



Union Excise Duties: Evolution and Present Structure

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ABSTRACT

Excise duties are an important source of indirect tax revenue for the Central Government. This paper looks at the evolution of the excise duty structure in India. The nomenclature, administration and revenue significance of excise duty has been outlined. The paper then looks at the reforms in the excise duty structure by analysing the recommendations of the various Committees constituted in this regard. We also examine the problem of the taxation of inputs and the resulting cascading effect on the prices of final products by looking at the transition from pre-MODVAT arrangements to MODVAT and CENVAT structure. Finally, the paper highlights the problems created by exemptions and concessions and how these concessions are misused. There is a need to understand that if concessions are judiciously used, they can become an effective tool of economic change on desired lines.

Keywords: *Excise duty, MODVAT, CENVAT, Exemptions.*

1.0 Introduction

Excise duties are an important source of indirect tax revenue for the Central Government. They are levied on a wide range of products of the industrial sector of the economy. In accordance with the provisions of the Constitution, various types of excise duties and cesses are imposed by the Union Government on commodities covered by the Central Excise Act, 1944 and other Acts. The important duties currently in operation are the following.

Basic Excise Duty: Levied under Section 3 of the Central Excise Act, 1944, this is the main duty commonly known as basic excise duty. This duty may be fixed with reference to the value, weight, volume, unit, length or area of the excisable goods. These details are given in the Schedule of the Central Excise Tariff Act, 1985.

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Additional Duties in Lieu of Sales Tax: These duties are imposed under the Additional Duties of Excise (Goods of Special Importance) Act, 1957, which provides for the levy and collection of additional duties on sugar, tobacco, cotton fabrics, rayon or artificial silk fabrics and woollen fabrics produced or manufactured in India. These duties are in addition to the duties payable under the Central Excises and Salt Act, 1944, and replace, by agreement with State Governments, the sales tax levied by them on these commodities. The net proceeds from additional excise duties are distributable among the States in accordance with the principles of distribution formulated and the recommendations made by the Finance Commissions from time to time.

Cesses: These are levied under separate enactments on certain commodities and the revenue is earmarked for specific purposes. For example, handloom cess is levied on fabrics to raise funds for developing *khadi* and other handloom industries and for promoting the sale of *khadi* and other handloom cloth. Cesses are also levied under various Acts on tea, jute, indigenous crude oil, paper, sugar, *bidis*, automobiles, vegetable oils, and television sets.

The Central Excise Act, 1944, is the main enactment under which duties are levied on different commodities. Under Section 37 of this Act, a set of rules known as the Central Excise Rules, 1944, has been framed to implement the provisions of the Act. Another set of rules under the same section deals exclusively with the valuation of the excisable commodities and is known as Central Excise (Valuation) Rules, 1975. The Act and the Rules are amended from time to time. Broadly speaking, the Act embodies substantive law, and the Rules contain both substantive law and procedural matters.

Although the Central Government is empowered to levy duties on agricultural products also, it has refrained to do so in view of the administrative difficulties involved. Therefore, the excise system has remained confined mostly to the products of the industrial sector with the notable exceptions of tea and coffee.

2.0 Different Procedures to Collect Excises

Central excise duties are assessed and collected through a vast network of offices scattered all over the country. There are various procedures to assess and collect excise duties.

2.1 Physical Control System

This procedure, based on personal verification of production by excise officers, was the chief procedure to realise excise duties till it was replaced by a new system called self-removal procedure from June 1, 1968. Under the physical control method, excise control was exercised by the officers of the Excise Department who were posted

at the factory to keep watch over the operations in the various departments of the factory to prevent illegal disposal of the manufactured articles. The physical control procedure was based on personal verification of production, storage, and clearance of excisable goods.

The manufacturers, however, were unhappy with this direct interference in the manufacturing process. Therefore, ever since Independence they had been demanding abolition of the physical control scheme and its replacement by a system based on audited accounts. The Taxation Enquiry Commission, 1953-54, favoured the retention of the physical control system. It observed, "It seems to us reasonable for the Government to ensure that for the period intervening between production and clearance the goods should be kept in a proper place and under adequate supervision. The procedure followed in India in this regard is also practically the same as that obtaining elsewhere. Physical supervision is considered to be necessary in such cases in almost every country."¹ The organised sector, however, continued to build up pressure for the replacement of the physical control system and ultimately the self-removal procedure was introduced with effect from June 1, 1968. A few commodities are still subject to the physical control system including sugar, chewing tobacco, and matches.

2.2 Self-Removal Procedure (SRP)

Under this liberal system, introduced in place of the physical control system, an assessee is allowed to take clearances on his own assessment of the duty liability without prior permission of physical checks by excise officers. This procedure is applicable to most of the commodities under the excise net. An assessee is, however, required to get his classification list approved by the excise authorities before effecting any removal. In the classification list the assessee details the description of the goods produced so that they may be categorised in terms of the rate of duty applicable to them. In case of *ad valorem* duties, the assessee is further required to submit a price list showing the prices charged along with discounts and deductions, if any. In essence, the SRP is a record-based system of duty collection relying on mutual trust and belief. Unfortunately, heavy evasion of excise duty has taken place under this scheme. Excise evasion under this liberal scheme is generally resorted to by following such malpractices as incorrect accounting of goods, undervaluation of goods, and flouting the conditions subject to which any goods may be exempted from duty.

2.3 Compounded Levy Scheme

This is another procedure for the benefit of small-scale sector and for administrative convenience. Levying of excise duties on small-scale sector has always

remained a major problem of the Indian excise system. In many cases, small-scale sector accounts for a significant portion of the output of an industry and it becomes necessary to subject it to excise taxation. However, the procedures adopted for collection of excise from big firms have often been found expensive and time-consuming when applied to small firms. This has necessitated the adoption of special procedures suitable for small-scale sector.

Under the compounded levy scheme introduced in 1954, a lump sum payment is made on the basis of some installations, e.g. the number of looms in case of textile units. Once the compounded levy has been paid, the producer becomes free from all excise formalities except to maintain a record of looms in operation. The scheme is applicable at present to small units producing *khandasari* and cotton fabrics produced on powerlooms. This system affords considerable advantages to the small producers insofar as they are saved from the cumbersome normal excise procedures and also by the fact that the fiscal burden under compounded levy is generally lower than the burden under normal procedures.

3.0 New Excise Tariff Nomenclature

The year 1986 was a landmark in the evolution of excise taxation in India. In that year a new internationally accepted harmonised system of commodity classification was introduced in place of the then existing antiquated system introduced by the British. The history of excise tariff classification dates back to the year 1944 when the Central Excises and Salt Act was passed, consolidating separate enactments for different goods. This Act of 1944 covered 11 tariff items which were arranged in alphabetical order.

In 1960, the tariff items, the number of which had soared to 30, were rearranged in accordance with the sections of the Standard International Trade Classification (SITC). By 1986, the excise tariff schedule covered 137 tariff items and if account is taken of the sub-items, the number was well over 355 main classifications. The description of tariff commodities was based on the definitions of the Indian Standard Institution, and the descriptions and explanatory notes of the Customs Co-operation Council Nomenclature (CCCN). The domestic trade parlance was also relied upon.

On September 22, 1984, the Government set up a Technical Study Group to undertake a comprehensive review of the then existing tariff nomenclature. The Group drafted a comprehensive and elaborate tariff nomenclature broadly patterned on Harmonised System Nomenclature (HSN), fully corresponding up to 2-digit level (i.e. Chapter level) in respect of 82 of the effective 96 chapters in the HSN. It also suggested that the new tariff should be provided for by a separate Act to be called the Central Excise Tariff Act in place of

the then existing system of tariff being governed by the First Schedule of the Central Excises and Salt Act, 1944.

The recommendation of the Technical Study Group as regards the new tariff nomenclature was accepted by the Government and a new Central Excise Tariff Act, 1985, was passed for the purpose. The excise tariff based on the internationally accepted harmonised commodity description and coding system came into effect from February 28, 1986, ushering a new era in excise taxation. The Schedule of the Central Excise Tariff Act, 1985, describes the excisable commodities and the rate of duty leviable on them. The new tariff is spread over 91 chapters and covers around 700 four-digit headings and 1,400 six-digit headings.

4.0 Administration of Excise Taxation

There is an elaborate administrative machinery for the collection of excise duties. At the apex level is the Central Board of Excise and Customs which is a statutory Board forming part of the Department of Revenue in the Ministry of Finance. The Board, consisting of a chairman and five members, is responsible for the proper collection of customs and Central excise duties, and framing and implementation of related fiscal policies under the control and direction of the Union Finance Minister.

At the field level, under the Central Board of Excise and Customs there are 34 Commissionerates of Central excise entrusted with the task of collecting Central excise duties. Each of the Commissionerates is headed by a Commissioner of Central Excise who is aided by a number of Additional Commissioners and Deputy Commissioners. A group of Commissionerates is headed by a Chief Commissioner. For administrative convenience, each Commissionerate is divided into a number of divisions, each such division headed by an Assistant Commissioner. A division is further sub-divided into a number of ranges. Each range is headed by a Superintendent of Central Excise who in turn is assisted by a number of Inspectors.

In fact, the range is the basic unit in the administrative set up responsible for the proper assessment of Central excise duties and generation of the statistical information relating to revenue collection. The range is the primary unit which is in contact with the assesseees and tries to ensure that the laws and procedures are properly followed by the production units. To ensure that the goods are properly classified, assessable value correctly determined, and the duties correctly paid, each Commissionerate has an internal audit wing which is headed by an Additional Commissioner directly responsible to the Commissioner of Central Excise. The internal audit is in addition to the statutory audit conducted by the Comptroller and Auditor-General of India.

Each Commissionerate has an anti-evasion wing headed by an Additional Commissioner directly responsible to the Commissioner of Central Excise. The anti-evasion wing makes checks on the basis of intelligence and information to ensure that proper duties are paid and there is no evasion of duties or leakage of revenue. In some Commissionerates, there is a separate Commissioner to look after the judicial and adjudication work. There are Commissioners who attend to appeals against orders passed by officers lower in rank to them.

Moreover, a number of supportive organisations under the Central Board of Excise and Customs undertake work of a specialised nature. Thus, there is the Directorate of Inspection headed by a Chief Commissioner which undertakes the inspection of Central excise formations. The Directorate of Anti-Evasion has the responsibility to ensure all-India co-ordination of anti-evasion work. The National Academy of Customs, Excise and Narcotics is entrusted with the task of training officers. The Directorate of Publicity and Public Relations is responsible for printing and publicity. The Directorate of Statistics and Intelligence is responsible for compiling and updating statistical information.

5.0 Revenue Significance

In the post-Independence period, the relative share of excise duties in Central Government's tax collections has increased precipitously. In 1950-51, excise duties accounted for a modest 16.8 percent of the total Central tax collections: Rs. 68 crore out of Rs. 404 crore. Within a span of 20 years, the proportionate share shot up to 54.9 percent in 1970-71. It declined to 49.3 percent in 1980-81 and further down to 42.6 percent in 1990-91. It stood at 36.3 percent in 2000-01 and 17.4 percent in 2010-11. It was estimated at 15.2 in the budget for 2014-15 (Table 1). A Government document noted the following reasons for this downward trend, "The buoyancy of excise has suffered because of a variety of factors including numerous exemptions and concessions which have given rise to substantial administrative and legal complexities. Recent years have witnessed an unprecedented increase in litigation."²

Although excise duties are imposed on a large number of commodities, a substantial proportion of revenue is derived from a limited number of items. These high revenue yielding commodities include iron and steel, motor spirit, tyres and tubes, cigarettes, cement, plastics and refined diesel oil. It is noteworthy that many of the high revenue yielding items are commodities of mass consumption and therefore the burden of excise duties falls on all sections of society.

6.0 Commodity Coverage

As already noted, excise taxation in India was fairly selective in terms of commodity coverage during the pre-Independence period. However, the need for resources required for planned economic development made it necessary to rely on excise taxation for additional funds. This was particularly so in view of the extremely narrow base for direct taxation and the dwindling relative revenue significance of customs duties owing to euphoria for import restrictions and substitution. The scope for extension of excise coverage improved considerably as development efforts were intensified for the production of industrial goods that enjoyed a relatively large and stable domestic market.

Table 1: Trends in the Relative Significance of Union Excise Duties in Gross Tax Revenues* of the Central Government: Selected Years

(Rs. crore)

| Central taxes | 1950-51 | 1960-61 | 1970-71 | 1980-81 | 1990-91 | 2000-01 | 2010-11 | 2014-15 |
|-------------------------------|----------------|----------------|------------------|-------------------|-------------------|---------------------|---------------------|----------------------|
| A+B Gross tax revenues | 404 (100.0) | 888 (100.0) | 3,206 (100.0) | 13,179 (100.0) | 57,576 (100.0) | 1,88,603 (100.0) | 7,93,072 (100.0) | 13,64,524 (100.0) |
| A. Direct Taxes | 174 (43.1) | 290 (32.6) | 870 (27.1) | 3,004 (22.8) | 11,025 (19.1) | 68,306 (36.2) | 4,45,962 (56.2) | 7,36,221 (54.0) |
| B. Indirect taxes of which | 229 (56.7) | 599 (67.5) | 2,337 (72.9) | 10,175 (77.2) | 46,552 (80.9) | 1,20,297 (63.8) | 3,47,110 (43.8) | 6,28,303 (46.0) |
| Union excise duties | 68 (16.8) | 414 (46.6) | 1,759 (54.9) | 6,500 (49.3) | 24,514 (42.6) | 68,526 (36.3) | 1,38,299 (17.4) | 2,07,110 (15.2) |

* Before transferring States' share in Central taxes; 2014-15 Budget estimates

Figures in parentheses are corresponding percentages of gross tax revenues.

Sources: Government of India, Ministry of Finance, *Explanatory Memorandum on the Budget of the Central Government* (various years); *Receipts Budget* (various years); and *Budget at a Glance*, 2014-15.

The Taxation Enquiry Commission (TEC), 1953-54, after having studied the then existing excise system, made important recommendations in terms of commodity coverage. It recommended the extension of excise coverage to sewing machines, vegetable oils, woollen textiles, biscuits, paper, dry batteries, electric lamps, aerated waters, electric fans, glass and glassware, paints and varnishes, and ceramics. In the

opinion of the TEC these industries had developed sufficiently as a result of protection and it was necessary to impose excises on them to raise the much needed revenue for financing development programmes.

Consequent upon the recommendations of the TEC, the history of excise taxation in India since 1954 is one of increasing commodity coverage. Cement, footwear, rayon or artificial silk fabrics, and soap were added to the excise system in 1954. In 1955, excise duties were imposed on paints and varnishes, paper, woollen fabrics, electric batteries, electric light bulbs, and electric fans. In 1956, the excise net was extended to vegetable non-essential oils, rayon or synthetic fibres and yarn, and motor cars. With the start of production of diesel oil and other fuel oils at the new refineries in Bombay, excise duty was imposed on a variety of petroleum products for the first time in 1956. These included refined diesel oil, diesel oil, and furnace oil. In 1959, excise duties were imposed on asphalt, bitumen, and tar.

The early 1960s witnessed another big expansion in the coverage of excise taxation in India. In 1960, eleven additional goods were subjected to excise duties including aluminium, pig iron, silk fabrics, and motor vehicles. In 1962, the number of additional products brought under the excise system was sixteen and included, *inter alia*, soda ash, caustic soda, cosmetics and toilet preparations, glass and glassware, copper and copper alloys etc. In 1962, ten more products including gases, rubber products, plywood, jute manufactures, and iron and steel products were covered under the excise net. In 1968, duties were imposed on radio-parts, steel furniture, leather cloth, and chocolates. The biggest expansion was witnessed in 1971 when 25 additional products including linoleum, ready-made garments, vacuum flasks, and pressure cookers were brought under the excise net. The process of covering more and more items under the excise system reached its pinnacle when Tariff Item No. 68 was introduced in 1975. Tariff Item No. 68 was a catch-all item which encompassed all goods not elsewhere specified in the excise tariff. This residual tariff item was abolished with the introduction of a harmonised system of commodity classification introduced from February 28, 1986. The large assortment of commodities under this head got scattered under proper heads in the new nomenclature of excise tariff. The Tax Reforms Committee, 1991, identified many items which are currently outside the excise net but which could be considered for levying excise duty. Some of the identified items are: butter and cheese, skimmed milk powder, spices, fertilisers, feature films, wood pulp, umbrellas, bicycles, toys and sports goods, buttons, and vacuum flasks.

7.0 Excise Tariff Structure

Once the commodities for excise taxation are identified, the next step is to formulate a tariff structure for various commodities. The nature of excise tariff and the issues related to its rationalisation are now described.

7.1 Statutory versus Effective Rates

Rates of excise duty approved by the Parliament are termed as statutory or tariff rates. However, the Government enjoys the power to exempt, by notification, any excisable goods from the whole or any part of duty leviable on such goods. In exercise of this power, the Government determines and notifies from time to time the effective rates of duty. The rationale for granting such powers to the executive is that during the period intervening two consecutive budgets, necessary adjustments might be made to regulate exports, consumption, and prices of different commodities. However, the delegation of this power to the executive has led to frequent changes in excise rates, creating an unsettling atmosphere for trade and industry and problems for the administration.

Moreover, since the notifications are technically not rules, there is no obligation to place them on the table of the House. Consequently, the Parliament does not always have the information on the variations made in the rates approved by it. The determination of the operative or effective rates of duty by executive decisions leads to abridgement of Parliamentary control over the excise system. Duty changes should be discussed and legislated in sessions of Parliament which are held regularly at short intervals.

Under the Central Excise Tariff Act, 1985, the Government is empowered to enhance the rates of duty specified in the Schedule of the Act through notifications. The increase of duty is subject to certain limits and such powers are exercised only in emergent circumstances. The notifications bringing into force such increases are subject to approval by the Parliament. The said limits are: (a) in case where the rate of duty immediately before the issue of notification is nil, a rate of duty not exceeding 50 percent *ad valorem* may be specified, and (b) in any other case, the increase in the rate of duty shall not be more than twice the rate of duty in force immediately before the issue of notification.

7.2 Specific versus *Ad Valorem* Duties

In the early days of the excise system of independent India, the emphasis was on specific rates due to administrative reasons. However, the emphasis shifted to *ad valorem* rates when the economy started experiencing frequent spells of inflation³. The

1970s saw a big shift from specific rates of duty to *ad valorem* rates. While introducing the change in the 1969-70 budget, the Finance Minister observed, "...*ad valorem* duties are more rational than specific duties whose incidence declines during periods of rising prices and increases when prices fall. *Ad valorem* duties can also act as a spur to reduction in costs and prices." ⁴ He converted the then existing specific rates into *ad valorem* rates on cement, vegetable products, electric fans, lighting tubes and bulbs, soaps, soda, and sodium silicate. The change of duties on paper and cotton fabrics into *ad valorem* tax was effected in 1976 and on paints, varnishes, radios, and tape recorders in 1977.

However, beginning with the 1980s, the tendency to shift to *ad valorem* rates was not only halted but reversed in view of an unprecedented spurt in litigation which mainly pertained to disputes over classification and valuation of goods for purposes of excise levies. As a measure to combat tax avoidance and evasion, the basis of duty was changed from *ad valorem* to *ad valorem-cum-specific* rate or specific rate on a number of commodities. Important commodities where the shift took place (with year of change given in brackets) were: flat glass, aluminium metal (1982), paper, aerated waters, motor cars, cigarettes, sugar (1983), paper boards, tyres for buses and trucks (1984), gases, tubes and flaps of tyres, and colour television sets (1985).

The Technical Study Group on Central Excise Tariff, 1985, made estimates of the relative revenue significance of various forms of excise duty. The share of specific duties (including the specific component of *ad valorem-cum-specific* duties) was estimated at Rs. 8242.91 crore or 66.7 percent of the total estimated excise revenue of Rs. 12361.35 crore for the year 1985-86. The rest of the revenue was attributable to *ad valorem* duties. Broadly speaking, specific duties accounted for two-thirds of the revenue and the *ad valorem* duties for the remaining one-third. (Government of India, 1985, p.7)

The balance further tilted in favour of specific duties as the policy of conversion from *ad valorem* rates to specific rates continued right up to 1990-91. In this connection, the Tax Reforms Committee, 1991 observed, "As a result of this gradual shift to more and more specific rates over the years, the share of revenue from specific-rated items has increased from a level of about 46 percent of the total revenue in 1981-82 to 65 percent in 1986-87 and has currently (presumably 1990-91) reached a level of about 70 percent." The Committee examined the advantages and disadvantages of *ad valorem* and specific rates of duty and concluded, "the advantages of having *ad valorem* duties far outweigh the administrative benefits derived by switching over to specific duties. In a system of comprehensive taxation with a wide coverage of Modvat, it would be necessary to have by and large only *ad valorem* duties in order to ensure a rational system of taxation."

(Government of India, 1991, p.114) Following the recommendations of the Committee, a modest switch over to *ad valorem* rates was made in the 1992-93 budget.

At present, important commodities which bear wholly specific rates of duty are cigarettes, coffee, tea, sugar, beverages, mineral fuels, mineral oils, silk, man-made staple fibres, and iron and steel. *Ad valorem* rates of duty predominate for commodities including organic chemicals, pharmaceutical products, leather, footwear, ceramic products, tools and implements, machinery and mechanical appliances, electrical machinery and equipment, and miscellaneous manufactured articles. A few commodities, viz. cotton fabrics, paper and paper boards, are subject to *ad valorem*-cum-specific rates of duty.

7.3 Multiplicity of Excise Tariff

The excise rate structure is provided by the Schedule of the Central Excise Tariff Act, 1985, which includes goods ranging from toys to nuclear reactors. The Schedule is divided into 20 sections covering 96 chapters. Goods falling under each chapter are divided and sub-divided into numerous headings and sub-headings. The statutory rate of duty applicable in respect of each item is shown against the appropriate commodity heading/sub-heading. These statutory rates are modified, if necessary, by Government notifications to determine effective rates of duty.

Prior to tax reforms initiated in 1991, excise taxation in India was an interesting example of the multitude of rates which were subject to frequent revisions. Numerous considerations contributed to the complexity of excise rates. The labyrinthine intricacies of the tariff often led to confusion and litigation amongst the taxpayers and revenue authorities.

Commodities such as sewing machines, water coolers, and bicycles, though on the tariff list, were completely exempt from the payment of duty. However, a host of other commodities were subject to a wide amplitude of excise rates. The rate of duty on necessities of life like food products (cheese, butter, vegetable oils), pharmaceutical products, and footwear ranged from 10 to 15 percent *ad valorem*. Rates of excise duty on semi-luxuries like washing machines, tape recorders, refrigerators, and colour televisions ranged from 25 percent to 40 percent *ad valorem*. Luxury items like cosmetics and air-conditioners suffered a high rate of duty ranging from 100 to 110 percent.

Most capital goods, classified under chapter 84 of excise tariff, were subject to duty ranging from 15 to 20 percent *ad valorem*. Some important items under this category were machine tools, cranes, agricultural machinery, textile machinery, printing machinery, calculating machines, automatic data processing machines, and other office machines.

Tobacco items were, and continue to be, conspicuous by high rates of duty. Successive upward revision of excise duty on cigarettes has all along remained a notable feature of tobacco tariff in India. Upward revision of excise duty on cigarettes is almost an annual feature. No surprise that the commodity has earned such nicknames as *annual hardy*, *old faithful* etc. In the 1997-98 budget, excise duty on various categories of cigarettes was increased ranging from Rs. 20 to Rs. 70 per thousand.

Broadly speaking, necessities of life were either exempt or paid a low rate of duty, semi-luxuries were moderately taxed, and luxuries and tobacco products stood out distinctly as high-rated tariff items. Capital goods were subject to a relatively low rate of duty.

7.4 Reforms in Excise Duty Structure

A number of Committees formed over a period of time have recommended a simpler and more rational excise duty structure. Some of the important Committees and their recommendations have been given below.

Committee on Rationalisation and Simplification of Tax Structure (Chairman: S. Bhoothalingam), 1968: In 1968, the Government of India appointed Mr. S. Bhoothalingam to examine the structure of direct and indirect taxes in India. In his report he recommended, *inter alia*, a general excise duty at the rate of 10 percent *ad valorem* on all manufactured products (Government of India, 1968, p.8). However, this recommendation was not accepted by the Government.

Indirect Taxation Enquiry Committee (Chairman: L.K. Jha), 1978: The problem of multiplicity of rates was also considered by the Indirect Taxation Enquiry Committee, 1978 which recommended a set of four excise rates. The Committee observed, "Instead of a pattern of which some product groups are very heavily taxed while others have remained either totally exempt or have been taxed at very low rates, the attempt should be to tax all consumer products, including those now falling under Tariff Item No. 68, at rates of 10, 20, 30 or 40 percent (cumulative), though some exceptional products may need to be taxed at lower or higher rates on special consideration." (Government of India, 1978, p. 174)

By suggesting a 10 to 40 percent range, the Committee virtually favoured a ceiling on excise rates. The Government disfavoured any drastic regrouping of the then existing rates. In his 1979-80 budget speech the Finance Minister observed, "A major restructuring of the excise tariff has to be ruled out in view of the need for resources and on other pragmatic considerations. Also, there is reason to apprehend that a major departure from the present pattern of excise taxation may upset the balance between different sectors of production."

Technical Study Group on Excise Tariff (Chairman: J. Dutta), 1985: The Technical Study Group on Central Excise Tariff, 1985, also favoured a drastic reduction in the number of duty rates to simply duty collection and compliance. The group recommended a band of five duty rates: middle rate, two rates below it and two above. Besides this, it also suggested a *zero rate* category. The middle rate (M) was defined to represent overall average incidence of excise duties. The two rates below this middle rate (L1 and L2) were suggested for adoption for inputs and important items of real mass consumption. The two rates in the upper scale (H1 and H2) could be applied to a few inputs, consumer durables and items consumed largely by the rich. The *zero rate* was recommended for products which deserve exceptional treatment on economic or social or administrative considerations.

The Group attempted only a broad and vague exercise of rate levels in terms of middle, below the middle, and above the middle rates of duty without specifying, even on a tentative basis, the duty rates in numerical terms. By leaving the actual fixation of rates to fiscal authorities, the Group left the exercise wide open.

The Finance Minister announced, in his 1997-98 budget speech, three new rates of excise duty, namely 8 percent, 13 percent and 18 percent. He was of the view that eventually the excise rate should gravitate towards a mean rate of 18 percent.

Triple Rate Excise Structure: Multiple rates of commodity taxes have long been considered a weakness of the indirect tax system of India. Admitting the problems created by the multiplicity of rates, the Finance Minister in his 1999-2000 budget speech observed, “The multiple rates of indirect tax are generally recognised to be a major source of misclassification, tax evasion and avoidance and cumbersome litigation. The multiplicity also encourages inefficient allocation of resources. Over a 100 countries in the world now enjoy the benefits of a Value Added Tax (VAT) with very small number of rates in each case.”⁵

Thus, in a landmark move, the Finance Minister announced in his 1999-2000 budget a triple rate excise structure. In other words, the then existing 11 major ad valorem rates were reduced to 3, viz. a central rate of 16 percent, a merit rate of 8 percent and a demerit rate of 24 percent. This was done by (a) merging the existing rates of 5 percent, 10 percent and 12 percent into the existing 8 percent rate, (b) creating a new rate of 16 percent by merging the existing 13 percent, 15 percent and 18 percent rates into it and (c) fixing a new rate of 24 percent in substitution of the existing rate of 25 percent. The initiative of the Finance Minister to rationalise the rate structure of excise system was widely appreciated.

The standard rate of excise duty (CENVAT) which was brought down to 8 percent after two successive reductions in December 2008 and February 2009 was

increased to 10 percent in the Budget for 2010-11. It was further increased to 12 percent in the Budget for 2012-13 and remained the same for the financial year 2013-14.

Task Force on Indirect Taxes (Chairman: Vijay Kelkar), 2002: The Task Force on Indirect Taxes recommended the following excise duty structure (Table 2).

As regards duty exemption for the small scale sector, the Task Force on Indirect Taxes recommended as under:

- Duty exemption should be extended to only small units with a turnover of Rs. 50 lakh.
- Duty exemption limit for the larger SSI units should be gradually brought down to Rs. 50 lakh as per the following time frame: from Rs. 100 lakh to Rs. 75 lakh by the year 2004-05 and from Rs. 75 lakh to Rs. 50 lakh by the year 2005-06.

Table 2: Central Excise Duty Structure Recommended by the Task Force on Indirect Taxes

| | |
|---|--|
| 0 percent | For life-saving drugs and equipments, security items, food items, necessities and the like, and agricultural products. |
| 6 percent | For processed food products and matches. |
| 14 percent | Standard rate for all items not mentioned against other rates. |
| 20 percent | For motor vehicles, air-conditioners and aerated water. |
| Separate rates for tobacco products and their substitutes (like pan masala) | |

Source: Government of India, Ministry of Finance and Company Affairs, *Report of the Task Force on Indirect Taxes*, December 2002, p. 181.

8.0 Excises on Inputs

One perennial problem of the Indian excise system has been the taxation of inputs (raw materials, components, and other intermediates) and the resulting cascading effect on the prices of final products. Prior to the Second Five Year Plan (1956-61), excise coverage was limited to consumer goods with the notable exception of steel ingots. However, the need for additional resources for successive Plans necessitated extension of the excise net to capital goods and raw materials. Various inputs like internal combustion engines, aluminium, cotton yarn, woollen yarn, fertilisers, chemicals, were, and continue to be, within the excise ambit. The disadvantages of input excises are well-known.⁶ However, levies on inputs form an integral part of the excise system in India for reasons of sheer administrative convenience.

8.1 Pre-MODVAT Arrangements

Prior to the introduction of MODVAT in 1986, there were provisions in the Central Excises and Salt Rules, 1944, under which certain inputs were exempted from taxation to minimise the cumulative effect of excise levies. Thus, Rule 56-A of the said Rules, introduced in 1962, allowed the manufacturers of certain notified finished excisable goods to bring excise-paid components (for example compressors for refrigerators) to take credit for the said duty in the Proforma Credit Account to get adjustment of duty on the final excisable good.

The Indirect Taxation Enquiry Committee, 1978, which made an in-depth study of the cascading effect of input excises, recommended a wider extension of Rule 56-A to products falling under different tariff items. The same Committee recommended also the introduction of Value Added Tax (VAT) at the manufacturing stage, called MANVAT, to tackle the problem of cascading effect of excise taxation.

The Long Term Fiscal Policy (December 1985) also envisaged the extension of the Proforma Credit Scheme and observed, “The basic approach will be to move towards an extension of the present system of proforma credit to all excisable commodities with the exception of a few like petroleum, tobacco, and textile products. This programme would amount to a modified system of VAT or MODVAT for short. The programme will be implemented in a phased manner over a period of years, taking due account of the revenue implications, the need to revise administrative procedures and the lessons from experience gained in the early stages of the reform.”⁷ In pursuance of the proposal made in the Long Term Fiscal Policy Statement, the Government introduced a modified system of value added tax or MODVAT with effect from March 1, 1986.

8.2 MODVAT Scheme

The features and advantages of MODVAT scheme are explained below.

Features: MODVAT scheme provides for instant and complete reimbursement of excise duty and additional duty of customs (countervailing duty) paid on the components and raw materials when used in the manufacture of the final products. Articles which are not used as inputs in the manufacturing process are not eligible for credit under this scheme.

Initially, the MODVAT scheme covered 38 chapters of the schedule to the Central Excise Tariff Act, 1985. These chapters pertained to the products of chemical and allied industries, paints and packaging materials, plastics, glass and glassware, rubber products, base metals and articles of base metals, machinery and mechanical appliances including electrical equipment, motor vehicles, and certain miscellaneous manufactured products. The scheme was extended to all the remaining chapters (except

those relating to textiles, tobacco, and the petroleum sector) in 1987. The extension covered food products, mineral products, leather and travel goods, footwear, paper and paper-board, wood and cork products, asbestos cement products, and precious metals. As long as the inputs and the final products are covered by the specified chapters, credit of duty on inputs is available. In 1994, MODVAT scheme was extended to tobacco, fibres, yarn and fabrics, and petroleum products (excluding motor spirit and high speed diesel oil) used as input. The features of the MODVAT scheme are as follows.

1. The credit under MODVAT is available to a manufacturer of a final product only if the final product is dutiable. Where the final product manufactured by a manufacturer is exempt from excise duty then no credit of the duty paid on the inputs is available. Credit is allowed only after the evidence of payment of duty has been received by the Department.
2. Where the same input is used for different finished products, some of which are not dutiable, the credit of duty is allowed only for that part attributable to inputs which are used for the manufacture of dutiable finished products.
3. The credit of the duty paid on the inputs under the MODVAT scheme may be utilised for payment of duty on the final products in which the inputs are used.
4. Under the MODVAT scheme, credit of duty is not restricted to raw materials and components only but covers all specified inputs which are used in the manufacture of final products.
5. Machines, plant, equipments, apparatus, tools or appliances used in the manufacture of the final products are not covered by the term 'inputs' for the purpose of MODVAT benefits.
6. Under the MODVAT scheme, inputs may be either procured from outside or manufactured within the factory. In either case, the duty credit would be available to the extent of duty actually paid.

The Government had made it clear in its Long Term Fiscal Policy that the proposed MODVAT scheme was to be broadly revenue-neutral. Thus, along with the introduction of MODVAT which considerably reduced the cost of final products, the rates of duty on final products were suitably revised upwards by the Finance Act, 1986, to retain the collection of excise duties at the earlier level. This was justified on grounds of resource mobilisation for the Plans.

Advantages: MODVAT scheme is claimed to have the following advantages:

1. It aims at making excise levies transparent so that the effective rate of taxation on a particular commodity can be known. This information will be helpful in undertaking meaningful studies of excise incidence. The results of these studies may be used to control excise burden on different commodities to ensure the desired degree of

progressivity in the excise levies.

2. It seeks to avoid cascading effects associated with a traditional turnover tax. In particular, it will work as a cost-saving device through the availability of instant credit of the duties paid on the inputs and the consequent reduction of the interest costs.
3. MODVAT scheme will improve the competitive strength of the small-scale sector by allowing credit of duty which may be in excess of the duty actually paid on the inputs made by the small-scale units.
4. MODVAT scheme is claimed to encourage indigenisation because full set off is available when indigenous inputs are used. However, no credit of basic and auxiliary customs duties is permissible on imported materials and components. Although MODVAT scheme provides for set off of countervailing duty⁷, this element of import duty is not very significant in comparison with other elements of import duty viz. basic and auxiliary duties. As the scope of MODVAT is widened, the process of indigenisation would gather momentum.
5. MODVAT scheme is designed to encourage exports by making them more competitive in the international market. Since MODVAT allows set off through different stages of production, the final duty becomes clear on final goods which can be exported without payment of duty under bond. The payment of duty drawback will be swifter in view of the transparency of excise duty.
6. It is claimed that MODVAT will check excise evasion because credit of input duty cannot be claimed unless actual production is declared to the excise authorities.
7. MODVAT scheme will also help reduce the number of disputes, arising on account of classifications requiring lower or higher rates of duty, because the duty element on a large number of components will become irrelevant for manufacturers in view of set off. Previously, a selective set off triggered disputes as regards the eligibility of an input for set off. The introduction of Harmonised System Nomenclature will further reduce the scope for ambiguities.

Some experts feel that MODVAT is old wine in a new bottle because the facility under it is practically the same as was and is still available under Rule 56-A. In other words, MODVAT scheme is only an extension and liberalisation of the proforma credit facility in operation for the last three decades. Though some degree of similarity does exist, the two schemes cannot be termed identical. Rule 56-A scheme was restrictive and had several procedural formalities, e.g. a manufacturer had to intimate the Excise Department about the arrival of input materials for verification by the excise officials. Moreover, it was applicable on a commodity-to-commodity basis and involved discretion in taking decisions. MODVAT scheme is more comprehensive and rule-based

and therefore curtails the discretionary powers of the Excise Department. MODVAT credit on inputs can be availed on the basis of a duplicate copy of the invoice.

The Tax Reforms Committee, 1991, examined, *inter alia*, the scope of extending the MODVAT scheme and observed, “there is no alternative to gradually transforming the present excise tax system, consisting of two parts, namely (a) Modvat and (b) excise on gross value basis with no set off for some sectors, into a genuine VAT at the manufacturing level. Manufacturing and such a VAT should include also the ‘manufacture’ of services although some services may be exempted on practical considerations.” (Government of India, 1992, p.36)

8.3 Introduction of CENVAT

In his 1999-2000 budget, the Finance Minister had introduced three ad valorem rates of basic excise duty, namely 8 percent, 16 percent and 24 percent. Furthering the reform of excise taxation, the 2000-01 budget introduced a single rate Central Value Added Tax (CENVAT) by converging the three ad valorem rates to a single rate of 16 percent. The 8 percent excise rate was abolished and most of the items under it were moved to 16 percent rate. Similarly, items that were mainly in the nature of raw materials or intermediates were moved from the 24 percent rate to 16 percent CENVAT.

However, in addition to the 16 percent CENVAT rate, three rates of special excise, viz. 8 percent, 16 percent, and 24 percent were introduced. While the CENVAT rate is modvatable, the special excise duties are not, i.e. users cannot avail of MODVAT credit of these duties. Some of the commodities on which special excise duties apply include white cement, glazed tiles, cosmetics, air conditioners, aerated water and chewing tobacco. Since these commodities are not in the nature of inputs therefore they are not modvatable.

MODVAT scheme (rechristened as CENVAT scheme) was further expanded and rationalised in the sense that now all inputs (excepting high speed diesel oil and petrol) and all capital goods are included in the eligible list of MODVAT scheme. However, the availability of MODVAT credit on capital goods is spread over a period of two years.

Underlining the significance of CENVAT, the Finance Minister observed that it would eliminate disputes pertaining to classification of goods and remove uncertainties in the minds of producers. He hoped that the establishment of CENVAT would encourage the State Governments to implement their agreed programme for converting their sales tax into VAT by April 1, 2001.

It is noteworthy that under the Constitution, the Central Government is empowered to impose excise duty on goods produced or manufactured. It has no power to carry forward the

tax up to the retail stage. Thus, CENVAT is a kind of VAT at the manufacturing stage. In any case, it has paved the way for a national VAT.

8.4 Further Simplification

In his 2001-02 budget, the Finance Minister reduced the three rates of special excise duty to a single rate of 16 percent. In other words, the 8 percent and 24 percent rates of special excise duty were abolished. Some of the items which bear 16 percent basic rate of CENVAT plus 16 percent special duty (32 percent total duty) include aerated soft drinks, soft drink concentrates and motor cars).

Following these measures, about 80 percent of the revenue in respect of ad valorem duties comes from the single rate of 16 percent and about 17 percent from the combined rate of 32 percent.⁸ Feeling satisfied after completing the task of excise rate rationalisation, the Finance Minister remarked, "...in the matter of rates of duties of excise, I have almost achieved the ultimate with only one basic rate of CENVAT and one rate of special excise duty."⁹ Undoubtedly, the Government has provided a stable excise system to create confidence among the entrepreneurs, particularly the prospective ones, so that they may plan their investment and production without the Damocles sword of excise changes hanging over their heads.

9.0 Exemptions and Concessions

As in other countries, exemptions and concessions are an integral part of the Indian excise system. Excise preferences and reliefs are given to promote a wide spectrum of socio-economic objectives. If judiciously used, such tax preferences can become an effective tool of economic change on desired lines. The rationale for excise preferences is as follows.

1. Exemptions and concessions are necessary to ensure progressivity in the structure of commodity taxation.
2. Excise preferences are justified to induce entrepreneurs to undertake activities which they would otherwise shirk, e.g. adopting labour-intensive techniques of production. Concessions are designed to promote enterprises deemed *vital* by society though it is controversial as to which activities are *vital* and require governmental support.
3. Exemptions/concessions provide the desired flexibility to the tax system to deal with changing market situation. They are used as a corrective mechanism to stabilise demand, production, and profits of different industries. Due to continuous diversification of the economy and inflation, markets for various commodities have not remained stable in India after Independence. Because of the changing market

conditions, the levels of profit in different industries have also been fluctuating and on balance have shown a rising trend. Excise rates, it may be argued, should be modified upward to mop up excess profits and downward to boost sluggish demand for idle-capacity industries.

4. Exemptions may be granted on administrative considerations. The duty on unmanufactured tobacco was abolished in 1979 mainly on account of the administrative difficulty of assessing and collecting duty from a large number of growers, and curers. Similarly, exemption of smaller of the small industries is also due to administrative problems. Agricultural products are also exempt owing to the same reason.

9.1 Problems Created by Concessions

The desirability of excise preferences is to be viewed against problems created by them.

1. Excise concessions narrow the tax base and therefore shrink governmental revenues.
2. Excise concessions interfere with the designing of the excise system and lead to complexities in the excise law which in turn may lead to tax evasion and litigation.
3. They also obscure the evaluation of excise system, particularly from equity angle.
4. Excise concession to a particular industry may lead to a chain reaction, i.e. similar demands by other industries, causing unsettling effects on producers, consumers, and the administration. Exemptions/concessions are often the result of persistent representations and pressure tactics by industry and trade than any economic justification.
5. It is not always possible to segregate the effects of duty reduction on production, costs, prices, and consumption because duty concessions operate in conjunction with other non-tax policy measures to affect the production process.

9.2 General Exemptions

There are various general exemptions which purport to serve a wide variety of socio-economic objectives. Thus, goods of the following description are exempt from the whole of the duty of excise leviable thereon.

1. All excisable goods, produced in a technical, educational and research institute during the course of imparting technical training of an academic or vocational nature.
2. All excisable goods donated for the welfare of defence personnel.
3. All excisable goods donated to the National Defence Fund or to the Ministry of Defence.
4. Excisable goods, supplied as stores for consumption on board a vessel of the Indian navy.
5. All excisable goods sent abroad as exhibits in any international trade fair or exhibition.

Apart from these general exemptions, excise tariff is extensively used to serve a host of other objectives including export promotion, industrial development, and mopping up a part of high profits earned by certain industries. Excise exemptions and concessions are particularly important in promoting labour-intensive technology and small-scale industries. Central excise law contains provisions the sole objective of which is employment generation. Products of a number of industries are exempt from excise duty if they are manufactured without the aid of power. Duty differentials have been used to discourage mechanisation in certain industries.

Similarly, concessions are available to the handloom sector of the textile industry. Processed *khadi* cloth woven on handloom wholly from hand spun cotton yarn or in admixture with similar silk and/or woollen yarn enjoys full exemption since 1969. Cotton fabrics manufactured on handlooms and processed by a factory owned by a registered handloom co-operative society enjoy full exemption from duty.

The Expert Committee on Tax Measures to Promote Employment, 1980, made estimates of the annual cost of protecting or subsidising employment through concessions in excise duties. It found that the annual cost of protecting or subsidising employment through concessions in excise duties was Rs. 523 per full-time worker in the handloom industry, Rs. 881 in *khandasari*, and Rs. 2,669 in the cottage sector of the match industry. (Government of India, 1980, pp. 91, 113, and 117)

9.3 Concessions to Small Industries

In line with Government's policy of encouraging small-scale industries, a wide range of concessions and exemptions from excise duty is available to small producers to enable them to stand in competition with large-scale manufacturers. Also, relatively simple and concessional procedures are followed for the assessment and collection of excises from the small-scale sector. As a part of the Comprehensive Policy Package on SSI and Tiny Sector announced by the Prime Minister on August 30, 2000, the excise exemption limit for SSI was raised from Rs. 50 lakh to Rs. 1 crore with effect from September 1, 2000.

9.4 Misuse of Concessions

Though preferential treatment to small units and labour-intensive methods of production is desirable, the misuse of these concessions has created doubts as regards the ultimate beneficiaries of such facilities. Concerned about the misuse of excise concessions, the Finance Minister in his 2001-2002 budget speech announced the withdrawal of exemption on certain items and observed, "Products of SSI are exempt from excise duty up to Rs. 1 crore. This exemption is intended to provide fiscal support

to the genuinely small producers. I propose to withdraw this exemption in respect of the following items, in which misuse of the exemption is more than likely: (a) cotton yarn, (b) ball or roller bearings and (c) arms and ammunition for private use."¹⁰

It has now been well-established that certain products, particularly footwear, domestic electrical appliances, electronic goods, and wires and cables are purchased on a fairly large scale by established concerns from the exempted sector and marketed in the brand names of such concerns. However, under the present scheme introduced in 1986, a small-scale manufacturer of excisable goods is allowed to clear his goods with the brand name of another manufacturer and is eligible for exemption for such clearances. It is clear that small producers depend heavily on private marketing organisations to sell their products and this dependence needs to be reduced by strengthening and building up co-operatives and other officially sponsored marketing organisations to market the products of small sector. This seems to be one way out of the existing dilemma.

Endnotes

1. Government of India, Ministry of Finance, *Report of the Taxation Enquiry Commission*, (Chairman: John Matthai), 1953-54, Volume II, p. 323.
2. Government of India, *Long Term Fiscal Policy*, 1985, p.25.
3. Excises are levied in specific and/or *ad valorem* forms. A specific or volumetric duty represents a fixed amount of tax on a unit of the physical quantity of the product. This type of duty is generally preferred for commodities the classifications and sub-classifications of which are not numerous, i.e. the commodity is standardised, e.g. sugar. Specific duties are easy to apply and have the political and psychological advantages of obscuring the actual ratio of the tax to the selling price. They are, however, price-neutral, i.e. price changes, if any, in the product do not affect the revenue yield. Specific duties are quality-neutral also unless differential rates are prescribed with reference to the quality of the product. *Ad valorem* duties are imposed as a fixed percentage of the price of the product taxed. They are preferred when a commodity has many classifications and sub-classifications, e.g. textiles. *Ad valorem* duties are responsive to price changes and thus help maintain the proportion of taxes in national income. The main problem in applying *ad valorem* rates is the determination of the tax base, i.e. valuation of production.
4. Government of India, Ministry of Finance, *Speeches of Union Finance Ministers, 1947-48 to 1984-85*, p. 313.
5. Government of India, Ministry of Finance, *Budget Speech of the Finance Minister, 1999-2000*, Part B, p. 21.
6. Excises on inputs enhance costs and profits and therefore increase the prices of goods much more than the amount of excise collected. The cost of production increases because producers and middlemen require larger amounts of working capital to maintain the

necessary stocks of inputs. Prices of finished products tend to reflect taxes imposed on inputs used. If the middlemen apply fixed percentage mark ups to purchase prices as their profit and if the purchase prices include taxes, the mark ups will be applicable to the tax component of the purchase price as well. In other words, increase in the price of the manufactures is in excess of the excise revenue accruing from input taxes.

Further still, excises on inputs may promote vertical integration in an industry, a trend which is harmful to the growth of small-scale sector. Lastly, input excises impose an inequitable burden on different economic classes by not discriminating between essential and non-essential uses of a product. For example, an excise on aluminium hits indiscriminately the use of the product for decoration purpose as well as for making utensils (generally used by the poor).

Notwithstanding the various disadvantages of input excises, governments in many countries impose duties on inputs due to administrative convenience. Many items of inputs are the end-product of one manufacturer but merely a component for another (e.g. tyres and tubes) and are also used as replacement items. Exemption of such items will be discrimination in favour of replacement consumption and certain commodities (say motor cars) may be sold with avoidable components and accessories stripped off. Moreover, provisions can be made in tax laws to minimise the cascading effects of input excises.

7. It is an element of import duty equivalent to excise duty on domestically produced goods.
8. Government of India, Ministry of Finance, *Budget Speech of the Finance Minister, 2001-2002, Part B*, p. 26.
9. Government of India, *Long Term Fiscal Policy*, 1985, p. 38
10. Government of India, Ministry of Finance, *Budget Speech of the Finance Minister, 2001-2002, Part B*, p. 27.

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