registered by the District Registrar. The basic difference between registration under the Hindu and the Special Marriage Act is that the former is a mere recording of a legal action that has been performed elsewhere. The sub-registrar, therefore, is only required to demand proof of age and residence from parties to the contract. The Karnataka government has simplified procedures for such registration in 1999. The present format requires an application signed by both parties (there is no need for signatures of parents or the priest), proof of residence and of age. The sub-registrar is expected to immediately record the matter in his register and if desired furnish a certified copy on the payment of a fee. It was observed during a visit to the sub-registrars' office at Jayanagar that inadequate supply of printed forms for certificates and application forms is being managed by private supply of these formats for obtaining the sub-registrar's signature.

5.20 Government has been considering making registration of marriages compulsory to protect the interests of women. An Act in this regard which has been approved by the Government of India several years back is pending enforcement. If this happens, care will have to be taken to facilitate registration. The Inspector General of Registration is considering setting up user-friendly welcoming offices specially geared to handle such functions. Local body offices may perhaps be better suited to deal with the matter. We recommend therefore that panchayats in rural areas should be given the power to register marriages under the Hindu Marriage Act as soon alongside maintenance of a networked computerised data base of such registrations.

5.21 In the case of marriages conducted under the Special Marriages Act, the District Registrar has a clear statutory role. 30 days' notice of marriage has to be given after obtaining an application along with reliable proof of age and residence. Registration and issue of the certificate are done after expiry of this period. To prevent rent-seeking, the procedure should be publicised on the web site, at kiosks and through other methods like posters and brochures within the department, application forms should be freely available within the office (and not offered for sale along with draft certificates through private booths), publication of the marriage notice should not just be on the notice board but by some other more effective method and the certificate automatically issued after expiry of the thirty days. For the present, we do not recommend transfer of this function to local bodies.

JUDICIAL STAMP DUTIES

5.22 In its first report, the Tax Reforms Commission had deferred consideration of judicial stamp duties, which are fees levied to defray part of the costs of running the civil justice system in the country. From a purely economic viewpoint, the civil justice mechanism may have to be treated as an impure public good with large social externalities. The extent to which costs incurred in supplying the public good should be recovered, that is the share of government expenditure on civil justice that must be recouped from levying court fee has to be determined; in addition, how this burden should be spread among different categories of litigants will also have to be decided. While deciding the latter issue, we may have to examine whether the incidence of court fees should be modulated among user categories on the basis of the ability to pay principle or the benefit principle after examining the extent to which it is possible to quantify the costs incurred for supplying civil justice to a litigant and his ability to pay.

5.23 Some of these matters have been discussed in detail by the Supreme Court while deciding a bunch of appeals against various State governments in a judgment commonly referred to as Aswathnarayana Shetty and others vs. State of Karnataka-AIR 1989 Supreme Court 100. Since court fee is not a tax but a fee, there should be a *quid pro quo* between the service and the class of citizens served in the form of a "broad and general correlation" between revenues earned and expenditure incurred on providing services, even when revenues are merged in overall revenues and the services also benefit persons who have not paid the fee. After considering in great detail the significance and implications (economic and administrative) of the benefit and the ability to pay principles, however, the Court did not clearly pronounce in favour of either of them. Instead, it laid down a detailed mechanism for levying court fees by suggesting that a nominal fee of around 2% to 21/2% could be levied on the initial slab of Rs. 15000, an *ad valorem* levy not more than 7.5% could be laid on claims above Rs. 15000 subject to a limit of Rs. 75000 and after this limit is reached, progressively decreasing rates down to ½% could be applied in graduated scales.

5.24 An argument often used is that judicial stamp duties could be used to deter speculative and frivolous litigation. This may not be sustainable simply because the expensiveness of the legal system (which could result in denial of access to justice for poorer persons or deter litigants) is due today much more to costs other than judicial stamp duties-lawyers' fees, "the law's delays" and the like-rather than to prohibitive court fees. Exemplary costs are in fact provided in Section 35 of the Civil Procedure Code (they have recently been enhanced) for those responsible for frivolous litigation.

These are expected to be awarded to opposing litigants alone, but the provision is rarely exercised. In view of this as well as in view of the fact that costs other than court fees are likely to deter litigation, the Commission does not also think it necessary for the State to claim a part of such exemplary costs.

5.25 The more important objection to using judicial fees to discourage frivolous litigation relates to the inalienable duty of the State to provide justice for its citizens. It must be remembered that litigants take recourse to courts only after exhausting the potential of private dispute settlement mechanisms like arbitration and conciliation. The provision of justice should not therefore be expected to be entirely self-supporting, particularly since the judiciary does not merely decide individual cases, but also considers and settles in the course of litigation, general principles of law. The civil justice method of resolving disputes could also be considered as a safety valve that reduces the scope for violent altercations and criminal action. For this reason, there would be no case for recovering the entire cost of judicial administration from users alone. When a comparison is made of revenues and costs on this item, the focus should be on ensuring that the quantum of fees raised is not higher than expenditure incurred on the judicial system.

5.26 While considering the issue of judicial stamp duties, therefore, the basic question of determining the share of expenditure on civil justice that could be recovered through court fees and how this burden should be shared between different user categories will have to be examined.

Statutory basis of the levy

5.27 There are several items in the Central, State and concurrent lists of Schedule VII of the Constitution which relate to fees as well as judicial administration. Item 96 of the Central list empowers the Centre to levy fees for all matters except those taken in any court. Judicial stamp duties and court fees themselves fall specifically under item 3 of the State list (List II) of the Seventh Schedule of the Constitution which refers to fees collected in all courts except the Supreme Court. (Item 66, which is a companion item to item 96 of List I, empowers States to raise fees-other than those taken in any court-from any matter in the State list). The power of administration of justice which was once a State power (item 11 of the State list) was transferred to the concurrent list (item 11A) in 1976. Similarly, item 26 of the concurrent list referring to legal, medical and other professions, has enabled Parliament, if it so desires, to determine stamp duty payable on applications for enrolment as advocates. The concurrent list like the other two also has an omnibus provision under item 47 covering the levy of fees in respect of matters in the list, excluding court fees.

5.28 By construing these provisions together, the present position regarding the levy of judicial stamp duties and court fees is that only fees charged in courts fall within the ambit of State legislation under item 3 of List II. They are administered by courts of law under the overall supervision of the Law department. Tribunals and quasi-judicial bodies that are not referred to as courts fall within the ambit of provisions of the Constitution other than item 3 of List II. This has sometimes had the effect of reducing a source of State revenue, when for expeditious disposal of specific disputatious matters, special tribunals are set up to dispose of particular categories of civil disputes. Consumer protection tribunals and, more recently, debt recovery tribunals have been established in this manner; the latter procedure has resulted in removal of a fairly lucrative source of court fee revenue for States. States must take note of this aspect whenever special tribunals are proposed. Although it should be convenience of litigation and not revenue that should be the principal consideration, the State government could review all cases of special tribunals that have been set up in this fashion. The basic principle to be considered from the court fee point of view when a matter usually handled by civil courts is transferred to a special tribunal is that the government which furnishes the service should be entitled to determine fee rates and reap revenues.

5.29 Another feature of special tribunals is that court fee rates are laid down in the constituting statutes themselves. They tend therefore to escape review for long periods of time. The State government should regularly examine such rates with reference to the service rendered and the position before creation of the tribunal.

5.30 Finally, there are process fees levied on plaintiffs under the Civil Procedure Code to cover the costs of summoning witnesses and documents and ensuring attendance or production. These are covered by the Civil Rules of Practice framed and administered by the High Court. The revenue realised is not earmarked for expenditure to be incurred on witnesses. It is accounted for under the omnibus head of judicial stamp duties while expenditure on witnesses is booked under normal Court administration.

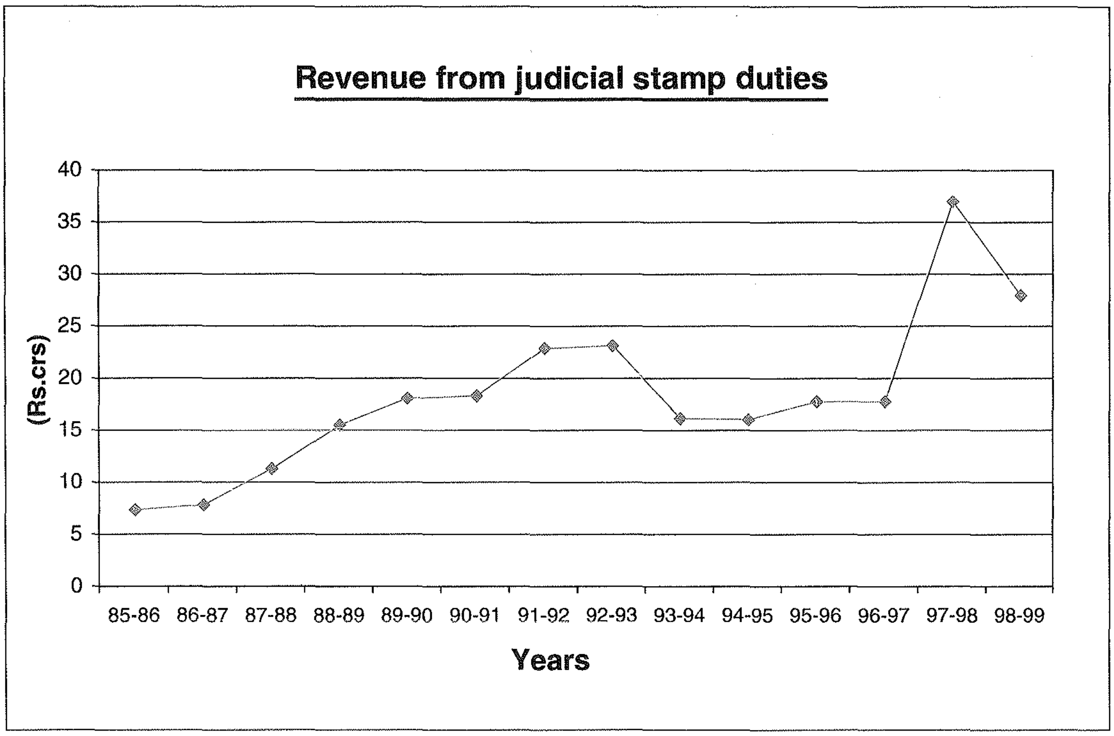
5.31 The Karnataka Court Fees and Suits Valuation Act of 1958 is the statute applicable to levy and collection of judicial stamp duties in the State. As for process fees, since they have been reviewed as recently as 1999, there may be no case for further immediate increases.

Revenue significance of the levy

Table II

Revenue from judicial stamp duties

Year	(Rs.crs)
1985-86	7.3
1986-87	7.79
1987-88	11.26
1988-89	15.46
1989-90	18.05
1990-91	18.28
1991-92	22.87
1992-93	23.11
1993-94	16.11
1994-95	16.05
1995-96	17.75
1996-97	17.76
1997-98	36.99
1998-99	27.97



5.32 Revenue realised from judicial stamp duties has been indicated at Table II. There is considerable fluctuation in revenues, which show increase up to 1992-93, after which there is a distinct slump from around Rs. 23 crs. to Rs. 16 to Rs. 17 crs. From this level, revenue is again seen to have more than doubled to Rs. 37 crs. and once more reduced to around Rs. 28 crs. The reasons for such fluctuations are difficult to determine since responsibility for the levy is diffused over several departments and agencies. The variations noticed might even be due to misclassification of receipts! There is a case for closer monitoring at the Finance department and treasury levels, which should be possible today since these departments as well as courts and major tribunals are being extensively computerised. Recent comparable figures of judicial stamp duties for other major States are not readily available but the 1995 NIPFP study (Table 9 of Chapter II) notes the wide range (between 4% and 35%) within which these figures move across years. There is not much clustering around median values either.

5.33 There appears to be no mechanism today to capture the quantum of fees realised from judicial courts, administrative and other courts and government departments and authorities (as a whole as well as under different items) for reasons which will be discussed in greater detail under administration and evasion. Informed conclusions and policy decisions are not possible in such a system.

Quid pro quo between service and fee

5.34 As indicated earlier, the major issues to be considered under this head pertain to the extent to which expenditure on providing civil justice should be recovered from users and the manner in which the tax burden should be shared among different categories of users. It is appropriate to expect judicial fees to defray part of the costs of revenue administration, that is expenditure incurred on recurring personnel and maintenance costs. Capital expenditure on buildings, residential and official as well as on equipment, furniture etc. ought to be met by government out of the general budget. Latest accounts figures for judicial administration from the Finance department for 1999-2000 indicate that Rs. 127 crs. were spent on running all courts (including criminal courts), of which Rs. 112 crs.were on salaries. Rs. 5.8 crs. were spent on works (official and residential buildings). Figures available from the High Court indicate that civil and sessions courts accounted for around Rs. 90 crs. in 2000-2001. Since the court fee head also covers receipts from other tribunals and quasi-judicial and even administrative authorities set up by the State, expenditure on all such agencies could be assumed to be around Rs. 100 crs. It would be appropriate to realise through court fees approximately half these costs; the above principle may be treated not as a rigid rule, but as a broad guideline to evaluate the working of the system from the financial viewpoint. There is a case to gradually increase revenue realizations from judicial fees to Rs. 50 crs. by streamlining the tax structure. This should be attempted, however, only alongside substantial upgradation and modernisation of infrastructure facilities for the judiciary and litigants. The burden of court fee should also be distributed equitably among litigants in line with benefits received and their ability to pay.

Distribution of tax burden

5.35 Although the Supreme Court did not specify clearly the principles on the basis of which the burden of court fee should be shared by different categories of users, it considered several issues like the number of manhours expended on a legal proceeding, the value of the subject matter etc. A mix of the concept of vertical and horizontal equity and the benefit principle seems appropriate while allocating the fee burden among different users. The principle of cost recovery can be applied only at the macro level while determining the share of expenditure on maintaining the civil justice system that should be recovered through court fees. It cannot be used to allocate the fee burden since it is not possible to determine the manhours expended in deciding each case and compute their cost. Benefit can, therefore, be measured only in terms of financial advantage derived from taking up a civil matter in the courts and fees tailored accordingly. Such an approach is also in line with the equity principle. There is also a case for exempting or charging low specific fees when legislative protection is proposed to be given to special beneficiary classes, like accident victims, those whose land has been compulsorily acquired by the government or factory workmen.

Rationalisation of slabs and rates

5.36 The general structure of the Court Fees Acts of different States is drawn from the basic Central Court Fees Act of 1870 and the Suits Valuation Act of 1887 which were in force in British India under the unitary political structure. Some States like Karnataka and Tamilnadu enacted their own Acts after independence while others adopted the earlier statutes with amendments. As in the case of non-judicial stamp duties, in respect of judicial stamp duties also, for this reason, there is little differentiation among States in statutory provisions and fee schedules despite the absence of a conscious mechanism for harmonisation or consultation among them. In general, court fee acts have a general chapter (Chapter IV in the case of Karnataka) indicating how fee should be computed and two schedules (Schedules I and II in Karnataka) covering items subject to specific and *ad valorem* duties. General chapters focus on determining the fee base for different kinds of proceedings and plaints, but they also lay down the fee rate in cases (like adoption suits, revenue matters and the like) in which no value can be arrived at on the disputed subject matter. Tax base determination is pegged to the amount claimed or the relief sought and sometimes there are floor and ceiling rates. Evasion by under-valuation is, however, possible when claims are not in monetary terms; this is discussed in later paragraphs.

5.37 *Ad valorem* fees are prescribed on plaints, petitions, appeals and various kinds of applications filed in different courts or before various authorities. On the whole, they follow the guidelines laid down by the Supreme Court in Aswathnarayana Shetty vs. Government of Karnataka and others (mentioned earlier). However, there are different ways in which States have applied these guidelines as the comparative fee structure in respect of Karnataka, Tamilnadu and Kerala given in Annexure I will show. A related issue with respect to *ad valorem* rates is the valuation question which will be discussed further on in this chapter. As in the case of non-judicial stamp duties, specific rates are applicable whenever valuation of the disputed or claimed item is not possible; they are also levied on a large variety of applications to executive and quasi-judicial authorities. In Karnataka, rates have in general remained static from 1979; very few rates were changed in 1982. There is also a case for adjusting rates to general inflation levels to generate more revenues to modernise tribunals and improve their services for litigants, advocates and magistrates

5.38 In the case of general suits, in the Karnataka Schedule I, there is an inordinately large number of slabs and rates finely differentiated on the basis of suit value. This was introduced by an amendment on 29/1/93 to implement the Supreme Court's guidelines in A. Shetty's case. Against 16 items in the Karnataka schedule, Kerala has only 6 and Tamilnadu just 3! Since the Supreme Court had only laid down guidelines, there is sufficient leeway for the State to simplify and rationalise its fee structure in the interests of transparence and administrative facility.

5.39 Going by the basic principles of public finance, there is no justification for such excessive rate differentiation. The rationale behind the prevailing rate structure is also weak. The "inverted U" rate curve is regressive; the rate structure is also inversely related to the benefits received from litigation. The present schedule thus violates both the benefit and the equity principles. In our view, the court fee structure should be proportional to the value of the disputed property. This would require merger of the existing multiple rates into a single low rate, which should be applied to suit value. We recommend that the rate should be determined by computing the prevailing effective average rate and rounding it off to the nearest integer. The rate might stabilise around 2.5% to 3%. A minimum low floor rate could also be fixed. This will create a simple transparent system that would be comprehensible and acceptable to lawyers and litigants.

5.40 Other modifications proposed are the following:
-the fee to be raised from $1/8^{th}$ to $1/4^{th}$ of the security value in cases of suits for the possession of title documents as in some neighbouring States
-for adoption suits, the fee to be raised to Rs. 50 for cases with market value below Rs. 5000

-drop provisions relating to suits under old statutes like the Bombay and Hyderabad Land Revenue and Mamlatdar Courts Acts
-dropping from the Second Schedule item 2 referring to petitions under Section 26 of the Insolvency Act and Section 95 of the Code of Civil Procedure, for which the present duty level is half that for suits (to discourage frivolous insolvency petitions and applications for arrest and attachment), since Rs. 1000 is the maximum compensation that can be claimed under the provision and Rs. 100 would be the maximum court fee that could be collected.
-At item 3 relating to petitions under Sections 53 or 54 of the Insolvency Act, an across-the-board fee of Rs. 500 could be levied.
-removal of the differentiation between applications filed within and beyond the limitation period at item 5 (applications for review of judgments). Applications for review presented to the High Court, civil courts and KAT could be charged at 5% and those to government at Rs. 100.
-in the case of letters of probate and certificates under the Succession Act, the rate could be 1% up to a value of Rs. 1 cr. and 5% in other cases.
-for undertakings under Section 49 of the Divorce Act, appeals to any court other than the High Court or executive officers, appeals to KAT and government, the fee rate should be Rs. 50
-for appeals to the High Court, the fee should be Rs. 100
-for appeals under the Arbitration Act, the fee should be 1% with a minimum of Rs. 50
-copies of judgments of criminal courts should be charged Re. 1 and those of High Court decrees, Rs. 5
-copies of stamped documents presented in lieu of originals should be charged Rs. 2
-copies of other proceedings should be charge Re. 1/page
-petitions to excise, revenue and municipal officers and to DCs for land leases should not be charged fees
-petitions for lapsed deposits presented after six months should be charged Rs. 5
-other petitions to government as also to DCs should not be charged fees
-petitions to KAT relating to legal powers should be charged Rs. 50 and other cases Rs. 10
-petitions to executive magistrates should not be charged fees
-applications for temporary injunctions presented to a court should be charged Rs. 100 and those to other authorities Rs. 50
-applications for arrest or attachment before judgment (other than to a High Court) should be charged Rs. 50
-applications under Rule 58 CPC in a revenue court should be charged Rs. 50 and in other courts Rs. 100
-applications under Section 47 and Rule 90 CPC should be charged Rs. 50
-applications under Order 17 Rules 1 and 2 CPC in the High Court should be charged Rs. 100 and in other courts Rs. 50
-the fee rate for original petitions not otherwise provided for should be similar to that in Kerala
-the fee rate for applications to set aside arbitration awards and applications for directions to file arbitration awards should be similar to those in Tamilnadu
-revision petitions in the High Court under Section 115 CPC should be charged Rs. 50
-writ petitions in the High Court under Art. 226 (except *habeas corpus*) and under Article 227 should be charged Rs. 500 as also appeals to the High Court
-applications under the Specific Relief Act should be charged Rs. 100

-petitions to the High Court and KAT not otherwise provided for should be charged Rs. 5
-election petitions for membership, presidentship and vice-presidentship of the Taluk Board or *panchayat* (or equivalent) should be charged Rs. 50
-applications to sue as pauper should be charged Re. 1
-applications to appeal as pauper in the High Court should be charged Rs. 2 and in other courts Re. 1
-bail bonds and other other instruments under the CPC and CrPC not otherwise provided for should be charged Re. 1
-copy of power of attorney or vakalatnama filed in any court should be charged Rs. 5
-the lower slab for agreements for question for opinion under the CPC could be dropped from the schedule
-all caveats should be charged Rs. 10

Determination of market value for computing the fee payable

5.41 As indicated earlier, procedures prescribed for evaluating the tax base, which are critical from the equity and revenue viewpoints, are relevant only in cases when the claim or relief is not specified in money terms, but described as movable or immovable property which require valuation. The legal procedures prescribed as well as actual practices make a difference in this area.

5.42 In the Karnataka Act, determination of the market value of immovable property is governed by the provisions of Section 7 of the Karnataka Act, under which values are determined as a multiple (121/2 to 25 times) of the land revenue or 15/30 times the net profit for unassessed land. The plaintiff is expected to file a statement along with the suit indicating the market value and the court is expected to adjudicate this issue first. Since land revenue rates have remained stagnant since 1965 in Karnataka, this implies that in respect of immovable property, court fee rates are today totally out of alignment with market values. In the Kerala Act, however, Section 7 determines the market value of agricultural land as ten times the annual gross profit minus assessment, of buildings as ten times the rental value or actual market value and of other property as estimated by the plaintiff but not less than fixed by the Collector under the Stamp Act. Under the Tamilnadu system, thirty times the assessment, rent etc. is taken as market value for specified classes of agricultural land but the market value is treated as ten times the difference between the annual gross profit and assessment for other categories of agricultural land; for house sites, market value is taken for determination of the court fee.

5.43 Both the neighbouring States mentioned above have moved away generally from linking market valuc to land revenue to the gross profit minus assessment approach. It is desirable for Karnataka too to adopt guidance values notified by subregistrars for valuation purposes. A gradual transition to market-linked valuation could be made with fee rates adjusted downwards to prevent undue hardship to litigants on account of sharp increases.
Exemptions

5.44 The list of exemptions prescribed under Section 69 is given in Annexure II. The list may be reviewed in the light of the recommendation made by us further on to remove court fee on applications made to government offices on non-judicial matters.

Proceedings in non-judicial tribunals and administrative matters

5.45 Suggestions have been made for raising fee levels for quasi-judicial tribunals-consumer and labour courts, economic offences and motor vehicle tribunals, arbitration matters and the like. As mentioned earlier, fees can be levied only in tribunals through which the State provides services. Since arbitration is governed by the provisions of a Central Act and costs are fully met by the litigants themselves, there is no case for levying court fees.

5.46 A substantial component of labour legislation is enforced through criminal complaints. Matters under the Industrial Disputes Act are dealt with in labour courts manned by judicial officers, but expenditure is not recovered through court fees as a specific exemption notification has been issued by government. Such exemption is justified since these disputes relate to an important component of economic legislation-the protection of workers' rights.

5.47 Consumer courts are an example of special tribunals that have been set up under a Central Act to decide matters that were once subject to civil legislation. A provision in the Act constituting tribunals provides for court fee exemption although costs of running the courts are met by State governments. Since the issues decided relate to civil claims in respect of goods and services that have already been paid for, there is a case for levying a fee even if there is an element of social legislation about the disputes handled by such courts. It is suggested, therefore, that an across-the-board nominal fee of Rs. 100 should be charged in consumer courts which could be eventually debited to the losing party.

5.48 In the case of land acquisition awards, court fee is not being levied today on the enhanced compensation amount given by courts, when matters are referred to them by the Land Acquisition Officer under Section 18 of the Act. Such references are mandatory when a landowner accepts the compensation fixed by the officer under protest. Courts often enhance the compensation to a substantial extent, but a view has been expressed that court fee cannot be charged on this amount since proceedings have arisen on the basis of administrative referral not on *suo moto* approach to the court by the landowner. Court fees are leviable in the rare cases when appeals are filed in higher courts against lower court orders determining compensation. We have considered the matter in depth. Since compensation amounts are routinely enhanced by courts, there is a case for levying a fee of .5% on the compensation awarded which should be collected after the case is decided while paying the amount.

5.49 Motor vehicles accident tribunals manned by judicial personnel are exempted from court fees by a specific government notification under the Motor Vehicles Act although the costs of running such tribunals are met by the State. There may be a case to charge a low fee of .5% on the value of the compensation awarded, (which is generally paid by insurance companies) to be collected only after the conclusion of the case from the compensation amount itself.

Fee collection mechanisms and e governance

5.50 Judicial stamp duties are paid by affixing adhesive stamps on documents presented to courts or public authorities or preparing documents on impressed stamp paper (Sections 71 and 72). As in the case of non-judicial stamps, judicial stamps, copying sheets for orders and impressed stamp paper are printed in security printing presses on indents placed by the State Treasury department on the basis of requirements indicated by registered stamp vendors. Stamps are distributed to vendors who are entitled to the usual scale of commission for selling them to users. Section 4 provides that no document chargeable with fee should be filed, exhibited or recorded in or be acted on or furnished by any court or public officer unless the required fee has been paid. Courts and administrative authorities are expected to ensure that the required value of stamps is affixed to documents presented to them. They are expected to cancel stamps while receiving documents to prevent re-cycling and fee evasion (Sections 4 and 74). The practice is fairly systematically observed in offices concerned with judicial and quasi-judicial work, but it is probably increasingly neglected in purely administrative offices.

5.51 Levy of fees on routine petitions and applications filed on administrative matters to government seems anomalous in modern offices which are expected to be open, welcoming and responsive to citizens and their needs and complaints. It goes against the current emphasis on transparence and open government which is based on citizen interaction and feedback. The Commission is of the opinion that the existing procedure of charging stamp duty for petitions and applications made to the government should be given up since this is followed more in the breach than in the observance. It is incompatible with an e governance environment since the revenue realised from fees is disproportionate to the cost of monitoring a plethora of departments. Unless the fee provision is dropped, it could be used in a discretionary manner for rentseeking and harassment by individual officials. The bar on unstamped documents being legally accepted for adjudication has also been modified to some extent in judicial courts due to the current practice of treating even letters as starting points for public interest litigation

5.52 Adhesive judicial stamps are printed in denominations of 10 and 60 paise and 1, 2, 4, 5, 10, 20, 25, 30, 35, 40, 45, 50, 60, 75, 100, 200, 300, 500, 1000, 3000, 5000 and 25000. Judicial copying sheets are printed in 35 paise denominations. It was indicated that in 1999-2000, Rs. 86 lakhs were spent on printing judicial stamp paper. Suggestions have been made for rationalising the number of denominations and aligning them with the schedule to the extent possible, since even today, stamps of higher value are often affixed to documents, due to non-availability of stamps of the required value. This should be done expeditiously. There is also a case for considering (as in the case of non-judicial stamp duties) whether online computerised collection would be possible. Actual collection of fee in cash, through demand drafts, pay orders and the like and franking in tribunals themselves, even when they have been fully computerised, may not be easily accepted. Collection and related franking through banking channels could be considered side by side with stamp vending. Over time, more modern methods would drive away antiquated procedures based on stamp affixation with their attendant problems of artificial shortages and forgery.

5.53 A visit to the court of the Principal City Civil Judge at Bangalore on 23/7/2001 furnished us with a comprehensive overview of how court fee is administered and collected. The complex of courts served by this area accounted for Rs. 6.57 crs. of gross revenue (without accounting for refunds) in 2000-2001 (which would amount to close to 1/5th of the revenue realised from judicial stamp duties). If we consider the revenue realised from the Court of Small Causes which is another very busy civil tribunal at Bangalore, it is clear that these courts alone could account for the major share of court fee revenue.

5.54 The courts gathered under the Principal City Civil Judge at Bangalore are the first cluster of civil courts to be computerised; since 4 months, documents are being received at two computerised counters linked to a Local Area Network. The counters deal with original and miscellaneous suits. Administrative personnel attached to the court have themselves been trained to work on computers. Staff manning the counters make initial entries into the computer which is programmed to do a preliminary verification of documents with reference to jurisdiction (both territorial and pecuniary). They enter the claim value indicated in the plaint into the computer which generates the court fee payable on this account and this is verified at the counter itself. Since there are no facilities for scanning documents, connectivity that is already available is not at present being utilised. Documents that are cleared by the computer are passed on manually to the back office which is manned by two Sheristedars (Office Superintendents). The Superintendents do a detailed manual scrutiny in which the adequacy of the court fee is also examined with reference to market value and stamps are cancelled. A brief note is entered into the computer and the file sent to the Principal Civil Judge for allocation to the appropriate court for decisions on doubtful issues including adequacy of the court fee. The Principal City Civil Judge's court, which is probably the busiest civil court in the State, receives around 40 to 60 original petitions and around 100 miscellaneous ones daily. A Daily Register of Court Fees is prepared manually in the back office from which an annual total of gross collection is prepared and sent to the High Court at the end of the financial year.

5.55 From the users' viewpoint, the following improvements could be introduced into the system without much difficulty:
There is a case for a kiosk system under which the document could be scanned and court fee computed for the benefit of users without recourse to the counter
The extent to which connectivity could be used for interaction between personnel at the counter and the back office and the Principal City Civil Judge could be examined
A citizens' charter could be developed and enforced to ensure processing without delay
Connectivity could be used for online verification of pendency and delay
Back office MIS outputs seem to have been developed but they have not yet been put into effect; these could be streamlined for regular outputs regarding fee realised from different kinds of suits and documents and feedback given not only to the Controlling Judge but also to the Treasury and the Inspector-General of Registration
A user-friendly computer manual detailing inputs, outputs and the like could be prepared and made available to all users and personnel.
There is a case for developing expert-system software for mechanising scrutiny of documents in the back office to the extent possible

5.56 From the accounting point of view, there is today a monthly report furnished by District Treasuries relating to revenue realised from stamp duties as a whole that is furnished to the Director of Treasuries and the IGR. Duty is collected at the point of sale of stamps and stamp paper before the transaction liable to duty actually takes place. Dispersed sale and receipt of documents in different tribunals and offices characterise the levy. As seen above, however, it appears feasible even without computerisation to obtain regular reports from all tribunals regarding various kinds of court fees recorded by them while receiving documents.

5.57 We have already considered the tricky issue of likely under-valuation. The practice is for defendants to routinely take the plea that the subject matter of suits is not properly valued. Courts have to, therefore, in most cases,consider and pass judgment on the adequacy of valuation as a preliminary to registering the plaint and taking a decision on the subject matter of suits. When appeals are preferred, orders can be passed on the adequacy of the fee levied and deficit fee collected; eventually unpaid deficit fee is collected as land revenue arrears.

5.58 Fee refunds are provided under Chapter VII when a plaint is rejected for delay in presentation, or delay in remitting deficit fee, when plaints are remanded to lower courts, when earlier orders are reversed or reviewed, when settlements are arrived at before the hearing takes place etc. At the court of the Principal City Civil Judge at Bangalore refund orders were being issued on the computer but data relating to refunds was not being netted out for MIS purposes. This could easily be done since connectivity has been established.

5.59 Court fee examiners (officers of the rank of Assistant Registrars) can be appointed by the High Court under section 17 of the Act to inspect records of subordinate courts from the viewpoint of adequacy of valuation and fee collection. The Karnataka High Court, which was providing for such inspections every two years, has discontinued the practice recently. There is a case for reintroducing it as provided under the Act.

5.60 A penalty of 6 months imprisonment and/or fine of Rs. 500 is prescribed in Section 76 for registered stamp vendors who disobey prescribed rules and for sale of stamps by unregistered stamp vendors. There is no case for any change at present.

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Acknowledgements:

Justice P. Venkatarama Reddy, Former Chief Justice, Karnataka High Court.
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Shri. Aswathnarayana, Bar Council, Bangalore

Annexure I

RATES OF JUDICIAL STAMP DUTIES IN	KARNATAKA	KERALA	TAMILNADU
Money suit	on amount claimed	on amount claimed	on amount claimed
Suit for maintenance	on amount claimed to be payable for one year	on amount claimed to be payable for one year	on amount claimed to be payable for one year
Suit for annuities or periodical payments	on 5 times amount claimed to be payable for one year (if annuity is payable for less than 5 years, on total sum payable)	on 5 times amount claimed to be payable for one year (if annuity is payable for less than 5 years, on total sum payable)	on 5 times amount claimed to be payable for one year (if annuity is payable for less than 5 years, on total sum payable)
Suit for movable property other than title documents -if subject matter has market value -in other cases	 on market value on amount of relief sought (if suit is for goods pledged as security for debt, on debt amount)	 on market value on amount of relief sought	 on market value on amount of relief sought
Suit for possession of title documents	1/8th of amount or market value of property secured if plaint alleges or issue framed regarding title to money or property secured by docum-ent	1/4th of amount or market value of property secured if plaint alleges denial of title to money or property secured or issue framed regarding title to money or property secured by document	1/4th of amount or market value of property secured if plaint alleges denial of title to money or property secured or issue framed regarding title to money or property secured by document
Suit for possession of title documents where plaintiff's title is not denied	on amount of relief sought	on amount of relief sought	on amount of relief sought
Suit for declaration -where prayer is for possession of property -where prayer is for injunction on immovable property -other cases	 on market value or on Rs. 1000 whichever is higher 1/2 the market value or on Rs. 1000 whichever is higher on amount of relief sought or on Rs. 1000 whichever is higher	 on market value or onRs1000 whichever is higher 1/2 the market value or on Rs. 1000 whichever is higher; on plaint amount oronRs1000, whichever is higher,if it relates to copyright infringement on market value or on Rs. 1000, whichever is higher	 on market value or onRs.300 whichever is higher 1/2 the market value or on Rs.300 whichever is higher; on plaint amount or onRs500, whichever is higher,if it relates to copyright infringement on market value or on Rs. 400, whichever is higher

RATES OF JUDICIAL STAMP DUTIES IN	KARNATAKA	KERALA	TAMILNADU
Suit for adoption -in Munsiff's court where market value below Rs. 5000 -in other cases	Rs. 25 Rs. 1000 if market value less than Rs. 15000 & Rs. 250 in other cases	Rs. 50 Rs. 150 if within Rs. 15000 in Munsiff's court and Rs. 500 in sub-judge's or district court	Rs. 50 in district munsiff's court, Rs. 100 in city civil court Madras or sub-courtor district court up to Rs.10000 & Rs.500 in others& Rs500 in High Court
Suit for injunction -connected with immovable property relating to title -in other cases	1/2 market value or on Rs. 1000 whichever is higher on amount of relief sought or Rs. 1000 whichever is higher	1/2 market value or on Rs. 500 whichever is higher on amount of relief sought or Rs. 500 whichever is higher	1/2 market value or on Rs. 300 whichever is higher (Rs. 500for copyright infringement & 400 in others)
Suit relating to trust property	1/5th of market value with cap of Rs. 200;on Rs. 1000 if there is no market value	1/5th of market value with cap of Rs. 200;on Rs. 1000 if there is no market value	1/5th of market value with cap of Rs. 200;on Rs. 1000 if there is no market value
Suit for possession under Specific Relief Act	1/2 market value or on Rs. 1000, whichever is higher	1/3 market value or on Rs. 150, whichever is higher	1/2 market value or on Rs. 200, whichever is higher
Other suits for possession of immovable property	on market value or on Rs. 1000, whichever is higher	on market value or on Rs. 1000, whichever is higher	on market value or on Rs. 400, whichever is higher
Suit relating to easement	on amount of relief sought with minimum of Rs.1000	on amount of relief sought or on Rs.1000,wh.is higher	on amount of relief sought which should not be belowRs. 300
Pre-emption suit	on consideration for sale or market value, whichever is less	on consideration for sale or market value, whichever is less	on consideration for sale or market value, whichever is less

RATES OF JUDICIAL STAMP DUTIES IN	KARNATAKA	KERALA	TAMILNADU
Suit relating to mortgage			
-to recover money due	on amount claimed	on amount claimed	on amount claimed
-where prior mortgagee seeks determination of charge	on written statement on amount claimed	on written statement on amount claimed	on written statement on amount claimed
-where prior mortgagee is to be paid out of sale proceeds of mortgaged property	on amount claimed	on amount claimed	on amount claimed
-where co-mortgagee claims for all mortgagees	on total amount claimed	on total amount claimed	on total amount claimed
-where sub-mortgagee claims his share	on amount claimed under sub-mortgage	on amount claimed under sub-mortgage	on amount claimed under sub-mortgage
-for redemption of mortgage	on amount due or 1/4th of principal secured, which-ever is higher	on amount due or 1/4th of principal secured, which-ever is higher	on amount due or 1/4th of principal secured, which-ever is higher
-for foreclosure of mortgage	on amount claimed as principal and interest	on amount claimed as principal and interest	on amount claimed as principal and interest
Suit for accounts	on amount sued for	on amount sued for or on Rs. 1000 whichever is higher	on amount sued for
Suit for dissolution of partnership	on value of share	on value of share	on value of share
Partition suit			
-where claimant's share is denied	on market value of share	on market value of share	on market value of share
-where claimant is in joint possession	Rs. 15 if value of share below Rs. 3000, Rs. 30 if value between Rs. 3000 & Rs. 5000, Rs. 100 if value between Rs. 5000 & Rs. 10000, Rs. 200 in other cases	Rs. 50 in Munsiff's court, Rs. 300 in sub-court or district court	Rs. 30 in District Munsiff's co urt, Rs. 300 in High Court, Rs. 30 up to Rs. 5000, Rs. 100 up to Rs. 10000 & Rs. 200 in other cases in other courts
-where in addition to one of the above, claimant claims his separate share	on 1/2 the market value of share or 1/2 the rates, depending on which is applicable	on 1/2 the market value of share or 1/2 the rates, accor-ding to whether he claims po-ssession or joint possession	on 1/2 the market value of share or 1/2 the rates, accor-ding to whether he claims po-ssession or joint possession
Suit for joint possession	on market value of share	on market value of share	on market value of share
Suit for cancellation of decrees	value sought to be cancell-ed	value sought to be cancell-ed	value sought to be cancell-ed

RATES OF JUDICIAL STAMP DUTIES IN	KARNATAKA	KERALA	TAMILNADU
Suit to set aside attachment	on 1/4th of market value of attached property or amount for which property attached, whichever is less	on 1/4th of market value of attached property or amount for which property attached, whichever is less	on 1/4th of market value of attached property or amount for which property attached, whichever is less
Suit to set aside other orders	on 1/4th of market value or rates applicable to other suits	on 1/4th of market value or rates applicable to other suits	on 1/4th of market value or rates applicable to other suits
Suit for specific performance -sale -mortgage -lease -exchange -other cases	 on consideration on amount secured on fine and premium and average of annual rent on consideration on market value or as for other suits	 on consideration on amount secured on fine and premium and average of annual rent on consideration on market value or as for other suits	 on consideration on amount secured on fine and premium and average of annual rent on consideration on market value or as for other suits
Suit for recovery of immovable property from tenant	on premium and rent payable for year before date of presenting plaint	on premium and rent payable for year before date of presenting plaint, on rent to be	on premium and rent payable for year before date of presenting plaint
Other suits between tenant and landlord	on rent payable for year before date of presenting plaint alleges or issue framed	apportioned or reduced in such cases	on rent payable for year before date of presenting plaint
Suit for *mesne* profits	on amount sued for	on amount sued for	on amount sued for
Suit to alter or cancel entry in revenue registers etc	Rs. 50	Rs. 150 if within Rs. 15000 in	Rs. 15
Suit in revenue court relating to village office	Rs. 50		Rs. 50
Suit in Tahsildar's courts under Bombay	Re. 1.50		
Mamlatdar Courts Act			
Suit under Bombay and Hyderabad Land Revenue Acts	Re. 1.50		
Suit relating to public matters	Rs. 50	Rs. 10	Rs. 50
Third party proceedings	on 1/2 the claim made	on 1/2 the claim made	on 1/2 the claim made
Other suits -in revenue courts -in civil courts	 Rs. 50 Rs. 20 if subject matter below Rs. 5000, Rs. 100 if value between Rs. 5000 & Rs. 10000 and Rs. 200 in other cases	 Rs. 25 Rs. 50 in Munsiff's court, Rs. 200 if value is below Rs. 25000 and Rs. 400 in other cases in sub-court and district court	 Rs. 15 Rs. 300 in High Court, Rs. 30 in District Munsiff's court & Rs. 30 up to Rs. 5000,Rs. 100 up to Rs. 10000 & Rs. 200 in other cases & courts

RATES OF JUDICIAL STAMP DUTIES IN	KARNATAKA	KERALA	TAMILNADU
Plaint, written statement, pleading setoff counter-claim or memorandum of appeal			
-within Rs. 15000	21/2%	Rs.2 within Rs. 100, 2% for additional amount or part up to Rs. 15000, 5% for additional amount or part up to Rs. 50000, 7.5% up to Rs. 10 lakhs, 5% up to Rs. 1 cr.and .5% over this amount.	40 ps.up to Rs.5, 40 ps/Rs.5 between Rs.5&Rs. 100,75ps per Rs. 10 over Rs. 100
-between Rs. 15000 & Rs. 75000	Rs. 375 + 71/2% of amount over Rs. 15000		
-between Rs. 75000 & Rs. 250000	Rs. 4872 + 7% of amount over Rs. 75000		
-between Rs. 250000 & Rs. 500000	Rs. 17125 + 61/2% of amount over Rs. 250000		
-between Rs. 500000 & Rs. 750000	Rs. 33375 + 6% of amount over Rs. 500000		
-between Rs. 750000 & Rs. 1000000	Rs. 48375 + 51/2% of amount over Rs. 750000		
-between Rs. 1000000 & Rs. 1500000	Rs. 62125 + 5% of amount over Rs. 1000000		
-between Rs. 1500000 & Rs. 2000000	Rs. 87125 + 41/2% of amount over Rs. 1500000		
-between Rs. 2000000 & Rs. 2500000	Rs. 109625 + 4% of amount over Rs. 2000000		
-between Rs. 2500000 & Rs. 3000000	Rs. 129625 + 31/2% of amount over Rs. 2500000		
-between Rs. 3000000 & Rs. 4000000	Rs. 147125 + 3% of amount over Rs. 3000000		
-between Rs. 4000000 & Rs. 5000000	Rs. 177125 + 21/2% of amount over Rs. 4000000		
-between Rs. 5000000 & Rs. 6000000	Rs. 202125 + 2% of amount over Rs. 5000000		
-between Rs. 6000000 & Rs. 7000000	Rs. 222125 + 11/2% of amount over Rs. 6000000		
-between Rs. 7000000 & Rs. 8000000	Rs. 237125 + 1% of amount over Rs. 7000000		
-over Rs. 8000000	Rs. 247125 + 1/2% of amount over Rs. 8000000		

RATES OF JUDICIAL STAMP DUTIES IN	KARNATAKA	KERALA	TAMILNADU
Petition under Section 26 of Insolvency Act	1/2 above duty scale	1/2 above duty scale	1/2 above duty scale
Appeal on such petitions	As in duty scale	As in duty scale	As in duty scale
Petition under Sections 53 & 54 of Insolvency Act	1/2 duty scale with cap of Rs. 500	1/2 duty scale with cap of Rs. 500	1/2 duty scale with cap of Rs. 500
Appeal on such petitions	1/2 duty scale with cap of Rs. 500	1/2 duty scale with cap of Rs. 500	1/2 duty scale with cap of Rs. 500
Memorandum of appeal under Succession Act	1/2 duty scale	1/2 duty scale	1/2 duty scale
Application for judgment review presented within 90 days	1/2duty leviable on plaint or appeal	1/2duty leviable on plaint or appeal in all cases	1/2duty leviable on plaint or appeal in all cases
Application for judgment review presented after 90 days	duty leviable on plaint or appeal		
Application for review of KAT order	Rs. 20		
Probate of will when value over Rs. 1000 on part over Rs. 1000 up to Rs. 300000	5%	1% up to Rs. 1 cr..5% in other cases	2% between Rs. 1000 & Rs. 5000, 3% in other cases
Probate of will when value over Rs. 300000 on part over Rs. 300000	10%		
Certificate under Succession Act	Fee leviable for probate on security and 11/2 times this fee on value of security to which certificate is extended	1% of value up to Rs. 1 cr. .5% in other cases	1% up to Rs. 5000 & 3% in other cases
Petition for divorce or dissolution	Rs. 100		Rs. 10 for Christians & Muslims, Rs. 30 for Hindus Parsis, Rs. 50 for Colonial Divorce Jurisdiction Act
Undertaking under Section 49 of Divorce Act	Rs. 5		Re. 1
Appeal to any Court other than High Court or executive officer	Rs. 4	Rs. 5	Re. 1
Appeal to KAT	Rs. 8		Rs. 2
Appeal to High Court -if order relates to suit of value over Rs. 1000 -in other cases -if appeal under Section 45B of Banking Companies Act -if appeal under Section 411 A of CrPC	 Rs. 15 Rs. 8 Rs. 100 Rs. 5	 Rs. 10 Rs. 5, Rs. 10 in some cases & Rs. 100 in others Rs. 100 Rs. 5 Rs. 2 under Agriculturists Debt Relief Act	 Rs. 2 Rs. 5 in some cases, Rs. 10 in some & Rs. 100 in others Rs. 100 Rs. 5 Rs. 2 under Agriculturists Debt Relief Act

RATES OF JUDICIAL STAMP DUTIES IN	KARNATAKA	KERALA	TAMILNADU
Appeal to government not chargeable under any other act	Rs. 10	Rs. 5	Rs. 5
Appeal under Arbitration Act -where value within Rs. 5000 -where value between Rs. 5000 & Rs. 50000 -other cases	 Rs. 15 Rs. 50 Rs. 150	 Rs. 25 up to Rs. 15000, 1% up to Rs. 1 lakh, 2% up to Rs. 5 lakhs,.5%in other cases	 Rs. 15 up to Rs. 5000 from District Munsiff's court or higher & Rs. 100 in others
Judgment copy not being a decree	Re.1		50 ps up to Rs.50,Re.1in others,Rs. 2 in High Court
Judgment copy of criminal court	50 paise	Re. 1	50 ps.
Copy of decrees made by courts other than High Court	Re.1		75 ps.up toRs.50, Rs. 1.5 in others
Copy of decree of High Court	Rs. 4	Re. 1	Rs. 5
Copy of stamped document presented in place of original -when stamp duty on original within Re. 1 -other cases	 Duty chargeable on original Re.1.25	 Duty chargeable on original 0.75	 Duty chargeable on original 0.75
Copies of other proceedings	50 paise/360 words	0.75	0.75
Petition to excise, revenue and municipal officer	Re. 1		.25 ps. To .75 ps.
Petition to DC for land lease	Rs. 2	.75,.25 for non-lease cases	.25 ps. To .75 ps.
Petition to Forest Officer for lease extension -if value below Rs. 5000 -if value above Rs. 5000	 Rs. 25 Rs. 5/Rs. 1000 over Rs. 5000	 Rs. 5 Re. 1/Rs. 1000 over Rs. 5000	 Rs. 5 Re. 1/Rs. 1000 over Rs. 5000
Petition for attestation of documents for use abroad	Rs. 10	Re. 1	Re. 1
Petition for lapsed deposit presented after 6 mths -when amount within Rs. 50 -when amount between Rs. 50 & Rs. 1000 -in other cases	 Re. 1 Rs. 2 Rs. 4		 .5 ps Re. 1 Rs. 2
Petitions to government not provided for -relating to legal powers -other cases	 Rs. 4 Rs. 2.50	 Rs. 2 Rs. 0.5	 Rs.2 Rs. 0.5
Petitions to KAT, etc. not provided for -relating to legal powers -other cases	 Rs. 2 Re. 1		 Rs. 2 Rs. 1.5
Petition to Civil Court (other than Principal Civil Court of original jurisdiction), DC etc. of value below Rs. 50	Re. 1	Re. 1	25 ps.
Petition to Court etc. for copy of decree	Re. 1	Re. 1	25 ps.

RATES OF JUDICIAL STAMP DUTIES IN	KARNATAKA	KERALA	TAMILNADU
Petition to Court for calling for records by post	Re. 1 + application fee	Re. 1	75 ps. + application fee
Petition of criminal complaint (except those for which police can arrest without warrant)	Re. 1	Re. 1	75 ps.
Petition to deposit or determine rent	Re. 1	Re. 1	Re. 1
Other petitions to executive magistrates, etc.	Re. 1	Re. 1	Re. 1
Application for temporary injunction -presented to a Court -presented to other authorities	 Rs. 10 Rs. 5		 Rs. 5 in High Court & Re.1 up to Rs. 50 & Rs. 2.5 in
Application for arrest or attachment before judgment (other than to a High Court)	Rs. 5	Re1 for values below Rs.50, Rs. 2.50 in other cases,Rs.5 in High Court	other cases and courts
Application under Rule 58, CPC -in revenue court -in other courts	 Rs. 5 Rs. 10	 Re. 1 Rs. 5 in High Court, Rs. 2.5	 Re. 1 Rs. 5 in High Court & Rs.
Application under Section 47 & Rule 90 CPC	Rs. 5	in other courts in all cases	2.5 in other courts in all cases
Application under Order 17 Rules 1 & 2 CPC -in High Court -in other courts	 Rs. 10 Rs. 5		
Application under Trusts Act	Rs. 5	Rs. 5	Rs. 5
Application for probate to have effect in India	Rs. 25	Rs. 25	
Other applications for probate or succession certificate -where value within Rs. 2000 -where value between Rs. 2000 & Rs. 10000 -where value over Rs. 10000	 Rs. 5 Rs. 10 Rs. 20	Re. 1 up to Rs. 1000, Rs. 5 in other cases	75 ps.up to Rs. 1000, Rs. 5 in other cases
Original petitions not provided for -in High Court -in other courts	 Rs. 12 Rs. 2	Re. 1 in munsiff's court, Rs. 20 in High Court, Rs. 10 in other courts	Rs1&5 in munsiff's court, Rs. 20 in High Court, Rs. 10 in other courts
Application to set aside arbitration award -when value within Rs. 5000 -in other cases	 Rs. 25 Rs. 100	Rs. 25, Rs. 100 up to Rs. 10000, Rs. 250 in others	Rs. 100 up to Rs.10000, Rs. 250 in others when above Rs. 5000 in all courts except Dt. Munsiff's Court, Rs. 25 in other cases

RATES OF JUDICIAL STAMP DUTIES IN	KARNATAKA	KERALA	TAMILNADU
Application for direction to file arbitration award -in Munsiff's court -in other cases	 Rs. 50 Rs. 200	 Rs. 15 in all cases,but Rs.100 in non-munsiff's court if value up to Rs. 10000&Rs. 250 in other cases	 Rs.250 when aboveRs.10000, Rs. 100 between Rs. 5000 & Rs. 10000 & Rs. 15 below Rs. 5000 in all courts except Dt. Munsiff's Court, Rs. 15 in other cases
Revision petition in High Court under Section 115 CPC -where value is within Rs. 1000 -where value is between Rs. 1000 & Rs. 10000 -in other cases	 Rs. 5 ? Rs. 20		 Rs.5 Rs. 10 in other cases
Winding up petition for company	Rs. 100	Rs. 100	Rs. 100
Writ petition in High Court under Article 226 (except *habeas corpus*) or petition under Article 227	Rs. 100		Rs. 25
Appeal to High Court	Rs. 100		
Application under Specific Relief Act	Rs. 10	Rs. 100	Rs. 100
Petition to High Court and KAT not provided for	Rs. 2	Rs. 2	Rs. 2
Election petition -for Taluk Board or Panchayat -President and Vice-President of these bodies -TMC members -Municipal Council members -Mayor, Deputy Mayor or Municipal Chairper-son	 Rs. 15 Rs. 25 Rs. 50 Rs. 100 Rs. 200	For VP member, Rs.25, VP President,member of munici-pal&district Board Rs. 50, Rs.200 for Municipal Chair-man or District Board Presid-ent,Rs. 250 for general elect-ions	Rs. 25 for VP member, Rs. 50 for VP President, Dt Boa rd & municipal council membr Rs.200for municipal chairman
Application to sue as pauper	75 paise		75 ps.
Application to appeal as pauper -in High Court -in other courts	 Rs. 2.50 Rs. 1.25		 Re. 1 Rs. 2
Bail bond or other instrument under CPC and CrPC not provided for	Rs. 1.25	Rs..25 in village court and Re. 1 in others	75 ps.
Copy of power of attorney filed Vakalatnama -to Karnataka Appellate Tribunal -to High Court -to KAT -to government	Rs. 2 Rs. 2 Rs. 3 Rs. 3 Rs. 3	Re. 1 Rs. 3 Rs. 5 Rs. 5	75 ps. Rs. 3 to High Court & gover nment, Rs.to Board of Reven ue or CEO, Rs. 1.5 to others

RATES OF JUDICIAL STAMP DUTIES IN	KARNATAKA	KERALA	TAMILNADU
Agreement for question for opinion under CPC			
-where value within Rs. 5000	Rs. 15	Rs. 15	Rs. 15 and Rs. 100
-in other cases	Rs. 100	Rs. 100	
Caveat under Succession Act		Rs. 10 in all cases	Rs. 10 in all cases
-where value within Rs. 2000	Rs. 6.25		
-in other cases	Rs. 12.50		
Other caveats			
-in High Court	Rs. 10		
-in KAT	Rs. 10		
-in other Courts	Rs. 5		

Annexure II

EXEMPTIONS FROM JUDICIAL STAMP DUTY

Written authority to institute or defend a suit executed by non-civilian armed forces personnel
Memorandum of appearance for defendants in criminal cases
Plaints and documents in suits in village courts
Application presented to concerned revenue officer prior to land revenue settlement
Application relating to irrigation water from government sources
Application to extend cultivation or relinquish land not settled permanently by government
Application to serve notice to relinquish land or enhance rent
Written authority to an agent to distrain
First application to witness (other than petition containing criminal charge of information)
Bail bonds in criminal cases and recognizances
Application regarding an offence made to police
Petition by prisoner
Complaint by public servant
Application to remove timber in government forests (except from contractors for extending leases)
Application for money due from government other than refund of lapsed deposit 6 months after lapse
Appeal against municipal tax
Application for compensation for land acquisition
Petition under Section 48 of Indian Christian Marriage Act
Appeal, copies and applications for copies by government servant against dismissal, reduction or suspension orders
Copy of record of rights filed with plaint or application

CHAPTER VI

MOTOR VEHICLE TAX

CHAPTER VI

MOTOR VEHICLE TAX

6.1 In the first report, the Tax Reforms Commission had comprehensively reviewed the existing structure of motor vehicle taxation in Karnataka and made detailed recommendations for reform. It had examined the fiscal rationale for the tax and considered related regulatory issues. It had studied tax structure, slabs and rates with reference to those prevailing in neighbouring States and suggested improvements. It had also assessed the impact of the policy of nationalisation of passenger services on State revenues and the tax structure. Eventually, it had looked at administrative, compliance and other governance issues. The final report will, therefore, only focus on the few matters that were deferred for more detailed examination in the earlier report.

6.2 Government of Karnataka has already introduced some of the measures suggested by the Commission relating to *ad valorem* taxation, rationalisation of slabs and removal of exemption for rigs. It is hoped that recommendations relating to progressive denationalisation of passenger bus services, abolition of exemptions for vehicles owned by educational, religious and charitable institutions, pollution control, tax collection through banks and by electronic transfer and eventual reversion to annual tax will be taken up for early consideration. Re-examination of the permit requirement for transport vehicles and facilitation of inter-State vehicle transfers by removing re-registration and "lifetime tax" refund mechanisms are proposed to be taken up by the State government with the Centre.

Objectives to be served by motor vehicle taxation

6.3 In the first report of the Tax Reforms Commission, we have commented on the multiple and often contradictory objectives that are implicitly sought to be achieved by motor vehicle taxation. The major ones seem to be energy conservation, control of pollution and traffic congestion and minimising road damage. The fiscal tool is perceived to be an effective disincentive for restraining indiscriminate use of motor vehicles in general and discouraging high-polluting, road-damaging and congesting vehicles. The extent to which this is feasible within the motor vehicle tax schedule has been examined in the Karnataka context. An attempt has been made to fit the existing tax structure for motor vehicle tax in Karnataka to the range of objectives, by generating ratios for fuel efficiency, pollution, road damage, congestion and tax burden for the five main classes of passenger vehicles-two and three wheelers, light, medium and heavy motor vehicles-and the three main classes of goods vehicles-light, medium and heavy vehicles. Comparative statements have also been generated *inter se* for comparable categories of passenger and goods vehicles. The accompanying box gives the assumptions underlying our analysis of the multiple objectives of motor vehicle taxation in Karnataka.

PREPARATION OF A GRID OF OBJECTIVES FOR MOTOR VEHICLE TAXATION-ASSUMPTIONS BEHIND THE ANALYSIS

For passenger vehicles, persons normally carried by each vehicle category have been determined on the basis of permitted capacity and results of a survey done by the Transport department in 1997. The following assumptions have been made for the 5 vehicle categories listed below:
-two-wheelers: permitted capacity 2; 1.5 taken for our purposes
-three-wheelers: permitted capacity 3; 2 taken for our purposes in accordance with survey results
-motor cars and jeeps (light motor vehicles): permitted capacity between 3 and 5; we have assumed 3 as no survey data is available
-maxicabs (medium motor vehicles): permitted capacity between 7 and 12; we have assumed 12 since this category of vehicles is extensively used for carrying passengers and vehicles are invariably full, if not overloaded
-buses (heavy motor vehicles): permitted seating capacity between 35 and 63; we have assumed 50 since most vehicles operate like stage carriages

For calculating mileage in kms.per litre of fuel, quantities consumed have been considered, not values (since from the pollution and energy conservation angles, the effect of one litre of diesel is not different from that of one litre of petrol); mileage has been calculated on the basis of the consumption of more frequently used models as below:
-two-wheelers: 40 kms.
-three-wheelers: 20 kms.
-light motor vehicles: 12.5 kms.
-medium motor vehicles: 8 kms.
-heavy motor vehicles: 4 kms.

As for polluting capacity, parameters prescribed in Rule 115 of the Motor Vehicles Rules (Euro I norms for Karnataka) have been adopted. The norms in force today outside Delhi are still seven to eight years behind European norms.

In the case of congestion, norms applicable to India (in Passenger Car Unit equivalents-PCUs) cited in "Traffic Engineering and Transport Planning" by L.R. Kadiyali, 2000 edition have been adopted.

Norms for road damage may be available with the Ministry of Surface Transport drawn from research undertaken at the Central Road Research Institute. It will be useful to further refine the present study by accessing such data. Some empirical data applicable to current Karnataka conditions is available from a survey conducted by SPAN Consultants Bangalore for the Karnataka Road Development Corporation under the World Bank Roads Project on the Bangalore-Mysore State Highway. This is based on actual loads (including loads above registered laden weight-these constituted 30% of the vehicles surveyed) for light commercial vehicles, buses and two and 3 axle trucks. Statistics obtained for light commercial vehicles is being adopted for motor cars and maxicabs also in the absence of other data. No data is available for two and three wheelers; very low figures have been assumed since road damage is negligible.

The relative tax burden on goods vehicles has been assessed using the following parameters:
Load:
Light vehicles: 7 tons registered laden weight (RLW)
Medium vehicles: 12 tons RLW
Heavy vehicles: 20 tons RLW
Mileage (kms./litre):

Light vehicles: 10 kms.
Medium vehicles: 6 kms.
Heavy vehicles: 4 kms.

Finally, a comparison has been done of the tax structure for comparable goods and passenger vehicles using the following parameters:
Light vehicles: 2 tons RLW compared with vehicles carrying 3 passengers (cars and jeeps)

Medium vehicles: 7 tons RLW compared with passenger vehicles carrying 12 passengers (maxi-cabs)

Heavy vehicles: 20 tons RLW compared with vehicles carrying 50 passengers (buses).

6.4 Parameters relating to different objectives calculated on per passenger basis for passenger vehicles have been placed alongside the annual motor vehicle tax rate for each vehicle category and reworked in the form of ratios treating medium motor vehicles as 1 at Table I. A similar comparison has been done on per tonne basis for goods vehicles at Table II. Bar charts have also been prepared for each objective as well as for tax burden on per passenger basis for passenger vehicles and per tonne basis for goods vehicles. A comparison of the relative tax burden on passenger and goods vehicles is presented in Table III.

6.5 These tables clearly indicate that the existing tax schedule of the State for passenger vehicles is not closely aligned with any of the objectives of motor vehicle taxation, not even with the professed objective of compensating for road damage. Fulfilment of the last objective would require reducing the relative tax burden on light motor vehicles and raising that on heavy motor vehicles. To fulfil the three other objectives, however, we would require a completely different tax structure-one in which three-wheelers are taxed the most, followed broadly by two-wheelers, light, medium and heavy vehicles. (To fulfil the fuel-efficiency objective, however, the highest relative tax burden should be on light vehicles, followed by three-wheelers, two-wheelers, medium and heavy vehicles).

Table I

FITTING MOTOR VEHICLE TAX STRUCTURE TO FISCAL OBJECTIVES

Passenger vehicles

OBJECTIVES	UNIT	2 WHEELER	3 WHEELER	LIGHT MOTOR VEHICLE	MEDIUM MOTOR VEHICLE	HEAVY MOTOR VEHICLE
Fuel consumption	litres/100 kms.	2.5	5	8	12	25
Pollution	gms./km.	10	15	12	30	37
Congestion	PCUs	0.5	0.75	1	2	3.5
Road damage	vehicle damage factor	0.01	0.02	0.058	0.058	0.016
Tax per annum (adjusted in case of "lifetime tax" for 15 yrs.)	Rs.	150	120	1000	24000	90000

Passenger vehicles

(ratios)

OBJECTIVES	UNIT	2 WHEELER	3 WHEELER	LIGHT MOTOR VEHICLE	MEDIUM MOTOR VEHICLE	HEAVY MOTOR VEHICLE
Fuel consumption	litres/100 kms.	1.67	2.5	2.67	1	0.5
Pollution	gms./km.	2.67	3	1.6	1	0.3
Congestion	PCUs	2.06	2.34	2.06	1	0.44
Road damage	vehicle damage factor	0.17	0.34	1	1	0.28
Tax per annum (adjusted in case of "lifetime tax" for 15 yrs.)	Rs.	0.05	0.03	0.17	1	0.9

Note: Calculations have been done on per passenger basis.

Table II

Goods vehicles/ tonne

OBJECTIVES	UNIT	Light vehicle	Medium vehicle	Heavy vehicle
Fuel consumption	litres/100 kms.	1.42	1.42	1.25
Pollution	gms./km.	1.71	2.5	2
Congestion	PCUs	0.41	0.17	0.18
Road damage	vehicle damage factor	0.044	0.051	0.322
Tax per annum	Rs.	342	400	450

Goods vehicles/tonne

(ratios)

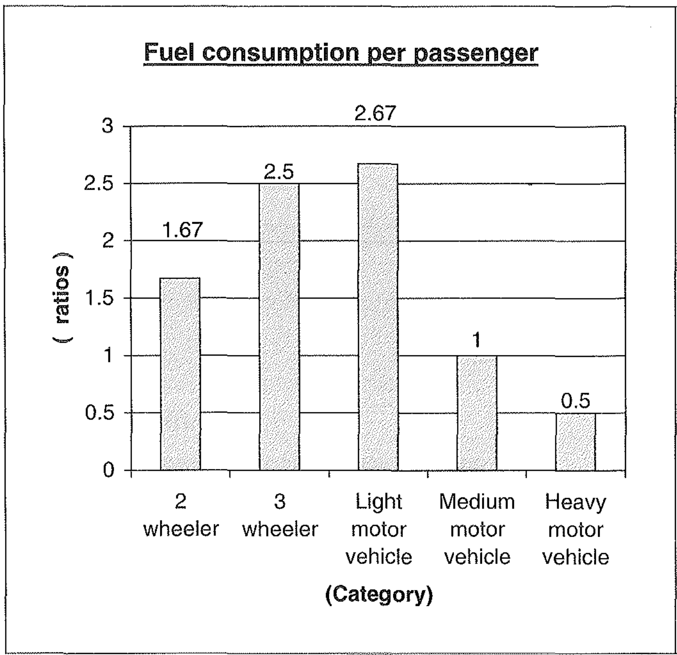
OBJECTIVES	UNIT	Light vehicle	Medium vehicle	Heavy vehicle
Fuel consumption	litres/100 kms.	1	1	0.88
Pollution	gms./km.	0.68	1	0.8
Congestion	PCUs	2.41	1	1.06
Road damage	vehicle damage factor	0.08	1	6.31
Tax per annum	Rs.	0.86	1	1.125

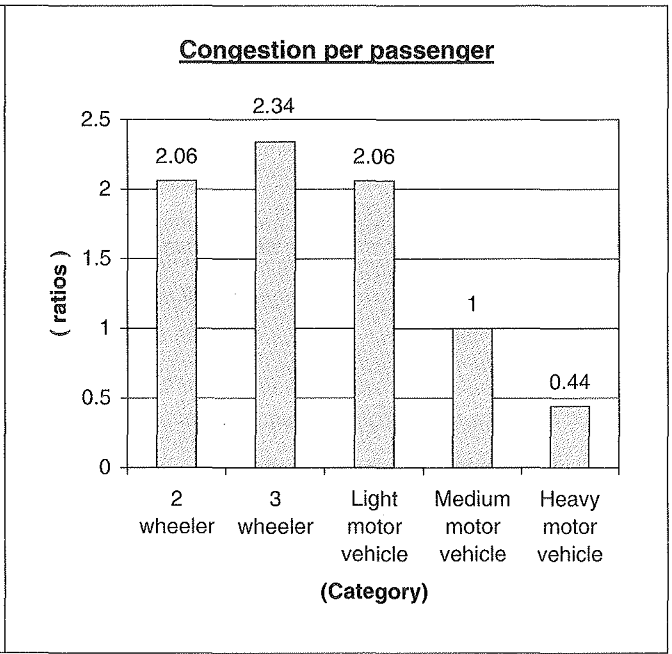
Table III

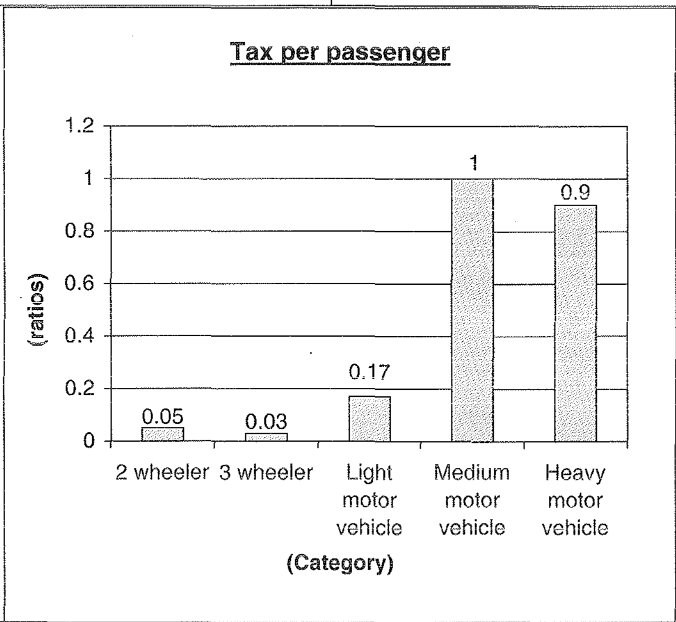
COMPARATIVE MOTOR VEHICLE STRUCTURE FOR GOODS AND PASSENGER VEHICLES

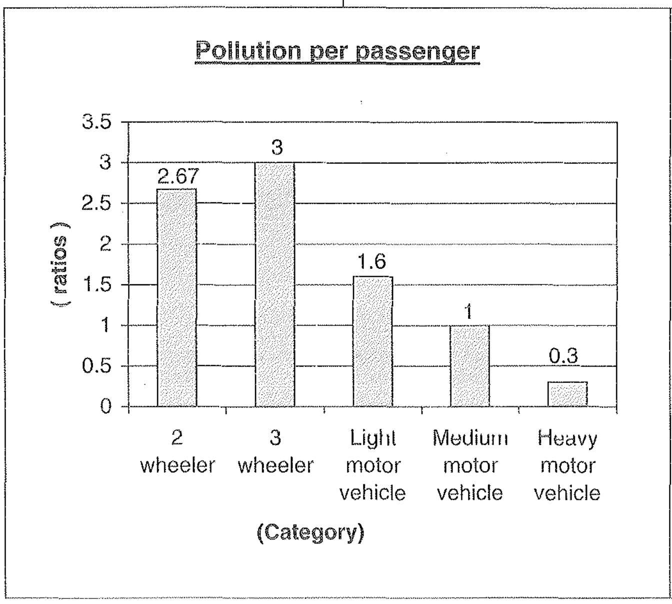
(Rs.)

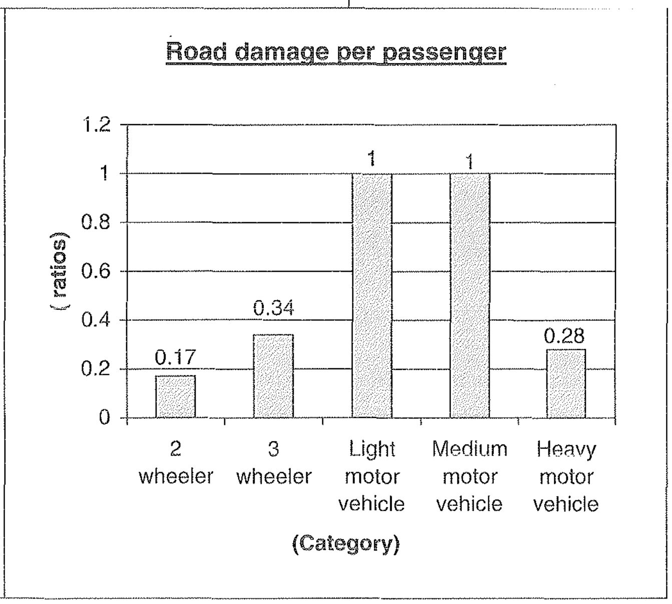
	Light vehicle	Medium vehicle	Heavy vehicle
Goods	2400	4800	9000
Passenger	1200	24000	900000

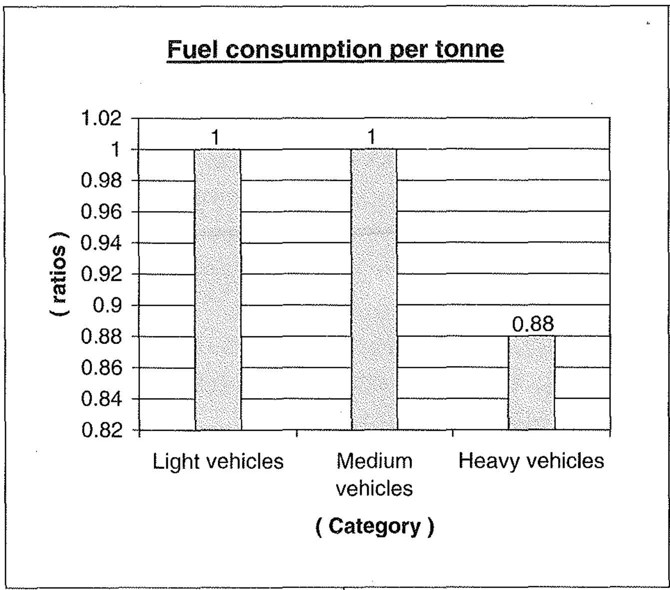

Fuel consumption per passenger
(ratios)
3
2.5
2
1.5
1
0.5
0
1.67
2.5
2.67
1
0.5
2 wheeler
3 wheeler
Light motor vehicle
Medium motor vehicle
Heavy motor vehicle
(Category)

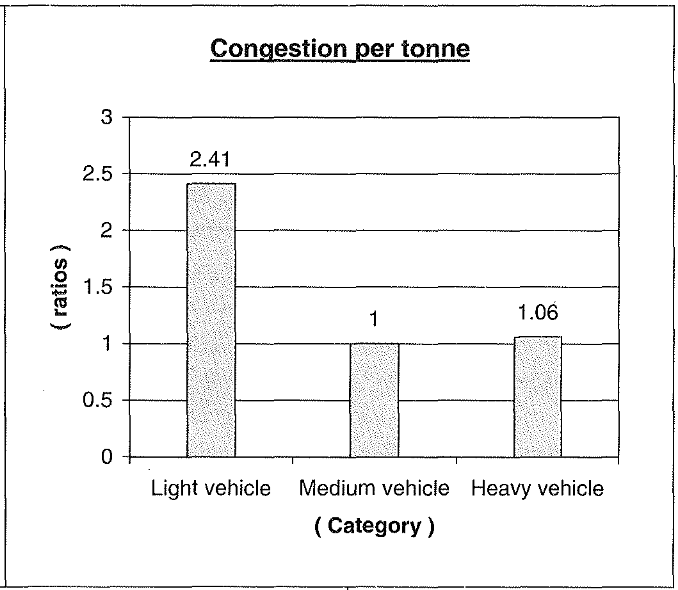

Congestion per passenger
(ratios)
2.5
2
1.5
1
0.5
0
2.06
2.34
2.06
1
0.44
2 wheeler
3 wheeler
Light motor vehicle
Medium motor vehicle
Heavy motor vehicle
(Category)

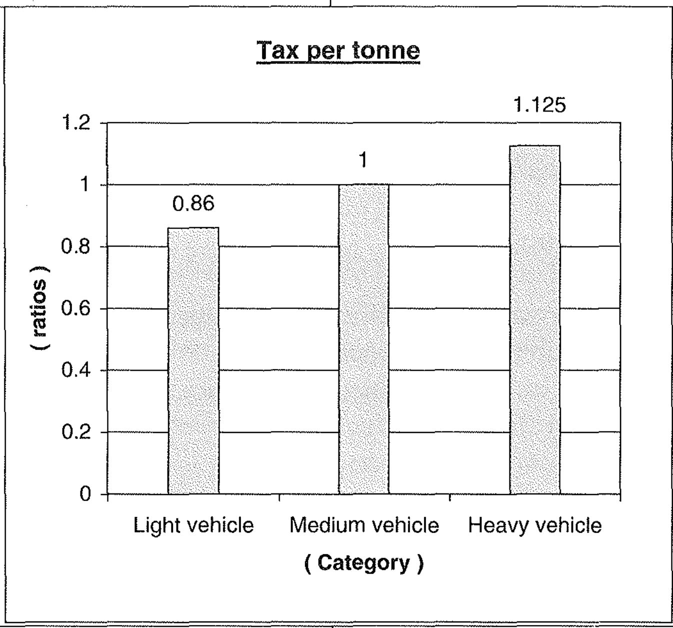

Tax per passenger
(ratios)
1.2
1
0.8
0.6
0.4
0.2
0
0.05
0.03
0.17
1
0.9
2 wheeler
3 wheeler
Light motor vehicle
Medium motor vehicle
Heavy motor vehicle
(Category)

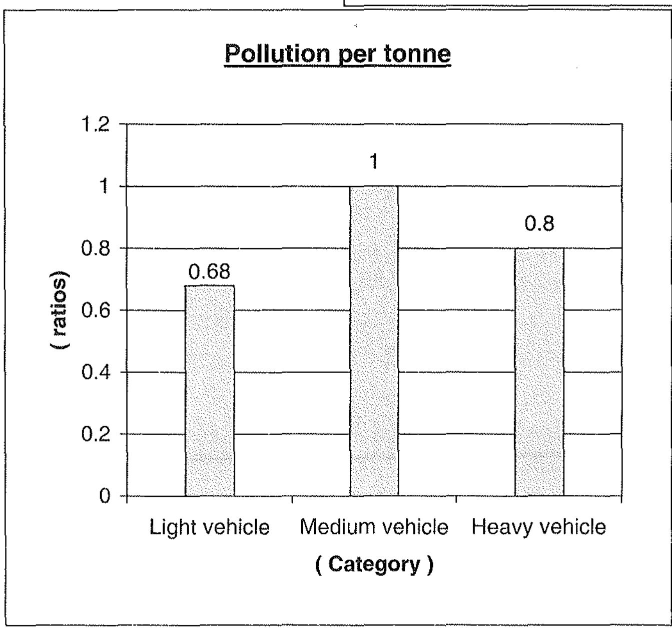

Pollution per passenger
(ratios)
3.5
3
2.5
2
1.5
1
0.5
0
2.67
3
1.6
1
0.3
2 wheeler
3 wheeler
Light motor vehicle
Medium motor vehicle
Heavy motor vehicle
(Category)

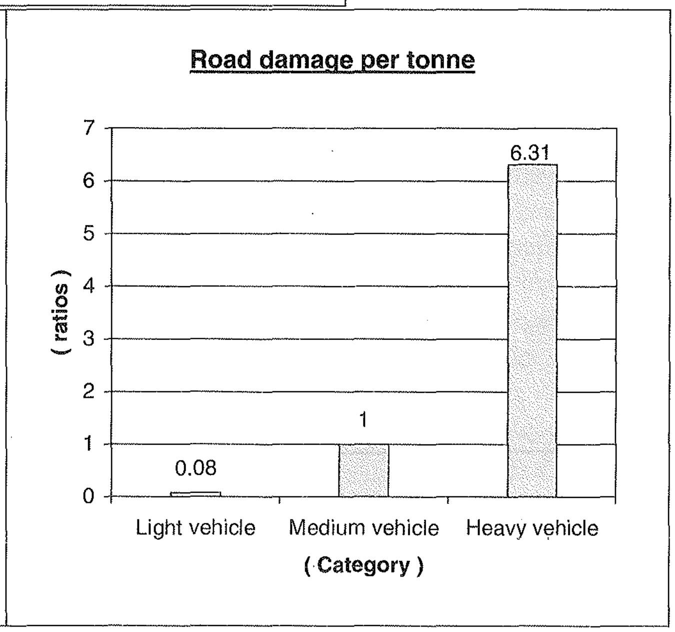

Road damage per passenger
(ratios)
1.2
1
0.8
0.6
0.4
0.2
0
0.17
0.34
1
1
0.28
2 wheeler
3 wheeler
Light motor vehicle
Medium motor vehicle
Heavy motor vehicle
(Category)


Fuel consumption per tonne
(ratios)
1.02
1
0.98
0.96
0.94
0.92
0.9
0.88
0.86
0.84
0.82
1
1
0.88
Light vehicles
Medium vehicles
Heavy vehicles
(Category)


Congestion per tonne
(ratios)
3
2.5
2
1.5
1
0.5
0
2.41
1
1.06
Light vehicle
Medium vehicle
Heavy vehicle
(Category)


Tax per tonne
(ratios)
1.2
1
0.8
0.6
0.4
0.2
0
0.86
1
1.125
Light vehicle
Medium vehicle
Heavy vehicle
(Category)


Pollution per tonne
(ratios)
1.2
1
0.8
0.6
0.4
0.2
0
0.68
1
0.8
Light vehicle
Medium vehicle
Heavy vehicle
(Category)


Road damage per tonne
(ratios)
7
6
5
4
3
2
1
0
0.08
1
6.31
Light vehicle
Medium vehicle
Heavy vehicle
(Category)

6.6 Evidently, from the point of view of carrying capacity, heavier vehicles score over lighter categories in terms of fuel consumption, pollution and congestion; in terms of road damage, however, medium and light vehicles seem to be the most damaging (on per passenger basis). The existing motor vehicle tax structure is not geared to meeting the objectives of energy conservation and reduction of pollution and congestion, but it is, by and large, aligned to that of compensating for road damage (the only anomaly being the low tax rate on light vehicles). To use motor vehicles taxation as a fiscal mechanism for achieving the objectives of conservation, pollution and congestion control, it will have to be substantially restructured and such modification might inhibit its use as a tool for compensating for road damage. For the present, instruments like sales tax on vehicles and fuel, tolls, parking fees and the like would have to be employed for achieving these aims. It appears desirable to retain a single simple objective for motor vehicle taxation-realisation of revenue to compensate for road damage.

6.7 As for goods vehicles, the existing tax structure is broadly in line with what is desirable from the point of view of energy conservation and pollution control. Since heavy vehicles in use today are not of the multi-axle type, the road damage caused by them does not seem to be adequately compensated by the relative tax levied. This may not imply increase in tax levels, since heavy vehicles are the principal conveyors of goods throughout the country. It, however, underlines the need to move to less-damaging multi-axled vehicles. From the point of view of congestion, light vehicles are the most congesting; non-fiscal regulations seem to be required to reduce indiscriminate use.

6.8 Finally, the *inter se* tax structure between goods and passenger vehicles indicates that light passenger vehicles (personal and commercial cabs) are lower taxed than light goods vehicles, but rates on medium and heavy vehicles are much higher for passenger than goods vehicles. (A loaded goods vehicle imposes a greater burden than a loaded passenger vehicle of the same category). This is appropriate given the carrying capacity of passenger vehicles and the importance of goods transport for the economy as a whole.

Estimation of revenue potential

6.9 In its first report, the Tax Reforms Commission had noted the low growth rate of revenues from motor vehicles taxation in Karnataka vis a vis those in other States as well as the decline in growth rates in the nineties. Receipts from motor vehicle taxation grew by 11.6% between 1985-86 and 1998-99; only Uttar Pradesh and West Bengal among the 14 major States had such low growth rates for this item. Deceleration in growth is evident during the nineties; from 90-91 to 98-99, the growth rate was 10.8% in Karnataka, which was again higher than only Uttar Pradesh and West Bengal among the 14 major States. (Annexure II of Chapter VII of the first report). Tax to SDP ratios also seem to be declining from around .95% in the eighties to a low of .48% by 1998-99. Per capita revenues at current prices of Rs. 76 (98-99) hover around the average for 14 major States. (Tables I and II of Chapter VII of the first report).

6.10 Revenue buoyancies have now been computed at Table IV for the 14 major States against NSDP for two periods of time ('80-'81 to '92-'93 and '80-'81 to '98-'99). These are quite disturbing. The buoyancy of motor vehicle tax in

Karnataka, which was 1.01 in the eighties, drops to .55 when the combined period of the eighties and nineties is taken into account. The buoyancy of motor vehicle tax must therefore be below .55 in the nineties, although computations for this period alone may not be possible because of change in the NSDP computation methodology from '93-'94. The buoyancy level for the tax from '80-'81 to '98-'99 is the lowest among the 14 major States.

Table IV

Buoyancies of motor vehicle tax revenue

	'80-'81 to '92-'93	'80-'81 to '98-'99
ANDHRA PRADESH	0.88	1.34
BIHAR	1.14	0.6
KARNATAKA	1.01	0.55
GUJARAT	0.98	0.86
HARYANA	0.9	0.97
KERALA	1.12	0.89
MADHYA PRADESH	1.07	1.21
MAHARASHTRA	1.04	0.94
ORISSA	1.29	0.84
PUNJAB	0.75	0.7
RAJASTHAN	0.85	0.94
TAMILNADU	0.87	0.67
UTTAR PRADESH	0.91	0.62

Source:- Revenues based on RBI studies of State finance of various years furnished by Institute for Social and Economic Change Bangalore. Since RBI has included entry tax under tax on goods and passengers, this item has been included under sales tax for Karnataka and Tamilnadu. In the case of Madhya Pradesh, which has both entry tax and tax on goods and passengers, the item has been shown under other taxes.

NSDP from published & unpublished data of Central Statistical Organisation.

6.11 The revenue performance of Karnataka relative to other States in the case of motor vehicle tax can be estimated by employing the regression approach, under which revenue from the tax in 14 major States is regressed on the tax base or its proxy variables in a cross-section regression model. The estimated regression coefficient provides the "average" behavioral norm. Based on estimates, tax potential can be estimated by substituting actual tax base values in the equation. Comparison between tax potential and actual tax collection will indicate the performance of the State. Such an analysis, however, requires reliable data on the tax base or its proxies.

6.12 We have tried to assess the revenue performance of Karnataka in respect of motor vehicle tax based on cross-section analysis by regressing revenue from motor vehicle tax on the total number of vehicles and the proportion of heavy vehicles in major States for 1994-95 and 1996-97 using both linear and loglinear models. A similar analysis was carried out by taking light vehicles, trucks and buses separately as explanatory variables. Although the equation shows a good statistical fit, it is only the number of light vehicles that is significant in 1996-97. (Table V) This result is difficult to explain because tax rates are higher for heavy vehicles in all the States and therefore, the variable-number of heavy vehicles-should have had a significant positive coefficient. This casts serious doubts on the reliability of data relating to the number of motor vehicles.

6.13 Doubts on data reliability arise also when we examine the responsiveness of revenue from motor vehicle tax to its proxy bases-the number of motor vehicles and the proportion of heavy vehicles-over a period of time in Karnataka State. We have attempted to estimate the responsiveness of the tax by regressing revenue from motor vehicle tax on the number of motor vehicles and the proportion of heavy vehicles in the State over the time period 1991-92 to 1998-99. Again, in the equation, while the effect of the number of vehicles on tax revenue is significant, the proportion of heavy vehicles has no significant impact on revenue. As mentioned earlier, the tax rate imposed on heavy vehicles is substantially higher than that on light vehicles and, therefore, this result appears to be implausible.

6.14 Data relating to the number of motor vehicles appears suspect for Karnataka as well as other States. Any serious analysis of such data can produce misleading results. It is extremely important to collect accurate information on different types of motor vehicles not only to get a clear idea of tax potential, but also to properly administer the motor vehicle tax in the State. We hope that the State Government will take necessary measures to collect this information on a scientific basis to enable proper administration and enforcement of the tax.

TABLE V

Regression Results: Dependent Variable - Motor Vehicle Tax Revenue

	Independent Variables					
	Constant	Light vehicles	Trucks	Buses	R^2	F
Linear						
1994-95	1283.942 (0.202)	0.004 (1.020)	0.196* (2.720)	0.007 (0.021)	0.764	10.795
1996-97	2854.990 (0.297)	0.017* (3.447)	-0.013 (-0.128)	-0.046 (-0.115)	0.711	8.186
Log linear						
1994-95	-1.670 (-0.804)	0.321 (1.616)	0.697* (2.512)	-0.071 (-0.267)	0.773	11.348
1996-97	-1.858 (-0.663)	0.986* (3.576)	-0.068 (-0.220)	-0.125 (-0.423)	0.698	7.693

Note: Figures in parenthesis are T values. * Significant at 1 per cent level.

6.15 The Commission's views regarding eventual return to annual taxation of motor vehicles have already been spelt out in the first report. In our view, as early as possible, once modernisation and introduction of measures of e governance in the department has substantially reduced the need for taxpayers to physically visit departmental outlets, we could revert to the system of annual taxation of motor vehicles. On the issue of nationalised operation of passenger bus services, additional remarks are made in the succeeding section of this report.

Further comments on revenue implications of nationalisation of passenger transport

6.16 The first report of the Commission examined the distorting effect of nationalisation of passenger transport on the motor vehicle tax schedule and suggested measures to eliminate anomalies. Apart from reviewing the nationalisation policy itself and fixing motor vehicle tax rates on passenger basis not on floor area basis for maxicabs, private service vehicles and omnibuses after denationalisation, it was also suggested that immediately stage carriages operated by STUs should be brought on par with other stage carriages, private buses leased by the KSRTC pay normal stage carriage rates directly to government, the Contract Carriages (Abolition) Act repealed and stage carriage permits given freely for private bus operation within 20 kms.of district headquarters.

6.17 Data has been collected relating to practices adopted in some neighbouring States regarding adjustment of taxes collected from motor vehicles against budgetary outflows to State Transport Undertakings under various heads. As we have already noted in our first report, motor vehicle tax due from STUs in Karnataka is adjusted against subsidy due to them from government on various counts. In Kerala and Tamilnadu this is not done, while in Maharashtra, it has recently been decided that a fixed percentage of the tax on passengers and roads should be retained by the STU and converted into loan in lieu of capital while the remaining amount is adjusted to compensate for subsidies extended by government.

6.18 In consonance with what we have recommended earlier, we would like to reiterate the damaging effects of the policy of nationalised monopoly passenger bus services on passenger safety, convenience and comfort as well on the exchequer. Progressive and speedy denationalisation appears inevitable. This could commence with disinvestment of government's equity holding and proceed to eventual private control. A Transport Regulatory Authority should also be set up by the Central government to regulate different modes of transport.

6.19 It must also be noted that by artificially suppressing the private provision of additional passenger transport facilities on nationalised routes, economic activity in the service sector is being reduced as also employment and income. As a beginning, we recommend transition to denationalised operation by shifting from area nationalisation to route nationalisation (as done in most States) and freezing grant of future routes to the KSRTC. Routes thus released should be made available for private operation to enable increase in government revenues, economic activity and passenger security and comfort.

Further modifications to tax schedule

6.20 An area that was not touched upon in the Commission's first report pertained to haulage vehicles. This includes goods vehicles which are used to draw trailers, vehicles not constructed for load-carrying but used for haulage, cranes, forklifts etc. and fire engines and sprinklers (with or without trailers).

6.21 In the case of goods vehicles to which trailers can be attached, at present there are 9 slabs based on gross laden weight. It is suggested that these could be rationalised particularly since the last amendment was done as far back as 1986. It would be desirable to charge Rs. 100 for every 1000 kgs. or part for this vehicle category.

6.22 For haulage vehicles, at present there are 7 slabs, which are proposed to be reduced to two-with gross laden weight below and above 7500 kgs. For the former, the quarterly tax proposed is Rs.1000 and for the latter Rs. 2000 with an additional Rs. 25 for every 250 kgs. over 15000 kgs. In the case of cranes no amendments are proposed. As for fire engines and sprinklers, there are 9 slabs at present. Since most vehicles in this category are owned by government, they would be in any case tax exempt. The few private fire engines owned by industries or utilities for inhouse use could be tax exempt; only sprinklers could be charged Rs. 1000 for every 40 kgs. of GLW or part. This rate mechanism could be applied also to trailers attached to sprinklers.

Tax structure for temporary road use

6.23 In the first report, the Commission had deferred this issue for further consideration. Schedule B of the Motor Vehicles Taxation Act lays down the tax rates for vehicles temporarily using the roads of the State. The schedule is organised in the same manner as Schedule A which is applied to vehicles registered within the State, but there are two sets of rates-for periods less than a week and for periods between a week and a month. As noticed in our earlier report, this schedule tends to lag behind Schedule A when changes in tax categories and classifications are introduced. Data is not readily available regarding the revenue earned from temporary users, but it could be collected easily once checkposts are linked to the department's data base. It would be useful to do this as a part of policy planning exercises. In any case, inter-State agreements have resulted in notifications by all States providing tax exemption for personal vehicles coming from other States using roads within the State for less than a month. Schedule B needs to be amended to take note of this situation. Keeping in mind the need to align Schedule B closely with Schedule A, we recommend the following modifications:

-items 1 and 2 in the schedule (personalised cars, scooters and invalid carriages) may be dropped for reasons indicated earlier

-item 3 relating to goods vehicles, for which there are 10 slabs, should be categorised into 5 slabs-those with gross laden weight up to 3000 kgs., 5000 kgs., 12000 kgs. and 15000 kgs. and those above 15000 kgs. The tax liability for a week and for a month for each category should be as below:

Rs.	up to 7 days	from 8 to 31 days
up to 3000 kgs.	100	300
3001 to 5500 kgs.	200	600
5501 to 12000 kgs.	300	900
12001 to 15000 kgs.	450	1400
Above 15000 kgs.	460 +75/250 kgs. over 15000 kgs.	1380 +160/250 kgs. over 15000 kgs.

6.24 When these vehicles are used to haul trailers, for every 1000 kgs., the tax rate could be Rs. 25 for a month's use of the State's roads and Rs. 75 for a week's use.

-no modification is necessary in respect of multi-axled vehicles (item 3A)

-for motor cabs, the present range of 5 slabs could be reduced to three: for vehicles carrying up to 5 passengers excluding the driver, the proposed rate is Rs. 10 for a week and Rs. 30 for a month/passenger; for those carrying between 6 and 12 passengers, it may be kept at the present rates of Rs. 75 for a week and Rs. 150 for a month per passenger.

-no modification may be necessary in the present scheduled items 5 (motor cabs carrying more than 12 passengers for whom the tax rate is Rs. 250 for a month's use and Rs. 100 for a week's use per passenger) and 6 (luxury buses carrying more than 12 passengers for whom the tax rate is Rs. 400 for a month's use and Rs. 200 for a week's use per passenger).

-for omnibuses and private service vehicles, there are at present 5 slabs linked to floor area, two linked to ownership by schools and other educational institutions linked again to floor area and one linked to ownership by driving training schools based only on floor area. The department is of the opinion that the number of such vehicles coming from outside the State is limited and that it would be cumbersome and impractical for check post staff to measure floor area. Since 1958, the State has been exempting omnibuses from Tamilnadu, Kerala and Maharashtra from taxation by notification. It has been suggested that tax should be reintroduced on seating basis with three slabs: for vehicles carrying up to 12 passengers, Rs. 75 for a week and Rs. 150 for a month per passenger, for those carrying more than 12 passengers, Rs. 100 and Rs. 200 respectively per person and for educational institutions, Rs. 10 and Rs. 30 per person respectively. We agree with this suggestion.

-for ambulances and hearses it is proposed that there should be no tax as in the case of such vehicles registered within the State (item 9)

-for haulage vehicles, the existing 7 slabs could be reduced to two; for vehicles weighing more than 7500 kgs., the tax could be Rs. 300 and Rs. 900 respectively for road use of a week and a month and for those below 7500 kgs., it could be Rs. 150 and Rs. 400 respectively. However, no change is required for tractors and trailers (item 11)

-for fire engines, there need be no tax while for sprinklers and other similar vehicles, the existing 9 slabs could be rationalised and two tax rates prescribed at Rs. 10 for a week's use and Rs. 30 for a month's use.

-no change is required in respect of drilling rigs (item 13)

-for imported and company cars for which there are four categories and several slabs today, it is proposed to merge them into item 16 (campers' vans) and levy tax on all these kinds of vehicles at the rate of Rs. 75 for a week's use and Rs. 200 for a month's use per 1000 kgs. or part of unladen weight. Vehicles used to haul campers' trailers

would bear a tax of Rs. 10 for a week's use and Rs. 30 for a month's use per 1000 kgs. of unladen weight.
-no change is required for the tax applicable to cranes (item 17).

Fines

6.25 In the first report, the Commission had listed the list of fines (including composition fees) leviable for violations of the Motor Vehicles Act (mainly under Chapter XIII) at Annexure XI of Chapter VII and noted that these are enforced by officers of both the motor vehicles and police departments. It had also recommended strict enforcement of endorsements of offences on driving licences through a points system so that insurance premia could be tied to such points.

6.26 The Commission has further examined the existing fine structure. They seem to fall into four broad groups. There are fines for violation of various regulations relating to registration, driving licences, pollution certificates, permits, running driving schools and the like. Both police and transport department officials are authorised to enforce these regulations except for those relating to private agencies connected with transport like driving schools and vehicle dealers which are the sole concern of the Transport department. The only anomaly here relates to overloading of goods vehicles in respect of which enforcement powers that were once exercised jointly by both departments have now been reserved for motor vehicle inspectors alone. This was done in response to demands made by transporters, perhaps because MVIs are usually present at check posts and are less visible on roads than police officers.

6.27 We have looked at the question of overloading in some detail. The Gujarat experience of automatised check posts shows that if overloading fines are pitched at a reasonable level, compliance goes up as also revenue. However, since these are meant to be penalties for violation of safety regulations, a balance will have to be struck between the penalisation and revenue objectives. The present Karnataka fine is Rs. 2000 for the first tonne of excess weight and Rs. 1000 for every additional tonne. We now suggest reducing this to Rs. 500 for the first tonne and Rs. 600 for additional tonnes. However, this reduction should become operable only after the composite computerised check post is set up. A record of violations can also be built up over time and increase in fines and other penalties contemplated for frequent violators.

6.28 Again, there are fines for a vast array of traffic offences some of which are enforced by the Police department alone. As in all statutes, there are general provisions relating to obstruction of departmental officials, abetment etc. Finally, the Motor Vehicles Act also prescribes fines for violation of the obligations of conductors and drivers of passenger transport vehicles-that is refusal to transport a passenger, indulging in drug or other trafficking, demanding excess fare etc. These relate perhaps purely to contractual relationships between vehicle owners and their employees or users. Under this category we find also fines for passengers unauthorisedly occupying seats reserved for women. Such provisions might require review if government controls over transport rates are eliminated.

6.29 For different categories of fines, we have given at Annexure I suggestions for change alongside comparisons of the fine structure of Karnataka with that in some neighbouring States.

Treatment of vehicles under non-use

6.30 Under Section 34A of the Motor Vehicles Taxation Rules, intimation of non-use of a vehicle can be done on payment of a fee of Rs.100, surrender of RC and tax card and declaration of the location in which the vehicle is garaged. Vehicles so declared are not permitted to be moved without the permission of the taxation authority. There is always the apprehension that such vehicles will be misused particularly if the garage is located outside the State, since they are unlikely to be verified by the inspectors of the States concerned. The department has therefore suggested that intimations of non-use should only be done by registered post, that garaging outside the State should not be permitted and that double the normal rate should be charged for the entire period of declared non-use if vehicles are caught operating during this period. The sector that is likely to be affected by prohibition of garaging outside the State are transport operators whose vehicles are undergoing body building work outside the State. After due consideration, the Commission suggests that the present situation could continue and attempts made to improve information-sharing arrangements with other States by electronic and other means.

Tax refund provisions

6.31 Under Section 7 of the Motor Vehicles Taxation Act, non-use of vehicles for periods over one month during a period for which tax has been paid entitles the owner to refunds as prescribed in Rules 20 to 23. To claim a refund, an application has to be made to the RTO who is expected to consider whether it is admissible and sanction or reject it. Refunds arise out of removal of a vehicle to another tax jurisdiction, cancellation of registration due to an accident or scrapping and alteration of a vehicle with the effect of bringing it within a lower tax category. The first category of refund is very common. The procedure for transfer of vehicles outside the State is through a "no objection" certificate issued by the State of origin which is accepted at the destination to permit change in residence/transfer of ownership, registration and tax liability. There are complaints of delay when such transactions occur since tax refunds are effected only after receipt of proof of having effected transfer of ownership or change of address. All this can cause considerable hardship particularly when personalised vehicles are subject to "lifetime" taxation. Departmental officials indicate that delay is due to non-receipt of intimation of removal of vehicles from other States. Vehicle owners do not also report destruction of vehicles after accidents as required under Section 55 of the Act. Acceptance of "lifetime tax" paid in other States and removal of re-registration and refund provisions can simplify matters and improve compliance. This is possible only if low-tax States like Goa and Union Territories like Pondicherry align their rates with those generally in vogue in the country. We have already made a reference to this in the first report. The issue may be taken up in inter-State fora and in the Transport Development Council.

Revenues and road maintenance

6.32 In the first report, the Commission pointed out the difficulty of bringing under one head budgetary expenditures on road maintenance since they tend to get accounted in different ways. In the context of the World Bank structural adjustment loan for the State that has been signed recently, several discussions have been held regarding creation of a Road Fund for the State by earmarking a portion of the revenues received from tolls, user fees, a fuel levy, license fees varied on axle weight etc., interState and intra-State transit fees and overloading fines. Consultants to the World Bank assisted Road Development Project assessed the requirement for PWD and other roads at Rs. 1801 crs and proposed setting up the Road Fund in the following manner:

	(Rs.crs.)	Contribution to Fund
Tolls on major State highways		2(.2%)
Motor vehicles tax	405 (estd.rev.)	243(23.9%)
Tax on petrol sales (@ 22%) and cess @ Rs 0.25/lt	575 (do.)	330(32.5%)
Tax on diesel sales (@ 15.5%) and cess @ Re. 0.1/lt	640 (do.)	370(36.5%)
Central Road Fund	70 (do.)	70(6.9%)
Total	1690	1015

6.33 In lieu of the non-lapsable fund originally proposed, which was to be partly funded by motor vehicle tax revenue, later discussions have focused more on establishing an independent authority similar to the National Highway Authority of India. It was hoped initially that such an Authority would be answerable only to the legislature and be empowered to raise and manage funds for road development. The latest form of the proposal, however, that has been accepted as a conditionality for World Bank assistance is to set up a State Highway Authority that will make technical studies and function in an advisory capacity to the Secretary in charge of Public Works. This agency will *inter alia* examine the need for a Road Fund and how it could be constituted, set up and managed.

6.34 The poor quality of maintenance of different kinds of roads in the State has been frequently criticised. Maintenance norms fixed by Finance Commissions are inadequate for meeting repair costs and budget provisions are not evenly allocated to all regions and all road categories. At the same time, expenditure is incurred on road maintenance under several schemes making it impossible to identify spending overlaps. The unreliability of the existing data base on roads, the practice of breaking down road works into miniscule pieces to avoid the tendering process and the difficulty of clearly differentiating between maintenance and upgradation add to the confusion and lack of transparency. Under such circumstances, increased budget allocations are justified only if they are accompanied by wideranging reforms to enhance the accountability and efficiency of the road maintenance mechanism. This would mean setting up a Road Fund at the State level provided with adequate resources from the budget to meet maintenance requirements, compiling an accurate central data base of roads of all kinds using GIS if required, strict adherence to rules concerning contract size and award of tenders and prohibiting works taken up under the Road Fund from being funded from any other source. The different elements of this package must be implemented together to ensure effective use of revenues raised to repair roads.

Administration and e governance

6.35 Comprehensive recommendations relating to governance have been made in the Commission's first report both under the general chapter on governance (Chapter X) and under the specific head of motor vehicle taxation (Chapter VII). The experience of the Transport department with e governance and use of computerised systems has been long, arduous and eventually successful. As already indicated in the first report, computerisation started in the late eighties with the installation of a mini computer with terminals and the development of appropriate modules at the office of the Yeshwanthpur RTO. This modern oasis was swept away after some years of successful working when hardware became obsolete. A second effort has been made to bring back e governance to the department. This time, however, the experience of Yeshwanthpur is being replicated and rapidly extended to other RTOs and backup arrangements made to develop data bases at the Transport Commissioner's office networked with regional offices as well as border check posts.

6.36 Among southern States, Karnataka is the only one that has developed an advanced computerised mechanism for the Motor Vehicles department. In several ways, the experience of the Motor Vehicles department can well serve as a model for other government departments, particularly revenue raising ones, as indicated below:
-The department did not tinker with computerisation of peripheral areas like personnel or finance like many others. Instead, from the very beginning, it moved into core areas like licensing, registration and driving tests, which have a direct impact on both the public and internal administration.
-Unlike other States, the department concentrated on developing modules for the RTO's office which is the cutting edge for motor vehicles administration. In retrospect, the decision was a wise one. This created a self-contained manageable task which could be tackled independently and successfully. The experience of a working model computerised office at Yeshwanthpur has created confidence in taxpayers as well as government staff and facilitated rapid replication.
-The department allocated tasks associated with computerisation in an intelligent manner. The National Informatics Centre was in charge of overall development and preparation of the SRS. However, it interacted closely with departmental officials to finalise the required data bases, input and output formats. Existing data bases were inputted using an external consultant-ECIL. And instead of setting up a separate external group to work on computers, departmental personnel have been trained to run the computerised system. Officers and officials at all levels are today familiar and comfortable with working on computers at the office of the Yeshwanthpur RTO. This has made computerisation sustainable and ensured its continuance.
-A constituency for computerisation has also been built up among taxpayers. At Yeshwanthpur, vehicle data bases are maintained on the hard disk, inputs directly entered and outputs drawn as required at various counters where visitors are offered quick and immediate service. A kiosk is also operational to furnish information for the public apart from a reception counter, which supplies forms in both Kannada and English and notice boards.

6.37 Networking among offices and developing MIS systems for head office operations are the tasks taken up in the second phase of computerisation. 15 terminals have been set up in different sections in the head office and senior officers have also been connected. MIS for use at various levels has been finalised and programs are under preparation. Online operations are planned among RTOs, Deputy Commissioners and the Commissioner's office using VSAT connectivity; the proposal is pending government approval. When completed it will connect 40 offices (5 of which are in Bangalore) at a cost of Rs. 71 lakhs.

6.38 The department has made efforts to improve interaction with the public by preparing and enforcing a citizens' charter. Two kinds of time limits have been set for performing key functions in computerised and non-computerised offices. It is necessary to enforce them rigorously and obtain regular feedback from customers. Locked suggestion boxes have been installed in offices. For several years, PROs have been working in all offices to assist customers; they are now being given training in public relations using external consultants. *Adalats* are being organised once a week to interact with users and their associations and ideas generated at these meets are being processed to improve departmental functioning. A departmental web site has been set up which is being posted with information required by the public. An effective arrangement to regularly update and run the site should be set up and queries of visitors attended to promptly. There is a case for online processing of applications in selected areas. The matter may be studied by the department and a decision taken.

6.39 In the Commissioner's office, arrangements have been made to oversee the computerisation effort by setting up a high-power committee chaired by the Commissioner with senior officers in charge of different functions as members. Areas which require greater attention are preparation of users' manuals for each office, (which should be readily available to all members of the staff) and setting up an effective group and procedures within the department to support the computerisation effort. In the Commissioner's office also, departmental staff has been trained to run systems. Posts of programmers and systems personnel created for the department should be filled up using own staff or contract staff instead of looking for persons to be taken on deputation.

6.40 Connectivity should be established between data bases of the Motor Vehicles department and the police and treasury departments as well as with data bases of other States. Smart cards incorporating the data available in RC books are proposed to be introduced after GOI finalises standards which can be uniformly applied to all States.

6.41 From the point of view of infrastructure,there is a case for improving the ambience of RTOs' and other offices through user-friendly information boards, clean and cheerful surroundings, better seating and waiting arrangements for the public, queue management to reduce delays, parking arrangements and a well-laid out hall for holding the written component of driving tests. Ergonomics in RTOs' offices needs improvement; a model office could be laid out using the services of a consultant in Koramangala or Indiranagar. The department is also in urgent need of open area for conducting fitness inspections and holding driving tests.

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Annexure I

Fines

Nature of offence	Proposed change	Composition fine in State	Max. fine level on conviction	Addl. penalty on conviction	Compounded by	in TN	in M'tra	in Kerala
Offences relating to regulations								
Driving without valid licence	250 for 2 wheeler	300	500	3 mths imprnmt	MVIs,PSIs	250	300	500
	400 for 4 wheeler							
	non-transport &							
	500 for transport							
	vehicle							
Under age driving	Do.	300	500	Do	MVIs,PSIs	250	300	500
Owner permitting above		300	1000	Do	MVIs,PSIs	50	300	250
Driving during disqualification period	300	100	500 for pvt person 100 for conductor	Do 1 mth imprnmt	MVIs,PSIs	250	200	100
Unauthorised driving of transport vehicle			500	3 mths imprnmt	MVIs,PSIs	250	300	500
Using with other State's registration for year		100	100 for first offence 300 for later ones		MVIs,PSIs			
Permitting others to use licence		100 300	100 for first offence 300 for later ones		MVIs,PSIs	50	100	75
Carrying persons in excess of seating capacity	100for 1st offence 300 for later ones	300	100 for first offence 300 for later ones		MVIs,PSIs	50	100	1000
Overloading cab, maxicab and auto		100 for cab & auto and 100 for buses	100 for first offe-nce and 300 for later ones		MVIs,PSIs	50	100	75
Driving without number plate		100 (NT) 300 for others	100 for first offence 300 for later ones		MVIs,PSIs	50	100	75
Carrying more than 6 persons in goods vehicle and more than 2 persons in light goods vehicle	100for 1st offence 300 for later ones	300	100 for first offence 300 for later ones		MVIs,PSIs	50	100	75
Carrying persons on top of the vehicle	100for 1st offence 300 for later ones	300	100 for first offence 300 for later ones		MVIs,PSIs	50	100	75
Carrying explosives in bus	100for 1st offence 300 for later ones	300	100 for first offence 300 for later ones		MVIs,PSIs	50	100	75

Nature of offence	Proposed change	Composition fine in State	Max. fine level on conviction	Addl. penalty on conviction	Compounded by	in TN	in M'tra	in Kerala
Permitting person to stand at upper door of double decker		100	100 for first offence 300 for later ones			50	100	75
Carrying explosives in transport vehicle		200	100 for first offence 300 for later ones		MVIs,PSIs	50	100	75
Carrying persons in trailer	100	200	100 for first offence 300 for later ones		MVIs,PSIs	50	100	75
Excess weight	500 for 1000 kgs & 600 for addl. 1000 kgs. or part	2000 for 1000 kgs & 1000 for addl 1000	2000 and 1000 for every 1000 kgs & 3000 for refusing weighment		MVIs	1000 1000	2000 500	2000 1000
Driving without insurance	500	300	1000	3 mths imprnmt	MVIs,PSIs	500	300	250
Unauthorised sale or alteration of vehicle		500	500		MVIs	50	300	400
Running driving school without license		100 for first offenc 300 for later ones	100 for first offence 300 for later ones		MVIs	50	100	75
Conductor overloading stage carriage		100	100 for first offence 300 for later ones		MVIs	50	100	75
Using vehicle without dealer's trade certificate	2000	100	2000 to 5000 for first offence and 5000 to 10000 for later ones	1 year imprnmt	MVIs	250	300 (NT) 1000 (T)	200 (NT) 1000 (T)
Improper use of trade certificate by dealer	2000	500	2000 to 5000 for first offence and 5000 to 10000 for later ones	1 year imprnmt	MVIs	250	300 (NT) 1000 (T)	200 (NT) 1000 (T)
Failure to provide good braking system		100	100 for first offence 300 for later ones		MVIs	50	100	75
Causing pollution Two wheelers and three wheelers Four wheelers For heavy vehicles		 200 500 700	1000 for first offence and 2000 for later ones			250	500	300
Carrying hazardous goods			3000 for first offence and 5000 for later ones	1 yr for first offence 3yrs for later ones		50	100	75

Nature of offence	Proposed change	Composition fine in State	Max. fine level on conviction	Addl. penalty on conviction	Compounded by	in TN	in M'tra	in Kerala
Traffic related offences								
Exceeding speed limit		300	400 for first offence 1000 for later ones		MVIs,PSIs	200	200	150
Causing others to exceed speed limit		300	300 for first offence 500 for later ones		MVIs,PSIs	200	200	150
Driving dangerously	200 up to 90 cc 400 over 90 cc 500 for others	100 up to 90 cc 200 over 90 cc 300 for others	1000 for first offence and 2000 for later ones within 3 years	6 mths imprison-ment for first offe-nce or 2 years for later ones within 3 years	MVIs,PSIs	500	500	400 800
Racing on road		300	500	1 mth imprnmt	MVIs,PSIs	250	300	500
Driving when unfit	200	100	200 for first offence 500 for later ones		MVIs,PSIs	100	100	100
Drunken driving			2000 for first offence 3000 for the later					
Failure to stop at unmanned railway crossing		100	100 for first offence 300 for later ones		MVIs,PSIs	250	300	500
Disobeying stop orders	400	200	500 500		MVIs,PSIs	50	200	400
Parking in prohibited area		100	100 for first offence 300 for later ones		PSIs			
Jumping traffic signal, violating no entry sign & using shrill horn		100	100 for first offence 300 for later ones		PSIs			
Refusing to give information or take action reqd. in case of accident			500 for first offence 1000 for later ones	3 mths imprnmt 6 mths imprnmt	PSIs			
Using vehicle in unsafe condition			250					
Using unsafe vehicle and causing accident			1000	3 mths imprnmt			500	300
General provisions								
Disobedience and obstruction	400	200	500		MVIs,PSIs	50	200	400
Withholding information or giving false information	500	200	500	Do	MVIs,PSIs	50	200	400
Interference with vehicle	100	200	100	Do	MVIs,PSIs	100	100	75
Other offences	100for 1st offence 300 for later ones	300	100 for first offence 300 for later ones		MVIs,PSIs	50	100	75
Abetment			As for offence					

Nature of offence	Proposed change	Composition fine in State	Max. fine level on conviction	Addl. penalty on conviction	Compounded by	in TN	in M'tra	in Kerala
Non payment of tax		20% of the tax amount.	Equal to qrtly. tax Maximum up to annual tax for the first offence Equal to twice qrtly. tax maximum up to twice the annual tax for the later ones.					
Other provisions								
Demanding excess fare	100for 1st offence 300 for later ones	200	100 for first offence 300 for later ones		MVIs,PSIs	50	100	75
Using cab for prostitution or smuggling	100for 1st offence 300 for later ones	300	100 for first offence 300 for later ones		MVIs,PSIs	50	100	75
Demanding excess fare and refusing transport	100for 1st offence 300 for later ones	200	100 for first offence 300 for later ones		MVIs,PSIs	50	100	75
Drunk conductor		100	100 for first offence 300 for later ones		MVIs,PSIs	50	100	75
Contract carriage refusing to take passengers		500 (T) 200 for two & 3 wheelers & 200 for others	50 for 2 & 3 wheelers and 200 for others		MVIs,PSIs	50	200	100
Failure of conductor to collect fares etc.		100	100 for first offence 300 for later ones		MVIs	50	100	75
Occupying seat reserved for female passengers		100	100 for first offence 300 for later ones		PSIs			
Improperly engaging canvasser or agent			1000 for first offence and 2000 for later ones	6 mths imprnmt for second and later offences				

CHAPTER VII

TAXING AGRICULTURAL INCOME

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Underlying principles

7.1 It is not surprising that policymakers and taxpayers have been allergic to the taxation of agricultural income, since it has been principally seen from the days of Ricardo as an effective means of transferring resources out of agriculture as a pre-requisite for economic and social development. This has resulted in non-transparent methods of taxing agriculture, particularly policies of import-protected industrialisation coupled with depression of agricultural prices below world levels and import restriction resulting in raising exchange rates and lowering domestic currency earnings from agricultural exports. Such policies have led to demands for subsidies on agricultural inputs and caused enormous price distortions. Current thinking on the matter is moving towards retention of resources raised from agriculture within the sector for infrastructure development and productivity-enhancing land improvement.

7.2 Following the lead given by Richard Bird, Indira Rajaraman and M. J. Bhende list four different kinds of taxes on agriculture-taxes based on land, on the income and rental value concepts and special purpose taxes. From the equity and efficiency viewpoints, the earliest and simplest taxes have been those on agricultural land, which is an important productive asset in inelastic supply that is unequally distributed. However, taxes on land require reliable land records and stratification of productive capacity (including productivity linked to irrigation, for the public provision of which user charges could also be levied). An income-based tax has to be presumptive in nature using objective, easily measurable capacity indicators, as accounts relating to actual transactions are not generally available. Since the major indicator is likely to be the extent of land cultivated, in practice, there is little difference between land and income based taxes. Taxes on rental value (like property taxes) and special purpose taxes (like capital gains or betterment taxes) are impractical given the small number of transactions in agricultural land.

7.3 An area-based land tax is useful for identifying increases in land-linked income; it also eliminates the valuation problem. Tax rates will have to be indexed to product-price inflation and productivity increases. Valuation-based land taxes, which link income to a fixed percentage of land value, have also been adopted in some countries. A pre-requisite for such a tax is an acceptable index to which land values can be tied and updated from time to time. The successful French system of "forfait", adopted by many Francophone countries, is a presumptive land-based tax calibrated in physical units with room for negotiation within the presumptive framework based on actual accounts of taxpayers. Given the several methods in vogue for taxing agricultural income, economists seem to prefer "a presumptive income-based tax on land calibrated in physical rather than value units, stratified by crop, region and irrigation status, with provision for catastrophe exemption and periodic updating of yield and cost norms" (Indira Rajaraman and Kanwarjit Singh, 1995).

7.4 The advantages of presumptive taxation vis a vis return based income taxation are to some extent offset by the problems posed by substantial price and weather fluctuations which drastically alter agricultural incomes and tax liabilities from year to year. It is difficult to devise a satisfactory method to deal with such calamitous changes in the presumptive context, particularly when crop insurance mechanisms are still in their infancy. This difficulty becomes more acute under rainfed cultivation.

7.5 Indira Rajaraman and Bhende have, in their 1998 paper, also cited the views of Hoff, who has recommended a mix of output and land based taxes, but they do not favour this mode of taxation on the ground that it seems more suitable for global not local levy although it would succeed in transferring resources from other sectors into agriculture since tax incidence would fall on the consumer. They concede, however, that revenue realised from this kind of tax could be distributed to a certain extent among local jurisdictions on the origin principle.

Statutory basis for taxing agricultural income

7.6 Difficulties underlying agricultural taxation have been exacerbated in the Indian context by the separation of fiscal powers in relation to this area under our federal political structure. Item 82 of the Central List (List I) read with item 46 of the State List (List II) of the Seventh Schedule of the Constitution stipulate that taxation of agricultural income should be done by States while taxation of all other income falls within Central competence. Item 45 of the State List also brings land revenue (including assessment and collection) under State powers of taxation. The separation of powers dates from the pre-Independence Income Tax Act of 1935, enacted at the time when federalism was first formally instituted in India under the Government of India Act of 1935 of British India. (Before this date, income from agriculture was by turn included and excluded from taxation, mainly on the ground that it was already taxed in the form of land revenue).

7.7 In effect, therefore, in almost all States today, land revenue is levied on agricultural land through Land Revenue Acts administered by the Revenue department, agricultural income tax through Acts administered by the Commercial Tax department (in 4 States alone) and there is a whole area of demarcation between agricultural and non-agricultural income determined by the Central Income Tax Act. Each of these will be considered separately in the current Karnataka context further on in this chapter.

Revenue significance of the levy

7.8 Revenue realised from land revenue and agricultural income tax separately and together in the 14 major States is presented in Annexures I, II and III. The land revenue head accommodates all related receipts, particularly those realised from grant or lease of government lands, so much so that the actual receipts from land revenue alone probably account for a very small component of total receipts. Demand under the head of account covers arrears, payments made for land grants, lease rent, fees and fines for converting agricultural land into non-agricultural use, cesses, survey, mutation and copying fees. In the case of Karnataka, for example, current land revenue demand for a year is only of the order of Rs. 3.5 crs., which is less than 10% of total receipts of Rs. 38 crs.in 1998-99.

This is likely to be the case in other States too. West Bengal, Maharashtra and Andhra Pradesh account for close to 60% of the land revenue collected in the country (the comparatively high yield from this source in West Bengal may be due to the substantial area under wet cultivation.) In all States, revenue tends to fluctuate, which is not surprising if major components are receipts from conversion charges of agricultural land for non-agricultural use or sale and lease of government land. States like Uttar Pradesh and Gujarat raise moderate doses of revenue from the levy but it is practically defunct in agriculturally developed States like Punjab and Haryana.

7.9 In the case of agricultural income tax, which is almost solely a levy on plantations, of the four States which levy the tax, Karnataka raises the maximum revenue (Rs. 48.5 crs. in 1998-99). Therefore, when receipts from both land revenue and agricultural income tax are considered, Karnataka overtakes many States and moves up to 4th position among the14 major States. West Bengal outstrips all other States in revenues from agriculture, since the levy is only on one plantation crop-tea.

7.10 Annexures IV and V furnish a basic analysis of the tax burden from the two levies for selected years in major States measured in terms of per capita revenues and tax/NSDP ratios. It is interesting to see the manner in which these taxes have been reduced to insignificance in States like Punjab and Haryana which have witnessed substantial increases in agricultural productivity and income during the period as a consequence of the Green Revolution. Per capita revenue has in fact come down in terms of current prices in both the above States since 1985-86. Karnataka, however, has witnessed increase in per capita revenue from taxation of the agricultural sector, due solely to income increases attributable to spurt in coffee prices. Kerala and West Bengal have a higher overall tax burden on agricultural income than Karnataka. Tax/NSDP ratios are very low in all States. In States, which do not levy agricultural income tax, the contribution of taxes on agricultural income to own tax revenues has fallen steadily, which is understandable in the context of price-insensitive land revenue rates.

Land revenue

7.11 Land revenue is basically a presumptive levy, although there are regional diversities in design and construction. It is levied in almost all States on the basis of land surveys, dating generally from pre-independence days. Historically, land revenue rates had been fixed before independence ("settled") on cultivators or intermediaries. Some pockets of Karnataka too have a history of settlements on intermediaries; in these areas, *ad hoc* or negotiated settlements were made with cultivators when intermediaries were abolished after 1947.

7.12 Land revenue is today levied in the State under the Karnataka Land Revenue Act, which has been in force from 19th March1964. Sections 114 and 114A of the Act provide for settlement or determination of land revenue. A settlement is generally expected to be in force for 30 years. It is done by dividing land into groups and fixing standard rates for each group. Groups are formed taking into account physical configuration, climate and rainfall and yield and prices of main crops. Other factors considered for grouping land for land revenue assessment enumerated in the Act are marketing and communication facilities, the standard of husbandry, population and supply of labour, agricultural resources, variations in the area of occupied and cultivated lands between two settlements, wages, costs of cultivation of principal crops and sale values of agricultural land.

7.13 The detailed settlement procedure is laid out in the Karnataka Land Revenue Rules of 1966 (Chapter VI). The land revenue due is determined for each parcel of land bounded by survey stones which is given a survey number or a subdivision of a survey number at the time of settlement or subsequent mutation (change of ownership or use). All productive land (that is all land that is assessed for land revenue) is classified in *annas* by a relative assessment of productivity and quality; unproductive land (*pot kharab*) is identified and exempted from land revenue. A standard rate is determined for a homogenous group of lands with reference to the average yield and the value of the principal crops grown over at least 2/3ds of the gross cropped area. A principal crop is defined as one that is cultivated over at least 20% of the gross cropped area (5% if it is a cash crop). Detailed procedures have also been prescribed for assessing each of the variables that have to be taken into account for determining the land revenue to be paid. The average crop yield, for example, is to be ascertained on the basis of detailed data provided by the Village Accountant for all land parcels grouped as "good" (classification value of at least 87% for plantation and 69% for other lands), "medium" (classification value of at least 75% for plantation and 37% for other lands) and "inferior" (classification value below 75% for plantation and 37% for other lands) land.

7.14 Under Section 2(27) of the Land Revenue Act, the standard rate is fixed at 4% of the average crop yield per acre for land with full classification value (1% for plantation crops). After determination and approval of standard rates of assessment by the legislature (Section 121 of the Act), the assessment for each survey number is fixed on its relative classification value as per tables prepared by the Commissioner for Survey, Settlement and Land Records.

7.15 At the time of assessment, agricultural land is divided into dry, wet, garden (wet or dry)-called *khushki, tari and bagayat*-and plantation land. (In some pockets, there are two kinds of *bagayat* or garden land-*patasthal bagayat* which is surface irrigated and *motasthal bagayat* which is well irrigated; land revenue rates are lower for the second category). The classification is based on the kind of crops that can be grown without using water provided from government facilities. There is however a provision under Section 125 for additional assessment to be levied for irrigation facilities provided by the government if water rate has not been levied separately on this account. Plantation crops are cardamom, coffee, pepper, rubber and tea {Section 2(8)}.

7.16 Section 117 of the Act is significant, since it clearly exempts productivity increases attributable to irrigation facilities and land improvements effected by the landowner himself from consideration while determining land revenue. This was apparently meant to be an incentive for agriculturists to *suo moto* undertake long term investments to increase productivity.

7.17 At the time of the last land revenue settlement done in 1965, 41 zones were identified. The lowest and highest standard rates/acre then fixed for different categories of land are given below:

	Lowest rate	Highest rate
Dry land	.64 paise	6.26 paise
Wet land	1.06 paise	23.02 paise
Garden land	.96 paise	77.51 paise
Plantation land	6.25 paise	11.36 paise

7.18 While a settlement is in force, there are provisions for revising assessment in certain situations and determining assessment on unassessed land (Section 122 B). In practice, this happens while converting agricultural land for non-agricultural use and changing dry land into plantation land. Assessment is fixed in such cases with reference to the rate applicable to similar neighbouring lands.

7.19 The government has been contemplating a fresh resettlement exercise for some time. High court rulings interpreting the Land Revenue Act do not, however, permit across-the-board revision of land revenue rates without a formal settlement process. A possible loophole exists under section 204 of the Panchayat Act which provides for levying a local cess equal to land revenue but this has to be earmarked for local bodies. An announcement has also been made in the budget for 2000-2001 about doubling land revenue and transfer of the levy to *panchayats.* Simultaneously, a proposal for conducting a fresh summary settlement over a two year period at a cost of around Rs. 9 crs. is under consideration. A Cabinet sub-committee is likely to be constituted to oversee the entire process.

7.20 Cesses are also levied on land revenue (local cess at 50%, education cess at 10% and health cess at 15%). They are levied under Rules legislated by the departments concerned. Cesses are credited to land revenue and become a part of the general budget. The local cess component is meant for local bodies but it is absorbed into general revenues from which allocations are made to village *panchayats* in accordance with State Finance Commission recommendations as accepted by government.

7.21 From July 1977, holders of less than 2 hectares of dry land or its equivalent were exempted from land revenue. This limit was extended to 10 acres in an order of 18th October 1980. A fee of Re. 1 was levied on each *khatedar* (landowner) for the maintenance of the record of rights, which was raised to Rs. 5 on 30th January 2001. This is also accounted for under the head of land revenue.

7.22 The districtwise classification and assessment of basic land revenue as on 31st August 1994 is given in Annexure VI. Annexure VII furnishes latest actual demand after taking into account remissions for small holders. Against a total assessment of Rs. 5.57 crs., remissions amount to Rs. 2.07 crs., leaving only around a paltry sum of Rs. 3.5 crs.as actual demand.

7.23 In effect, therefore, land revenue is a kind of presumptive taxation of agricultural income, but the tax base takes into account only income realisable from the inherent productivity of the land (its physical features, soil, location and the like). Benefits realised from technological improvements and investment on land by the landowner himself, including those attributable to irrigation facilities, have been specifically excluded in the Karnataka Act presumably to encourage long term investment under the predominantly dry land cultivation characteristic of much of the State. Benefits realised from irrigation provided by government investment are charged separately through user charges or water rates. The presumptive nature of land revenue is based on the land classification mechanism although tax due is fixed separately for each parcel of land or survey number. Costs of cultivation and wages are also considered but the standard rate of 4% is determined on gross not net average crop yield for every class of land in a group. The most significant feature of this form of taxation is its stability as there is only a very limited inbuilt mechanism to vary the tax due from year to year. There is no provision for indexing land revenue to inflation but there is a facility for specific remission or suspension in the case of natural calamities. Land revenue acts themselves prescribe limits to permissible rate increases in most States.

7.24 The inflexibility of land revenue is both an asset and a disadvantage. It obviates the need for costly, detailed settlement exercises. The flip side is the increasing disequilibrium between land revenue assessment and actual productivity over the very long periods for which a settlement is in force, particularly when there are major technological changes in agriculture as has happened in the post-independence period. Large gaps between settlements induce administrative inertia and delay the rate revision process. The result is that in land revenue "the...relationship between levy and land productivity...(are)..seriously lagged (and) inadequately stratified" (Indira Rajaraman and Bhende, 1998). Land revenue is also regressive in nature, as there are no rate differentials based on income derived from the total holding of a *khatedar*; assessment is linked only to the productivity of different land parcels. When land revenue is set with regard to principal crops grown over 2/3ds or more of cropped area within a land category, income from profitable minor crops escapes taxation. The exemption limit has also substantially reduced revenue from the levy in Karnataka. By reducing land revenue liability to a pittance, the incentive to provide associated essential services like the maintenance of land records is again seriously diluted.

Agricultural income tax

7.25 Karnataka is one of five States levying agricultural income tax under Entry 46 of the Second List of the Seventh Schedule of the Constitution. Other States levying such a tax today are Tamilnadu, Kerala, Assam and West Bengal. Receipts from the tax and growth rate over the last decade for Karnataka alone are given in Annexure VIII. Since coffee accounts for a major share of revenue, receipts tend to fluctuate with movements in coffee prices. This explains the tripling of revenue in 1995-96 when incomes of coffee growers rose as a result of spurt in coffee prices in the preceding year (this also coincided with dismantling of the public sector marketing mechanism through the Coffee Board); with sharp drop in prices in 2000-20001, agricultural income tax revenues are also plummeting.

COMPARATIVE TAX STRUCTURES FOR AGRICULTURAL INCOME TAX
(furnished by State departments)

Tax rates

There is a single rate of 45% in West Bengal. In other States, the differentiation is broadly as follows:

A. Rates for individuals:

Karnataka

Where income is below Rs. 40000, no tax
Between Rs. 40000 and Rs. 50000-10% on income above Rs. 40000
Between Rs. 50000 and Rs. 75000-Rs. 1000 + 20% of income over Rs. 50000
Between Rs. 75000 and Rs. 100000-Rs. 6000 + 30% of income over Rs. 75000
Over Rs. 100000-Rs. 13500 + 40% of income over Rs. 1 lakh

Tamilnadu

There is no tax up tc 8 acres.
-for the next 4 acres,it is Rs. 150/acre
-for the next 13 acres, it is Rs. 200/acre
-for the next 15 acres, it is Rs. 300/acre
-for the next 10 acres, it is Rs. 500/acre

Kerala

-no tax up to Rs. 40000
-for incomes between Rs. 40000 and Rs. 50000, 20% on amount above Rs. 40000
-for incomes between Rs. 50000 and Rs. 60000, Rs. 2000 + 30% on amount above Rs. 50000
-for incomes between Rs. 60000 and Rs. 1 lakh, Rs. 5000 + 40% on amount above Rs. 60000
-for incomes over Rs. 1 lakh, Rs. 21000 + 50% on amount above Rs. 1 lakh

B. Rates for companies:

Karnataka

Where income is within Rs. 100000: 30%
Where income is between Rs. 100000 and Rs. 500000: Rs. 30000 + 40% of income over Rs. 100000
Where income is over Rs. 100000: Rs. 190500 + 50% of income over Rs. 500000

Tamilnadu

-up to Rs. 22000, no tax
-between Rs. 22000 & Rs. 30000, 20%
-between Rs. 30000 & Rs. 50000, the earlier amount & 30%
-between Rs. 50000 & Rs. 1 lakh, do. & 40%
-over Rs. 1 lakh, do. & 50%
(These rates apply to all taxpayers who are not companies).

Kerala

For domestic companies and cooperative societies
-for incomes up to Rs. 25000, 45%
-for incomes between Rs. 25000 and Rs. 1 lakh, 50%, subject to an upper limit = to Rs. 10000 + 80% of the income over Rs. 25000
-for incomes between Rs. 1 lakh and Rs. 3 lakhs, 55% subject to an upper limit = to the amount payable for incomes of Rs. 1 lakh + 80% on the amount over Rs. 1 lakh
-for incomes over Rs. 3 lakhs, 60% with a similar upper limit
For foreign companies, 85%

C. Rates for others:

Karnataka

For firms: 40%

Kerala

For firms, the rate is 40%

Composition provisions:

Karnataka

Under Section 66 composition is possible for individual taxpayers holding up to 150 acres as below:
For land below 15 acres, there is no tax
Between 15 and 20 acres: Rs. 750/acre on land exceeding 15 acres
Between 20 and 25 acres: Rs. 3750 + Rs. 1000/acre on land exceeding 20 acres
Between 25 and 30 acres: Rs. 8750 + Rs. 1400/acre on land exceeding 25 acres
Between 30 and 40 acres: Rs. 15750 + Rs. 1750/acre on land exceeding 30 acres
Between 40 and 50 acres: Rs. 33250 + Rs. 2250/acre on land exceeding 40 acres
Between 50 and 100 acres: Rs. 1150/acre
Between 100 and 150 acres: Rs. 1250/acre

Tamilnadu

The composition facility is available up to 50 acres as below:
-up to Rs. 25000, 45%
-between Rs. 25000 and Rs. 1 lakh, the earlier amount & 50% on the additional income
-between Rs. 1 lakh and Rs. 3 lakhs, do. & 55%
-between Rs. 3 lakhs and Rs. 10 lakhs, do. & 60%
-over Rs. 10 lakhs, do. & 65%

Kerala

Composition is possible at different rates for different crops for holdings up to 500 hectares as below (there is no tax for the first 5 has.):

Rs./acre	Next 3 has.	Next 5 has.	Next 5 has.	On rest
Pepper	400	600	1000	1750
Coconut, cocoa, rubber	500	1000	1700	2500
Cardamom B zone	550	1000	2000	2800
Cardamom B zone, arecanut	750	1200	2700	3500
Tea	350	500	900	1500
Coffee	700	1000	1800	3000
Cardamom C zone and other crops	300	450	800	1400

7.26 Crops subject to tax and tax structures differ among States. Under Sections 1(a) and (q) of the Karnataka Agricultural Income Tax Act of 1957, agricultural income tax is now applicable only to rent or revenue from plantation crops (coffee, tea, cardamom, orange, pepper, rubber and linaloe) grown on plantation land. This includes income from buildings on or in the vicinity of such land. In Tamilnadu, arecanut and cloves are also covered but not orange or linaloe, while only income from tea is subject to tax in West Bengal. Under Sections 3 and 4 of the Karnataka Act, agricultural income derived from the State by residents and non-residents in the previous year is liable to taxation. Section 5 provides for admissible deductions like taxes (land revenue, local rates, cess etc.), excise duty on agricultural produce, rent, expenditure on the maintenance of irrigation or protective works, expenditure on the purchase or construction of capital assets, depreciation (calculated as a percentage on the written down value prescribed in Rule 3), interest on borrowings done for incurring capital expenditure, mortgages and debt incurred for acquiring agricultural land, revenue expenditure for earning agricultural income (cultivation cost and the like), expenditure on collecting agricultural income or repair of capital assets used for collection, expenditure incurred on fresh cultivation of land and maintenance of immature plants. Only actual expenditure incurred on these items is permitted to be deducted; thus, the accrual principle is not applied in taxing agricultural income. Section 5A also provides for exemption in respect of insurance premia and provident fund contributions as per a prescribed scale subject to a maximum of Rs. 40000 in the case of Hindu Undivided Families; in all cases such deductions are limited to 10% of the assured sum. Finally, Section 12 provides for exemption of certain components of agricultural income which have already been subject to tax in other hands, within an undivided family, as shareholder of a company or partner of a firm or association, trust property etc. The Section also provides exemption for donations made for specified charitable purposes.

7.27 Current rates of agricultural income tax in Karnataka and other States are specified in the accompanying box. Karnataka rates and composition facility compare favourably from the taxpayer's point of view with those in other States. In Karnataka, losses are permitted to be carried over for six years (Section 15).

7.28 The assessment procedure in Karnataka is similar to that adopted for other direct taxes on income. Under Section 18, returns are required to be filed by all persons who had taxable income during the previous year or 15 acres and more of plantation land, within 4 months of the end of the year. Tax is expected to be paid along with the filing of the return. A 30 day notice is given to persons liable to tax who do not file returns within the specified time. Assessments can be completed on the basis of returns or on best judgment basis after giving the taxpayer an opportunity to be heard. Provisional assessments can be made in advance of the regular assessment against which there is no right of appeal. Assessments have to be completed within 3 years of the submission of returns. Appeals can be filed against assessments made by Assistant Commissioner to the Joint Commissioner (Appeals) within 60 days of the service of orders imposing penalties for a difference higher than 25% between tax paid and tax payable, rejecting denial of assessment liability, determining income or tax and refusing to re-open a best judgment assessment. A second appeal is possible to the Appellate Tribunal. There is also a provision for revision by the Joint Commissioner or Additional Commissioner within 4 years of the order. An escapement provision is available for 5 years of the close of the year being assessed. Rectification can be done within the same period.

7.29 Out of 4143 assessees for agricultural income tax at the close of 1996-97, more than half (2330) had opted for composition. The composition facility was extended from 50 to 150 acres in April 2000. This has increased the proportion of assessees who benefit from the facility (3245 out of 4247 assessees that is over 75%). Not much additional revenue has been realised on account of increase in the composition (it is only around Rs. 5 crs). An option for composition is deemed to be in force for 3 years. Three-fourths of the revenue from actually assessed cases (excluding composition) is derived from companies alone.

7.30 The penalties prescribed for violations of the Act are as below:
-when 25% or more of the tax due has not been paid, 24% of the short paid tax, subject to a maximumof Rs. 100 for agricultural income below Rs. 25000
-when return has not been filed or there has been delay in filing, 24% interest up to the date of filing the return or completion of assessment
-for concealing income, penalty up to the tax payable
-for default in paying tax or any amount due, 2% interest/month on unpaid amount
-for failure to furnish information sought, Rs. 5/day of default.

7.31 Tax is collected by cheque, demand draft, postal order or in the treasury. Tax could be permitted to be remitted in up to 4 instalments along with interest equal to the bank rate on unsecured loans. Government is also liable to pay interest at 12% on amounts refunded that have not been returned within 90 days.

7.32 Not only is agricultural income tax a plantation based levy, assessment is also largely confined to companies, with composition applicable to most individuals. The presumptive component of the tax is quite prominent. The tax is levied in addition to land revenue. Poor revenue yield from non-plantation crops in Karnataka when they were subject to agricultural income taxation in the past indicates that taxation on a self-declaration basis is feasible only for plantations for which there is a readily available yield norm per tree and standardised capital and operating costs. Since *ad valorem* rates are applied to assessments that do not fall within the composition scheme, the tax is somewhat price sensitive. Tax slabs also introduce the element of progression suitable for direct taxation.

Interphase between taxes on agricultural and non-agricultural income

7.33 On the basis of the recommendation of the K.N.Raj Committee, Government of India has implemented the policy of "partial integration" of agricultural and non-agricultural income in 1973 itself. Although agricultural income is not included in an assessee's total income for purposes of the Central income tax (under section 10-1 of the Income Tax Act), it is added to non-agricultural income for tax computation when non-agricultural income is higher than the exemption limit and net agricultural income exceeds Rs. 600. Such integration is not applicable to companies, firms, local authorities or cooperative societies. This means that the marginal income tax rate is determined on the combined income of an assessee, but the rate is only applied to the non-agricultural tax base. There is no provision for adjusting losses incurred on earning agricultural income against non-agricultural income (Rule 9). Losses incurred on agricultural operations in any year cannot also be carried forward and set off against profits earned in subsequent years, except in the case of tea (discussed further on).

7.34 A principal policy concern arising out of the division of fiscal responsibility for agricultural and non-agricultural income between the Centre and the States is with regard to differentiation of the tax base. To clarify matters and avoid disputes, agricultural income has been defined in Article 366(1) of the Constitution itself as "agricultural income defined for the purposes of the enactments relating to Indian income tax". Both agricultural and non-agricultural income are defined in the Central Income Tax Act, the former in Section 2 (1A) and the latter in Explanation 2 of the section. The definition is solely for the purpose of determining non-agricultural income for levying Central income tax. Because of the Constitutional provision cited above, this definition becomes applicable when income has to be allocated as agricultural or non-agricultural.

7.35 Under the Central Income Tax Act, agricultural income extends to rent and revenue derived from land used for agriculture situated in the country. It includes income earned by processing agricultural produce and that derived from farmhouses. Income earned from buildings located on or close to agricultural land, occupied or owned by cultivators and landlords and used as residence, store, barn and the like for agricultural activity is treated as agricultural income. Agricultural land should also be assessed for land revenue and be located at least 8 kms.away from urban areas. Capital gains arising from the sale of urban land (as defined above) are not treated as agricultural income. From 2001-2002, (as per Explanation 2 to the above provision), income derived from lands and buildings which satisfies all the criteria given above for income from non-agricultural sources is not treated as agricultural income.

7.36 Detailed Rules have been prescribed for allocating different kinds of agricultural income to compute Central income tax. Agricultural income is accounted for as income from other sources in income tax returns and treated like profits from a business or profession. Income derived from buildings on agricultural land, which is legally considered as agricultural income, is treated like income from house property.

7.37 Composite income partially derived from agriculture, is differentiated in the manner indicated in Rule 7 of the Act. A major area of overlap between agricultural and non-agricultural income is that of agro-processing. Courts have held that agricultural operations are those which directly involve spontaneous growth from the soil, like ploughing, harvesting etc. This means that poultry and animal husbandry are treated as non-agricultural activities, while forestry, pisciculture and floriculture are considered to be agricultural activities. The relative jurisdictions of State and Central governments in determining agricultural income have been indicated in judicial pronouncements. Assessment officers at the State level dealing with agricultural income tax cannot ignore assessments made by Central Income Tax officers but they can rectify them in the rare cases when they violate the Central Act and Rules. The primacy of the Central Act is therefore ensured.

7.38 Rule 4 of the Income Tax Rules lays down a rule-of-thumb formula for allocating income derived from tea (which is sold generally in semi-processed form) between agricultural and non-agricultural income. 40% of the income is treated as non-agricultural and 60% as agricultural. Rule 8 also permits carry forward of losses incurred on tea from year to year. There is a corresponding provision in Section 8 of the Karnataka Agricultural Income Tax Act. An identical provision has been enacted in last year's Central budget in the case of coffee, which can become operational only if corresponding amendments are made in the State Act.

7.39 The truncated taxation of individual and corporate incomes under our federal constitution has revenue implications which are generally not assessed by States or questioned by them in Centre-State consultations. By permitting the Central government to unilaterally define "agricultural income", the Constitution has permitted it to encroach into State fiscal territory. This seems to have happened in the case of coffee in the current year's budget. The few large coffee producers whose incomes were hitherto subject only to State taxation will divert part of their tax payments to the Central treasury when the 60-40 income apportionment formula mentioned above is made operational by an appropriate amendment in the State Act. The Finance department should be alert to such modifications, estimate the likely revenue loss and môve the matter with the Union Finance Ministry to protect State tax inflows. Coffeegrowers who now benefit from the composition facility under the State Act, will under the current amendment become liable to return based assessment if they undertake non-farm gate activities since composition is not possible under the Central Income Tax Act.

7.40 Partial integration of incomes reduces to a certain extent the incentive for passing off legitimate or illegitimate non-agricultural income as agricultural. There are, however, several areas of ambiguity. Leases are restricted under State Land Reforms Acts and even prohibited in some States like Karnataka. Purely commercial relationships between companies which finance and provide inputs and extension to farmer-growers as well as buy back their produce are structured as joint development arrangements (in States where leasing is illegal) and the income earned is passed off as agricultural income. Seed companies attempt to do this even when the relationship with farmers does not and cannot extend to actual possession of agricultural land. Similar legitimate arrangements, which do not extend to land leasing, would normally be subject to non-agricultural income tax.

7.41 False declaration of agricultural income is used as a mechanism to launder black money which is then used as equity or working capital margin in business or invested in real estate. The usual method adopted is declaration of high yield figures for agricultural crops and/or artificial depression of expenses to produce inflated figures of agricultural income which is then brought back into circulation. There is justified apprehension among Central income tax officers that illegal collections like bribes, brokerage for government contracts and exorbitant donations for admissions to educational institutions could be thus legitimised; in the last case, this might be done in the returns of both the institutions as well as the individuals running such institutions.

Suggestions for reforming the structure of agricultural taxation

7.42 Since independence, different methods have been suggested for levying a comprehensive tax on agricultural income. Economists have in general criticised under-taxation of the agricultural sector. Complaints of this nature voiced by government committees coalesced in the setting up of the Committee on the Taxation of Agricultural Wealth and Income, familiarly known as the K.N.Raj Committee in 1972, which suggested levy of a single agricultural holdings tax (AHT) in lieu of all direct taxes on agriculture to be calculated by using the following procedure:

-dividing the country into homogeneous tracts on the basis of soil and climate and differentiating them by crop groups.

-developing moving average annual output norms for crops based on 10 year yields and using 3 year market prices to calculate the gross value of production

-netting out costs by multiplying the percentage of gross income retained per hectare after deducting expenditure on material inputs and hired labour (not family labour and irrigation costs) with value of gross output; costs were to be computed on the basis of norms drawn from existing cultivation cost surveys and net income or rateable value determined

-preparing schedules of rateable value/hectare for different crops and crop groups for each tract; each crop group was to be given a single rating in terms of rateable value

-arriving at assessable rateable value by deducting water charges actually paid for privately irrigated land or allowing a 20% rebate for privately irrigated land

-allowing a development rebate of 20% subject to a cap of Rs. 1000

-taxing net income at .5%

-taking the family and the operational holding as units for taxation

-applying a uniform methodology for the country

-introducing the tax in two phases by tackling operational holdings with assessable rateable value above Rs. 5000 in the first stage.

7.43 Initial criticism of the Committee's recommendations were focused on basing AHT on operational holdings, using average productivity norms for an entire tract and concurrent taxation of land revenue in the first phase of the levy. But these elements of AHT do not account for its rejection by all States. One reason for non-implementation was perhaps the over-ambitious nature of the recommendations themselves, given the infeasibility of collecting information about the cropping patterns of all cultivators for covering all crops. There was also no systematic provision for exemption using yield thresholds in cases of unique (not general) crop failure, since the threshold fixation procedure suggested by the committee was region-specific and based on holding size.

7.44 Several variants of AHT were considered and suggested over time although the tax itself was never introduced in any State. Some of the problems identified were sought to be remedied by later modifications proposed by Dr. Raj; thes included sharing the tax burden between the owner and cultivator in the case of leased land and triennial or quinquennial assessments. A simplified form of AHT was suggested by Dr. Bagchi in 1978 which would limit the computation of rateable value to the gross output of one or two main crops in each area and restrict cultivation costs to a flat 30%. The U.P.

Taxation Enquiry Committee of 1980, headed by Dr. Lakdawala even estimated incremental yield from the tax in 7 districts of the State and found it negative.

7.45 Several Karnataka-specific ideas have also been mooted over time. The Mysore Taxation and Resource Enquiry Committee headed by Mr.Bhoothalingam had proposed that net income likely to be earned on each crop under different regional and irrigation conditions (standard income) should be notified annually; it could be revised every three years or when prices or climatic conditions alter substantially. Deductions could also be reviewed in the same manner. The rates proposed were between 8% to 50% of agricultural income with exemption for the first slab of Rs. 5000.

7.46 The Karnataka Taxation Enquiry Committee of 1981 chaired by Prof. Gulati had recommended a land tax in lieu of land revenue for non-plantation crops. All agricultural land was to be graded on existing *annewari* basis into poor, medium and good lands which meant that the classification would be based on both soil fertility and existing irrigation facilities. An equation for categorising all land categories in terms of dry land was then developed as follows:
5 acres of dry land = 3.5 of rainfed wet land = 2 acres of irrigated single cropped land =1.5 acres of irrigated double cropped land = 1 acre of irrigated perennial source of water land.

7.47 The classification was, therefore, to be based on the productivity potential of the land, not on actual crop grown although tax incidence would be based on a concept of average rateable value. The gross value of output of an acre of poor dry land was to be computed. The State was to be divided into 4 homogeneous zones and equations to be worked out for different land categories separately for each zone; there was a provision to rework equivalences between different land categories every five years.

7.48 It was suggested that 15 acres of dry land or its equivalent should be exempt from land tax, but a nominal one rupee should be charged for the maintenance of the record of rights. For holdings between 15 and 50 acres, Rs. 5 per acre were to be charged, between 50 and 100 acres, Rs. 6.25/acre, between 100 and 150 acres, Rs. 7.5/acre and over 150 acres, Rs. 10/acre. These rates were to be applicable to families; companies, associations, cooperatives and the like would be subject to the highest tax rate.

7.49 Indira Rajaraman and M.J.Bhende (1998) have suggested an agricultural income tax that would supplement land revenue which could be separately indexed to product price inflation. Agricultural activities (including floriculture, aquaculture and other land based activities) with tax potential within an area are to be identified by district planning committees and sent for survey and income assessment to the State government which is better equipped to undertake such studies. This will provide room for considering regional diversities and requirements and occupational changes within the agricultural sector. The authors have suggested that in the interests of horizontal equity, field surveys should take into account imputed costs of family labour and home-produced inputs while assessing income derived from agricultural activities. The surplus generated for each item over total variable cost should then be plotted and a threshold fixed at the yield at which the percentage stabilises. Activities with no income stability should not be taxed on presumptive basis. Under such a system, annual assessment will be required only for farmers growing any of the few designated crops. Assessment at pre-determined levy rates per acre would be done only when a farm moves above the prescribed yield threshold and the applicable rate would be worked out at the threshold not average yield. Land owned by a taxpayer would alone be taken into account for computing taxable income not operational holdings. Adjustments could also be made to ensure that the tax burden falls only on income earned from marketed surpluses in the case of food crops.

7.50 Since garden crops are subject to less diversity and income uncertainty, yield and land use are reasonably stable and not dependent on irrigation and soil suitability may be taken as given, it has been suggested that in their case, actual yields should be taken into account, rebates given for earlier years and annual scaling done till the crop reaches normal yield levels. Such land categories are to be converted into equivalents of dry-poor land and the same rates of tax applied on the basis of the expected annual average gross income per acre and comparison of the tax incidence on garden crops in relation to irrigated non-garden crops. Gestation periods should be taken into account while determining tax exemptions. *Panchayats* are to be authorised to levy the supplementary tax proposed above on crop-specific basis; they would also retain the revenue and can use it to improve local agricultural infrastructure.

7.51 The main issues raised in the debate on taxing agricultural income over the last three decades seem to be the following:

-there seems to be general agreement about the need to improve and generalise the taxation of agricultural income but there are divergent views about retaining land revenue and adding on another levy or replacing land revenue by a totally new tax

-the importance of a presumptive approach has been recognised by all writers but opinions vary regarding the extent to which account-based assessment should be insisted upon given the poor information base

-whether tax should be based on operational or owned holdings and on the family or individual is in dispute

-whether there should be a generalised tax or scope for local variation is not clear

-whether family labour should be treated as an imputed cost is under debate

-different methods of yield and crop valuation have been proposed but there are several common features in the proposals

-the ticklish question of exemptions for those at the bottom by holding size or threshold yield has to be resolved

-the tax rate and whether it should be specific or *ad valorem* has to be considered

-further deductions for encouraging investment and development have been suggested

-how to treat garden crops and other land-based occupations is a major problem

-a transparent, easily operated method of remission in the case of calamities and price fluctuations has to be instituted

7.52 In some writings of the nineties, the virtual silence on the taxation of agricultural income of the eighties (following the general rejection of the suggestions of the Raj Committee) has been replaced with concern for intersectoral equity and prevention of evasion of non-agricultural income tax using the agricultural income loophole. Presumptive taxation is the most favoured option although some economists advocate a tax based on assessment or integration with Central income tax. Proposals for long term change and transitional measures for taxing agricultural income will be made by us in the following paragraphs keeping in mind these views.

Recommendations for taxing agricultural income

7.53 Despite widespread dissatisfaction among economists with the inadequacy of the current system of taxing agricultural income from the equity and efficiency points of view, it has not been easy to develop a practical and acceptable replacement that would suit the changing technological and occupational structure in rural areas. It is widely believed that the agricultural sector is under-taxed. Statements to this effect are frequently made by economists and policymakers. The Planning Commission and the Union Finance Ministry regularly refer to the untapped fiscal potential of the agricultural sector. We have, therefore, attempted to estimate this potential, as a prelude to recommending appropriate tax policies.

7.54 The simplest method would be to update the existing land revenue assessment in line with inflation. The current demand for land revenue is based on the 1965 settlement with adjustments for cultivable areas that have been added or deducted in the intervening period. As on 31/8/1994, this demand is only Rs. 5.44 crs. (before remission for small holdings). If we apply the Consumer Price Index for Agricultural Labourers to this figure, the demand increases to Rs. 40.46 crs. This means that receipts from land revenue alone could grow by eight times if they are indexed for inflation. (Annexure VI). With indexation, the total revenue under this head of account would have been around Rs. 55 crs.in 1994-95; if agricultural income tax is added, the State would have raised around Rs. 72 crs. that year from direct taxes on agriculture. The revenue from the sector would thus have been double that actually realised. As already indicated, indexation is not permitted under existing statutes. Unless the Land Revenue Act is amended, the formal settlement procedure, which provides for public notice of revised rates and disposal of objections received, will have to be observed. The department estimates that settlement without resurvey will take around two years and cost about Rs. 9 crs.

7.55 A more detailed assessment of tax potential might be possible by individually estimating net income/hectare for some major crops. We have chosen a few important agricultural (sugarcane, paddy, maize, ragi, jowar, groundnut, tur, cotton and sunflower) and horticultural (potato, onion and coconut) crops using secondary data and looking at the most widely grown variety under typical watering conditions. Two methods of cost estimation are being done today for agricultural crops, one based on farm management studies finalised annually by a committee of officials and researchers and another calculated by the department for determining the scale of finance for crop lending. The former takes into account not only variable costs, but also land revenue and items like interest on investment and working capital (estimated), depreciation charges, risk premium (estimated on variable cost), managerial cost (standardised), rental value (estimated on gross income) etc. These estimates are done by the Agriculture department for making recommendations to the Central Agriculture department regarding fixation of minimum support prices.

7.56 The two methodologies use different methods for calculating variable costs. Calculations based on farm management studies rely on the quantity of inputs actually used on farms and prices prevailing at the relevant points of time but scale of finance costing is based on the package of practices recommended for different crops by the Agriculture department. The latter set of costs tends to be higher than the former since agriculturists may not apply all the recommended inputs or labour for the prescribed number of mandays. Cost estimates based on farm management studies (depending on practices adopted by farmers, not those recommended to obtain optimal results) reflect field-level realities. We have, therefore, chosen the results of these studies for estimating income from major crops. We have not taken fixed costs into account, except for one element: taxes like land revenue and related cesses. Net income per hectare for different major agricultural crops based on farm management studies is presented in Table I. Although market prices during the season for each crop in the main market in which it is traded in the State have been used to estimate gross incomes for three different years, to even out the effects of substantial price variations, average prices have been computed by excluding price levels which are substantially different where required. The results may be taken to be purely indicative.

7.57 From our limited analysis, the most remunerative rainfed crop appears to be cotton, but even with the net surplus per hectare estimated by us, only a person with a holding in excess of 10 hectares would have taxable income if the current exemption and standard deduction levels for non-agricultural income tax are applied. At the other end of the scale, a holder of double cropped irrigated land might become liable to tax with a holding of around 2 to 3 hectares. The income estimation made by us indicates therefore that small and marginal holdings would in any case be below the exemption limit. Using processed but unpublished data available from the latest Census of Agricultural Holdings (available from the Directorate of Economics and Statistics) which furnishes information relating to 1995-96, if holdings not likely to be taxed are excluded, we are left with only around 1 lakh holdings (1.7% of all holdings) covering an area of less than 7 lakh hectares (around 6% of gross cropped area).

Table I

Income per hectare based on farm management studies.

(Rs.)

Crop	Average net income over total cost	Average net income over variable cost	Average net income over variable cost & land revenue
Irrigated			
Sugarcane (last 3 years)	21760.15	36330.13	36322.47
HYV Paddy (last 2 years)	14230.20	21370.89	21362.82
Maize (last 2 years)	2079.52	5907.27	5904.06
Rainfed			
Cotton (last 2 years)	6307.38	7794.39	7788.52
Groundnut (last 3 years)	-3126.42	-700.46	-705.12
HYV Jowar (last 3 years)	-993.64	450.09	447.62
Tur (last 2 years)	-6209.04	-3643.89	-3650.82
Sunflower (last 2 years)	674.70	2157.89	2154.27
HYVRagi (last 3 years)	-4523.25	1768.49	1762.39

7.58 Since deductions for savings, investment, development, insurance, climate and price fluctuations etc. ought to be given for agricultural income tax payers, it would be logical to assume a higher exemption/deduction limit of Rs. 1 lakh. At Annexure IX, we have made two sets of computations. At the upper end, we have assumed income from fully irrigated holdings at Rs. 25000/hectare and that from fully unirrigated holdings at Rs. 5000/hectare. At the lower end, we have taken income from fully irrigated holdings as Rs. 15000/hectare and that from fully unirrigated holdings at Rs. 3000/hectare. Using average holding sizes and irrigation data (for partially irrigated holdings alone) and applying current tax slabs applicable to non-agricultural income tax, estimations of tax potential have been made for the State under both assumptions at Annexures IXa and IXb.

7.59 It is evident that even with fairly high yield and valuation assumptions for agricultural produce, the revenue likely to be realised will not exceed Rs. 100 crs (Annexure IXa). The number of taxed holdings would be 105000 (which is only 1.74% of total holdings) and the area covered by them 687000 hectares (6% of the gross cropped area). Almost three-quarters of this revenue is likely to be from wholly irrigated holdings, while revenue from wholly unirrigated holdings would be negligible.

7.60 The second set of computations at Annexure IXb indicates that the number of holdings likely to be subject to tax is as low as 19600 (which is only .33% of total holdings) and the area covered 236000 hectares (2% of the gross cropped area). The tax likely to be realised is only around Rs. 18 crs. Under this assumption, wholly unirrigated areas would generate no tax at all as also holdings below 7.5 hectares.

7.61 In the case of horticultural crops, cultivation requirements differ between orchard type crops like coconut and annual crops like vegetables. The latter are grown over periods of four to six months, while fruits are cultivated in orchard type operations involving heavy one-time investment on planting and limited annual maintenance expenditure. Among the major horticultural crops of Karnataka, cultivation costs have been estimated by the State government in recent years for onion and potato for market intervention operations at the State level. These were also approved by the Government of India in 1997. In the case of coconut, minimum support operations are undertaken annually by the Central government and for this, cultivation costs are estimated and sent to the Centre by the State Horticulture department. Mango, chillies and arecanut have not come under market intervention mechanisms. Estimated annual net income from potato, onion and coconut prepared by the department is presented in Table II. In the case of coconut, only annual maintenance charges have been taken into account for calculating net income, not the initial cost of establishing an orchard. Substantial price fluctuations seen in the case of coconut indicate the extent to which net income from a major horticultural crop could vary from year to year. We have not made an assessment of the tax potential from horticulture since it is far more differentiated than agriculture, cultivation is not often concentrated in clusters and income fluctuates wildly from year to year because of price variations attributable to the instability of current marketing arrangements. When it is undertaken on a large scale through organised marketing agencies geared to a reasonably predictable demand, it could prove to be a growing source of income which could be taxed by the government.

Table II

Income per hectare for some horticultural crops

(Rs.)

Crop	Gross income	Cultivation cost	Net income *
Potato (1997)	20200.00	25000.00	-4800.00
Onion (1997)	43520.00	19000.00	24520.00

Coconut	Gross income	Maintenance cost	Net income *
1998	29062.00	12665.00	16397.00
1999	30825.00	12665.00	18160.00
2000	20850.00	12665.00	8185.00

* Land taxes are not taken into account in costs.

7.62 The above analysis suggests that the revenue potential of a return-based tax on agricultural income from non-plantation crops may not be very high. It would also require elaborate administrative arrangements which might be difficult to maintain at a high efficiency level and may not be cost-effective. In the short term, therefore, we see little justification for a return-based tax on all agricultural crops particularly if it is designed to replace land revenue like the Agricultural Holdings Tax of K.N.Raj.

7.63 A better alternative that we propose for immediate adoption is amendment of the Land Revenue Act to permit annual indexation of rates. The price index that we would suggest for adoption is the Consumer Price Index for Agricultural Labourers (CPIAL) that is regularly prepared on a monthly basis by the Simla Labour Bureau. The index is not directly based on the prices of agricultural commodities, but it uses a basket of items of daily consumption of agricultural labourers, which may be considered an acceptable substitute. Arrangements will, however, have to be made to make the annual indexation as transparent, objective and public as possible to ensure that even the smallest taxpayer is not at the mercy of unscrupulous officials to know his tax liability. The announcement of rates should also be done before the main *kharif* crop season commences in June. This may not be difficult, since Labour Bureau data for the last month of the previous year is available within a month of the close of the year and annual averages can be immediately computed and applied to land revenue rates. The computerised information network proposed for district revenue and panchayat administration should be used to disseminate assessment rates. Remissions now given for small holders should also be removed and cesses merged with the main tax.

7.64 An eight-fold increase in land revenue rates may not be acceptable unless it is accompanied by visible benefits to ratepayers. Price-indexed land revenue rates should be introduced only when computerised RORs are made easily available through kiosks in villages to facilitate the paperwork required for agricultural lending. Government has already completed much of the work of ROR computerisation and should be in a position to provide the required facilities alongside amendment of the statute to permit automatic adjustment of land revenue rates to inflation. The Commission recommends that resurvey of agricultural land should also be done using modern techniques like GIS and digitised aerial and satellite mapping. Outside rapidly urbanising areas, the number of transactions may not be so large as to make this task too difficult. Village records for a large part of the State could, therefore, be brought up-to-date with concerted effort. Special attention may have to be given, however, to metropolitan areas and Bangalore and its suburbs might present insurmountable problems. The Commission believes that resurvey would offer an excellent opportunity to consider partial adoption of the Torrens system of title insurance, which, as we have mentioned in our first report, is essential for taxpayers to willingly seek registration of documents relating to property transactions and pay the accompanying fees and duties. It is desirable to set up a high-level committee at the State level to oversee the entire resurvey and settlement process. We also recommend removal of the statutory provision excluding income realised from improvements made on the land by the landowner in the period between settlements while determining land revenue rates.

7.65 By recommending indexation of land revenue rather than introduction of a return-based comprehensive agricultural income tax on all crops, we are not shutting our eyes to the inequity of the current income tax mechanism or the legal loophole available for evading non-agricultural income tax (more precisely for converting black money into white). We note that the changing face of agriculture in Karnataka-from subsistence based, low end food crops to hybrid commercial crops, horticulture and other ancillary activities-has been testified to by several studies. Newly developed occupations which fall under the definition of agricultural income like floriculture, pisciculture and forestry generate surpluses, which should not escape taxation. The number of cultivators making such investments is also growing over time. We believe that there is a strong case for putting in place a levy based on self-assessment (with provisions for presumptive taxation) for occupations like horticulture, floriculture, social forestry, pisciculture and similar activities as quickly as possible. This will supplement the basic restructured land revenue suggested above. We recommend immediate action to undertake the required surveys and develop productivity parameters for such avocations. Data available with financial institutions, which lend for such activities or refinance them like NABARD, could be used for computing presumptive taxation.

7.66 As for agricultural income tax on plantations, the incidence in Karnataka is probably lower than in Tamilnadu and Kerala (Tamilnadu has a lower exemption limit, while Kerala has higher rates). We do not recommend increase in rates keeping in mind existing difficult conditions for coffee growers who are the principal taxpayers. 44% of the State's coffee production of 3 lakh tonnes covering 3.4 lakh hectares is accounted for by holdings below 4 hectares and another 15% by those between 4 and 10 hectares. 56.5% of the area under coffee and 70% of the production of the country is also from

Karnataka. Apart from farmer-growers, around 5 lakh persons are employed by the industry (including 50000 estimated as indirectly employed). Between January 2000 and April 2001, farmgate prices for coffee have halved for both *arabica* and *robusta* varieties causing widespread distress and fall in incomes. The Commission has met coffee-growers at the Coffee Board and considered their various demands touching on agricultural income tax.

7.67 In the interests of horizontal equity, we believe that as far as possible taxation of agricultural and non-agricultural income should be done in a similar manner with identical rates, exemptions and procedures. From the conceptual point of view, the deductions permitted for computing tax liability and definitions of costs and gross income in the Karnataka Agricultural Income Tax Act are in line with those admissible for non-agricultural enterprises in the Central Income Tax Act. However, rates are not being modified annually to align with income tax rates. We therefore recommend that effective tax rates for agricultural income tax should be brought on par with those applicable to non-agricultural income tax. The rate and method of depreciation should also be similar. There may be no case for providing fiscal incentives for exports undertaken by grower-exporters (direct exporters) similar to those available for industries under 80 HHC of the IT Act or for investments made in R&D, since there is already a replanting allowance and such fiscal incentives are themselves not justified in tax administration. While not recommending increase in the composition limit from 150 acres to 500 acres as in Kerala, we suggest annual determination of composition rates to ensure that price fluctuations for each season are taken note of and undue hardship to cultivators avoided. The replanting allowance which was fixed several years back should be revised keeping in mind inflation over time. The State government should take measures to arrest the declining productivity of coffee. Schemes for promoting investment in the sector (like the Investment Deposit Scheme of 1995) are worth examination.

7.68 The Commission is seriously concerned about the existing possibility of using agricultural income tax as a loophole to evade Central income tax. We suggest that whenever a taxpayer declares agricultural income above a fixed limit in his income tax assessment, it should be treated as such under the Agricultural Income Tax Act and subject to tax. This would be in line with the present judicial position that agricultural income determined under the Central Income Tax Act must be treated as such by State assessment officers. However, there may be difficulty in taxing this income under the State Act unless it is amended and a blanket provision included making agricultural income (derived from any crop) declared to Central income tax authorities above a certain limit taxable. We suggest that the legal provisions required for this be introduced into the State Act to prevent evasion, raise revenue and enforce other regulatory statutes. The Finance department should assess the financial and other implications of the amendment introduced in the last Central budget allocating income derived from coffee on presumptive basis as agricultural and non-agricultural and take appropriate action from the point of view of revenue as well as taxpayer compliance.

Local bodies and agricultural taxation

7.69 Indira Rajaraman and Bhende (1998) have rightly emphasised the fact that land-based taxation which bears clear jurisdictional markers is appropriate for local governments. They point out, however, that there is little incentive to improve buoyancy if revenue is shared on per capita basis or on a redistributional formula and not on origin basis. They suggest, therefore, that land revenue should continue to be levied as at present but the decision of whether to impose or not the additional crop-specific tax recommended by them should be left to *panchayats*. In their view, collection of the tax should continue to be done by existing administrative mechanisms; this responsibility may be handed over to *panchayats* when they are suitably staffed.

7.70 Karnataka has for several years had a local cess on land revenue which is absorbed into general revenues out of which funds are devolved to *panchayats* as determined by the State Finance Commission. There is also no system like that in Gujarat, Rajasthan, Madhya Pradesh, Tamilnadu and Uttar Pradesh of allowing *panchayats* to levy a capped cess on land revenue. In our view, land revenue is suited for levy by *panchayats*. Local knowledge is needed for applying the tax and if taxpayers perceive a close relationship between tax payment and benefits received, compliance and fund utilisation improve. We suggest, therefore, that government seriously consider transferring the levy to *panchayats* to strengthen their financial responsibilities.

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Annexure I

Receipts from land revenue in major States

(Rs.crs.)

States	85-86	86-87	87-88	88-89	89-90	90-91	91-92	92-93	93-94	94-95	95-96	96-97	97-98	98-99
Andhra Pradesh	21.23	13.11	16.24	41.53	32.85	28.70	30.37	65.36	62.24	60.25	57.50	67.95	72.95	103.38
Bihar	27.84	26.57	15.58	18.56	15.00	20.00	13.00	19.83	24.81	25.81	28.78	24.86	23.56	24.68
Gujarat	17.25	21.14	18.83	25.62	30.62	34.19	36.61	46.00	59.16	60.75	77.48	87.58	75.13	71.98
Haryana	3.79	2.33	0.53	0.73	0.73	0.94	1.09	1.35	1.35	1.34	1.31	2.43	3.93	3.88
Karnataka	7.85	10.66	17.31	18.41	15.17	15.36	17.17	16.78	16.07	19.78	28.56	46.04	44.58	38.00
Kerala	5.83	6.14	6.96	11.59	11.04	11.12	11.44	11.85	19.79	22.65	23.71	22.33	23.75	32.72
Madhya Pradesh	19.55	15.52	19.41	24.04	20.54	24.80	30.67	28.55	31.47	24.58	20.22	24.04	28.14	26.97
Maharashtra	37.37	29.68	48.74	45.84	79.29	61.64	44.11	71.66	76.91	113.84	120.52	109.96	92.09	112.46
Orissa	15.92	20.81	30.16	35.60	78.94	81.90	24.77	27.16	31.46	31.00	39.47	35.20	38.69	58.57
Punjab	3.23	3.03	2.97	3.21	3.15	2.63	3.50	3.65	2.90	3.87	3.20	3.02	3.57	2.90
Rajasthan	15.62	20.02	22.63	28.48	36.96	36.33	32.58	30.09	22.79	38.38	33.87	37.74	44.77	33.27
Tamilnadu	16.46	12.89	16.98	15.06	13.82	14.43	26.50	19.30	31.87	35.27	25.21	18.77	60.31	28.29
Uttar Pradesh	27.91	29.48	35.76	35.77	53.16	39.65	42.21	60.31	47.77	53.80	62.53	72.63	66.57	88.34
West Bengal	126.23	149.65	187.01	279.68	287.45	218.06	278.23	172.75	223.48	593.11	755.31	468.32	439.46	325.37
Total	346.08	361.03	439.11	584.12	678.72	589.75	592.25	574.64	652.07	1084.43	1277.67	1020.87	1017.50	950.81

Annexure II

Receipts from agricultural income tax in major States

(Rs.crs.)

States	85-86	86-87	87-88	88-89	89-90	90-91	91-92	92-93	93-94	94-95	95-96	96-97	97-98	98-99
Karnataka	6.90	8.71	11.42	10.46	15.52	7.23	9.07	10.86	9.01	16.82	49.73	39.53	30.05	48.50
Kerala	20.83	16.26	9.60	13.83	16.52	23.94	35.12	12.52	20.88	17.24	26.08	12.10	21.38	27.02
Tamilnadu	19.32	10.03	6.57	6.78	9.00	17.97	26.20	20.04	12.77	16.73	19.47	13.86	39.36	38.53
West Bengal	18.92	6.09	8.11	5.99	14.28	29.99	27.61	7.35	13.11	8.21	-4.00	2.18	6.70	15.86
Total	65.97	41.09	35.70	37.06	55.32	79.13	98.00	50.77	55.77	59.00	91.28	67.67	97.49	129.91

Source:- RBI studies of State finance of various years furnished by Institute for Social and Economic Change Bangalore.

Annexure III

Combined receipts from land revenue and agricultural income tax in 14 major States

(Rs.crs.)

States	85-86	86-87	87-88	88-89	89-90	90-91	91-92	92-93	93-94	94-95	95-96	96-97	97-98	98-99
Andhra Pradesh	21.23	13.11	16.24	41.53	32.85	28.70	30.37	65.36	62.24	60.25	57.50	67.95	72.95	103.38
Bihar	27.84	26.57	15.58	18.56	15.00	20.00	13.00	19.83	24.81	25.81	28.78	24.86	23.56	24.68
Gujarat	17.25	21.14	18.83	25.62	30.62	34.19	36.61	46.00	59.16	60.75	77.48	87.58	75.13	71.98
Haryana	3.79	2.33	0.53	0.73	0.73	0.94	1.09	1.35	1.35	1.34	1.31	2.43	3.93	3.88
Karnataka	14.75	19.37	28.73	28.87	30.69	22.59	26.24	27.64	25.08	36.60	78.29	85.57	74.63	86.50
Kerala	26.66	22.40	16.56	25.42	27.56	35.06	46.56	24.37	40.67	39.89	49.79	34.43	45.13	59.74
Madhya Pradesh	19.55	15.52	19.41	24.04	20.54	24.80	30.67	28.55	31.47	24.58	20.22	24.04	28.14	26.97
Maharashtra	37.37	29.68	48.74	45.84	79.29	61.64	44.11	71.66	76.91	113.84	120.52	109.96	92.09	112.46
Orissa	15.92	20.81	30.16	35.60	78.94	81.90	24.77	27.16	31.46	31.00	39.47	35.20	38.69	58.57
Punjab	3.23	3.03	2.97	3.21	3.15	2.63	3.50	3.65	2.90	3.87	3.20	3.02	3.57	2.90
Rajasthan	15.62	20.02	22.63	28.48	36.96	36.33	32.58	30.09	22.79	38.38	33.87	37.74	44.77	33.27
Tamilnadu	35.78	22.92	23.55	21.84	22.82	32.40	52.70	39.34	44.64	52.00	44.68	32.63	99.67	66.82
Uttar Pradesh	27.91	29.48	35.76	35.77	53.16	39.65	42.21	60.31	47.77	53.80	62.53	72.63	66.57	88.34
West Bengal	145.15	155.74	195.12	285.67	301.73	248.05	305.84	180.10	236.59	601.32	751.31	470.50	446.16	341.23
Total	412.05	402.12	474.81	621.18	734.04	668.88	690.25	625.41	707.84	1143.43	1368.95	1088.54	1114.99	1080.72

Source:- RBI studies of State finance of various years furnished by Institute for Social and Economic Change Bangalore.

Annexure IV

Per capita receipts from land revenue & agricultural income tax in 14 major States.

(Rs.)

States	85-86	90-91	93-94	97-98	98-99
Andhra Pradesh	4	4	9	10	14
Bihar	4	2	3	2	3
Gujarat	5	8	14	16	15
Haryana	3	1	1	2	2
Karnataka	4	5	5	15	17
Kerala	10	12	13	14	19
Madhya Pradesh	3	4	5	4	3
Maharashtra	5	8	9	10	13
Orissa	6	26	10	11	17
Punjab	2	1	1	2	1
Rajasthan	4	8	5	9	6
Tamilnadu	7	6	8	16	11
Uttar Pradesh	2	3	3	4	6
West Bengal	24	37	33	58	44

Source: Computed on data from RBI studies of State finance of various years furnished by the

Annexure V

Tax / NSDP ratios for land revenue & agricultural income tax in 14 major States and shares of such taxes in own tax revenue

(%)

States	Tax / NSDP ratios					Share in own tax revenue			
	85-86	90-91	93-94	97-98	98-99	85-86	90-91	93-94	97-98
Andhra Pradesh	0.16	0.09	0.12	0.08	0.10	1.48	1.08	1.62	1.03
Bihar	0.23	0.09	0.07	0.04	0.04	4.84	1.75	1.42	0.99
Gujarat	0.14	0.14	0.14	0.09	0.08	1.60	1.42	1.50	1.14
Haryana	0.07	0.01	0.01	0.01	0.01	0.76	0.09	0.08	0.17
Karnataka	0.14	0.11	0.07	0.12	0.11	1.37	0.97	0.66	1.16
Kerala	0.41	0.29	0.17	0.09	0.11	3.65	2.62	1.73	1.00
Madhya Pradesh	0.16	0.09	0.07	0.04	0.03	2.35	1.41	1.18	0.62
Maharashtra	0.14	0.11	0.08	0.05	0.06	1.58	1.20	1.00	0.67
Orissa	0.26	0.85	0.20	0.14	0.19	5.57	12.25	3.66	2.72
Punjab	0.04	0.02	0.01	0.01	0.01	0.48	0.20	0.13	0.12
Rajasthan	0.20	0.20	0.08	0.08	0.06	2.76	2.99	1.17	1.24
Tamilnadu	0.26	0.12	0.09	0.11	0.06	2.31	1.04	0.93	1.15
Uttar Pradesh	0.11	0.08	0.06	0.05	0.06	2.16	1.25	1.16	0.95
West Bengal	0.83	0.79	0.49	0.50	0.32	12.92	11.63	8.12	9.88

Old series NSDP data used up to 1992-93

Source: Computed on data from RBI studies of State finance of various years

Annexure VI

Land classification & land revenue (actual & adjusted for inflation up to 31-8-94)

District	Area in lakh hectares					Assessment in lakh rupees					Adjusted for inflation				
	Dry	Wet	Garden	Plantation	Total	Dry	Wet	Garden	Plantation	Total	Dry	Wet	Garden	Plantation	Total
Bangalore (U)	1.18	0.15	0.11		1.44	3.59	1.40	1.39		6.38	26.68	8.47	10.33		45.48
Bangalore (R)	2.69	0.25	0.23		3.17	9.30	1.45	2.46		13.21	69.13	10.78	18.29		98.20
Kolar	4.15	0.54	0.59		5.28	13.66	2.74	4.59		20.99	101.54	20.37	34.12		156.03
Tumkur	5.71	0.41	0.69		6.81	12.58	1.72	7.08		21.38	93.51	12.78	52.63		158.92
Chitradurga	4.06	0.19	0.32		4.57	18.07	0.42	1.36		19.85	134.32	3.12	10.11		147.55
Davanagere	5.46	0.16	0.12		5.74	8.76	0.64	0.42		9.82	65.11	4.76	3.12		72.99
Shimoga	1.15	1.45	0.12		2.72	1.56	18.94	4.13		24.63	11.60	140.78	30.70		183.08
Mysore	2.90	0.57	0.12		3.59	10.90	2.85	1.98		15.73	81.02	21.18	14.72		116.92
C' R' Nagar	2.01	0.12	0.07	0.0029	2.20	6.44	0.88	1.00	0.07	8.39	47.87	6.54	7.43	0.52	62.36
Mandya	2.26	0.92	0.29		3.47	5.76	5.77	2.21		13.74	42.81	42.89	16.43		102.13
Kodagu		0.48	0.00	0.7251	1.21	0.30	6.26	0.03	16	22.59	2.23	46.53	0.22	119.6	168.58
D' Kannada	6.74	1.28	0.23	0.0324	8.28	2.97	8.16	8.67	0.29	20.09	22.08	60.65	64.45	2.16	149.34
Udupi	2.10	0.83	0.14	0.0038	3.07	2.64	8.99	3.20	0.02	14.85	19.62	66.82	23.79	0.15	110.38
Hassan	3.02	0.63	0.35	0.3925	4.39	9.80	6.12	5.41	5.29	26.62	72.84	45.49	40.21	39.32	197.86
C' Mangalore	1.44	0.61	0.27		2.32	5.56	6.87	5.09	11.82	29.34	41.33	51.07	37.83	87.86	218.09
Belgaum	10.04	0.40	0.19		10.63	33.65	3.65	2.85		40.15	250.12	27.13	21.18		298.43
Bijapur	8.12	0.03	0.05		8.20	16.92	0.16	0.30		17.38	125.77	1.19	2.23		129.19
Bagalkot	4.39	0.04	0.03		4.46	16.82	0.07	0.52		17.41	125.03	0.52	3.87		129.42
Dharwad	3.30	0.28	0.01	0.0003	3.59	21.39	3.78	0.08	0.01	25.26	158.99	28.10	0.59	0.07	187.75
Gadag	4.90	0.02	0.01	0.0054	4.94	16.50	0.11	0.04	0.02	16.67	122.65	0.82	0.30	0.15	123.92
Haveri	3.33	0.44	0.03	0.0022	3.80	15.23	4.10	0.28	0.03	19.64	113.21	30.48	2.08	0.22	145.99
U'Kannada	0.45	0.80	0.12		1.37	0.78	9.13	5.91		15.82	5.80	67.86	43.93		117.59
Gulbarga	11.99	0.11	0.09		12.19	47.94	0.57	0.44		48.95	356.34	4.24	3.27		363.85
Raichur	6.06	1.21	0.04		7.31	23.09	6.40	0.32		29.81	171.63	47.57	2.38		221.58
Koppal	4.57	0.07	0.02		4.66	15.73	0.92	0.16		16.81	116.92	6.84	1.19		124.95
Bellary	12.35	0.99	0.00		13.34	7.05	1.97	0.00		9.02	52.40	14.64			67.04
Bidar	4.67	0.03	0.10	0.0026	4.80	18.82	0.26	0.80	0.02	19.90	139.89	1.93	5.95	0.15	147.92
TOTAL	**119.04**	**13.01**	**4.34**	**1.1672**	**137.56**	**345.81**	**104.33**	**60.72**	**33.57**	**544.43**	**2570.44**	**773.55**	**451.35**	**250.2**	**4045.54**

Source: Revenue department

Annexure VII

KHATA HOLDERS AND LAND REVENUE DEMAND

(lakhs)

DISTRICT	NO. OF KHATAS	NO. OF REMISSION KHATAS	NO. OF PAYMENT KHATAS	LAND REVENUE ASSESSMENT	LAND REVENUE REMITTED	LAND REVENUE LEVIED
Bangalore (U)	1.49	0.61	0.88	6.17	2.09	4.08
Bangalore (R)	3.37	1.75	1.62	13.77	4.71	9.06
Kolar	4.61	1.52	3.09	21.52	1.55	19.97
Tumkur	6.05	5.30	0.75	21.37	16.28	5.09
Chitradurga	3.16	1.98	1.18	9.17	1.18	7.99
Davanagere	2.47	1.30	1.17	11.91	4.87	7.04
Shimoga	2.27	0.43	1.84	26.38	4.27	22.11
Mysore	3.90	1.62	2.28	16.63	4.63	12.00
C' R' Nagar	1.71	1.06	0.65	8.63	2.63	6.00
Mandya	5.77	2.20	3.57	13.25	3.24	10.01
Hassan	4.04	1.09	2.95	26.62	8.24	18.38
C' Mangalore	1.93	0.71	1.22	31.38	27.24	4.14
Kodagu	0.70	0.06	0.64	25.94		25.94
D' Kannada	5.71	2.40	3.31	14.30	5.38	8.92
Udipi	2.63	1.95	0.68	14.85	4.65	10.20
Bellary	2.06	1.60	0.40	8.44	6.02	2.42
Bidar	1.66	1.36	0.30	19.89	17.20	2.69
Gulbarga	5.46	4.37	1.09	53.74	26.23	27.51
Raichur	2.63	1.39	1.24	29.79	10.28	19.51
Koppal	2.35	1.43	0.92	17.33	9.09	8.24
Belgaum	4.51	1.84	2.67	44.10	5.32	38.78
Bijapur	4.29	3.22	1.07	17.38	6.32	11.06
Bagalkot	2.34	1.37	0.97	19.31	5.62	13.69
U'Kannada	1.40	0.75	0.65	28.59	4.28	24.31
Dharwad	1.27	0.72	0.55	20.39	7.37	13.02
Gadag	1.56	1.16	0.40	16.53	6.99	9.54
Haveri	1.59	0.93	0.66	19.29	11.38	7.91
Total	**80.93**	**44.12**	**36.75**	**556.67**	**207.06**	**349.61**

Source: Revenue department

Annexure VIII

Receipts from agricultural income tax in Karnataka

Year	Tax collected (in Rs.crs.)	Growth rate
1989-90	15.52	48.37
1990-91	7.23	-53.41
1991-92	9.07	25.45
1992-93	10.86	19.73
1993-94	9.01	-17.03
1994-95	16.82	86.68
1995-96	49.78	195.96
1996-97	39.53	-20.59
1997-98	30.05	-23.98
1998-99	48.50	61.39
1999-2000	31.62	-34.80
2000-2001	23.77	-24.83

Source: Commercial tax department

Annexure IX a

(Estimated Tax Potential) - Option I

(income from fully irrigated holdings at Rs.25000 / hectare, from fully dry holdings at Rs.5000/hectare)

Holding size (hectares)	Wholly irrigated holdings			Partially irrigated holdings			Wholly unirrigated holdings			Total	
	No.(' 000)	Estimated net income per holding (Rs. '000)	Tax (Rs. lakhs)	No.(' 000)	Estimated net income per holding (Rs. '000)	Tax (Rs. lakhs)	No.(' 000)	Estimated net income per holding (Rs. '000)	Tax (Rs. lakhs)	Holdings (' 000)	Tax (Rs. lakhs)
4 - 5	28	100.75	161							28	161
5 - 7.5	26	134.5	1974							26	1974
7.5 - 10	10	187.5	1750							10	1750
10 - 20	6	287.5	2805	23	123.15	1065				29	3870
20 and above	0.6	583.25	849	3	248.15	1048	8	116.25	260	11.6	2157
	70.6		7539	26		2113	8		260	104.6	9912

Category of holdings	Total no. of holdings (' 000 s)	Area (' 000 hectares)	Tax expected (Rs. lakhs)	Holdings paying tax		Area covered by tax	
				No. (' 000)	% to total holdings	' 000 has.	% to total area
Wholly irrigated	1194	1472	7539	71	5.95	408	27.71
Partially irrigated	646	1756	2113	26	4.02	93	5.29
Wholly unirrigated	4182	7936	260	8	0.19	186	2.34
Total	6022	11164	9912	105	1.74	687	6.15

Annexure IX b

(Estimated Tax Potential) - Option II

(income from fully irrigated holdings at Rs.15000 / hectare, from fully dry holdings at Rs.3000/hectare)

Holding size (hectares)	Wholly irrigated holdings			Partially irrigated holdings			Wholly unirrigated holdings			Total	
	No.(' 000)	Estimated net income per holding (Rs. '000)	Tax (Rs. lakhs)	No.(' 000)	Estimated net income per holding (Rs. '000)	Tax (Rs. lakhs)	No.(' 000)	Estimated net income per holding (Rs. '000)	Tax (Rs. lakhs)	Holdings (' 000)	Tax (Rs. lakhs)
7.5 - 10	10	112.50	250	-	-	-	-	-	-	10	250
10 - 20	6	172.50	870	-	-	-	-	-	-	6	870
20 and above	0.6	349.95	393	3	148.89	293	-	-	-	3.6	686
	16.6		1513	3		293	-	-	-	19.6	1806

Category of holdings	Total no. of holdings (' 000 s)	Area (' 000 hectares)	Tax expected (Rs. lakhs)	Holdings paying tax		Area covered by tax	
				No. (' 000)	% to total holdings	' 000 has.	% to total area
Wholly irrigated	1194	1472	1513	16.6	1.39	155	10.53
Partially irrigated	646	1756	293	3	0.46	81	4.61
Wholly unirrigated	4182	7936	-	-	-	-	-
Total	6022	11164	1806	19.6	0.33	236	2.11

CHAPTER VIII

TAXES ON MINES AND MINERALS

CHAPTER VIII

TAXES ON MINES AND MINERALS

8.1 Although taxes on mines and minerals are covered under Entry 50 of the State list of the Indian Constitution, revenue from the levy is accounted for under non-tax revenue in the State budget. Previous Commissions appointed to study the State's fiscal structure in 1981 and 1991 have not examined this item as a source of tax revenue. Royalties on mineral exploitation are, however, considered as taxation in public finance discourse; in resource-rich countries, they often account for the major share of public revenues. In the light of the existing Constitutional and academic position, therefore, the Commission has in this chapter studied existing mechanisms of levying royalties on minerals and made appropriate recommendations.

Principles underlying taxes on natural resource exploitation

8.2 The fiscal regime for exploitation of natural resources, principally minerals and mineral oils like petroleum, is treated as a distinct entity in public finance discourse, because of issues related to public responsibility for conservation and proper extraction. Exploitation of mineral resources tends to be an "enclave activity"(1) with few direct links to the domestic economy. In this area, therefore, in most countries, the public sector tends to perform not only a sovereign fiscal role but also functions as owner of natural resources with responsibility for translating the benefits accruing from resource exploitation into wider economic benefits for the country's population. This means that attention has to be paid to the timing and pricing of resource extraction and the distribution of benefits with an eye on both the needs of current economic growth as also those of conservation for future generations. A stable fiscal environment and efficient resource development will be advantageous for both the government and resource extracting companies; the problem is that each of these parties may try to shift prospecting and other risks to the other. Long term agreements are the norm in this area because negotiating strength shifts between the players in the course of discovery and extraction of the natural resource. The advantage enjoyed by the resource company in the exploration phase passes on to government when profits are generated but it moves back to the company when the resource is getting exhausted. To protect both parties, product-based fiscal instruments (which guarantee a minimum payment for natural resource exploitation to the government) have to be supplemented with profit-based instruments (which give government some share in returns from projects that are more profitable than expected).

8.3 Governments often resort to sharing ownership through equity participation in the extracting company to get a fair share in profits and to control the pace and manner of extraction. This has its own drawbacks, mostly linked to the responsibilities and pains of direct involvement in production decisions. From the purely fiscal viewpoint, government as the owner of mineral rights is entitled to receive an additional payment

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(1)Nellor, David C.L."Taxation of Mineral and Petroleum Resources" in "Tax Policy Handbook" edited by Parthasarathi Shome, International Monetary Fund 1995. This section is based on the cited article.

over and above the normal tax on corporate income. The instrument chosen for the purpose must satisfy the usual public finance requirement of minimal distortion of investment and production decisions. It must also, however, be geared to what the investor is willing to pay and the minimum return that government is willing to accept. One-time auctions or lease bonuses, although economically efficient and easy to administer (the investor bears the risk and government gets a fixed return), may not yield the expected revenue, as investors are likely to peg their offers at a low level for fear of future changes in policies. Government, on its part, may have to independently assess the opportunity cost of current resource extraction vis a vis conservation and future exploitation.

8.4 For this reason, a royalty, levied on the volume or value of resources extracted, tends to be the most preferred tax tool for raising revenues from natural resources. Royalties effectively arbitrate between the investor's expectations of current profit from resource extraction and government's opportunity cost (since a resource once exploited is lost). They yield revenues as soon as production starts, ensure a minimum return to the exchequer and are easy to administer. However, they increase the marginal cost of resource extraction and discourage development of marginal projects or poor quality resources within viable projects. Royalties should be based on transparent price formulae- the minehead price is generally used; sometimes it is replaced by the export f.o.b. price. The maximum amount of royalty that can be imposed is the difference between the price adopted and the extraction cost. Royalty rates should be readily and predictably adjustable to reflect relevant costs. They should be income tax deductible as a component of production cost. They could also vary across projects depending on profitability perceptions and market prices.

8.5 Taxation of natural resource exploitation in our country is also based on the royalty mechanism. A distinctive feature of the Indian situation is the elaborate structure that has been put in place through Constitutional and statutory measures to regulate and manage royalties for different minerals and metals within the federal framework.

Constitutional position

8.6 As indicated earlier, State governments have been empowered under Entry 50 of List II (the State list) of the Seventh Schedule of the Constitution to levy taxes on mineral rights but this is subject to limitations imposed by Central laws relating to mineral development, since Entry 53 of List I (the Central list) gives the Centre the right to regulate and develop oilfields and mineral oil resources and Entry 54 the right to regulate mining and mineral development. Entry 54 invests the Central Parliament itself with power to legislate the extent to which regulation of mining and mineral development is expedient in the public interest. The Mines and Minerals (Development and Regulation) Act of 1957 was enacted by the Centre in exercise of these powers.

8.7 The fundamental principle underlying the intermeshing of State and Central powers is the distinction between major and minor minerals. The tax and regulatory structure for the latter category (defined under Section 3e of the Central Act) are determined by State Rules. All other minerals are treated as major minerals and royalty rates specified in the Second Schedule of the Central Act itself. Revenue from all royalties, however, is realised and utilised by State governments. The manner in which federal supervision is coordinated with State administration is discussed in detail further on in the chapter.

8.8 Karnataka is estimated to have more than 40000 sq. kms.of green stone belt containing vast mineral deposits. It is also well known for iron ore, chromite and manganese deposits. About 20 varieties of major minerals and 5 varieties of minor minerals are being exploited today, but there is considerable scope to step up mining and promote the growth of mineral based industries.

Revenue significance

8.9 Revenues realised from royalties and fees on minerals in Karnataka are presented in Table I, indicating separately revenues from major and minor minerals and, within minor minerals, revenues from granite alone. Realisations were insignificant up to 1992-93; the subsequent spurt, particularly in 1994-95 and 1995-96-was attributable both to growth in revenue from minor minerals like granite as to growth in revenue from major minerals like limestone. This was due to enhancement of royalty and dead rent rates for granite (increases were between 21/2 to 3 times), judgment of the High Court in 1993-94 making royalty applicable to leases on private lands in old Mysore area in respect of some minerals including granite and a judgment of the Supreme Court in 1994-95 which enforced increases in the royalty for limestone already notified by the Central government in 1992-93. Revenue has stabilised at around Rs. 100 crs. (The Rs. 10 crs. increase in revenue from granite in 1997-98 is due to one-time royalty payment on a disputed matter from a single company-Gem Granites). Revenues have been fairly stable since then, perhaps because granite values have declined.

Table I

Revenue Realised from Minerals

(Rs.crs.)

	Major minerals	Minor minerals	Total	of which granite
1990-91	8.39	5.67	14.06	1.33
1991-92	12.12	9.37	21.49	2.73
1992-93	24.68	9.88	34.56	2.76
1993-94	20.54	17.58	38.12	8.00
1994-95	24.50	30.60	55.10	21.09
1995-96	62.17	41.99	104.16	26.06
1996-97	43.51	49.17	92.68	29.76
1997-98	50.58	62.55	113.13	39.28
1998-99	50.57	44.42	94.99	21.18
1999-2000	56.77	52.65	109.42	21.79

Source: - Directorate of Mines and Minerals

8.10 On the whole, therefore, the contribution of major and minor minerals to revenue has been practically the same in recent years. Revenue from granite, which did not earlier account for a major share of total revenue, became increasingly important after 1993-94. The highest contribution of revenue from granite to total revenue was in 1994-95 when almost half the revenue was accounted for by granite. In later years, the share has fluctuated between 20% and 35% of the total revenue from this head. If we consider revenue generated by minor minerals alone, revenue from granite, which accounted for 20% before 1993-94, rose to almost 2/3ds of the revenue from minor minerals in 1997-98. In succeeding years, however, the share of granite in revenue from minor minerals has come down below 50%.

Major statutory provisions

8.11 The Central Act differentiates between "mineral oils" (natural gas and petroleum) and "minerals" (other minerals) and defines "minor minerals" which are subject to regulation at the State level. Soapstone, sand and limestone figure as both major and minor minerals. Low grade limestone, sand used for construction and soapstone used for handicrafts are treated as minor minerals subject to royalty rates laid down in State Rules; other varieties are considered as major minerals. The Central Act also defines the kinds of leases and permits that can be issued, stipulates that mining and prospecting can only be done under a lease or licence and provides for termination of such permissions under certain conditions. In respect of minerals specified in the First Schedule (coal and lignite, 11 atomic minerals and 10 other minerals), the prior permission of the Central government is essential before leases are granted by States. This enables the Centre to effectively control the manner and speed of exploitation of critical minerals, which are important from the strategic point of view for defence or industry.

8.12 In the case of major minerals, the Act itself lays down important lease conditions like minimum currency periods apart from eligibility criteria for applicants. Royalty rates for 51 major minerals are also laid down in the Second Schedule of the Act (in its present form, the Schedule specifies rates for 49 items and validates the rates for coal and sand for stowing laid down in a Coal Ministry notification). Section 13 of the Act defines the powers of the Central government to make rules in respect of major minerals and Section 15 those of the State government in respect of minor minerals. States determine and collect royalty and dead rent on mining leases and other mineral concessions on minor minerals under State-specific Rules.

8.13 The major set of Central Rules issued under the Act are the Mineral Concession Rules of 1960 and the Mineral Conservation and Development Rules 1988. The latter pertain principally to the establishment and functions of the Indian Bureau of Mines for regulating the development of mining. The former set of rules prescribe in detail the procedure for the grant of permits and licences for reconnaissance and prospecting as well as for operating mining leases on government and private land; thus, they apply wholly to the exploitation of major minerals (except coal and atomic minerals).

8.14 Rules have also been issued by the State relating to minor minerals in exercise of powers granted under the Central Act. The Karnataka Minor Mineral Concession Rules of 1994, which replaced the Karnataka Minor Minerals Concession Rules of 1969, cover the entire gamut of regulatory and revenue-raising issues for minor minerals. The revised Karnataka Rules, drafted on the basis of the recommendations made by a Joint Legislative Committee in 1993, came into effect from 28/5/1994. These Rules relate to the grant of leases and licences for minor minerals and cover rates of royalty and dead rent, security deposits and fees, transport permits and penalties (including confiscation) for statutory violations.

8.15 To handle the divergent granite exploitation policies adopted by States to respond to the revenue earning possibilities opening up in this area in the eighties and nineties, the Central government formulated the Granite Conservation and Development Rules in 1999 by exercising powers under Section 18 of the Mines and Minerals (Development and Regulation) Act of 1957 for "conservation and systematic development" of minerals and "protection of the environment by controlling pollution caused by prospecting or mining operations". These rules prescribe mechanisms for prospecting and mining granite within the ambit of formal scientifically formulated schemes implemented by qualified personnel.

8.16 The cumulative effect of the present legislation is that it is the Central government which has the right to define "minor" minerals and fix the royalty rates for major minerals. Leases for critical minerals specified in the Act can only be given with Central approval-gold, iron ore, manganese and copper are the minerals in this list that are important from the point of view of Karnataka. Detailed procedural mechanisms have also been laid down in Central rules relating to minimum lease periods, eligibility and lease conditions and the like for major minerals to ensure substantial administrative uniformity across the country. In respect of minor minerals, however, State governments are authorised to fix royalty and dead rent rates and determine procedures for exploitation. Revenues from mineral exploitation accrue to States alone. Central royalty and other ceilings are therefore used to keep the prices of minerals, which are vital inputs into industry, at competitive and affordable levels. Central control is also exercised on the number of leases granted for strategic minerals to regulate the manner and speed of resource exploitation.

General conditions for leases, licences and permits

8.17 Leases, licences and permits can be issued under the Central Act: mining leases for undertaking mining operations, prospecting licences for exploring, locating or proving the existence of mineral deposits and reconnaissance permits for preliminary prospecting through surveys or mapping. The State government is competent to grant these permissions and extend and rescind them, but in the case of minerals specified in the First Schedule it has to consult the Centre or take its permission. The minor minerals, which fall within State control, are mentioned in the Act-they are building stones, gravel, ordinary clay and sand. The list can be increased by notification by the Central government, but no notification has been issued so far. Granite, which comes under the category of building stones, is now a significant revenue earner for many States. There have been moves to transfer it to the category of major minerals but these have been stoutly resisted by States. The Granite Conservation and Development Rules of 1999 only stipulate the measures required for environmental protection when granite quarrying is undertaken. It must also be noted that exploitation of major minerals is described as mining and that of minor minerals as quarrying. Reconnaissance and prospecting are done only in respect of major minerals. Leases are given for quarrying on public lands and licences for operations on private lands.

8.18 The Central Act prescribes, in general, long term lease contracts. Prospecting and reconnaissance permits can be given only for three years and mining leases for between 20 to 30 years. State Rules relating to minor minerals prescribe 20 years as the maximum term for quarrying leases for specified minor minerals with two renewals of 20 years each. For non-specified minor minerals the tenure is 5 years with two renewals of 5 years each. In the case of an industry based on a non-specified minor mineral, however, the lease could be for 10 years and each renewal for a period of 10 years. Quarrying leases granted by tender-cum-auction are also limited to 10 years, with two renewals possible, each of which is limited to the period of the original lease. For quarrying licences on private land, the maximum tenure is again 10 years, except in the case of granite, for which it is 20 years.

8.19 To prevent pre-emption of permits without actual exploitation, limits have been placed on the period within which resource exploitation should be done after a lease or permit is obtained. The Central Act specifies that leases should not be kept idle for a period more than 2 years; when this happens, unless specific extensions are sought within six months, they will be considered to have lapsed. States are also prohibited from reviving lapsed leases more than twice during the lease period. The Central Rules detail the reasons which should be taken into account by States for considering extensions and the time limits and manner in which requests for extensions should be processed. There are no such restriction in the case of prospecting licences. Under State Rules, more than a year's delay in commencement of quarrying after grant of the lease or a year's break in quarrying can render the lease liable to cancellation, but there are again provisions for two relaxations of this requirement. When leases for specified minor minerals are taken for setting up an industry, the industry must be established within 2 years and there is provision for a year's extension.

8.20 There are also provisions to prevent large monopoly operations which do not apply to government undertakings. The Central Act itself prescribes that a single person cannot acquire a mining lease for more than ten sq. kms., a prospecting licence for more than 25 sq. kms and a reconnaissance permit for more than 10000 sq. kms. (5000 sq. kms.per permit). For specified minor minerals, the State Rules prescribe a maximum area of 50 acres for established export-oriented granite cutting and polishing units, 40 acres for established or proposed small units and proposed EOUs for cutting and polishing granite and cooperatives of Scheduled Castes and Tribes or stoneworking weaker sections and 10 acres for others. For non-specified minor minerals, the limit is 25 acres. The area covered by reconnaissance permits is also progressively reduced with the passage of time so that there is a distinct incentive to quickly complete reconnaissance work.

Determination of royalty and fee rates

8.21 Revenue is realised through two sets of fees: royalties and dead rent. Royalties for major minerals are specified in the Second Schedule of the Central Act and dead rent (payable when production is not done and royalty not paid) areawise in the Third Schedule. Present rates of royalties and dead rent for major minerals are given in Annexure I. There is a progressive move from specific rates to *ad valorem* royalty rates. The latter are generally pegged to sale prices of ore at the pithead. For some widely traded minerals, the royalty rate is tied to international indices like London Metal Exchange or Bullion Market prices of the final metal; actual royalty payable is based on the metal content of the ore. *Ad valorem* rates range from below 1% to 20% (for gypsum). To enable government to obtain a fair share of the rent derived by the mining firm from the exploitation of each mineral, the Central Ministry estimates the exploitation cost using the services of agencies like the Indian Bureau of Mines and determines the appropriate rate as a percentage of the pithead sale price. Existing procedures which divide the responsibility for levy of royalty and utilisation of proceeds between the Centre and the States may not be conducive to effective resource-raising. However, there may be no better alternative within the federal fiscal structure. It is desirable if information relating to exploitation costs for different minerals is regularly shared with States so that the royalty determination logic becomes transparent and scientific. The Act itself prohibits increase of rates of royalty and dead rent within a period of three years of their fixation. The present rates apply from 12/9/2000.

8.22 As in the case of motor vehicles regulation, a permanent institutional mechanism is in place for continuing policy coordination between the Centre and the States, which also provides for consultation with other interested parties. This is the Mineral Advisory Council chaired by the Central Minister for Mines, which holds half-yearly formal meetings. Informal meetings are also convened frequently at the official level particularly when rates are to be revised every 3 years. Such increases are rarely postponed although the consultation process takes around 18 months. There is persistent demand from States for automatic adjustment of royalty rates to inflation, but rate increases are generally looked at in the context of import prices. The Federation of Indian Mineral Industries, which is also a member of the Mineral Development Council, lobbies through this body to keep royalty rates within manageable limits.

8.23 Given the existing statutory position, it would be useful to consider whether Karnataka is affected from the revenue point of view by the Central ceilings on major minerals. Although the State is rich in major minerals and stones like gold, silver, diamond, corundum, garnet, iron ore, limestone and dolomite, asbestos, bauxite, China clay, chromite, copper ore, manganese, quartz and silica sand, vanadium, talc, clay, kyanite and magnesite, it was indicated by the Directorate of Mines and Geology that the principal areas of concern are with regard to iron ore and limestone. Karnataka produces 12 million tones of the former and 10 million of the latter. The royalty for iron ore has been fixed separately for lumps, fines and concentrates with specific rates graded on iron content. It was indicated that existing royalty rates are in line with international prices. Since 75% of the iron ore mined in Karnataka is exported, there are adjustment problems when international prices fluctuate as the present statute does not provide for changes in royalty rates within a 3 year period. This can lead to both unintended windfall profits or erosion of margins for mining companies, neither of which is desirable. A solution which could be explored to ensure equity as well as stability might be to shift to royalty on *ad valorem* basis. This presupposes a reliable international price index to which royalty rates could be pegged and there is no such index today. A large quantity of the iron ore mined in Karnataka is by the Central PSU-Kudremukh Iron Ore Company. Ore mined in the private sector is also canalised through two public sector companies, M.M.T.C. and N.M.D.C. Administratively, therefore, it should be possible to move to an *ad valorem* rate. Exploitation costs could, however, be somewhat inelastic even if the rate of exploitation can be slowed down and variable costs reduced when prices decline. Government may, therefore, make an indepth examination of the matter of fixing an *ad valorem* royalty rate for iron ore and take up the issue if necessary with the Centre after building up support from Orissa (the other major State concerned with this issue).

8.24 In the case of limestone, which is principally used in the domestic cement industry, Karnataka has the second largest deposits after Madhya Pradesh. Local exploitation is, however, inadequate and the State is a net importer of cement. For cement grade limestone also, the present royalty rate is specific; Rs. 40 has to be paid for every tonne that is quarried. The State government could consider conversion of this rate also to an *ad valorem* rate and take it up with the Centre after obtaining the support of other affected States.

8.25 As for minor minerals, existing royalty rates have been laid down in Schedule 2 of the Karnataka Minor Minerals Concession Rules. The present rates date from 28/5/1994. Although they can also be revised every 3 years, there has been no increase for 7 years. Annexure II gives the current picture and the rate structure in Tamilnadu and Andhra Pradesh. Rates in these States date from June 1999 and June 2000 respectively. Rate structure, slabs and incidence vary in respect of both royalty and dead rent among States.

8.26 In the case of granite, a Granite Development Council was constituted on 15/6/1995 and reconstituted on 24/4/1998. An official subcommittee of this council had suggested harmonisation of the policies of different States relating to granite and this was accepted by a conference of State ministers. An official expert committee had then formulated ceilings for royalty and dead rent, which were accepted by the Council on 18/8/1999. These have now been suggested for implementation for three years with effect from 2000. The ceilings recommended for royalty on granite are as below:

	Rs./cum.
Premium variety (over 70 cms.)	2000
Premium variety (between 30 & 70 cms.)	1000
Premium variety (below 30 cms.)	500
Good variety (over 70 cms.)	1500
Good variety (between 30 & 70 cms.)	750
Good variety (below 30 cms.)	300
Average (over 70 cms.)	1000
Average (between 30 and 70 cms.)	500
Average (below 30 cms.)	200
Waste	25/tonne

8.27 For dead rent, the annual ceiling per hectare for premium varieties is Rs. 40000, for good varieties Rs. 30000 and for average varieties Rs. 20000. These recommendations are not statutorily binding on the State, since granite continues to be a minor mineral under the Central Act.

8.28 Dead rent is generally levied on area basis. For major minerals rates/hectare are low since such minerals are generally mined on extensive basis over large leaseholds. In the case of minor minerals, the Karnataka schedule is much more differentiated than that of compared States. Considering current rates in some neighbouring States and keeping in mind the fact that royalty and dead rent have not been revised in respect of minor minerals in Karnataka for some time, increases have been proposed at Annexure II.

8.29 Apart from royalties, revenue is also realised from fees and penalties. Since disaggregated data regarding various components of revenue is not maintained by the department, it is not possible to readily ascertain revenue realised from these items. The Mineral Concession Rules of 1960 issued by the Central government prescribe maximum and minimum fee rates for reconnaissance permits and application fees and security deposits for reconnaissance permits and mining leases for major minerals. Fees in the Central Rules date from January 2000. In the case of minor minerals, fees are laid down in the State Rules. The existing fee structure can be seen at Annexure III. Fees for minor minerals date from 1994 except in the case of those for survey and demarcation and transfer of quarrying licences which were revised last year. Keeping this in mind, further revisions have been proposed for certain items at Annexure III. It is also recommended that the proposal already made in the Karnataka Mineral Policy to amend Rule 19(a) of the Rules to permit transfer of leases for minor minerals on payment of 20% of the annual dead rent as premium may be implemented early.

8.30 The present method of reviewing royalty rates for minor minerals is *ad hoc* and unstructured, a sea change from the regularity and predictability of the system operating with regard to major minerals within the Central government. The Commission believes that it is necessary to streamline the existing mechanism. A statutory body consisting of officials and experts should be set up to regularly study quarrying costs and methods in respect of minor minerals. It should suggest appropriate royalty rates as well as procedural and administrative changes. This will enable the State to generate revenue in a scientific and environmentally sound manner.

8.31 The Central Act enables Central and State governments to reserve unleased areas for undertaking mining or prospecting operations through Central and State government bodies and agencies. After 20/12/1999, however, as per an amendment to the Act, such operations are liable to the same level of fees prescribed for private persons. While reserving areas for public sector exploitation, the Central government is required to consult the State concerned; State governments which go in for such reservation are required to obtain prior Central approval. In the wake of economic liberalisation, the Central Act and Rules were amended in 1999-2000 to permit the entry of private entrepreneurs for reconnaissance and prospecting as well as for exploitation. Earlier, certain precious metals like gold had been notified for exclusive public sector prospecting and exploitation. After the Act was amended in December 1999, however, these have been opened to private entrepreneurs; since they continue in the list of minerals specified in the First Schedule of the Act, Central government approval of such leases is required. The major minerals for which there has been substantial public sector exploitation in Karnataka in the past are gold, silver and iron ore (through Bharat Gold Mines Ltd., Hutti Gold Mines Ltd., Kudremukh Iron Ore Company and Mysore Minerals). Private participation is now being encouraged and 4 reconnaissance permits for gold, silver and diamond were granted last year for an area of 14000 sq. kms. to firms like de Beers.

8.32 A major concern in this area is environmental. The Central government has the power to restrict grant of leases and reconnaissance and prospecting licences for environmental reasons in respect of major minerals and the State government in respect of minor minerals. The Forest Conservation Act of 1980 provides for regulating mining in forest areas. After a Supreme Court decision of 12/12/1996, mining in forest areas has been subject to stringent clearances from the Forest department. Rule 8(2) of the Karnataka Rules of 1994 do not permit quarrying leases to be granted in forest lands to private persons. This is in line with the recommendations of the Joint Legislature Committee which considered granite quarrying before the Rules were amended. In today's liberalised environment there may be a case for reconsidering this decision, but only in the context of strict regulation of quarrying operations by the forest and mines and minerals department. The Central Granite Development Rules also provide environmental protection by stipulating quarrying on the basis of approved mining plans using qualified personnel. The environmental issue has again surfaced in the context of the renewal of the mining lease given to Kudremukh Iron Ore Company in the Western Ghats area of Chikmagalur district.

8.33 Another ticklish issue relates to the definition of mining as non-agricultural activity. If mining is treated as non-agricultural, agricultural land used for mining would have to be converted under the relevant provisions of the Land Revenue Act and Rules. Unless special concessional rates are laid down, this could even become an exorbitant levy. In addition, by a saving clause under Section 70 of the Karnataka Land Revenue Act of 1964, pattedars in old Mysore and old Madras area are outside the purview of the Karnataka Minor Minerals Concession Rules in respect of sub-soil minerals like granite if mining is done without creating a lease (except for provisions relating to the transport of granite). This has been confirmed by the High Court of Karnataka in State of Karnataka vs. Dundamada Shetty (ILR 1993 Kar 2605). As a result, an inequitous situation has been created and there is considerable revenue loss for government. There is a strong case for amending the Land Revenue Act to introduce a reasonable conversion fee for mining on agricultural land and dropping the saving clause of Section 70.

Penalties

8.34 Apart from determining the penalty for undertaking prospecting, mining and transport of minerals without permit and providing for compounding as well as confiscation of vehicles and tools used for unauthorised extraction and transport and minerals unauthorisedly extracted or transported, the Act also fixes the maximum penalty that can be laid down under rules issued under the Act by the Centre as well as the States. (Rs. 5000 and/or a year's imprisonment for the first offence and an additional Rs.

500/day for offences that continue after conviction). Details of penalties prescribed under the Central Act and Central and State Rules are given at Annexure IV.

8.35 A proposal has already been made in the Karnataka Mineral Policy to permit a three month extension for exploitation of a mining lease beyond the mandatory period of 45 days and charge a penalty of 9% of the annual dead rent for every month of delay or part. This is yet to be implemented.

Administration and evasion

8.36 Under Rule 36 of the State Rules, dead rent is payable in advance every six months. Both royalty and dead rent are expected to be collected before minerals are removed or transported. Illegal transportation is detected through check posts and by using a mobile squad. 90 days time is given for payment of dues after which a notice is issued; if they remain unpaid for a further two months, the security deposit is forfeited. Interest at 15% is also charged on amounts overdue beyond a period of 60 days. It was indicated by the department that evasion is controlled in respect of limestone which is used principally in cement factories by laying down a conversion ratio in cement factories which have not installed weighing machines. However, the prescribed ratio is now under dispute and the matter has been referred to the National Council for Cement and Building Materials Research for a detailed spot study. This must be expedited. In the case of iron ore, since sales are made by or through public sector undertakings it is expected that evasion is negligible.

8.37 Several administrative improvements have been contemplated in the Karnataka Mineral Policy brought out by the government in 2000, including single window clearance and escort services for foreign investors and collaborators, inventorying and mapping mineral wealth and disseminating technical and administrative information to users, streamlining exploitation by consolidating leases, reviving idle leases, upgrading technology etc. and generating awareness of environmental concerns. Specific administrative mechanisms applicable to granite include disposal of lease applications within three months and self-assessment of granite for the issue of transport permits. Suggestions for simplification of procedures have also been made with reference to prospecting licences, renewal and transfer of mining leases, agreements, lease registration and interaction between the department and industry. The department may ensure that these recommendations are fully implemented.

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Shri. H. M. Khayum Ali, Deputy Director, Department of Mines and Geology

Annexure I

ROYALTY AND DEAD RENT RATES

	(Rs.for specific duties)
Agate Apatite:	10% of sale price 5% of sale price
Rock phosphate: -over 25% P2O5 -below 25% P2O5	 11% of sale price 5% of sale price
Asbestos: -chrysotile -amphibole	 726/tonne 35/tonne
Barytes	5.5% of sale price
Bauxite	.35% of London Metal Exchange aluminium metal price on content in ore
Ilmenite, rutile & zircon	2% of sale price
Cadmium	10 % of sale price
Calcite	15% of sale price
China clay: -crude -processed	 21/tonne 75/tonne
Chromite	7.5% of sale price
Copper concentrate	3.2% of London Metal Exchange price on content of ore
Corundum	10% of sale price
Diamond	10% of sale price
Dolomite	40/tonne
Feldspar	10% of sale price
Fireclay	12% of sale price
Fluorspar:	5% of sale price
Garnet: -abrasive -gem	 3% of sale price 10% of sale price

Gold: -primary -by-product	 1.5% of London Bullion Market Association price on gold content 2.5% of London Bullion Market Association price on gold content
Graphite: -above 80% fixed carbon -40% to 80% fixed carbon -below 40% fixed carbon	 225/tonne 130/tonne 50/tonne
Gypsum	20% of sale price
Iron ore: -lumps: --above 65% iron --62% to 65% iron --60% to 62% iron --below 60% iron -fines: --above 65% iron --62% to 65% iron --below 62% iron -concentrates below 40%	 24.5/tonne 14.5/tonne 10/tonne 7/tonne 17/tonne 10/tonne 7/tonne
iron	3/tonne
Kyanite	10% of sale price
Lead	5% of LME price on content of ore
Limestone: -L.D. grade -others	 50/tonne 40/tonne
Lime kankar	40/tonne
Magnesite Manganese ore: -ores -concentrates	3% of sale price 3% of sale price 1% of sale price
Mica	4% of sale price
Monazite	125/tonne
Nickel	.12% of LME price charg-on content in ore

Ochre	12/tonne
Pyrites	2% of sale price
Pyrophyllite	15% of sale price
Quartz, silica, moulding sand & quartzite	15/tonne
Ruby	10% of sale price
Selenite	10% of sale price
Sillimanite	2.5% of sale price
Silver: -byproduct -primary silver	 5% of LME price on production 5% of LME price charged on content in ore
Slate	40/tonne
Talc, steatite, soapstone:	15% of sale price
Tin	5% of LME price charged on ore content
Tungsten	20/unit % of WO3 content per tonne of ore on pro rata basis
Uranium	5 for dry ore with U3O8 content of .05% with pro rata increase/decrease of 1.5/mt.of ore for .01% increase/decrease
Vermiculite	3% of sale price
Zinc	6.6% of LME price charg-ed on ore content
Other minerals	10% of sale price

DEAD RENT RATES (per hectare)

	2nd to 5th year	6th to 10th year	11th year and afterwards
Up to 50 hectares	70	140	200
50 to 100 hectares	100	200	280
Over 100 hectares	140	230	350

Annexure II

ROYALTY AND DEAD RENT RATES FOR MINOR MINERALS

Royalty-Karnataka	(Rs.)	Proposed change	Tamilnadu	Andhra Pradesh
Black granite: -in Mysore district -in other districts	 2000/cum. 1500/cum.	 2500/cum. 2000/cum.	2500/cum.	2000, 1000 & 500 for size above 70cms., between 30 & 70 cms.& below 30 cms respectively for Prakash, Khammam & Warangal dts.
Other dyke rock varieties Pink and red granite: -in Hungund, Badami and Kushtagi taluks -in other districts	1000/cum. 2000/cum. 1000/cum.	1500/cum.	1500/cum.for other granite	1500, 750 & 300 resp. for blue granite in Srikakulam& red and black granite in Up-amangalur in Prakasam dt. 1000,500 & 200 for others
Fine grey granite	1500/cum.			33/cmt.for granite waste
Other grey granite	600/cum.	800/cum.		
Quartzite & sandstone used as ornamental stone	500/cum.	700/cum.		
Marble or crystalline lime-stone	100/cum.	1000/cum.		60/cmt.
Bentonite	85/tonne	100/tonne		60/tonne
Fuller's earth	80/tonne	100/tonne		do.
Shahabad stone	30/10 sq. ms.	40/10 sq. ms		
Non-cement limestone	15/tonne			6/sq.mt.or 80/mt.whichev-er is higher for non-black limestone and 3 or 40 resp for black
Other limestone	25/tonne	40/tonne		
Ordinary building stone	10/tonne	10/tonne	5/10 cft.for rough stone,7 for jelly, 3.5 for laterite	33/cmt.
Limeshell	25/tonne		15 for 10 cft. cartload for limeshell,limestone&kankar	40/mt.for limeshell& as in Central Act for others
Lime kankar	10/tonne	15/tonne		
Agate, chalcedony, flint Sand: -in Bangalore, Mysore and South Kanara districts -in Belgaum, Dharwar and Gulbarga districts -in other districts	70/tonne 25/tonne 20/tonne 15/tonne	70/tonne 25/tonne 15/tonne	23 for 10 cft.cartload 6.5 for 10 cft.cartload	30/tonne for chalcedony 30/cmt.
Brick earth or tile clay			3 for 10 cft.cartload.	3500/kiln up to 1lakh items per year
Steatite and sandstone used for household utensils	3/tonne	3/tonne	6 for 10 cft.cartload	
Murram	2/tonne	3/tonne		13/cmt.
Other minor minerals	25% of pithead sale value		20% of pithead sale value	
Waste rock from stone quarry	100/tonne or 300/cum.			40/tonne for mosaic chips 33/cmt.for boulders,13 for shingle,75/tonne for shale & slate, 13/tonne for Rehmati
Irregular waste rock	10/tonne	10/tonne		
Waste rock from Shahabad quarry	10/tonne			
Finished kerbstone larger than 30 cms.on each face	80/mt.	40/mt.		

DEAD RENT (Rs.)	Karnataka	Proposed change	Tamilnadu	Andhra Pradesh
Building stone, felsite, quartzite, sandstone, marble, crystalline limestone, bentonite and Fuller's earth	15000		200/hectare for granite and 100 for others	20000/ha.for limestone,building stone,marble,boulders shale, slate, mosaic chips, bentonite & Fuller's earth 10000for other non-granite items, 40000 for premium grade granite, 30000 for good granite and 20000 for average granite
Shahabad stone and non-cement limestone	6000			
Lime shell, lime kankar, agate and chalcedony	5000			
Building stone in:				
-Bangalore, Mysore and South Kanara districts	3500			
-Belgaum, Dharwar and Gulbarga districts	3000	3000		
-in other districts	2500			
Sandstone for making household articles	2000			
Sand	1000	1500		
Murram	500	700		
Brick and tile clay and steatite used for making household articles	100	150		
Other minor minerals	1000			

Annexure III

FEES CHARGED FOR MINERAL EXPLOITATION

	Fee	Statute	Proposed changes
Application for reconnaissance permit	Rs. 5/ sq. km.	Central Rules	
Reconnaissance permit fee	Between Rs. 5& Rs. 20/sq. km.	Do.	
Security deposit for reconnaissance	Rs. 20/sq. km.	Do.	
Fee payable to private person for prospecting	50 ps to Rs.5/ hectare/year		
Application for prospecting licence	Rs. 50 for first sq. km. & Rs.10 per addl.sq. km.		
Application for grant or renewal of mining lease for major mineral	Rs. 500	Do.	
Security deposit for mining lease for major mineral	Rs. 1000	Do.	
Application for grant or renewal of quarrying lease for specified minor mineral	Rs. 2000	State Rules	5000
Security deposit for grant or renewal of quarrying lease fo specified minor mineral	Rs. 5000/acre	Do	10000
Fee for survey & demarcation of area for quarrying lease for specified minor mineral	Rs. 500/acre	Do	
Processing fee for transfer of quarrying lease for specified minor mineral	Rs. 1000	Do	5000
Application for grant or renewal of quarrying lease for non-specified minor mineral	Rs. 1000	Do	2000
Security deposit for grant or renewal of quarrying lease fo non-specified minor mineral	Rs. 2000/acre		5000/acre
Fee for survey & demarcation of area for quarrying lease for non-specified minor mineral	Rs. 300/acre		
Registration fee for tender-cum-auctions of quarrying leases	Rs. 500		
Earnest money deposit for tender-cum-auctions of quarrying leases	A year's dead rent		
Fee for survey & demarcation of area for quarrying licenc	Rs. 500/acre		
Fee for transfer of quarrying licence	Rs. 5000/acre		
Fee for revision application	Rs. 300		500

Annexure IV

PENALTIES & FINES

Offence	Penalty	Statute
Mining operation & transport of minerals without permit	Rs. 25000 and/or 2 year imprisonment seizure & confiscation of vehicle, equipment & mineral	Act
Violation of conditions of minor minerals rules & leases	Rs. 2000 for non-specified minerals & Rs. 10000 for others if violation not remedied within 30 days & determin-ation of lease/licence	State Rules
Interest rate on overdue amounts	15% simple interest after 60 days	
Renewal of transport permit	5% of royalty/day from date of expiry to date of application for renewal	
Failure to produce valid transport permit at check post	5 times royalty	
Transporting minor minerals without permit	Rs. 5000 &/or 1 year imprisonment & additional fine of Rs. 500/day for continuing offence	Do
Quarrying without or against licence/permit	1 year imprisonment or fine of Rs.500 per day of continuance of offence	
Security deposit for return of seized minerals & documents pending enquiry	5 times royalty	

CHAPTER IX

CONCLUDING REMARKS

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9.1 The analysis of the tax structure as a whole in Karnataka and studies of individual tax sources undertaken in the two reports of the Tax Reforms Commission have been made with a long term as well as immediate perspective. Basic structural issues have come to the fore particularly in the case of commodity taxes, which account for most of the State's own tax revenue, in the wake of the imminent changeover to value added taxation. As there are many unresolved concerns for States and for the country in such areas, our discussions have focused not merely on actions that should be taken at the State level but also on the direction in which the country as a whole should move. We have, therefore, made suggestions about the stand that should be adopted by the State government in inter-State and inter-governmental discussions. We have also recommended measures that could be adopted in the transitional period in the course of the reform process itself. Where feasible, we have tried to project the timeframe within which major changes could be implemented. In areas in which Central tax powers impinge on State tax policies, we have proposed amendments that could be advocated by the State.

9.2 Over the last thirty years, the State government has stopped and taken stock of the tax structure once in a decade. Reform is not, however, a one-shot affair. We believe, therefore, that the Finance department and all tax collecting departments should continuously evaluate their own effectiveness and performance. In the first report, we have suggested the establishment of a permanent review mechanism under the Secretary (Resources) for this purpose. A framework for diagnosing tax systems has been developed at the World Bank, which is given in this chapter to guide them in such assessment.

9.3 The interdependence of States is becoming increasingly apparent in the context of the VAT exercise. Apart from the many institutional and informal methods for inter-State consultation already developed in the last half-century, newer ones are being contemplated to meet the challenge of taxing the national common market within the federal political structure. The right balance will have to be struck between harmonised tax policies and procedures and fiscal autonomy at the State level. We do not believe that uniformity of rates and administrative practices is essential for all State levies. The degree of coordination needed to manage VAT has already been determined. The same extent of levelling may not be required for the other major State taxes. We do not, for example, see any need for States to adopt more or less identical tax schedules and regulatory requirements in the case of State excise duties as demanded by producers of potable alcohol. In the case of stamp duties and registration fees also, State governments are entitled to exercise their discretion to determine tax rates and revenue-raising methods within the existing statutory and Constitutional framework. Welfare-enhancing fiscal competition among different jurisdictions may even be desirable for efficiency and accountability to the taxpaying constituency. In any case, the possibility of tax base diversion acts as an effective deterrent on the unrestrained exercise of State taxing powers. States generally keep an eye on tax rates and incentives prevailing across their borders and use this information to finalise their own policies. We have extensively compared the tax structures of Karnataka's neighbours to make reform recommendations.

BASIC FRAMEWORK FOR DIAGNOSING TAX SYSTEMS

Area	Performance indicators	Capacity	Institutions	Exogenous & environmental constraints
Tax policy	• Are tax policy, administrative law, and taxpayer-related procedures simple and equitable? • Are management decisions made efficiently?	• Is there capacity for policy formulation and research? • Is there capacity for training?	• Division of powers • Legal provisions governing administrations • Administrative autonomy & political interference • Adequacy of organizational structure • Appropriateness of tax structure	• Level of economic development • Openness • Level of commercial development • Extent of transition to market • Accounting profession and standards • Financial and banking development
Accountability	• Corruption • Revenue loss due to administrative-e lapses • Taxpayer survey	• Evaluation of resources devoted to management supervision, audit, and anti-corruption efforts (including training) • Civil society involvement	• Status of audits • Ombudsman and taxpayer survey process • Penalties and rewards in taxation department tied to performance evaluations	• Literacy • Legal conventions, constitutional law • Law and order • Compliance attitude of tax-payer • Government credibility
Service delivery-efficiency and effectiveness	• Ratios of revenue to potential revenue • Indicators of activity effectiveness • Ratios of revenue to costs • Time indicators • Taxpayers survey	• Evaluation of available resources (human and budget) • Career management and salary policy for staff • Training facilities • Automation • Feasibility and extent of outsourcing and privatization	• Adequacy of administrative procedures-compliance, taxpayer identification, tax audit, taxpayer education, taxpayer services, sanctions and appeals, custom clearance procedure, pre-shipment inspection, information sharing	• Government stability • Civil service conditions

Source: The Development Economies Vice Presidency and Poverty Reduction and Economic Management Network, The World Bank, April 2000

9.4 The basic principle that should be applied when considering harmonisation is ensuring that tax incidence falls on those who benefit from State expenditure, that is limiting the impact of State taxes to those who live within their borders. Avoidance of "tax exportation" should be a major objective of tax policy. Uniform procedural sameness is not, however, essential in the sphere of tax administration as in other areas. A major advantage of autonomic State policymaking has always been the freedom to innovate; a new initiative that succeeds in one State is easily picked up and used by others. We have ourselves benefited enormously from practices adopted by neighbouring States and drawn useful cues from them for our needs.

9.5 A heartening feature of inter-State interaction is the possibility of drawing on measures which have been successfully adopted elsewhere. Computerisation and e governance is one area in which each southern State seems to have succeeded in one major tax area. While Andhra Pradesh has effectively put in place a computerised system for the sub-registrar's office, Tamilnadu seems to have succeeded in doing this for State excise administration. Karnataka has done similar work in the motor vehicles department. It would be convenient for southern States to draw on these experiences and even use the system and programs developed by their neighbours to rapidly modernise their own departments. Closer coordination among southern States for exchanging technical and administrative competence would benefit them all.

9.6 For many departments, we have given detailed recommendations for modernisation, computerisation and mechanisation of procedures. Simplification and rationalisation, transparency and objectivity are essential to improve voluntary compliance to tax laws. The State has already launched a massive exercise of general administrative reform based on these principles. Taxation departments figure at the top of the list of government departments crying out for reform. They are the ones that will yield immediate tangible results from administrative overhauling in terms of increased revenue; they are also the ones that are particularly vulnerable to administrative malaises like rent seeking and poor public interphase. A great deal of improvement can come from overhauling the tax structure itself, reducing rates and slabs and removing exemptions as well as from publicising taxpayer obligations and departmental procedures.

9.7 Beyond mechanical and policy measures, however, lies the core issue of human resource development. We have not gone into the recruitment and training requirements of different department in detail in our two reports. We note, however, that several posts lie unfilled in major tax departments like registration and motor vehicles. We suggest that the post-reform requirements of these departments be assessed in depth and recruitment rules overhauled to meet their new needs. There are two areas to which particular attention should be paid: the first is the induction of persons with computer skills by modifying recruitment rules for all levels, the second is developing an economic and public finance perspective by alerting personnel to the consequences and effects of tax policies on SDP growth and welfare. Staff who are already in place must be given intensive in-house training in both these areas.

9.8 Administrative reform must also be focused on improving accountability for the department as a whole, for its different sections as well as for individual personnel. Timebound targets must be specified for all of them, which should be as objective, focused and simple as feasible. Such targets must also be linked to promotions and other incentives. Fixation of targets must be done with a clear understanding of the kind of behaviour that would be promoted by each of them. At the departmental level, budgets and other facilities could be linked to macro performance ratios. We have already noted the woeful inadequacy of facilities provided by government for the staff and taxpayers in many tax departments and made recommendations for filling the gap. There is a case for linking the provision of some additional amenities to achievement of a few pre-determined targets. Targets should not only be linked to revenue realisation; performance should be judged as much by improvement in taxpayer compliance and public satisfaction as by quicker and more effective audit and successful imposition of prescribed penalties. Incentivisation techniques must be explored for taxpayers as well as personnel. A major advantage of VAT is the inbuilt incentive for better compliance. We stress the need to ensure that this feature is not diluted when adaptations are made to introduce value added taxation in the transitional stage.

9.9 It is essential also to specially combat the vulnerability of tax departments from the point of view of corruption. As pointed out in a World Bank initiative(1), any strategy to combat corruption must limit the motives and opportunities for public officeholders to abuse their positions. There should also be focus on the supply side of bribes. The accompanying box gives a policy framework to attack this persistent evil. Caution must be exercised while offering incentives for revenue officials to ensure that they do not lead to overzealous harassment of taxpayers. Negative incentives should therefore complement positive ones. (Experience has shown that the present system which relies on negative incentives alone reduce the will of officials to work). Independent taxpayer surveys will help identify elements of the organization or tax offices that harbour severe corruption. Studies like recent ones undertaken by the Public Affairs Centre at Bangalore on ranking government offices on a consumer satisfaction index should be encouraged and their findings used for judging departments.

Basic motivation	**Negative incentives**
Mission and vision statements Elite ethos and esprit de corps	Effective sanctions for corruption Stronger taxpayer voice through independent surveys Citizen review and oversight
Positive incentives	**Supply- side elements**
Organizational autonomy Transparent budget procedures and performance-linked compensations Intra- and interagency competition Competitive base pay Transparent and non-arbitrary reward procedures	Effective sanctions for bribe payers Independent institutions to protect taxpayers from harassment and extortion Publicity for penalties

Source: The Development Economies Vice Presidency and Poverty Reduction and Economic Management Network, The World Bank, October 1999

9.10 Opportunities for corruption could be curbed by measures indicated in the accompanying box (drawn from the World Bank). Some of them are integral to the functioning of taxes like VAT and these should be protected even if VAT is introduced in a modified form at the initial stage. Internal audit divisions and anticorruption units within the department should be supplemented by effective judicial support, external reviews (including external audits) and interaction with taxpayer associations. Contact between officials and taxpayers could be reduced through withholding taxes, using third party data for tax assessment and account-based assessment. The last two are inseparable from value added taxation. In addition to these measures, we strongly recommend setting up an independent enforcement agency for all tax departments as a whole similar to the Bangalore Metropolitan Task Force now working in Bangalore city.

Tax structure reforms Low and few rates and limited exemptions Withholding and presumptive taxes Non-discretionary penalties	Transparent human resource procurement, and budgetary procedures Computerization and automation Privatization of selected functions
Organization and management Functional organization Increased use of third- party data Limited contact with taxpayer and suppliers Arm's-length, transparent, non-discretionary business procedures	**Internal and external checks** Independent internal and external audits Effective management supervision procedures Citizen review and oversight Internal anti-corruption units

Source: The Development Economies Vice Presidency and Poverty Reduction and Economic Management Network, The World Bank, October 1999

9.11 Corruption can be also kept under control by improving taxpayer awareness of rights and obligations by publicising procedures through brochures, web sites (regularly and correctly upgraded by an institutionalised system), kiosks and the like and enforcement (not mere announcement) of citizens' charters. As far as possible, payment mechanisms should be integrated into normal commercial methods by collecting tax through banks. On line filing of returns should be facilitated and taxpayers permitted to ascertain the processing stage of pending applications, the reasons for delay etc. Enquiries must be conducted swiftly on complaints received against departmental personnel and penalties enforced without delay. We must also guard against newer forms of corruption that could enter by the back door even after modernised systems are put into place. A common method of introducing middlemen into tax departments is by preventing the public from having access to the required forms. Apart from encouraging on line interaction, we must also arrange for forms to be automatically printed out at kiosks and other sale points. Unless a concerted and continuing effort is made, tax collecting offices may not become cleaner and more user-friendly.

9.12 In the last analysis, reform must be ushered in through a package of measures that cover statutes, procedures and administrative culture. If this is done, the effects are likely to be quickly felt on State revenues on a continuing basis. We have not, however, made estimates of what might have been the level of receipts under own State taxes as a whole and for each major State tax or made projections of levels likely to be attained when reform is undertaken. Methods available for the purpose have already been used by the State government to forecast revenues in the Medium Term Fiscal Plan recently announced under the World Bank's structural program. As we have pointed out in this report at several points, the aim should be to set up a structure that would respond satisfactorily to growth in Gross Domestic Product. This would eventually be the test of success of the reform agenda.

9.13 There are identifiable stages in the reform process starting with dissemination of the reform message and proceeding through consultation and compromise and conversion of decisions into timebound activities to the final phase of consolidation and maintenance. Unless the stretch is fully covered, the reform cannot be considered to be complete. We are therefore at the commencement of a long, arduous and challenging process that is likely to transform the existing tax structure of Karnataka.

References:

1) PREM Notes from the Development Economics VicePresidency and Poverty Reduction and Economic Management Network, October 1999 and April 2000
2) Salvatore Sachiavo-Campo and Pachampet Sundaram "To Serve and to Preserve: Improving Public Administration in a Competitive World", Asian Development Bank 2001

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Annexure

PROFESSION TAX E GOVERNANCE

AIX.1 In the first report, the Commission had deferred consideration of administrative improvements for managing profession tax. These are discussed in the present annexure.

AIX.2 Adminstration of profession tax is not being done on the computer at present. Registration and enrolment of employers and the self-employed can be done through computers if every Profession Tax Officer is given a computer with internet & website facilities. Registration certificates can also be issued online with the seal and signature of the PTO if adequate security is ensured. To prevent web overload, the certificate should be issued within a week of the application and stay on the web only for one month. Applications made in the normal manner could be scanned into the computer for processing. The register of taxpayers can be created as a data base within the computer in two parts as given below:

Register of employers

Sl.no.	Regn. no.	Name of the employer	Full postal address	Class of employer *	Status of person signing form**	Annual tax paid in previous year

* individual, partner, firm, company, corporation, society, clubs and associations and others
** proprietor, partner, principal officer, agent, manager, director, secretary and others
Column 7 need not be filed up for those who are registered during this year.

Register of self-employed persons

Sl.no.	Enrolment no.	Name of the applicant	Full postal address	Date of birth & age	Profession, trade & calling	Period of standing in profession in years & months

Other places of work (addr-eses)	Annual turnover	No. of workers in factory	No. of employees in establishme-nt	If co-operative society, whether State level, district level or taluk level	No. of vehicles with permit under M.V. Act	Previous enrolment no., if any. **	Annual tax paid in previo-us year

AIX.3 Cancellations of certificates due to death, or an employer ceasing to be an employer or as penalty should be brought on record and the register updated regularly. Maintenance of such a register will enable returns and tax payment to be continuously monitored.

AIX.4 Returns should be scanned to enable storage of data relating to the number of employees in appropriate salary ranges along with corresponding tax rates. Tax payment data could also be stored along with challan nos., dates and the name of the treasury or bank concerned. The computer could be programmed to check internal consistency of the data received on the following items:
*whether the rate of tax noted for each income slab is correct
*whether the number of employees multiplied by the tax rate in each slab equals the tax deducted.
*whether tax balances are correct

AIX.5 This could be used to generate outputs for comparing tax due and payment made and generating demand, collection and balance statements. A statement of under payment could be printed for each employer whose form is defective in a table of the type given below:

Underpayment of monthly/ quarterly profession tax.

Regn. No.	Name & address of the employer	Tax due as calculated by computer	Tax actually paid

AIX.6 The computer can highlight internal discrepancies and give an output indicating for all employers, who have filed returns, the following information.

Regn. no.	Name & address of the employer	Challan no. & date	Amount paid	Treasury or bank

AIX.7 This can be used by the department to reconcile figures with the treasury or bank till computerisation takes place in these institutions or electronic transfer of funds is arranged. When this happens, challan nos. and amounts paid could be instantaneously recorded in the profession tax officer's computers.

AIX.8 Since the database of registered employers registered is available in the computer, a report of those who have not filed returns within the time prescribed should be generated and notices printed within the computer for dispatch to defaulters.

AIX.9 Annual returns can be compared to cumulative totals derived from monthly or weekly data. This can complement results obtained from physical inspections undertaken by inspectors and PTOs. Additional demand raised should also be watched and collection statements tallied with reference to revised demand as well as arrears. A demand collection and balance statement for each assessment year can be prepared by the computer for every assessee.

AIX.10 Self-employed persons make one-time payments in advance before the 30th of April each year by any of the following methods:
*challan showing the name and address as well as enrollment no.a copy of which is sent to the PTO
*if the amount does not exceed Rs.500, it is paid to the commercial tax inspector attached to the jurisdictional assessing authority
*through an authorised collecting agent.

AIX.11 The taxpayer's name and address, enrollment certificate no. the period to which the payment relates and the amount paid is noted in payment documents. The self-employed do not file annual returns. The computer should be programmed to provide a statement for each self-employed person indicating his enrolment no., the amount paid by him, the method of payment, whether the payment is on time etc.

AIX.12 The list of those who have not paid the tax due within the prescribed period should also be provided. Issue of notices etc. can be done through computer and even via the internet. Inspections can also be undertaken to find out whether the self employed are paying tax as prescribed. Inspectors should also identify self-employed who are not enrolled by visits to generate the list of defaulters, so that they can be pursued for collection.

AIX. 13 As indicated in the Commission's first report, this is an area that cannot be managed manually without computerisation. Electronic transfer of funds through banks and the treasury is introduced regular monitoring of the filing of periodic & annual returns (using even the internet) could substantially improve the early availability of information regarding tax liability and payment. Staff time will be employed for more useful purposes like physical inspections, macro analysis etc.

AIX.14 A cursory assessment of statistics from the Statistics department indicates the likely size of the tax base for this tax:

Profile of Karnataka's work force.
Class I . Categories under which many persons qualify for profession tax.

	Category of works	Number in lakhs
1	Manufacturing in household industries	3.22
2.	Manufacturing in non-household industries	15.29
3.	Trade & commerce	13.80
4.	Transport & communication	4.55
5.	Other services	15.29
	Sub-total A	52.15

Class II. Categories under which at least some become eligible for profession tax.

	Category of works	Numbers in lakhs
1.	Mining & quarrying	1.16
2.	Livestock & allied activities	6.17
3.	Cultivators	59.16
	Sub-total B	66.49

Class III. Categories under which none or negligible qualify for profession tax

	Category of works	Number in lakhs
1.	Agricultural labourers	49.99
2.	Construction workers	4.28
	Sub-total C	54.27

Source: Karnataka at a Glance 1999-2000 published by Directorate of Economics & Statistics

AIX.15 Against this, the no. of assessees in 1998-99 was 3.29 lakhs of self-employed persons and 30421 registered employers. Thus there is need to fully computerise the profession tax system and make these offices as paperless as possible to set free staff to identify new assessees.

SUMMARY OF RECOMMENDATIONS

PARA

1.21 We recommend that the State establish an E-governance Group within the office of the Chief Minister accountable to him or her. It should be headed by a person with strong e-governance credentials, who should take responsibility, against defined targets, of leading the government's efforts in planning, coordinating and attaining pervasive e-governance on an affordable, cost-effective and self sustaining basis. Inter-State coordination and collaborative cost savings should form part of the tasks entrusted to this Group.

Value added tax on goods

2.37 In our view, the proposal to extend Central excises to the wholesale stage and manage it through States will evoke fierce opposition from State governments (because of their unhappy experience with Central management of earlier shared taxes) and thus jeopardise the VAT consensual mechanism, it should not be considered for the initial VAT package.

2.40 All parties have agreed that an independent dual VAT system is the only feasible option under current circumstances. From the technical point of view also, it is generally accepted that the eventual objective should be a consumption type VAT which allows input tax credit for both raw material and capital goods; it should be based on the destination principle and use the tax credit or invoice method to compute tax liability.

2.43 The VAT which is expected to be adopted in April 2002 will apply only to transactions within the State. A floor rate of 10% has been fixed but States are firming up different revenue-neutral rates. The initial assessment is that it would be high (between 12% and 17%) in southern States which have high tax to SDP ratios and may be low in States like Madhya Pradesh. A lower rate of 4% will be applied to 50 commodities-mainly commodities used by poorer sections. While commodities like sugarcane are to be kept outside VAT, processed salt and toned milk will come under VAT and there will not be separate rates for items sold through the public distribution system. Liquor might be brought under VAT at a special high rate of 20% and petrol, diesel and aviation turbine fuel taxed at a high rate but kept outside VAT (without input credit). Other petroleum products like natural gas, furnace oil etc. will come under the basic rate. 22 commodities (primarily from the unorganised sector) will also be tax-exempt. Lottery tickets will continue to be taxed as at present outside the VAT system. The Commission's recommendations on VAT for petroleum products, sugarcane, sugar, molasses, rectified spirit, arrack and IML are given in Annexure II of Chapter II.

2.47 The Commission urges that the preparation of the common commodity classification should be completed very early so that it can be used for training departmental personnel and assisting taxpayers.

2.48 The plethora of levies in the State today should be rationalised into a single simple VAT.For Karnataka, rationalisation must commence with merger of the several imposts now on the statute books-sales tax, purchase tax, turnover tax, entry tax and the infrastructure cess-into one common tax with wide coverage, few, moderate rates and no exemptions. In the first report, the Commission had urged that such rationalisation should be done immediately in Karnataka. Further delay can only compound the problem of introducing VAT effectively and successfully.

2.51 To tackle the fears and reservations of States, the Commission had, in the first report, formulated a complete frame of reference for Karnataka, bringing all commodities within the three floor rates of 4%, 8% and 12%, removing exemptions and merging commodity taxes. A special rate of 2% was retained only for bullion, specie and gold ornaments and 25% for petroleum products and alcoholic beverages. We had also pointed out that it was possible to rationalise the commodity tax system with little revenue loss or inequity. The framework suggested by us could be easily adapted to the revised modulated rate structure that the Empowered Committee has now firmed up for VAT.

2.52 We urge the government to undertake the required rationalisation and simplification of the State's commodity tax structure right away to prepare the administration and taxpayers for the VAT scenario.

2.53 Keeping in mind the VAT imperative of generalised commodity taxation with minimal exemptions, the exemption list had been pruned and rationalised in the first report. We recommend that the proposed expansion of the tax base by removal of exemptions be forthwith implemented.

2.56 Data is available with the Industries and Commercial Tax departments regarding actual tax benefit eligibility and claims made by units which have commenced production. This information should be compiled by the Commercial Tax department after collecting data from field offices; it should be reconciled with data available with the Industries department particularly for cases in which incentives have been given for expansion and upgradation of industries (where substantial overlap is possible). It is sufficient if the analysis is confined to large and medium industries and mega projects. The departmental MIS should also capture this data on a continuing basis. Once this is done, the extent to which tax benefit claims have already been exhausted by units which have come into production and the size of likely future entitlements can be realistically assessed. This will enable the department to make preparations for handling such commitments when VAT is adopted.

2.59 When VAT is adopted, any break in the VAT chain may make it difficult to give tax credit to units which supply inputs to industries which benefit from tax incentives on input purchases. They should be required to file tax returns on the basis of which the tax credit claims of their suppliers could be allowed. The net VAT liability of industries availing of deferral could be permitted to be enjoyed by them for the agreed period. Industries benefiting from sales tax exemption could also be given the benefit of tax deferral. Industries entitled to CST benefits should also be treated in the same way.

2.60 The proposal to give all industries entitled to tax benefits the right to retain the *gross* VAT amount collected from consumers under the deferral scheme is not desirable as it would affect the administration of the tax credit mechanism for suppliers to such industries. It would also imply giving an additional benefit similar to input tax exemption to industries which do not enjoy it today. This would go against the decision of the Empowered Committee to put an end to additional or fresh tax incentives for industries in future. We do not, therefore, support such a proposal.

2.66 Industries entitled to the deferral benefit must be also given the option of adopting the normal VAT regime like the rest of their competitors. We believe that in today's conditions of low and declining interest rates, there would be little incentive for industries to reduce costs by using the tax-deferral mechanism to cut down drawals on working capital limits from banks, particularly since this would make them ineligible for VAT credit on inputs. By keeping the door open for industries entitled to tax incentives to voluntarily move to VAT, it should be possible to phase out incentives even before their regular expiry date. Incentives given for the purchase of capital goods might have to continue for some time till VAT is extended to capital goods.

2.67 Revenue-neutral rates may also need to be computed at the micro level for major productive sectors and assumptions used for macro projections modified on the basis of empirical data. The studies done by us on petroleum products, sugar, potable alcohol and tea at Annexure II to Chapter II are relevant in this context.

2.67 For policy planning and revenue projections under VAT, it is essential to prepare an input-output table for the State as a whole. Fresh tables will have to be prepared so that we get a comprehensive overview of the inter-relationships between sectors before VAT is put in place. For this, the quantities and values of inputs into and output from all major sectors have to be compiled and integrated into a total matrix in which imports and exports out of the system will also have to be indicated.

2.69 In our view, the department should immediately prepare an input-output table by applying its theoretical framework to actual business practices in major sectors to enable it to forecast with reasonable accuracy the revenue outcomes of various policy measures.

2.70 The commodity study made by us at Annexure II of Chapter II throws light on several core issues relevant to the concept and application of value added taxation in the country. It indicates the incentive-disincentive mechanism operating today in the origin-based, cascading commodity tax structure at the State level. It helps us to identify areas for decision and action and provides fairly reliable estimates of the likely revenue from different tax rates. It can be used as a guide for further similar studies by the department which could be eventually put together to construct a complete input-output table.

2.71 It is essential that a decision is taken quickly on threshold limits for exemption and composition for dealers so that the task of educating taxpayers and tax collectors is not seriously affected.

2.79 Several options have been explored at the level of official committees for managing commodity taxation of inter-State trade when the intra-State VAT is in place and during the transition period before inter-State VAT is introduced. Care must be taken while choosing the appropriate mechanism to ensure that it does not generate perverse tax-induced incentives for procuring inputs from within States, even when this is not the most cost-efficient alternative or lead to fresh methods of distorting commercial transactions or accounting for commercial transactions and spawn further perversities.

2.81 From the point of view of long term sustainable reform, the additional effort required to hammer out a consensus on the management of value added taxation of inter-State trade at the commencement of VAT itself appears justified. Such an effort will help to bring to the fore the apprehensions of tax-exporting States, identify feasible mechanisms for providing safety nets in the transitional period and draw forth commitments from the Centre for meeting revenue gaps. It will also compel all players to make administrative arrangements for sharing and validating data.

2.103 The final form of inter-State VAT will zero-rate sales made between registered dealers in different States, but sales consequent on "consignment" transfers or those made to unregistered dealers will be treated like local sales to final consumers without the benefit of zero-rating.

2.104 To ensure smooth transition to inter-State VAT, a networked information system must be developed for online sharing of inter-State data on registered dealers and their transactions. Agreements are necessary with concerned States for ensuring the authenticity of transmitted data and there should be provisions for excluding States, which do not rapidly furnish reliable information. Technological innovations available today could be utilised for electronically verifying vouchers and dealers' records when monthly returns are filed and during random checks. A procedure that could be used for the purpose has already been indicated to the Commission and could be examined by the Commercial Tax department.

Provision should be made for the inter-State component in data processing systems at this stage itself to avoid problems when inter-State VAT comes into effect. To deter evaders, we also recommend a higher selection percentage of audit cases in respect of dealers with inter-State transactions and severe penalties for evaders.

2.110 "Consignment" transfers could offer a fairly painless method of moving from origin-based to destination-based commodity taxation.

2.111 Under an intra-State VAT, the existing "consignment transfer" mechanism might be used to reduce tax incidence on inter-State sales since full input credit would be available on local sales. Intra-State VAT may also become less onerous for inter-State transactions if low CST rates are charged on "resellers".

2.112 With intra-State VAT we might move gradually to a new equilibrium level with an imperfect commodity tax regime for inter-State transactions built around the practice of "consignment" transfers. Such transfers would more or less be similar to destination-based taxation of inter-State commerce. Goods subject to CST and sales to "resellers" may suffer a slightly higher tax incidence and continue to suffer from cascading. The overall result may not then be worse than the present situation. However, further effort would be required to move forward to true inter-State VAT, particularly since it will imply reversion to CST from "consignment transfer".

2.113 We suggest, therefore, that when intra-State VAT is introduced, "consignment" transfers should be relied on to painlessly convert origin-based taxation of inter-State trade to destination-based taxation. The CST rate should be simultaneously reduced to 2% to facilitate "reselling" across States. Over time, this should result in most inter-State transactions being done on "consignment" basis and stabilise destination-based taxation. When a decision is taken to shift to zero-rated inter-State VAT, an option could be given for dealers to shift to inter-State sales from "consignment" transfers by offering them input tax credit. It appears, however, that the Empowered Committee is proposing to encourage CST based transactions in the interim period itself by permitting dealers to avail of input tax credit against CST liability. In our view, this is not desirable as it would not serve the main purpose of inducing States to move to destination-based taxation. We recommend that Karnataka takes the matter up in the Empowered Committee and suggests modification of the present proposal.

2.114 The economic role of moving to destination-based commodity taxation and mitigating the residual cascading and distortive effects of intra-State VAT played by "consignment" transfers in the transition period should be recognised by States. This should be reflected in the manner in which "consignments" are treated under intra-State VAT. When the final shift to inter-State VAT occurs, definitions of what constitutes "sale" for tax purposes should also be satisfactorily modulated to enable (if feasible) transfers between branches of the same company registered in different

States to be treated as inter-State transfers. To a large extent, such preparation will enable the residual tax cascading on "consignment" transfers to be reduced to the minimum.

2.115 The procedure for inter-State transactions needs to be rationalised and simplified. It is essential to eliminate the C form requirement for sales to registered dealers, which causes considerable harassment and generates fraudulent practices. In the interests of encouraging the growth of a national market and building up a VAT constituency, it is hoped that at the initial stage itself, the form requirement will be dispensed with.

2.117 In our view, there should be a broad overall tax rate ceiling for both government levels (Centre and States) on most commodities, which can be modified only after consultations among all players.

2.118 In the interests of simplicity and transparency, it would be advantageous for taxpayers if the commodity groups subject to different rates in Central and State VAT statutes are broadly similar. Definitions, threshold limits and exemptions may require standardisation to some extent between Central and State VATs. The manner in which coordination between the Centre and the States should be ensured and administrative arrangements required for the purpose put into place has also to be clearly sorted out before a true VAT comes into effect at the Central and State levels. We recommend that the State government take this matter up urgently with the Central government since the benefits of VAT cannot be fully reaped by manufacturers and dealers without CENVAT reform.

2.120 From the long term conceptual and practical perspective, it may be necessary to consider a Central framework statute under which States and the Centre will be bound to move towards VAT within a system of prescribed rates and practices. Coordination at the level of inter-State committees in which the Centre is also a participant may not be sufficient to bind all parties to implement consensus decisions. Central intervention by legal methods which are cleared by States is desirable to ensure that different governments do not withdraw from the VAT process after commencement. We recommend, therefore, that the State government pursues this initiative at the national level.

2.211 A final decision was expected to be taken at the Central level on the three commodities on which additional excise duties are levied at present by the end of September. This must be expedited and existing anomalies rectified while introducing State level VAT in April 2002. The prohibition of State taxation of goods imported into the country under Article 286 of the Constitution also requires immediate amendment; this again was scheduled for a decision by end September.

2.122 Action must be taken at the Central level to draft a countrywide framework statute for VAT. This must be supplemented with effective institutional mechanisms for continued coordinated functioning of all governments. Existing arrangements like the NDC and the Inter-State Council may not suffice for constant interaction on administrative and procedural matters. We suggest that the institutional foundation for managing a functioning VAT should be put on the agenda of all State and Central governments.

2.123 Government of Karnataka must press ahead with demanding conformity by Union Territories to consensus decisions of the Empowered Committee relating to basic VAT rates, removal of exemptions etc.

2.127 In our view, a fund or resources arranged to manage the transition to VAT must be operated to induce States to agree to what is in the best interests of the economy. The problem is how to insulate States against revenue loss without draining the Centre's own strained resources. In the long term, States, as a whole must be given access to productive additional revenue sources. Compensatory tax sources (or grants) to offset immediate revenue losses on account of CST reduction/abolition will also have to be found at once. The only satisfactory solution appears to be enabling States to levy service tax concurrently with the Centre and inducing them to use this fiscal tool to fend for themselves.

2.132 The Commission has prepared an e governance framework document for VAT visualising three layers. The first or operational layer covers 6 basic tasks-compliance, processing returns, assessment, demand and collection, refunds, enforcement and inter-State relations.

2.133 The second or planning layer, was visualised to consist of 6 tasks-administration, training and motivation, productivity, fraud control, citizen access and citizen satisfaction.

2.134 The third or strategic layer was seen as comprising 6 tasks-the collection of economic data, assessing the tax base, increasing revenue, empowerment, inter-departmental co-operation and technology.

2.135 Under each task, it is necessary for the department to list out its activities as well as those which need to be computerised, problems foreseen in introducing and implementing VAT, transitional issues while moving from sales taxes to VAT and issues which need to be resolved before a comprehensive view on e-governance can be taken.

2.136 A decision is under way in the Empowered Committee regarding adopting income tax PAN numbers for VAT administration to facilitate data exchange across States. Whether this no. itself should be adopted or whether another no. should be derived from it for VAT purposes may have to be finalised. Numbers might then have to be generated for dealers who are not income tax payers and arrangements made to enable them to be allotted PAN numbers within the income tax system. The link with income tax should not also become a disincentive for dealers to opt for VAT.

2.137 The existing data base of around 2 lakh dealers (of whom 1.5 lakh are taxpayers) will have to be ported to the VAT system and numbers generated for fresh applicants. Simple forms will have to be prepared and registration facilitated by opening outlets and even kiosks in departmental field offices and offices of industry associations; online registration could also be considered. The registration procedure is yet to be finalised; it should be kept as simple and direct as possible. The application form may need to mention the legal and economic status of the applicant and the commodity handled by him. Proof of place of business may need to be appended. The applicant's signature could be stored for further recognition purposes when he subsequently files returns and other papers with the department. Data reported by dealers could be validated online using one or two cross-verifications with other reliable databases like registration with the Registrar of Companies, bank account number, passport, driving licence etc., but departmental inspections or security deposit requirements should not be enforced as pre-requisites for registration. Central excise dealer numbers should also be noted where applicable. Registration certificates should be automatically issued and rectification or modification of the original data permitted only to selected persons. The scope and motivations for fraudulent declarations should be considered and the circumstances in which registration should be cancelled laid down.

2.138 Security measures using bio-metric methods must be used to prevent pollution or tampering with this basic data base. Parallel servers can provide back-up facilities and a template used to prevent corruption by viruses. Selected sub-sets of the data base (not original applications) should be accessible to departmental officers concerned with returns as well as those concerned with investigation, intelligence and audit. The basic dealer application may in rare cases be downloaded under strict controls by those concerned with appeals. Within the department, decisions have to be taken regarding the department and the officers who should be authorised to receive and verify registration applications and maintain the data base up to date.

2.139 Finally, data mining interfaces and connectivity are required with the Central income tax and more importantly with the Central excise department. Some interface with the external world of taxpayers and others will have to be established through an interactive web site. The persons from other departments who should be given access to data must be clearly specified. This should be limited to few authorised persons. Erection of adequate firewalls to secure critical data and meet other secrecy requirements is a major requirement. Most important is the link that has to be established to data bases in other States which is essential to confirm the registration authenticity of dealers to whom sales are made across States. This is a critical area for evasion and fraud if zero-rating is adopted for inter-State trade since input tax credit will be given at the point of despatch of the commodity before it is actually sold. A dedicated web-server with the required data subset should be used for this interface. The system should envisage more than one area of checking for greater reliability. The dealer master base can be used to generate taxpayer master files which can be fed with data received from returns regarding tax liability and payment.

2.140 The commodity classification data base must also be maintained on the computer. It is therefore essential to finalise it quickly and adopt it definitively. Dealer exemption and composition thresholds must also be decided early to develop appropriate registration certificate issue software and operational linkages. Goods kept outside VAT may also need to be identified and linked to the data base to keep track of inputs and outputs entering into their manufacture and distribution.

2.141 Various forms under VAT have also to be designed. The invoice form to be used under VAT is a critical item. It must be simple and contain basic essential data. There is no need to duplicate information already stored in the computer or statistics that can be derived from such information except for one or two items for validation purposes. The items suggested for inclusion in the form by the Shome Committee on Tax Policy and Tax Reform for the Tenth Plan (2001) are the name, address and VAT number of the taxable person making the supply, the nature of the supply (the type of supply, the type of goods or services and the quantity supplied), the time of making the supply, payment made for the supply, VAT due, the name, address and VAT no. of the taxable person supplied, the date of issue of invoice and the serial number of the invoice (with identification of the printer). The invoice must also be drafted looking at trade practices and after interacting with dealers and manufacturers. How credit sales should be treated as also quantity discounts will have to be examined. The treatment of "adjustment sales" should also be determined. Invoice authentication by security seals or electronic methods should be looked at.

2.142 Return filing should be permitted to be done directly into the system and even online. Returns could also be scanned for easy capture of data into the system. The return form should be carefully designed keeping in mind essential requirements only. Certification by a Chartered Accountant should not be insisted upon for monthly returns-whether and how audited accounts should be annually sought has to be decided. As far as possible, no additional documents should be sought as attachments to monthly returns. Automatic issue of notices to taxpayers and penalty determination could also be done on the computer for non-registration or non-filing of returns. It is important to decide on the manner in which input tax credit can be claimed every month. Should actual tax paid during the month be set off against actual tax due or should the tax paid on large one-time purchases be set off in instalments over months? These are matters on which decisions must be taken before the system can be designed. How return monitoring and validation should be managed-in a centralised or decentralised manner, for example- and by whom should also be decided. It could be perhaps done by a nominated officer for each jurisdiction, who should be made responsible for notifying defaulters to others.

2.143 The manner of processing returns should be direct and simple under VAT. The parameters to be used for validation should be firmed up. The few critical internal (within the return itself) computerised validations to which all returns should be subjected must be identified; on no account should these be left to individual officers or original taxpayer documents demanded for scrutiny; neither should there be local inspections or visits at this stage. Whether returns could be also validated with reference to other external information and linked data bases must be determined. Information furnished in returns should be validated with that received from the treasury relating to tax payment. Only returns randomly selected through pre-determined criteria put into the computer should be subjected to audit.

2.144 The audit function should be substantially strengthened and streamlined under VAT. It should be largely officer based with hierarchies fixed only for supervision and guidance. Quotas should be fixed of the percentage of returns under different categories that will be subject to audit. Selection should be based on risk indicators modulated on the likelihood of evasion and fraud in different sectors. The selection criteria should be kept secret and changed only by intervention at very senior levels. Once a list of cases for audit is generated, the audit queue should not be disturbed at the discretion of the officer doing the audit; in fact, the next case for audit could be generated only after the earlier one is examined. Selection software will, therefore, have to be developed with great care. Sectors allotted for audit to different officers may even be rotated from time to time. Supervisory officers in the audit department should determine in detail the procedure to be adopted for audit. This should be based on examination of documents in different phases-the next stage of examination by calling for additional documentation from the taxpayer should be adopted only on the basis of *prima facie* specific irregularities or doubts raised by the earlier stage of analysis. Measures should be adopted to incentivise the audit function, with the initial eligibility for incentives and the kind of incentive determined from computer-generated data linked to both quantity and quality of performance and taxpayer feedback. Audit must involve verification of documents checked and recorded at border check posts. The audit section may need to have connectivity with departments and agencies outside the Commercial Tax department. These might have to be identified along with the level at which such connectivity should be established.

2.145 Tax collection procedures should be streamlined as done for other taxes. Payments should be as far as possible through banks through drafts, checks etc. Refunds and tax credits should also be managed on the computer. Detailed procedures for bank reconciliation have already been worked out within the department.

2.146 The Intelligence Wing should also have access to relevant data within the department as well as from the check post for effective functioning. Price and consumption information from external sources would also be critical for this division. Coordination may be required with data from the Motor

Vehicles department and the railway transport and freight handling departments, as also with the Central excise department. Appropriate connectivity should be established for the purpose.

2.147 MIS data of different kinds must be generated for continuous monitoring of key variables indicating performance efficiency. Existing computerised outputs should be adapted to VAT requirements. An area that could be given more attention is processing taxpayer data to identify trends and behaviour and use this for further investigation and eventual policy change. Data mining systems need to be installed to facilitate such analysis. Much closer interaction between the Commercial Tax and Planning departments would enable reliable data to be generated on critical macroeconomic indicators for the State. Data bases available from external sources (like those relating to product prices at the national and regional levels) which could be of help must also be accessed and made available to concerned departments as also to planners. A departmental web site would permit interaction with the public and with taxpayers. Apart from online registration, it could also provide information on tax policy, VAT practices, commercial and industrial trends and a chat room for clarification on tax matters.

2.148 A principal challenge to the design of an e-governance approach lies in devising means for cross and multiple, albeit quick, verifications of key facts online. This may in turn require a large multiplexed information system network. It will also be necessary to require taxpayers to adopt modern, electronic, business practices such as the keeping of verifiable records accessible from the government network, online filing of tax returns and electronic funds transfer.

2.149 Careful planning, design, scheduling and education are pre-requisites for successful adoption of VAT. VAT on goods must over time be extended to cover capital goods. In the very long run, it might even have to evolve into a single VAT administered at either the State or Central level.

Service taxation

3.21 It is essential to integrate, as quickly as possible, general service tax with VAT on goods, subject services to the same range of VAT rates and administer the tax alongside VAT on commodities.

3.22 There is no escape from formulation of a comprehensive statute for an integrated VAT on goods and services at the Central and State levels. A far reaching Constitutional clearing up is essential to lay down the principles for integrating goods and service taxation. The Commission agrees with the view taken by the Expert Group on Taxation of Services that the power to tax services should be enjoyed concurrently by the Centre and the States.

3.23 A comprehensive integrated VAT on goods and services concurrently levied by the Centre and the States appears to be the ideal formulation for the country today.

3.24 It is essential to work out the modalities of a common VAT framework as quickly as possible. As pointed out by the Expert Group on Taxation of Services, this cannot be done within the existing Central service tax statute, since it requires alignment of the rates of service taxes levied at the State and Central levels with those accepted for the VAT on goods, harmonisation of exemptions and tax bases and development of administrative practices for accountbased assessment, input credit and data base management apart from constitutional amendments and a common "framework" statute.

3.26 We have considered the appropriate framework for VAT on services in Karnataka in the light of the suggestions made by the Expert Group. We strongly support the Group's suggestion of concurrent Central and State VATs on goods and services. We recommend that the Finance and Commercial Tax departments take action right away to prepare for the tax by drafting statutes and regulations, studying revenue productivity and taking decisions on operational issues (covering items like *inter se* input tax credit mechanisms between goods and services, exempted services, return filing, account-based assessment, audit, inspection and appeal). An input-output table for the State's economy should be prepared for both goods and services; while doing this, some of the pointers given in the case studies appended to Chapter II of this report could be followed. Much more work is required to complete the services component of such a report and it is desirable to commence the analysis immediately. Substantial variations in macro figures of tax base and gross tax revenue arrived at in existing assessments of the VAT on services cited above indicate the need for a detailed and comprehensive understanding of the tax potential of the service sector. Net revenue figures must eventually be generated after accounting for tax credits.

3.27 Improved departmental knowledge of service taxation should be accompanied by a concerted campaign to build up support for such a measure among taxpayers and the general public. In all discussions, the department should highlight the two major economic advantages of the VAT on services-simplicity and fiscal neutrality. It should stress the fact that the tax would facilitate exports (through easy identification of the tax component of a product) and improve international competitiveness.

3.28 The broad framework of the generalised VAT on services in Karnataka should be in line with the rate structure adopted for the VAT on goods; the basic tax rate of 10% should be applied to all services and the lower rate of 4% could be considered for a limited number of selected items. As in the case of goods, for services too, State governments should agree on the items to be taxed at 10% and the few to which 4% should be applied. This agreement should be enshrined within a common national statute enacted by the Central government. Eventually, there should be a single VAT framework law for both goods and services.

3.29 States should also agree on the list of exempted services. The threshold level of Rs. 10 lakhs suggested by the Expert Group seems feasible and acceptable at the State level also. In general, the services listed by the Expert Group on Taxation of Services (Annexure I of Chapter III) in respect to the Central VAT on services could be adopted by the State also. However, we see no justification for exempting computer and related services (item B of 1 in the annexure) from service taxation, since this is *the* growing area of the services sector and putting it in the exempted category would affect the neutrality and revenue-productivity of the VAT on services. Nevertheless, keeping in mind current growth constraints in the area, we suggest levying VAT at the lower rate of 4% on such services at the initial stage. Items A and D at 10 in the annexure pertaining to entertainments and sports should be subject to VAT on services at the normal rate of 10% since entertainment tax is already being levied on them. We have referred to this in some detail in our first report. Banking and financial services suggested for exemption by the Expert Group may be kept outside the purview of VAT on services, but other similar services like venture capital financing should be subject to tax.

3.30 In the interests of economic neutrality, we concur with the view expressed by the Expert Group on Taxation of Services that VAT should be levied on fares of railway passengers and freight. While dealing with services rendered across State borders, like road transport, courier services etc. the principle of destination applicable to VAT on goods should be applied and similar accounting and collection procedures followed. Where there is difficulty in allocating tax bases among States, appropriate formulae should be devised by agreement among States.

3.31 *Ab initio*, operational methods for the VAT on services should be modern and cost effective. Self-assessment, non-discretionary functioning, fixed penalties for technical offences, provisions for settlements of cases and advance rulings on substantive issues recommended by the Expert Group on Taxation of Services for the Central VAT on services should be adopted at the State level also. Administrative innovations appropriate to service tax include selective audit based on normative parameters evolved on risk basis and compulsory certification by chartered accountants above a pre-determined level of gross receipts. We also strongly suggest that the tax should be administered from inception as an "e tax".

3.34 In our view, if preparations begin immediately, not more than a year's time is required after the Constitutional power to levy a concurrent VAT on services is given to States for actual adoption of the tax.

3.36 States should be permitted to exercise powers to levy VAT on services only after complying with the basic requirements of a harmonised VAT on goods. The amendment must also restore powers to States to tax all advertisements, though the power could be exercised initially only with respect to advertisements on television and radio (to a limited extent).

3.39 When intra-State VAT on goods is introduced from April 2002, the segregation of the service element from the amount charged for the contract as a whole will have to continue for determining the VAT liability of works contractors; input credit will also have to be given in respect of the tax paid on goods purchased for contracts. The present composition facility will have to be given up till the composite VAT on goods and services comes into effect. This must be specifically mentioned in the VAT law and sufficient publicity and orientation given for taxpayers. However, when a generalised State VAT on services is introduced, works contracts should be taxed on their gross value at the basic rate of 10% and tax credits given for taxes paid on services and goods used in the contract.

3.46 With integration into VAT on goods and services, the electricity duty structure of Karnataka will also have to fall into the general approved VAT rate schedule. This means movement to *ad valorem* rates.We should make the shift even before VAT is introduced and select a rate or rates as close as possible to likely VAT rates. To protect revenue, we recommend a uniform rate of 5% for all categories of consumers. The 10% basic VAT rate should be applied when electricity duty is merged with VAT on services. The State government should support this stand while negotiating with other States for a common VAT policy for services. Regional perceptions and sensitivities relating to the cost of power should not be allowed to affect selection of the appropriate rate of electricity duty under a VAT on services, since tax credit will be available for all intermediate producers/dealers for VAT paid on both goods and service inputs.

3.47 The principle of "immunity of instrumentalities" invoked in federal countries to prevent different government levels from taxing one another should not be extended to commercial operations like the Railways even if they are owned by the Central government. There is a case for appropriate Constitutional amendment and this should be pursued by the State. Since we have recommended that VAT on services should be introduced for rail transport also, the constitutional protection under Article 287 should be removed for the Railways and input tax credit given.

3.49 We recommend that duty should be charged on all consumers as and when metering is completed. When VAT on services is introduced, duty should be charged on domestic consumption for connections given under the *Bhagya Jyothi* scheme. Since this is in the nature of final consumption, there will be no tax credit for VAT paid on inputs. For most of the other categories, however, tax credit will be available if the activity is similar to intermediate production or trading.

3.51 We suggest that the Commercial Tax and Energy departments work together to prepare estimates of net revenue from electricity duty (after adjusting claims for input tax credit). Such estimates can be prepared at the macro and micro levels. Projections of future consumption by different customer categories made by KPTCL to the KERC could be used for macro estimations with correctives drawn from specific sector studies (like the recent ISEC evaluation of the *Bhagya Jyothi* scheme). At the micro level, industry and trade specific assessments can be done when input-output tables are prepared for the economy as a whole (covering both goods and services). Once prepared, such a comprehensive economic map can become an invaluable policymaking tool.

3.53 The Commission recommends that presumptive adjustments of duty due to the government from KPTCL should be given up and electricity duty accounted for on actual amounts collected by KPTCL. When computerisation of KPTCL accounts is completed, this should be possible.

3.54 At present, power generated for captive use is not subject to electricity duty, but duty is charged if it is sold to a third party. We suggest that this procedure may continue till the VAT on services gets stabilised. At this stage, the appropriate procedure for taxing captive power generation under the VAT on services could be developed.

3.56 The chain for the VAT on energy should begin with power generators from within and outside the State. Domestic power producers like the Karnataka Power Corporation (KPC), independent power producers (IPPs) etc. should charge VAT on energy sales to KPTCL and claim tax credits for VAT paid on inputs (goods and services). The transmitting and distributing chain should pass on the VAT and claim similar credits. Consuming intermediate producers and dealers in other sectors will also be eligible for tax credits. Tax incidence will then pass on to final consumers-through electricity duty itself in the case of households or in the form of final goods and services produced by manufacturers and service providers.

3.57 Inter-State transactions between KPTCL and power generators in other States and Central sector generators like NTPC will be treated like those relating to inter-State commerce on goods. The mechanism adopted for goods-zero-rating, tax credit and clearing house arrangements or any other method-will have to be applied to energy sales also. Taxes paid and recovered can then be incorporated into KERC's price fixation procedure under which input taxes are today computed as per current rates and permitted to be charged to customers as a component of the tariff.

3.63 The service and goods components of luxury tax need to be rationalised when VAT is introduced. Goods which are now taxed under this levy can be easily brought under VAT without any need to use the cumbersome entry tax mechanism once "declared goods" and goods subject to additional excise duty are permitted to be taxed by States. They should generally fall under the basic 10% rate and input taxes should be credited. Only tobacco and *gutkha* should be subject to the higher rate of 20% applicable to demerit goods without input tax credit. In the case of electronic goods, better enforcement and the improved compliance expected from VAT will have to be depended upon to control evasion. For services now under the luxury tax, which will come under VAT, we recommend that hotels charging up to Rs. 500/day should be exempt from VAT, the 4% rate should be applied to room rents between Rs. 500 and Rs. 1000/day and the 10% rate for rooms charged at higher rates. For convention and marriage halls, the exemption should apply to those charging up to Rs. 5000/ day, the 4% rate to those charging Rs. 5000 to Rs. 10000/day and the 10% rate to those charging higher rents. This should also give a fillip to tourists and business customers particularly when the sector as a whole is passing through recessionary days. Health clubs should be charged at the basic 10% VAT rate. These rationalisations could be introduced even during the transition period

3.68 The betting tax need not be brought within the ambit of the general VAT on services. It should be treated as a tax on demerit goods subject to a special higher rate of 20% without input tax credit facility. There is also a case for regular annual revision of the composition rate for totalisator tax.

Excise duties

4.55 Growth in alcohol production need not imply increase in consumption of potable varieties within Karnataka; IML brands could be developed for the foreign market and utilised by petroleum companies when alcohol-linked substitutes for motor fuel are evolved. Regulatory and fiscal policies should be geared to these requirements. The Commission suggests, therefore, that an expert committee should be appointed to look closely into the matter. It should consider the existing molasses surplus and the low capacity utilisation reported by licensed distilleries and determine the potential for utilising surpluses either by adding distilling capacity or by encouraging other alcohol-based production. Installed capacity should be indicated whenever fresh licences are given. For existing units, the committee mentioned above should fix minimum capacity utilisation levels after obtaining an annual declaration of expected utilisation from each distillery. Distilleries which do not achieve the prescribed minimum levels should be liable to cancellation of licences. They should not also be eligible to acquire fresh licences or run additional units. Frequent random checks of capacity utilisation should be undertaken in addition to implementation of the e governance mechanisms indicated by us in the annexure to Chapter IV.

4.56 Close examination of relevant indicators could disclose evasion. Energy consumption captured through electricity bills is a fairly useful indicator to assess the capacity utilisation of distilleries. In the case study on potable alcohol done at Chapter II of this report, we have noted that in Karnataka, this will be useful only at the blending and distillery stages, since earlier stages depend upon internally generated bagasse-based power. Some such pointers have been mentioned in the Commission's first report also. Turnover, profit and investment figures reported to statutory authorities for other purposes could also be used to confirm capacity utilisation figures given to the Excise department.

4.57 In view of the high licence fee structure in Karnataka, we recommend reduction in distillery and brewery licence fees to levels prevalent in neighbouring States. We also recommend making the rate proportional to installed capacity as in Andhra Pradesh and Maharashtra. The expert committee suggested above may also consider if incentivisation mechanisms could be developed for ensuring reasonably accurate reporting of capacity utilisation figures. Unutilised production licences should not be routinely renewed by the department. We recommend that since licences lead to pre-emption of production capacity, they should be in the nature of letters of intent as done in some States. The time limit for implementation should be specified in licences and extensions should not be given beyond 3 years. Old licenced projects which have not yet been implemented should be cancelled. If it is decided to add to existing distillery capacity, only integrated distillery-cum-blending units should be sanctioned and they should be as far as possible integrated with sugar factories.

4.61 We do not recommend modification of the existing routing of arrack blending to public sector undertakings and the auction system of country liquor vends. We suggest, however, upgradation of the quality of country liquor by making the use of neutral spirit mandatory and insisting on proper maturation of arrack. This should increase to some extent the end price of country liquor and mop up surpluses now accruing to vendors. It would also reduce the price differential between arrack and beer and help to restrain hard liquor consumption.

4.62 The ban on alcohol retail outlets near tribal areas should be extended all over the State. It could even be considered for other vulnerable hamlets like Lambani *tandas.* We recommend freezing the number of sale points in villages, which already have more than one outlet. An early decision may be taken on the policy to be adopted for fixing retail licence quotas and the Rules amended if necessary to pre-empt judicial intervention.

4.63 Evasion could be controlled and availability improved if mild liquor varieties like beer (below 5% v/v) and wine are permitted to be sold along with items of general consumption in large marketing outlets. Government may consider how this could be done in large metropolitan areas.

4.64 We do not propose any change in licence fees for hotels and restaurants for the present. In the case of clubs, however, there is no justification for the existing low concessional rate; we recommend that licence fees for serving liquor in clubs be increased to levels similar to those for hotels.

4.65 We recommend increasing the range of choice for consumers of alcohol in rural areas. Liquor varieties with low alcohol content should be promoted to offer competition to arrack. The arrack auction system now in vogue should therefore be extended to cover cheaper varieties of beer with low alcohol content. The two kinds of products should be stocked and sold in common outlets.Under a government notification issued under Rule 15 (3a) of the

Bottling of Liquor Rules of 1967, beer varieties below 4.5% v/v are not permitted to be bottled. The notification requires amendment; such low alcohol content varieties of beer should also be brought under the auction system for arrack. The services of an expert external consultant should also be taken to study how auction procedures could be modified so that cartelisation and cornering of bids is prevented.

4.66 We recommend auction of IML outlets using the standard mechanism of a reserve price. We also suggest that appropriate auction procedures be adopted to prevent cartelisation of bids.

4.69 We propose to modify to some extent the recommendation made for a dual excise duty-VAT mechanism in the first report. We suggest, therefore, retention of excise duty as a single impost on potable alcohol. However, in the interests of simplicity and transparency, as also for better administration and compliance and the prevention of evasion, we suggest that excise duty should be administered as a multiple of the basic price declared by the producer on which the final sale price should also be determined. The multiples should be fixed differently for mild and strong liquor, which means similar higher tax incidence (in *ad valorem* terms) on country liquor, IML and strong beer and lower incidence on light beer and wine. The structure would be basically similar to the Maharashtra excise duty mechanism.

4.70 We do not see any reason to modify the computations and comments made by us regarding evasion of excise duty and sales tax on IML as well as country liquor in the first report.

4.72 We have made suggestions in the annexure to Chapter IV for administrative measures which can help to keep track of molasses produced in sugar factories and *khandasari* units.

4.73 It is desirable to enact legislation similar to that in Maharashtra on the basis of the draft already pending with government for controlling molasses. The annexure to Chapter IV, which contains detailed suggestions for e governance in the Excise department, gives the minimum feedback required regularly from sugar production units to enable the department to control the escape of molasses from the organised sector. Prescriptions for the maintenance of minimum records of stock and movement and reporting requirements can be legally laid down and official verifications done for molasses only through formal legislation. A Molasses Control Act may be introduced covering these items but it is not desirable to enforce pricing or other distribution controls.

4.75 Checking mechanisms in distilleries themselves need to be substantially strengthened. The suggestions made in the annexure to Chapter IV to tighten up administration in distilleries should be implemented to improve the effectiveness of physical controls.

4.76 It is essential to focus on e governance methods within the distillery itself. We have made some suggestions in this behalf in the annexure to Chapter IV. We also recommend setting up a Joint Committee of the Excise and Industries departments to regularly review the external indicators available to judge the capacity utilisation and functioning of chemical units. Licences given to units, which are proved to be misusing spirit, should be cancelled.

4.78 Detailed recommendations for better governance in distilleries and blending units have been made in the annexure to Chapter IV. There is scope for improving existing distillery procedures for accounting for spirit. We recommend that the production ratio for rectified spirit should be reviewed by the technical committee suggested in earlier paragraphs, which is to be established for determining distillery capacity utilisation, by conducting controlled experiments to ascertain actual average recovery rates. We recommend that meters should be compulsorily installed at different points of the production chain to automatically record the quantities of spirit produced. Meters should be fixed at the point at which spirit moves into pipes and also when it falls into storage VATs. They should also be installed at the point where spirit is loaded into vehicles. Calibrations recorded on such meters should be linked to the departmental MIS.. The use of every litre of rectified spirit, neutral spirit and extra-neutral spirit as well as of denatured spirit should be recorded on computers so that it is directly available on the PC of the excise officer stationed at the distillery; these PCs should be part of the departmental network and the data conveyed on line to supervisory officers and the Excise Commissioner. The installation of such machinery must be made mandatory by amending Excise Rules. We also recommend that laboratory checks should be mandatorily applied by the two public undertakings at the entry point of RS into the arrack blending process.

4.81 We do not recommend any major change in packaging rules at present. In our view, sacheting may be continued for arrack vending since there is scope for misuse of bottling contracts.

4.83 We recommend that a specific severe penalty should be laid down in the Excise Act for the offence of tampering with security seals and a high compounding fee levied to deter offenders.

4.84 We do not propose any modification of existing wastage norms for excisable goods.

4.86 If our proposal for levying an *ad valorem* excise duty as a multiple of basic price is implemented, the principle will have to be extended to imported liquor and exemption extended to exported varieties.

4.87 We recommend strict enforcement of existing regulations as well as implementation of the e governance measures suggested in the annexure to Chapter IV to control evasion through misuse of transport permits.

4.92 We have considered the question of introducing public sector involvement in wholesale liquor distribution. Although this would facilitate revenue realisation to some extent, we do not consider it appropriate for government to assume the role of liquor distributor and take on the responsibility for price fixation, inventory management and other activities, which ought to be determined purely by market forces. Wholesale control is not also likely to eliminate "liquor tragedies". We suggest instead improved e governance measures for better administration and a tax structure that would provide some incentive for better compliance.

4.93 We have studied and adapted some of the elements of the Tamilnadu computerised excise package while making our suggestions for better governance.

4.95 An exercise to rationalise the Excise manual should be undertaken and the simplified structure put on a departmental web site in a suitably user-friendly manner.

4.96 Techniques for managing State excise duties without direct State intervention need to be further developed. There is a strong case for looking at incentivisation mechanisms to increase departmental commitment to governmental objectives at all levels. In the Commission's first report, we have proposed setting up fully mechanised composite check posts at State borders for the motor vehicles, commercial taxes and excise departments. A possible solution is installation of a similar post in distilleries themselves. Automatised posts should be set up at material despatch points in distilleries and blending units and these should be connected online to the departmental network. It should be made mandatory under the Rules to set up such facilities in production units.

4.87 There is a case to increase the powers of enforcement staff who are sometimes exposed to violence when they raid illicit distillation units. We recommend that check posts should be declared as police stations for the purpose of handling excise offences. They should also be provided with better communication facilities. Technical training (in chemical analysis for example) will greatly enhance departmental capabilities. We recommend incorporation of such training in normal departmental HRD programs.

4.98 We recommend the establishment of a modern laboratory for analysing material samples for the department. The Drugs Controller has prepared a proposal for setting up such an institution with the capacity to annually analyse 12000 samples. The cost to government of this unit would be around Rs. 2.5 to Rs. 2.7 crs.

4.99 Cash collections of excise duties and fees should be avoided and all fees should be collected through banks. It was indicated by the department that banks are reluctant to handle some fee collections since the amounts involved are nominal. This can be negotiated with banks who are getting business on other items.

4.100 Other regulatory measures should be strictly enforced like driving under the influence of alcohol through random checks using the latest apparatus available like breathalysers and offenders strictly punished through deterrent fines and endorsements on licences leading to eventual revocation for habitual offenders. We have recommended this in the chapter relating to motor vehicle taxes. We also endorse the views of the Health Task Force for prohibiting liquor vending outlets on national highways.

4.101 Government has established a Temperance Board. We recommend ploughback of a small fixed percentage of excise revenue for effectively running the Board and actively involving NGOs and researchers in publicising the adverse effects of liquor consumption. The Board should fund the preparation of appropriate material to be used in school and college textbooks for spreading the message of temperance among young people.

4.102 As regards the minimum drinking age, we recommend amendment of Section 36 of the Act to bring it in line with the Rules.

4.103 The Commission concurs with the views of the Health Task Force and recommends that liquor shops and pubs should be kept closed between 11 am. and 4 pm.

4.104 All excise licences should have validity for a three-year period. An automatic increase in licence fees of 10% may also be enforced every year.

4.105 In the context of VAT, if a decision is taken to restore commodity taxation on liquor to the Commercial Taxes department and administer it in addition to excise duties, it is essential to establish mechanisms for continuing coordination between the two departments. This responsibility should be undertaken by the Finance department at the Secretariat level and appropriate systems established under the supervision of Secretary (Resources) to counter the tendency of each department to deny the other access to relevant data for enforcement purposes.

Stamp duties and registration fees

5.3 We recommend application of the recommendation given in the Model Stamp Act circulated by the Central government to both hypothecation and pledge instruments.

5.4 It is necessary to tackle the prevalent practice of transferring ownership without executing a document by making purchasers equityholders in property and shifting only the equity to them which is being used to evade duty on conveyance. We recommend amendment of Section 17 of the

Registration Act at the State level to include such transactions under the definition of "conveyance".

5.5 To mitigate the disincentive effects for entities which are developing from firms into incorporated companies for economic and industrial reasons, we may reduce stamp duty and registration fee requirements for firms in which partners continue to hold controlling shares for a minimum lock-in period of 5 years.

5.6 We recommend introduction of a penalty for non-registration of registrable documents since this is the most common evasion technique.

5.7 Under Section 72 of the Registration Act there is only provision for a single appeal to the Registrar (D.C.) against an order of the sub-registrar refusing to register a document. We recommend that there should be provision for a second appeal to the Revenue Appellate Tribunal. We also recommend that inspection powers in Section 67B of the Stamp Act should be used to examine the records of developers who are suspected of undervaluing property and evading stamp duty.

5.8 A key suggestion that we would like to re-emphasise is the institution of a system of computerised generation of guidance values, for which, as we have already indicated in the first report, much of the preparatory work is practically complete. Concerted action over a six-month period is all that is required to bring in this radical improvement in the effectiveness and user-friendliness of departmental offices. We reiterate our view that computerisation at the superficial level of scanning registered documents or networking offices to improve MIS data would be inadequate to enhance the performance and image of the department. We hope government will move in the direction suggested in the first report as rapidly as possible in the interests of revenue and better compliance. As soon as this stage is reached, duties on conveyance should be brought down to the levels suggested in the Commission's first report.

5.9 A beginning should be made in improving physical infrastructure in sub-registrars' offices. We strongly recommend setting up modern offices spread over a single floor with personnel located in glass cubicles set opposite a comfortable public lounge provided with a computerised kiosk at which data concerning tax rates and procedures can be accessed in a user-friendly manner over the internet. Such offices should be provided with telephones and given powers to incur the expenditure required to purchase consumables for computers and take and preserve registered documents.

5.10 The need to fill up departmental posts which are lying vacant should be assessed after working out requirements after computerisation. Unauthorised persons found in sub-registrars' offices should be kept out after the required personnel are put in place. Recruitment rules should be modified to ensure that personnel with computer skills are preferred for appointment.

5.11 We suggest that the general recommendations on e governance made by us in this and the first report be adopted in this department. Some of the comments made regarding computerisation of the motor vehicles department would also be applicable to the Stamps and Registration department. We reiterate our view that regular departmental staff should be trained to use computers and used for managing systems when software development is completed. NIC or other special personnel should not be taken on board for routine computer operations; they may be required only for creating a core systems management group attached to the head office for trouble shooting and handling upgradation and similar issues.

5.12 Routine office management in sub-registrars' offices also requires substantial improvement. Since it is possible to precisely specify the verifications required to be done by the sub-registrar for each kind of transaction, check lists could easily be prepared and brought into use. It is heartening to note that the IGR has already prescribed an office inspection schedule and formats for conducting inspections. This should be strictly adhered to and closely supervised. There is also no departmental manual listing out procedures and requirements although there is an internal diary containing much of this information. This should be developed into an easily readable manual which can be used by both departmental staff as well as users. It should be made freely available to members of the public and put on the departmental website. It could also be broken down into brochures documentwise and these could be made available at all offices.

5.14 In the first report, we have already recommended online collection and accounting of duty by most institutions. To this end, officers of the appropriate level should be empowered to endorse documents and accept duty on behalf of the government. This could be routinely done online by financial institutions, stock exchanges, insurance companies and the like. It would, in fact, be a better alternative to stamps than franking. Appropriate verification mechanisms could be prescribed for departmental officers using documents and occasional physical checks. This would eliminate the need for stamps, franking machines and even methods like pass-books and revolving credit accounts which have been suggested in various reports and thoroughly modernise duty collection. Safeguards could be incorporated and powers granted to institutions made liable to withdrawal if they are found to be evading levy and collection of duty. We also recommend abolition of adhesive stamps as a means of collecting duty.

5.15 Measures to reduce such harassment must be explored as it is at the root of non-transparent, user-unfriendly departmental functioning. Whether *affidavits* and strict penalties for false declarations could substitute for the NOCs could be considered. However, removal of such requirements may need to be made contingent on feedback from concerned departments on documents registered. In any case, wide publicity should be given to prescribed procedures, their rationale, exemptions and NOC requirements through a citizen's charter in which time limits for registration and avenues for grievance redressal are indicated.

5.16 Online transactions could substantially improve data collection mechanisms and our understanding of the revenue productivity of different documents. For the present, it is preferable, as suggested by the IGR, for the Finance department to collate data relating to drafts collected by sub-registrars for stamp duty and registration fee payment obtained from sub-registrars' offices and information regarding sale of stamps furnished by district treasuries to arrive at a reasonably accurate estimate of revenue realised. This could be reconciled with the Accountant-General's office from time to time.

5.17 We do not recommend automatic issue of *khata* after registration by the sub-registrar himself, since the department may not be fully aware of local requirements. There should however be provision for online intimation of registration to concerned *khata* issuing authorities. Since the revenue department and municipal bodies are themselves getting computerised, provision should be made for such interaction when systems are developed. Till something akin to the Torrens system of title insurance in introduced in the country, the sub-registrar's office may only be required to advise visitors to obtain encumbrance certificates before registration and ensure the genuineness of the title to property. Agencies granting lands like local bodies, BDA etc. should be formally authorised to collect stamp duty and registration fees and exercise delegated powers to register documents on behalf of the department. This should be done after they are linked online to the IGR's network and systems are developed for transferring data relating to formal title to property for use by both parties.

5.18 In respect of other statutes administered by the Registration department, we must consider how the procedure could be simplified and insulated from harassment and rentseeking.

5.20 We recommend that panchayats in rural areas should be given the power to register marriages under the Hindu Marriage Act as soon as they are computerised alongside maintenance of a networked computerised data base of such registrations.

5.21 30 days' notice of marriage has to be given under the Special Marriages Act after obtaining an application along with reliable proof of age and residence. To prevent rent-seeking, the procedure should be publicised on the web site, at kiosks and through other methods like posters and brochures within the department, application forms should be freely available within the office (and not offered for sale along with draft certificates through private booths), publication of the marriage notice should not just be on the notice board but by some other more effective method and the certificate automatically issued after expiry of the thirty days. For the present, we do not recommend transfer of this function to local bodies.

5.28 The State government could review all cases of special tribunals that have been set up. The basic principle to be considered from the court fee point of view when a matter usually handled by civil courts is transferred to a special tribunal is that the government which furnishes the service should be entitled to determine fee rates and reap revenues.

5.29 A feature of special tribunals is that court fee rates are laid down in the constituting statutes themselves. They tend therefore to escape review for long periods of time. The State government should regularly examine such rates with reference to the service rendered and the position before creation of the tribunal.

5.31 Since process fee rates have been reviewed as recently as 1999, there may be no case for further immediate increases.

5.32 There is a case for closer monitoring of court fees at the Finance department and treasury levels, which should be possible today since these departments as well as courts and major tribunals are being extensively computerised.

5.34 It is appropriate to expect judicial fees to defray part of the costs of revenue administration, that is expenditure incurred on recurring personnel and maintenance costs. Capital expenditure on buildings, residential and official as well as on equipment, furniture etc. ought to be met by government out of the general budget. It would be appropriate to realise through court fees approximately half the recurring costs; the above principle may be treated not as a rigid rule, but as a broad guideline to evaluate the working of the system from the financial viewpoint. There is a case to gradually increase revenue realisations from judicial fees to Rs. 50 crs. by streamlining the tax structure. This should be attempted, however, only alongside substantial upgradation and modernisation of infrastructure facilities for the judiciary and litigants. The burden of court fee should also be distributed equitably among litigants in line with benefits received and their ability to pay.

5.35 A mix of the concept of vertical and horizontal equity and the benefit principle seems appropriate while allocating the court fee burden among different users. The principle of cost recovery can be applied only at the macro level while determining the share of expenditure on maintaining the civil justice system that should be recovered through court fees. It cannot be used to allocate the fee burden since it is not possible to determine the manhours expended in deciding each case and compute their cost. Benefit can, therefore, be measured only in terms of financial advantage derived from taking up a civil matter in the courts and fees tailored accordingly. Such an approach is also in line with the equity principle. There is also a case for exempting or charging low specific fees when legislative protection is proposed to be given to special beneficiary classes, like accident victims, those whose land has been compulsorily acquired by the government or factory workmen.

5.39 In our view, the court fee structure should be proportional to the value of the disputed property. This would require merger of the existing multiple rates into a single low rate, which should be applied to suit value. We recommend that the rate should be determined by computing the prevailing effective average rate and rounding it off to the nearest integer. The rate might stabilise around 2.5% to 3%. A minimum low floor rate could also be fixed. This will create a simple transparent system that would be comprehensible and acceptable to lawyers and litigants.

5.40 Other modifications proposed are the following:

-the fee to be raised from 1/8th to 1/4th of the security value in cases of suits for the possession of title documents as in some neighbouring States

-for adoption suits, the fee to be raised to Rs. 50 for cases with market value below Rs. 5000

-drop provisions relating to suits under old statutes like the Bombay and Hyderabad Land Revenue and Mamlatdar Courts Acts

-dropping from the Second Schedule item 2 referring to petitions under Section 26 of the Insolvency Act and Section 95 of the Code of Civil Procedure, for which the present duty level is half that for suits (to discourage frivolous insolvency petitions and applications for arrest and attachment), since Rs. 1000 is the maximum compensation that can be claimed under the provision and Rs. 100 would be the maximum court fee that could be collected.

-At item 3 relating to petitions under Sections 53 or 54 of the Insolvency Act, an across-the-board fee of Rs. 500 could be levied.

-removal of the differentiation between applications filed within and beyond the limitation period at item 5 (applications for review of judgments). Applications for review presented to the High Court, civil courts and KAT could be charged at 5% and those to government at Rs. 100.

-in the case of letters of probate and certificates under the Succession Act, the rate could be 1% up to a value of Rs. 1 cr. and 5% in other cases.

-for undertakings under Section 49 of the Divorce Act, appeals to any court other than the High Court or executive officers, appeals to KAT and government, the fee rate should be Rs. 50

-for appeals to the High Court, the fee should be Rs. 100

-for appeals under the Arbitration Act, the fee should be 1% with a minimum of Rs. 50

-copies of judgments of criminal courts should be charged Re. 1 and those of High Court decrees, Rs. 5

-copies of stamped documents presented in lieu of originals should be charged Rs. 2

-copies of other proceedings should be charged Re. 1/page

-petitions to excise, revenue and municipal officers and to DCs for land leases should not be charged fees

-petitions for lapsed deposits presented after six months should be charged Rs. 5

-other petitions to government as also to DCs should not be charged fees

-petitions to KAT relating to legal powers should be charged Rs. 50 and other cases Rs. 10

-petitions to executive magistrates should not be charged fees

-applications for temporary injunctions presented to a court should be charged Rs. 100 and those to other authorities Rs. 50

-applications for arrest or attachment before judgment (other than to a High

Court) should be charged Rs. 50
-applications under Rule 58 CPC in a revenue court should be charged Rs. 50 and in other courts Rs. 100
-applications under Section 47 and Rule 90 CPC should be charged Rs. 50
-applications under Order 17 Rules 1 and 2 CPC in the High Court should be charged Rs. 100 and in other courts Rs. 50
-the fee rate for original petitions not otherwise provided for should be similar to that in Kerala
-the fee rate for applications to set aside arbitration awards and applications for directions to file arbitration awards should be similar to those in Tamilnadu
-revision petitions in the High Court under Section 115 CPC should be charged Rs. 50
-writ petitions in the High Court under Art. 226 (except *habeas corpus*) and under Article 227 should be charged Rs. 500 as also appeals to the High Court
-applications under the Specific Relief Act should be charged Rs. 100
-petitions to the High Court and KAT not otherwise provided for should be charged Rs. 5
-election petitions for membership, presidentship and vice-presidentship of the Taluk Board or *panchayat* (or equivalent) should be charged Rs. 50
-applications to sue as pauper should be charged Re. 1
-applications to appeal as pauper in the High Court should be charged Rs. 2 and in other courts Re. 1
-bail bonds and other other instruments under the CPC and CrPC not otherwise provided for should be charged Re. 1
-copy of power of attorney or vakalatnama filed in any court should be charged Rs. 5
-the lower slab for agreements for question for opinion under the CPC could be dropped from the schedule
-all caveats should be charged Rs. 10

5.43 It is desirable for Karnataka to adopt guidance values notified by subregistrars for valuation purposes. A gradual transition to market-linked valuation could be made with fee rates adjusted downwards to prevent undue hardship to litigants on account of sharp increases.

5.44 The list of exemptions prescribed under Section 69 is given in Annexure II of Chapter V. The list may be reviewed in the light of the recommendation made by us further on to remove court fee on applications made to government offices on non-judicial matters.

5.45. Since arbitration is governed by the provisions of a Central Act and costs are fully met by the litigants themselves, there is no case for levying court fees.

5.46 Matters under the Industrial Disputes Act are dealt with in labour courts manned by judicial officers, but expenditure is not recovered through court fees as a specific exemption notification has been issued by government.

Such exemption is justified since these disputes relate to an important component of economic legislation-the protection of workers' rights.

5.47 Consumer courts are an example of special tribunals that have been set up under a Central Act to decide matters that were once subject to civil legislation. There is a case for levying a fee even if there is an element of social legislation about the disputes handled by such courts. It is suggested, therefore, that an across-the-board nominal fee of Rs. 100 should be charged in consumer courts which could be eventually debited to the losing party.

5.48. Since compensation amounts for land acquisition for public purposes are routinely enhanced by courts, there is a case for levying a fee of .5% on the compensation awarded which should be collected after the case is decided while paying the amount.

5.49 There may be a case to charge a low fee of .5% on the value of the compensation awarded to victims of motor vehicle accidents, (which is generally paid by insurance companies) to be collected only after the conclusion of the case from the compensation amount itself.

5.51 The Commission is of the opinion that the existing procedure of charging stamp duty for petitions and applications made to the government should be given up since this is followed more in the breach than in the observance. It is incompatible with an e governance environment since the revenue realised from fees is disproportionate to the cost of monitoring a plethora of departments. Unless the fee provision is dropped, it could be used in a discretionary manner for rentseeking and harassment by individual officials.

5.52 Suggestions have been made for rationalising the number of denominations and aligning them with the schedule to the extent possible, since even today, stamps of higher value are often affixed to documents, due to non-availability of stamps of the required value. This should be done expeditiously. There is also a case for considering (as in the case of non-judicial stamp duties) whether online computerised collection would be possible. Collection and related franking through banking channels could be considered side by side with stamp vending. Over time, more modern methods would drive away antiquated procedures based on stamp affixation with their attendant problems of artificial shortages and forgery.

5.55 From the users' viewpoint, the following improvements could be introduced into the system without much difficulty:
There is a case for a kiosk system under which the document could be scanned and court fee computed for the benefit of users without recourse to the counter
The extent to which connectivity could be used for interaction between personnel at the counter and the back office and the Principal City Civil Judge could be examined

A citizens' charter could be developed and enforced to ensure processing without delay
Connectivity could be used for online verification of pendency and delay
Back office MIS outputs seem to have been developed but they have not yet been put into effect; these could be streamlined for regular outputs regarding fee realised from different kinds of suits and documents and feedback given not only to the Controlling Judge but also to the Treasury and the Inspector-General of Registration. A user-friendly computer manual detailing inputs, outputs and the like could be prepared and made available to all users and personnel. There is a case for developing expert-system software for mechanising scrutiny of documents in the back office to the extent possible

5.56 It appears feasible even without computerisation to obtain regular reports from all tribunals regarding various kinds of court fees recorded by them while receiving documents.

5.58 Data relating to refunds was not being netted out for MIS purposes. This could easily be done since connectivity has been established.

5.59 Court fee examiners (officers of the rank of Assistant Registrars) can be appointed by the High Court. The Karnataka High Court, which was providing for such inspections every two years, has discontinued the practice recently. There is a case for reintroducing it as provided under the Act.

5.60 A penalty of 6 months imprisonment and/or fine of Rs. 500 is prescribed in Section 76 for registered stamp vendors who disobey prescribed rules and for sale of stamps by unregistered stamp vendors. There is no case for any change at present.

Motor vehicle tax

6.2 It is hoped that recommendations relating to progressive denationalisation of passenger bus services, abolition of exemptions for vehicles owned by educational, religious and charitable institutions, pollution control, tax collection through banks and by electronic transfer and eventual reversion to annual tax will be taken up for early consideration.

6.6 To use motor vehicles taxation as a fiscal mechanism for achieving the objectives of conservation, pollution and congestion control, it will have to be substantially restructured and such modification might inhibit its use as a tool for compensating for road damage. For the present, instruments like sales tax on vehicles and fuel, tolls, parking fees and the like would have to be employed for achieving these aims. It appears desirable to retain a single simple objective for motor vehicle taxation-realisation of revenue to compensate for road damage.

6.7 As for goods vehicles, the existing tax structure is broadly in line with what is desirable from the point of view of energy conservation and pollution control. There is however need to move to less-damaging multi-axled vehicles. From the point of view of congestion, light vehicles are the most congesting; non-fiscal regulations seem to be required to reduce indiscriminate use.

6.8 The *inter se* tax structure between goods and passenger vehicles indicates that light passenger vehicles (personal and commercial cabs) are lower taxed than light goods vehicles, but rates on medium and heavy vehicles are much higher for passenger than goods vehicles. (A loaded goods vehicle imposes a greater burden than a loaded passenger vehicle of the same category). This is appropriate given the carrying capacity of passenger vehicles and the importance of goods transport for the economy as a whole.

6.14 It is extremely important to collect accurate information on different types of motor vehicles not only to get a clear idea of tax potential, but also to properly administer the motor vehicle tax in the State. We hope that the State Government will take necessary measures to collect this information on a scientific basis to enable proper administration and enforcement of the tax.

6.15 The Commission's views regarding eventual return to annual taxation of motor vehicles have already been spelt out in the first report. In our view, as early as possible, once modernisation and introduction of measures of e governance in the department has substantially reduced the need for taxpayers to physically visit departmental outlets, we could revert to the system of annual taxation of motor vehicles.

6.18 In consonance with what we have recommended earlier, we would like to reiterate the damaging effects of the policy of nationalised monopoly passenger bus services on passenger safety, convenience and comfort as well on the exchequer. Progressive and speedy denationalisation appears inevitable. This could commence with disinvestment of government's equity holding and proceed to eventual private control. A Transport Regulatory Authority should also be set up by the Central government to regulate different modes of transport.

6.19 As a beginning, we recommend transition to denationalised operation by shifting from area nationalisation to route nationalisation (as done in most States) and freezing grant of future routes to the KSRTC. Routes thus released should be made available for private operation to enable increase in government revenues, economic activity and passenger security and comfort.

6.21 Goods vehicles to which trailers can be attached, could be rationalised. It would be desirable to charge Rs. 100 for every 1000 kgs. or part for this vehicle category.

6.22 For haulage vehicles, at present there are 7 slabs, which are proposed to be reduced to two-with gross laden weight below and above 7500 kgs. For the former, the quarterly tax proposed is Rs.1000 and for the latter Rs. 2000 with an additional Rs. 25 for every 250 kgs. over 15000 kgs. In the case of cranes no amendments are proposed. As for fire engines and sprinklers, there are 9 slabs at present. Since most vehicles in this category are owned by government, they would be in any case tax exempt. The few private fire engines owned by industries or utilities for inhouse use could be tax exempt; only sprinklers could be charged Rs. 1000 for every 40 kgs. of GLW or part. This rate mechanism could be applied also to trailers attached to sprinklers.

6.23 Data regarding the revenue earned from temporary users, could be collected easily once checkposts are linked to the department's data base. It would be useful to do this as a part of policy planning exercises. Inter-State agreements have resulted in notifications by all States providing tax exemption for personal vehicles coming from other States using roads within the State for less than a month. Schedule B needs to be amended to take note of this situation. Keeping in mind the need to align Schedule B closely with Schedule A, we recommend the following modifications:
-items 1 and 2 in the schedule (personalised cars, scooters and invalid carriages) may be dropped for reasons indicated earlier
-item 3 relating to goods vehicles, for which there are 10 slabs, should be categorised into 5 slabs-those with gross laden weight up to 3000 kgs., 5000 kgs., 12000 kgs. and 15000 kgs. and those above 15000 kgs. The tax liability for a week and for a month for each category should be as below:

Rs.	up to 7 days	from 8 to 31 days
up to 3000 kgs.	100	300
3001 to 5500 kgs.	200	600
5501 to 12000 kgs.	300	900
12001 to 15000 kgs.	450	1400
Above 15000 kgs.	460 +75/250 kgs. over 15000 kgs.	1380 +160/250 kgs. over 15000 kgs.

6.24 When these vehicles are used to haul trailers, for every 1000 kgs., the tax rate could be Rs. 25 for a month's use of the State's roads and Rs. 75 for a week's use.
-no modification is necessary in respect of multi-axled vehicles (item 3A)
-for motor cabs, the present range of 5 slabs could be reduced to three: for vehicles carrying up to 5 passengers excluding the driver, the proposed rate is Rs. 10 for a week and Rs. 30 for a month/passenger; for those carrying between 6 and 12 passengers, it may be kept at the present rates of Rs. 75 for a week and Rs. 150 for a month per passenger.
-no modification may be necessary in the present scheduled items 5 (motor cabs carrying more than 12 passengers for whom the tax rate is Rs. 250 for a month's use and Rs. 100 for a week's use per passenger) and 6 (luxury buses carrying more than 12 passengers for whom the tax rate is Rs. 400 for a month's use and Rs. 200 for a week's use per passenger).
-for omnibuses and private service vehicles, there are at present 5 slabs linked to floor area, two linked to ownership by schools and other

educational institutions linked again to floor area and one linked to ownership by driving training schools based only on floor area. The department is of the opinion that the number of such vehicles coming from outside the State is limited and that it would be cumbersome and impractical for check post staff to measure floor area. Since 1958, the State has been exempting omnibuses from Tamilnadu, Kerala and Maharashtra from taxation by notification. It has been suggested that tax should be reintroduced on seating basis with three slabs: for vehicles carrying up to 12 passengers, Rs. 75 for a week and Rs. 150 for a month per passenger, for those carrying more than 12 passengers, Rs. 100 and Rs. 200 respectively per person and for educational institutions, Rs. 10 and Rs. 30 per person respectively. We agree with this suggestion.

-for ambulances and hearses it is proposed that there should be no tax as in the case of such vehicles registered within the State (item 9)

-for haulage vehicles, the existing 7 slabs could be reduced to two; for vehicles weighing more than 7500 kgs., the tax could be Rs. 300 and Rs. 900 respectively for road use of a week and a month and for those below 7500 kgs., it could be Rs. 150 and Rs. 400 respectively. However, no change is required for tractors and trailers (item 11)

-for fire engines, there need be no tax while for sprinklers and other similar vehicles, the existing 9 slabs could be rationalised and two tax rates prescribed at Rs. 10 for a week's use and Rs. 30 for a month's use.

-no change is required in respect of drilling rigs (item 13)

-for imported and company cars for which there are four categories and several slabs today, it is proposed to merge them into item 16 (campers' vans) and levy tax on all these kinds of vehicles at the rate of Rs. 75 for a week's use and Rs. 200 for a month's use per 1000 kgs. or part of unladen weight. Vehicles used to haul campers' trailers would bear a tax of Rs. 10 for a week's use and Rs. 30 for a month's use per 1000 kgs. of unladen weight.

-no change is required for the tax applicable to cranes (item 17).

6.27 On the question of fines for overloading, the present Karnataka rate should be reduced to Rs. 500 for the first tonne and Rs. 600 for additional tonnes. However, this reduction should become operable only after the composite computerised check post is set up. A record of violations can also be built up over time and increase in fines and other penalties contemplated for frequent violators.

6.28 Provisions relating to fines for violation of the obligations of conductors and drivers of passenger transport vehicles-that is refusal to transport a passenger, indulging in drug or other trafficking, demanding excess fare etc.-and fines for passengers unauthorisedly occupying seats reserved for women might require review if government controls over transport rates are eliminated.

6.29 For different categories of fines, we have given at Annexure I of Chapter VI suggestions for change

6.30 After due consideration, the Commission suggests that the present situation regarding intimation of non-use could continue and attempts made to improve information-sharing arrangements with other States by electronic and other means.

6.31 Acceptance of "lifetime tax" paid in other States and removal of re-registration and refund provisions can simplify matters and improve compliance. This is possible only if low-tax States like Goa and Union Territories like Pondicherry align their rates with those generally in vogue in the country. We have already made a reference to this in the first report. The issue may be taken up in inter-State fora and in the Transport Development Council.

6.34 A Road Fund should be set up at the State level provided with adequate resources from the budget to meet maintenance requirements, compiling an accurate central data base of roads of all kinds using GIS if required, strict adherence to rules concerning contract size and award of tenders and prohibiting works taken up under the Road Fund from being funded from any other source. The different elements of this package must be implemented together to ensure effective use of revenues raised to repair roads.

6.38 In the citizens' charter, two kinds of time limits have been set for performing key functions in computerised and non-computerised offices. It is necessary to enforce them rigorously and obtain regular feedback from customers. An effective arrangement to regularly update and run the site should be set up and queries of visitors attended to promptly. There is a case for online processing of applications in selected areas. The matter may be studied by the department and a decision taken.

6.39 Areas which require greater attention are preparation of users' manuals for each office, (which should be readily available to all members of the staff) and setting up an effective group and procedures within the department to support the computerisation effort. Posts of programmers and systems personnel created for the department should be filled up using own staff or contract staff instead of looking for persons to be taken on deputation.

6.40 Connectivity should be established between data bases of the Motor Vehicles department and the police and treasury departments as well as with data bases of other States. Smart cards incorporating the data available in RC books are proposed to be introduced after GOI finalises standards which can be uniformly applied to all States.

6.41 There is a case for improving the ambience of RTOs' and other offices through user-friendly information boards, clean and cheerful surroundings, better seating and waiting arrangements for the public, queue management to reduce delays, parking arrangements and a well-laid out hall for holding the written component of driving tests. Ergonomics in RTOs' offices needs improvement; a model office could be laid out using the services of a consultant in Koramangala or Indiranagar. The department is also in urgent need of open area for conducting fitness inspections and holding driving tests.

Taxing agricultural income

7.39 Constitution has permitted it to encroach into State fiscal territory. This seems to have happened in the case of coffee in the current year's budget. The few large coffee producers whose incomes were hitherto subject only to State taxation will divert part of their tax payments to the Central treasury when the 60-40 income apportionment formula mentioned above is made operational by an appropriate amendment in the State Act. The Finance department should be alert to such modifications, estimate the likely revenue loss and move the matter with the Union Finance Ministry to protect State tax inflows. Coffeegrowers who now benefit from the composition facility under the State Act, will under the current amendment become liable to return based assessment if they undertake non-farm gate activities since composition is not possible under the Central Income Tax Act.

7.62 In the short term, therefore, we see little justification for a return-based tax on all agricultural crops particularly if it is designed to replace land revenue like the Agricultural Holdings Tax of K.N.Raj.

7.63 We propose for immediate adoption is amendment of the Land Revenue Act to permit annual indexation of rates. The price index that we would suggest for adoption is the Consumer Price Index for Agricultural Labourers (CPIAL) that is regularly prepared on a monthly basis by the Simla Labour Bureau. Arrangements will, however, have to be made to make the annual indexation as transparent, objective and public as possible to ensure that even the smallest taxpayer is not at the mercy of unscrupulous officials to know his tax liability. The announcement of rates should also be done before the main *kharif* crop season commences in June. The computerised information network proposed for district revenue and panchayat administration should be used to disseminate assessment rates. Remissions now given for small holders should also be removed and cesses merged with the main tax.

7.64 Price-indexed land revenue rates should be introduced only when computerised RORs are made easily available through kiosks in villages to facilitate the paperwork required for agricultural lending. The Commission recommends that resurvey of agricultural land should also be done using modern techniques like GIS and digitised aerial and satellite mapping. Village records for a large part of the State could, therefore, be brought up-to-date with concerted effort. Special attention may have to be given, however, to metropolitan areas and Bangalore and its suburbs might present insurmountable problems. The Commission believes that resurvey would offer an excellent opportunity to consider partial adoption of the Torrens system of title insurance, which, as we have mentioned in our first report, is essential for taxpayers to willingly seek registration of documents relating to property transactions and pay the accompanying fees and duties. It is desirable to set up a high-level committee at the State level to oversee the entire resurvey and settlement process. We also recommend removal of the statutory provision excluding income realised from improvements made on the land by the landowner in the period between settlements while determining land revenue rates.

7.65 We believe that there is a strong case for putting in place a levy based on self-assessment (with provisions for presumptive taxation) for occupations like horticulture, floriculture, social forestry, pisciculture and similar activities as quickly as possible. This will supplement the basic restructured land revenue suggested above. We recommend immediate action to undertake the required surveys and develop productivity parameters for such avocations. Data available with financial institutions, which lend for such activities or refinance them like NABARD, could be used for computing presumptive taxation.

7.66 We do not recommend increase in rates

7.67 In the interests of horizontal equity, we believe that as far as possible taxation of agricultural and non-agricultural income should be done in a similar manner with identical rates, exemptions and procedures.
We therefore recommend that effective tax rates for agricultural income tax should be brought on par with those applicable to non-agricultural income tax. The rate and method of depreciation should also be similar. There may be no case for providing fiscal incentives for exports undertaken by grower-exporters (direct exporters) similar to those available for industries under 80 HHC of the IT Act or for investments made in R&D, since there is already a replanting allowance and such fiscal incentives are themselves not justified in tax administration. While not recommending increase in the composition limit from 150 acres to 500 acres as in Kerala, we suggest annual determination of composition rates to ensure that price fluctuations for each season are taken note of and undue hardship to cultivators avoided. The replanting allowance which was fixed several years back should be revised keeping in mind inflation over time. The State government should take measures to arrest the declining productivity of coffee. Schemes for promoting investment in the sector (like the Investment Deposit Scheme of 1995) are worth examination.

7.68 We suggest that whenever a taxpayer declares agricultural income above a fixed limit in his income tax assessment, it should be treated as such under the Agricultural Income Tax Act and subject to tax. This would be in line with the present judicial position that agricultural income determined under the Central Income Tax Act must be treated as such by State assessment officers. We suggest that the legal provisions required for this be introduced into the State Act to prevent evasion, raise revenue and enforce other regulatory statutes. The Finance department should assess the financial and other implications of the amendment introduced in the last Central budget allocating income derived from coffee on presumptive basis as agricultural and non-agricultural and take appropriate action from the point of view of revenue as well as taxpayer compliance.

7.70 In our view, land revenue is suited for levy by *panchayats*. Local knowledge is needed for applying the tax and if taxpayers perceive a close relationship between tax payment and benefits received, compliance and fund utilisation improve. We suggest, therefore, that government seriously consider transferring the levy to *panchayats* to strengthen their financial responsibilities.

Taxes on mines and minerals

8.21 It is desirable if information relating to exploitation costs for different minerals is regularly shared with States so that the royalty determination logic becomes transparent and scientific.

8.23 A solution which could be explored to ensure equity as well as stability might be to shift to royalty on *ad valorem* basis. Administratively, therefore, it should be possible to move to an *ad valorem* rate. Government may, therefore, make an indepth examination of the matter of fixing an *ad valorem* royalty rate for iron ore and take up the issue if necessary with the Centre after building up support from Orissa (the other major State concerned with this issue).

8.24 The State government could consider conversion of this rate also to an *ad valorem* rate and take it up with the Centre after obtaining the support of other affected States.

8.28 Considering current rates in some neighbouring States and keeping in mind the fact that royalty and dead rent have not been revised in respect of minor minerals in Karnataka for some time, increases have been proposed at Annexure II.

8.29 Keeping this in mind, further revisions have been proposed for certain items at Annexure III. It is also recommended that the proposal already made in the Karnataka Mineral Policy to amend Rule 19(a) of the Rules to permit transfer of leases for minor minerals on payment of 20% of the annual dead rent as premium may be implemented early.

8.30 Reviewing royalty rates for minor minerals

The Commission believes that it is necessary to streamline the existing mechanism. A statutory body consisting of officials and experts should be set up to regularly study quarrying costs and methods in respect of minor minerals. It should suggest appropriate royalty rates as well as procedural and administrative changes. This will enable the State to generate revenue in a scientific and environmentally sound manner.

8.32 In today's liberalised environment there may be a case for reconsidering this decision, but only in the context of strict regulation of quarrying operations by the forest and mines and minerals department.

8.33 There is a strong case for amending the Land Revenue Act to introduce a reasonable conversion fee for mining on agricultural land and dropping the saving clause of Section 70.

Concluding remarks

9.2 In the first report, we have suggested the establishment of a permanent review mechanism under the Secretary (Resources) for this purpose. A framework for diagnosing tax systems has been developed at the World Bank, which is given in this chapter to guide them in such assessment.

9.3 We do not believe that uniformity of rates and administrative practices is essential for all State levies. The degree of coordination needed to manage VAT has already been determined. The same extent of levelling may not be required for the other major State taxes. We do not, for example, see any need for States to adopt more or less identical tax schedules and regulatory requirements in the case of State excise duties as demanded by producers of potable alcohol. In the case of stamp duties and registration fees also, State governments are entitled to exercise their discretion to determine tax rates and revenue-raising methods within the existing statutory and Constitutional framework. Welfare-enhancing fiscal competition among different jurisdictions may even be desirable for efficiency and accountability to the taxpaying constituency.

9.4 The basic principle that should be applied when considering harmonisation is ensuring that tax incidence falls on those who benefit from State expenditure, that is limiting the impact of State taxes to those who live within their borders. Avoidance of "tax exportation" should be a major objective of tax policy. Uniform procedural sameness is not, however, essential in the sphere of tax administration as in other areas. A major advantage of autonomic State policymaking has always been the freedom to innovate; a new initiative that succeeds in one State is easily picked up and used by others.

9.5 While Andhra Pradesh has effectively put in place a computerised system for the sub-registrar's office, Tamilnadu seems to have succeeded in doing this for State excise administration. Karnataka has done similar work in the motor vehicles department. It would be convenient for southern States to draw on these experiences and even use the system and programs developed by their neighbours to rapidly modernise their own departments. Closer coordination among southern States for exchanging technical and administrative competence would benefit them all.

9.6 Taxation departments figure at the top of the list of government departments crying out for reform.

A great deal of improvement can come from overhauling the tax structure itself, reducing rates and slabs and removing exemptions as well as from publicising taxpayer obligations and departmental procedures.

9.7 We note, however, that several posts lie unfilled in major tax departments like registration and motor vehicles. We suggest that the post-reform requirements of these departments be assessed in depth and recruitment rules overhauled to meet their new needs. There are two areas to which particular attention should be paid: the first is the induction of persons with computer skills by modifying recruitment rules for all levels, the second is developing an economic and public finance perspective by alerting personnel to the consequences and effects of tax policies on SDP growth and welfare. Staff who are already in place must be given intensive in-house training in both these areas.

9.8 Administrative reform must also be focused on improving accountability for the department as a whole, for its different sections as well as for individual personnel. Timebound targets must be specified for all of them, which should be as objective, focused and simple as feasible. Such targets must also be linked to promotions and other incentives. Fixation of targets must be done with a clear understanding of the kind of behaviour that would be promoted by each of them. At the departmental level, budgets and other facilities could be linked to macro performance ratios. There is a case for linking the provision of some additional amenities to achievement of a few pre-determined targets. Targets should not only be linked to revenue realisation; performance should be judged as much by improvement in taxpayer compliance and public satisfaction as by quicker and more effective audit and successful imposition of prescribed penalties. Incentivisation techniques must be explored for taxpayers as well as personnel. A major advantage of VAT is the inbuilt incentive for better compliance. We stress the need to ensure that this feature is not diluted when adaptations are made to introduce value added taxation in the transitional stage

9.9 It is essential also to specially combat the vulnerability of tax departments from the point of view of corruption. Strategy to combat corruption must limit the motives and opportunities for public officeholders to abuse their positions. There should also be focus on the supply side of bribes. Caution must be exercised while offering incentives for revenue officials to ensure that they do not lead to overzealous harassment of taxpayers. Negative incentives should therefore complement positive ones. Independent taxpayer surveys will help identify elements of the organization or tax offices that harbour severe corruption. Studies like recent ones undertaken by the Public Affairs Centre at Bangalore on ranking government offices on a consumer satisfaction index should be encouraged and their findings used for judging departments.

9.10 Internal audit divisions and anticorruption units within the department should be supplemented by effective judicial support, external reviews (including external audits) and interaction with taxpayer associations. Contact between officials and taxpayers could be reduced through withholding taxes, using third party data for tax assessment and account-based assessment. The last two are inseparable from value added taxation. In addition to these measures, we strongly recommend setting up an independent enforcement agency for all tax departments as a whole similar to the Bangalore Metropolitan Task Force now working in Bangalore city.

9.11 Corruption can be also kept under control by improving taxpayer awareness of rights and obligations by publicising procedures through brochures, web sites (regularly and correctly upgraded by an institutionalised system), kiosks and the like and enforcement (not mere announcement) of citizens' charters. As far as possible, payment mechanisms should be integrated into normal commercial methods by collecting tax through banks. On line filing of returns should be facilitated and taxpayers permitted to ascertain the processing stage of pending applications, the reasons for delay etc. Enquiries must be conducted swiftly on complaints received against departmental personnel and penalties enforced without delay. We must also guard against newer forms of corruption that could enter by the back door even after modernised systems are put into place. A common method of introducing middlemen into tax departments is by preventing the public from having access to the required forms. Apart from encouraging on line interaction, we must also arrange for forms to be automatically printed out at kiosks and other sale points.

9.12 Reform must be ushered in through a package of measures that cover statutes, procedures and administrative culture.The aim should be to set up a structure that would respond satisfactorily to growth in Gross Domestic Product. This would eventually be the test of success of the reform agenda.

9.13 There are identifiable stages in the reform process starting with dissemination of the reform message and proceeding through consultation and compromise and conversion of decisions into timebound activities to the final phase of consolidation and maintenance. Unless the stretch is fully covered, the reform cannot be considered to be complete.