



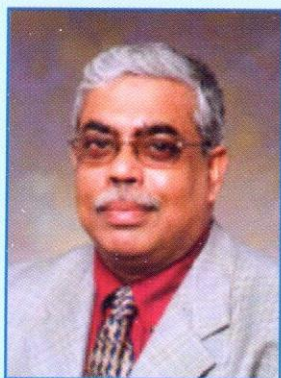
Policy Briefs

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Centre for Training and Research in Public Finance and Policy (CTRPF) is a Ministry of Finance, Government of India funded initiative. CTRPF Policy Briefs are prepared to communicate results of CTRPF research on specific policy issues to the policy makers.





Foreword

The Centre for Training and Research in Public Finance and Policy (CTRFPF) is engaged in analytical and policy related studies that are disseminated in the form of seminars, working papers and other publications. However, sometimes, the general educated reader, who is interested in the essential ideas and policy implications, may find these research works too long and difficult to comprehend. The series of Policy Briefs is our attempt to bring our research findings to a wider audience, who perhaps, do not have the time to delve too deeply into the intricacies of each topic but are interested in and would benefit from research based policy work.

Any views expressed in the Policy Briefs, however, are those of the author(s) and do not necessarily reflect those of the Centre for Training and Research in Public Finance and Policy (CTRFPF).

Sugata Marjit

RBI Chair Professor of Economics

Project Director, CTRFPF

West Bengal's Value Added Tax and "Unobserved" Unorganized Sector: A Possible Model

Avik Chakrabarti*

“The organized manufacturing sector has been gradually destroyed in the last few decades and unorganized sector has grown. This has resulted in low tax base in our state (West Bengal).”

Sugata Marjit

*Reserve Bank of India Professor
(Times of India, July 13, 2011)*

IN view of the dire state of finances, West Bengal's Finance Minister Amit Mitra reminded (March 23, 2012) the Assembly of the pressing need to broaden the tax net by expanding the number of companies and firms under the ambit and compliance of our state's Value Added Tax (VAT) and proposed an increase in the VAT rate by a full percentage point from 13.5% to 14.5% on luxury goods. This was anticipated despite the fact that

- West Bengal will get Rs. 24,784 crore as the Centre's share of taxes (in the budgetary estimates for the 2012-13) which is higher by Rs. 5,618 crore, compared to the central tax share of Rs. 19,166 crore in 2011-12;
- Centre has raised the state's borrowing limit by Rs. 2,706 crore from the original borrowing limit of Rs. 17,828 crore; and
- West Bengal has extended market borrowing by an additional Rs. 1,000 crore.

The state government, having historically failed to contain its non-interest revenue expenditure, has systematically used net borrowing for financing. Reports also indicate that the state government now owes hundreds of crores of rupees in VAT refunds despite the fact that the multi-point sales tax (levied at every stage of the value chain) was originally intended to relieve cascading tax burdens through a free and frictionless flow of credit toward taxes paid at any previous stage.

With this backdrop, it becomes imperative to visit the linkages between imminent increases in state VAT rates and a potential expansion of our state's VAT base to include the vast and growing unorganized sector characterizing a typical "unobserved" economy that remains a virtually untapped source for raising tax revenue and yet is allegedly subject to significantly large though undocumented amounts of extortion fees paid to political hooligans and corrupt policemen. In view of the spatial and temporal

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relevance of such linkages, notwithstanding the conspicuous absence of any systematic empirical study of relevance, it is worth highlighting some theoretical underpinnings.¹

An early lesson learned by a student of public finance is that taxes affect equilibrium prices and quantities of a commodity that is taxed. A rise in the tax rate will initially raise tax revenues as long as the percentage rise in the tax rate exceeds the percentage fall in quantity. After a point, the percentage fall in quantity will dominate the percentage rise in tax rates so that further tax rate increases cause tax revenues to fall. Based on this simple principle, Arthur Laffer had portrayed Adam Smith's conjecture that as tax rates rise continuously tax revenues will rise only up to a point and then decline due to the erosion of the tax base, a notion that gained visibility in the shape of the Laffer curve through the early 1980s when supply-side economists insisted that lower tax rates would be associated with higher revenues due to a broader tax base.

The Laffer curve essentially combines two opposing effects that changes in tax rates have on tax revenues: an arithmetic effect and an economic effect. The arithmetic effect is trivial: a rise in tax rates will raise tax revenues, for any given tax base. The economic effect recognizes the negative impact that higher tax rates have on the tax base by working as a disincentive. The economic effect will eventually outweigh the arithmetic effect in the "prohibitive range" where a hike in the tax rates can lower tax revenues.²

It has become increasingly evident though that the shape and position of the Laffer curve, the classic smooth and inverted-U look of which had once appeared to be a cornerstone of public finance, is sensitive to the size of the "unobserved" economy.³ In a proportional tax structure, absent an unobserved economy, as the supply elasticity rises, the revenue maximizing tax rate falls. Tax revenue realized at any given tax rate declines with a rise in the elasticity of supply.

Where does West Bengal's "unobserved" unorganized sector fit into all this? To isolate the plausible links of taxes to the unobserved component of the state's economy, by abstracting from the possibility of any reduction in the tax base following from the exclusive effect of a rise in the tax rates on the withdrawal of factors from the market, assume a perfectly inelastic supply. If tax evasion by the observed economy increases and the unobserved economy picks up an increasing share of the potential tax base, across the board rise in tax rate will lead to an erosion in the tax-base when the observed output shrinks relative to the unobserved output as higher tax rates increase the relative price advantage of dealing in the unobserved sector. If preferences decline for the output of the unobserved economy the Laffer curve shifts up i.e. the tax revenue realized at any given tax rate rises.

¹ For illustrative views shared by eminent economists, see excerpts from interviews of Professor Sugata Marjit, Professor Ajitava Raychaudhuri, and Professor Abhirup Sarkar, published by the Times of India, Mar 21, 2011.

² Source: Laffer, A., "The Laffer Curve: Past, Present, and Future", Backgrounder, The Heritage Foundation, 2004, 1-16.

³ Subsequent discussions draw heavily on Feige, E. L., and R. T. McGee, "Sweden's Laffer Curve: Taxation and the Unobserved Economy", *Scandinavian Journal of Economics* 85 (4), 1983, 499-519.

Determinants of Stamp Duty Revenue in Indian States

Vivekananda Mukherjee*

■ EXECUTIVE SUMMARY

This note, based on the study by Dr. Vivekananda Mukherjee of Department of Economics, Jadavpur University, Kolkata, investigates the significant determinants of stamp revenue collection in Indian states. Econometric analysis of a panel data set for 18 Indian states over the period 1993-94 to 2009-10 reveals that among all the parameters, per capita income of the states has the most significant impact on the stamp duty revenue collection. The tax buoyancy is estimated at about 0.36 i.e. 1% increase in the per capita income of the state is expected to raise the stamp duty revenue collection to the tune of 36%. The administrative reforms at the states' Stamp Duty and Registration Departments, like introduction of franking machines and e-governance have positive impact on the stamp duty revenue collection as well, but at a weaker level, the impacts being estimated at 22% and 17% increase in the revenue. The central government's choice of capital gains tax rate creates an externality on the stamp duty revenue collection of the states: lowering of capital gains tax rate by 1% lowers the stamp duty revenue collection by 2%. Surprisingly, the choice of tax rates by the states is found to have insignificant impact on stamp duty revenue collection.

The results of the study have important bearings in critical assessment of the policy of lowering of stamp duty rates and introducing administrative reforms as part of the Urban Reform Incentive Fund implemented by the Central Government since 2003-04 (later subsumed in Jawaharlal Nehru National Urban Renewal Mission (JNNURM)). It shows that the reforms, if successfully implemented by the states, should have a positive impact on the states' stamp duty revenue collection. On the assumption that maximization of stamp duty revenue is the policy objective, it provides particular suggestions for the Stamp Duty and Registration Department of the states on the future course of actions about the choice of stamp duty rates and administrative reforms and an overall guideline for the state governments on the use of JNNURM funds.

■ THE ISSUES

'Stamp duty' is defined as a tax on the value of instruments used in various business transactions. Currently in India the states collect revenue from two different types of 'stamp duty': (1) judicial stamp duty: collected as court fee; (2) non-judicial stamp duty: collected ad-valorem as transaction tax on transfer of immovable property. A tax in the form of 'registration fee' is also collected by the states on notification of contracts; in some of the states it is collected ad-valorem, in some others it is collected per transaction. A transaction tax on exchange of securities is collected by the Centre through the depositories. The security transaction tax has a uniform rate charged across India. But, the rates of other transaction taxes mentioned above vary from one state to another as their rates are decided by the respective state governments.

The major share of stamp duty revenue collection of the states comes from the non-judicial stamp duty on "conveyance" (or "deed of sale") at high value transactions in urban housing markets. For example

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during 2009-10 in West Bengal the urban agglomerates around Kolkata (the city itself and the districts adjacent to it) contributed nearly 70% towards the states' total collection of stamp duty revenue while their share in the number sale deeds across the state was only about 30%⁴.

Although stamp duty constitutes the 3rd or 4th important source of revenue for the state governments (after sale tax and state excise duty and sometimes after tax on vehicles, the all India average being between 7% to 14% of own tax revenue), it has been seen in India as an important source of inefficiency at the urban housing market. It had been pointed out: (1) the 2003-04 stamp duty rates in Indian states were very high compared to international standard (less than 5% at that point of time in most of the countries around the world); (2) the high stamp duty rates discourage the growth of urban property market; (3) the high rates induce widespread fraud by the use of fake stamp paper⁵ and tax evasion; (4) stamp duty generates negative externality on other levels of governments like urban local bodies and the central government by reducing their tax base (5) substantial transaction cost exists in stamp duty administration. Because of these reasons the central government started the Urban Reform Incentive Fund in 2003-04 (which 2005-06 onwards was subsumed in JNNURM) to induce the states in reducing their stamp duty rates and in implementing the administrative reforms so that they are able to reduce the associated transaction cost and to check the generation of black money as well. The funds are released to states as part of JNNURM on the binding condition (there are other conditions too) that by 2012 they would reduce their stamp duty rates to 5%. The condition of administrative reform however was not a binding condition: was optional for the states. Since, as mentioned above, stamp duty contributes a reasonably large share to a state's own revenue, therefore, the concern that becomes important is whether such policies would have a positive or a negative impact on the state's own revenue. This is specially so, because while proposed Goods and Services Tax (GST) in India casts a shadow of uncertainty on the states' revenue stream, the stamp duty revenue, as it is likely to fall outside the proposed GST⁶, promises a steady flow of revenue to the states.

■ DATA AND METHODOLOGY

The data have been collected for 18 states over 17 years from 1993-94 to 2009-10 from various official sources like Reserve Bank of India publications. The states included in the study are: Gujarat, Goa, Maharashtra, Rajasthan, Karnataka, Tamil Nadu, Kerala, Andhra Pradesh, Haryana, Himachal Pradesh, Punjab, Delhi, Orissa, West Bengal, Assam, Manipur, Meghalaya and Tripura. The stamp duty rates in a typical state usually have many slabs with the high value property transactions in urban areas attracting the maximum rate. The charges and surcharges add up on the base rate to define the maximum rate that is payable for high value urban property transactions. The study presumes that the most of the stamp duty revenue comes from the high value property transactions in urban areas and takes the maximum stamp duty rate in a year as the data on the stamp duty rate for a particular state in a particular year. The years preceding 1993-94 have not been considered due to non-availability of reliable data on the variables used in estimation. The states like Uttar Pradesh, Madhya Pradesh and Bihar which had been divided during this period to create new states have also been excluded. The capital gains tax rate in India has different categories: there are different rates for individuals and corporate entities. For this study, the average of the individual and the corporate rates has been taken as a typical year's entry.

⁴ The data has been collected from the Directorate of Stamp Duty and Registration, Government of West Bengal.

⁵ The Telgi scam that was unearthed in late 2003 found an organization, headed by Abdul Karim Telgi, printed and circulated duplicate stamp papers throughout India and evaded revenue to the tune of Rs. 780, 000 million or US\$ 17 billion (see S. Arvind "Stamping out Stamp Scam" Hindu Business Line, January 2, 2004).

⁶ See Poddar and Ahmad (2009).

The stamp duty revenue collection in a state is not a function of only the stamp duty rate and the administrative variables. To formally understand the determinants of stamp duty revenue in a state the study first develops a theoretical model of a housing market to identify a wider range of parameters that influence the stamp duty revenue collection. These parameters include, apart from stamp duty rate and administrative variables like introduction of franking machines and e-governance, per capita income of the state, capital gains tax rate chosen by the Centre, property tax rate chosen by the urban local bodies (ULBs), market rate of interest, market capitalization rate, depreciation of housing stock, depreciation of the value of the house and expected capital gains on the purchased house. From the model the expected effect of change in each of these parameters on stamp duty revenue collection has been derived. Then the model has been empirically tested with data collected on a subset of the above mentioned variables that include stamp duty rate, per capita income of the states, capital gain tax rate, administrative variables like introduction of franking machines and e-governance.

■ RESULTS

Econometric analysis of panel data set for 18 Indian states over the period 1993-94 to 2009-10 reveals that among all the parameters, per capita income of the states has the most significant impact on the stamp duty revenue collection. The tax buoyancy is estimated at about 0.36 i.e. 1% increase in the per capita income of the state is expected to raise the stamp duty revenue collection to the tune of 36%. The administrative reforms at the states' Stamp Duty and Registration Departments, like introduction of franking machines and e-governance have positive impact on the stamp duty revenue collection as well, but at a weaker level, the impacts being estimated at 22% and 17% increase in the revenue. The central government's choice of capital gains tax rate creates an externality on the stamp duty revenue collection of the states: lowering of capital gains tax rate by 1% lowers the stamp duty revenue collection by 0.02%. Surprisingly, the choice of tax rates by the states is found to have insignificant impact on stamp duty revenue collection.

The results show that the reforms initiated by the Central government, if successfully implemented by the states, should have a positive impact on the states' stamp duty revenue collection. The policies implemented to promote per capita income growth of the states add to the growth of stamp duty revenue collection significantly. The results also imply that if a state does not grow in terms of its per capita income and the administrative reforms are not introduced, the stamp duty revenue collection of the state may even fall because of the negative external effect it would have by the Central government's policy of gradual reduction of the capital gains tax on its own.

■ POLICY PRESCRIPTION

The results of the study suggest that at present the following should be the optimum policies of state governments regarding the stamp duty rate and its administration: (1) reduction of the stamp duty rate to 5%, as suggested by JNNURM and use of the funds received through it in productive way so that per capita income increases in the state; (2) introduction of franking machines (if not, equivalent systems like collection of stamp revenue through banks or e-stamping) in the administration for checking circulation of fake stamp papers; (3) introduction of e-governance in valuation of properties and use of more manpower for collecting disaggregated information about true market value of the properties. The prescribed policies are expected to improve stamp duty revenue collection of the states.

India's Move from Sales Tax to VAT: A Hit or Miss?

Sattwik Santra* &
Koushik Kumar Hati**

■ BACKGROUND OF THE STUDY

Tax earning is one of the most important sources of revenue for any government. In India, tax is basically of two types – Direct Tax and Indirect Tax. The direct tax is directly paid to the government by individuals. Income tax is a good example of this type of taxation. Indirect tax (such as sales tax, value added tax, or goods and services tax), on the other hand, is a tax collected by an intermediary (such as a retail store) from the person who bears the ultimate economic burden of the tax (such as the customer). In this paper we focus on the functioning of indirect tax to generate revenue across states of India. It can be well observed from various data sources that commercial tax i.e. the tax on goods and services in India, contributes almost a quarter of the total revenue collected across the nation. In the recent past also commercial tax has been a significant contributor in total taxes collected by the central as well as state governments.

From the year 2003, Government of India introduced Value Added Tax (referred to as VAT) over Sales Tax (referred to as ST) for the commercial sector. The main motive of the Government behind this move was to introduce transparency and raise the efficiency of the tax collection system (The Empowered Committee of State Finance Ministers, 2009).

The model of taxation of goods followed in India for more than fifty years post – independence was characterized by cascading and distortionary tax on production. A cascade tax or cascading tax is a turnover tax that is applied at every stage in the supply chain, without any deduction for the tax paid at earlier stages. Such taxes are distorting in that they create an artificial incentive for vertical integration. This according to many (Purohit M. C., 1986) (Gurumurthi, 1997) lead to misallocation of resources and dampen economic growth. Such cascading effects ultimately have a negative impact on the tax base thereby hindering the process of revenue generation and resource mobilization of the Government. To address this major problem of the prevailing taxation-system, VAT was introduced in early years of twentieth century. A VAT is a form of consumption tax. From the perspective of the buyer, it is a tax on the purchase price. From that of the seller, it is a tax only on the value added to a product. VAT in theory avoids the cascade effect of ST by taxing only the value added at each stage of production. It was thought that VAT would address the problems of the existing system of taxes (Purohit M. C., 1993) and is seen as an important breakthrough in the sphere of indirect tax reform in India.

■ OBJECTIVE OF THE STUDY

The Value Added Tax and Sales Tax are indirect commercial taxes in India. Government of India introduced VAT across all its states in subsequent stages in the early years of this millennium. The main motive behind this move was to make the commercial tax collection more transparent, accountable and revenue enhancing. The purpose of this paper is to see if the introduction of VAT has indeed served its purpose or not.

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■ DATA AND METHODOLOGY

The data on state finance and state domestic product have been collected from the Hand Book of Statistics on Indian Economy, Reserve Bank of India and some other secondary data sources. Some of them include, Department of Revenue, Ministry of Finance, Government of India, Finance Departments of various state governments, etc. The data for Perceived Anti – Corruption Effort has been taken from the book “Corruption in India: The DNA and RNA” by Laveesh Bhandari and Bibek Debroy.

To see the relative efficacy of VAT over ST, the paper checks if VAT has been able to increase the amount of commercial tax collection across states by lowering the volume of tax which remains untaxed. Imputation of transparency in the tax collection mechanism through reduction in corruption has also been compared between the two tax regimes. A Generalized Least Square (GLS) estimation from a panel of 29 states across the country has been followed to estimate the model, developed suitably, to capture the effect on untaxed volume and transparency.

■ RESULTS

Except for the year 2001, for the ST regime our estimate of untaxed volume (here after, referred to as γ) came out to be statistically insignificant. For the VAT regime i.e. from 2005 onwards, except for 2009, the estimated value of γ turned out to be significant. This indicates that the explanatory variables used for the ST regime failed to account for the total variation in tax collection. If we use the estimate of γ for the year 2001 as a prospective candidate for the estimation of γ under ST regime and compare the same under the VAT regime for the year 2005-2008, we can see a huge jump in the value of γ . This seems to suggest that introduction of VAT has contradicted its purpose (*refer Fig. 1*). But if we look at the estimate of γ for 2009 we notice a renewal in the untaxed amount. We also find that the magnitude of the index for anti-corruption has decreased substantially and towards the end of our period of

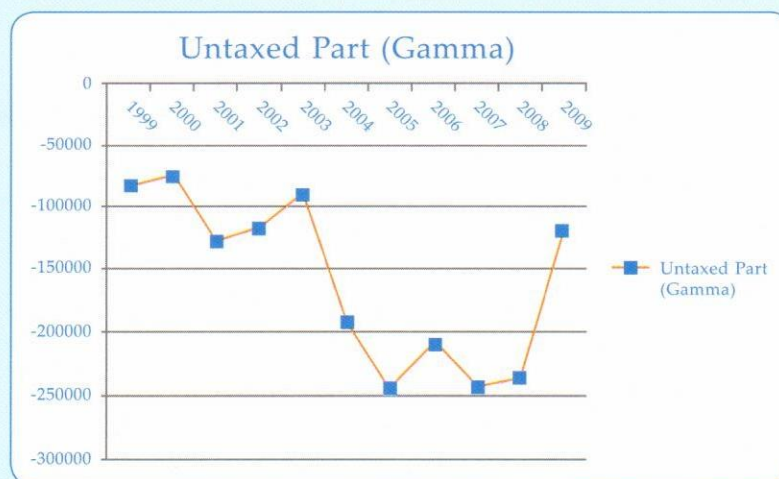


Fig. 1

analysis it has lost its significance. This seems to suggest that the overall transparency of tax collection for the VAT regime has increased compared to the ST regime.

The construction sector seems to influence the sales tax collection quite significantly for all the years except 2003. The contribution of registered manufacturing sector, on the contrary, remains insignificant for most of the periods (under ST regime the coefficient of manufacturing came out to be negative though it turned out to be positive under VAT regime). The coefficient associated with registered manufacturing though turned out to be significant for the initial years, become insignificant later on

■ CONCLUSION

- i) Our study reveals that introduction of VAT has indeed increased the amount left untaxed. As of now, it has been observed that VAT has not proved to be a better tax collection mechanism to enhance commercial tax revenue as compared to sales tax.
- ii) Overall transparency of tax collection under the VAT regime has increased compared to the ST regime.
- iii) More critical study on the impact assessment of VAT should be encouraged so as to scrutinize the system and detect the causes of non-responsiveness of the system.

The Centre for Training and Research in Public Finance and Policy (CTRFPF) was established in the year 2011 as a consequence of a MOU signed between the Centre for Studies in Social Sciences, Calcutta (CSSSC) and the Ministry of Finance, Government of India, for promotion of study, research and training in public finance and public policy.

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