

CHAPTER 9

VALUE ADDED TAX

1. Introduction

1.1 Value Added Tax (VAT) is unanimously acknowledged to be a major reform in the indirect taxation system for the following reasons:

- (i) It eliminates the cascading effect of taxes;
- (ii) It promotes competitiveness of exports;
- (iii) It has a simple and transparent structure; and
- (iv) It Improves compliance.

1.2 In recent time, more and more countries have been adopting VAT for taxation of commodities and services, and presently there are more than 120 countries in which VAT is in force. Only the USA and India are amongst the more populous countries that do not have a VAT. Economists have generally shared the view that VAT is best suited as a Federal or Central tax, and not at the State-level. However, states and provinces in a few large federal countries like Brazil, and, to a lesser extent, Canada, have adopted VAT, with varying degrees of success. By adopting VAT the country would soon be joining the majority of the countries and hopes to derive the advantages thereof in like measure.

1.3 Considering that the implementation of VAT is closely linked to the administration of other indirect taxes and impacts the tax to GDP ratio, it has become necessary to examine the relevant issues. In this direction the Task Force has had the benefit of meeting with the Empowered Committee of the Finance Ministers of the States, constituted for the purpose of implementing a nationwide State-level VAT. The Empowered Committee is indeed a unique experiment in federal fiscal planning and has achieved much in terms of building a consensus on many of the critical issues relating to implementation of VAT in a relatively short spell of time. Most countries have taken several years to implement VAT. As was learnt, decisions have been taken on the important features of VAT relating to replacement of the Sales Tax levied by the States (though some other local taxes like octroi, mandi cess etc. may continue); the Revenue Neutral Rate and other rates; the tax to be a multi-point levy, with the tax paid on inputs

within the State being set off against the tax payable on the dealer's sales (subject to a threshold limit); phasing out of CST in 4 years; adoption of uniform classification, etc. Most all vital areas have been covered by the Empowered Committee and it would not be appropriate, nor is it considered necessary for this Task Force to reexamine these issues. The Task Force would like only to highlight few issues to ensure successful implementation of VAT, and its continuity and stability in a dynamic sense. These matters assume importance in view of the limited time now left for the proposed implementation of State VAT, from 1st April 2003.

2. Preparedness for State VAT

2.1 For State VAT to become a reality, a high level of commitment is required for all concerned tax administrators and businesses which include the small traders. Thus, clear and transparent dissemination of information is going to be critical to the success of the implementation of State VAT. In this regard, it is evident that what is required is a comprehensive publicity programme across the country to apprise and educate all concerned regarding the implications of VAT. This programme should take place at National and State level and percolate down to the Districts. Naturally this requires resources. It is the view that the publicity programme must involve both Central and State Governments and the former should be prepared to extend financial support for this.

2.2 It is recommended that a publicity awareness programme should be started jointly by the Central Government and the State Governments and the former should extend financial support for this, if required. Since the State VAT is expected to be implemented from 1.4.2003 it is also necessary that the publicity awareness programme should be implemented at the earliest.

3. Uniformity of definitions

3.1 Reportedly, some of the State VAT legislations are not fully based upon the model legislation and, as a result, there is a variance in the definitions of dealers, distributors, etc. In some cases even the charging section is not uniform. Further there must also be uniformity in the procedures and documentation. In fact, common

classification of goods is critical, though there is one view that it would be difficult for the small dealers to adapt to the same. However, uniformity in all these matters is important for the creation of a truly common market. It will also take care of the apprehension that absence of uniformity may give rise to avoidable disputes.

3.2 It is recommended that an attempt should be made towards uniformity of all State legislations, procedures and documentation relating to VAT.

4. Compensation to States

4.1 One of the issues which impact the transition to VAT is the compensation to be given to the States upon the removal of Sales Tax and the introduction of State VAT, in the event the tax revenue drops due to the change over. In this regard it is observed that the experience world-wide has been that a move to VAT results in higher revenue realisation. Therefore, there is no cause for concern. Nevertheless if such eventuality arises any compensation should be through revenue mobilization (by the States) from specified services and not through Budgetary support. One avenue is to allow the States to collect and appropriate the Service Tax on identified services.

4.2 It is recommended that issue of compensation, if it arises, must be primarily tackled through mutually acceptable mechanism of additional resource mobilization through Service Tax and not through Budgetary support.

5. VAT to unify all local taxes

5.1 During the meetings that the Task Force had with several industry and trade bodies, it was represented that the switch-over to VAT must ensure that the desired benefits are achieved, especially in view of the fact that this switch-over will entail a major overhaul of systems and procedures for businesses and governments, and at substantial expenditure of money, time and effort. One of the views that was consistently expressed is that the simultaneous imposition of several taxes on goods, with VAT alone being eligible for credit and set-off, would not serve the purpose. Currently, about 16 States impose Entry Tax on goods, 12 States impose Luxury Tax on goods, in addition to which a number of States impose Mandi Cess and a number of local bodies impose

Octroi. The rates of each of these taxes vary widely between the States. It was pointed out that if VAT were to achieve its purpose including removal of the cascading effect then it must replace all these local taxes.

5.2 The Task Force is in agreement with the submission of the industry and trade. At the same time, it is a fact that local taxes such as Entry Tax, Octroi, Luxury Tax etc., in addition to Sales, Purchase and Turnover Taxes, are productive sources of revenue for many States, and that therefore, it would be difficult for the States to forego the revenue from these taxes. The proposed VAT should, therefore, meet both these concerns.

5.3 It is recommended that with the introduction of VAT, all other local taxes be discontinued, and the same should be taken into account in determining the RNR.

6. VAT and AED

6.1 The Additional Duties of Excise (Goods of Special Importance) Act, 1957 imposes Additional Duties of Excise (AED) on sugar, textiles and tobacco products. AED was introduced in lieu of sales taxes being levied at that time by the States. There is one view that the rationale for the Act is no longer valid and States should be allowed to levy sales tax on the goods. Another view is that as a policy multiplicity of levies must be reduced and in this direction AED is not required. A third view is that the goods, particularly tobacco products contribute significantly to the revenue that the matter of changing the methodology of levy and rate of tax must be handled with caution as the country can ill afford uncertainty in revenue generation. Accordingly, the matter has been examined in its entirety.

6.2 It is a fact that if AED is removed and the goods are subject to State level taxes the incidence thereon is likely to increase. Thus, the issue of removal of AED has to be examined in the context of impact of higher and also differential incidence of taxes from State to State. As regards tobacco products, it has been the experience of many countries that differential taxes on such high-excite goods particularly cigarettes, incentives large scale illegal cross-border movement resulting in huge evasion of revenue. Studies also reveal that such revenue losses, as a proportion to revenue

collected, range from 10-14% in the case of Canada to 25% in the case of Sweden. Unregulated tax rates on such high value good have also been seen to lead to displacement of domestic tax-paid cigarettes by contraband products, translating to significant losses in revenue. Further, being a final consumer product, there is very little value-addition beyond the manufacturing stage in respect of cigarettes. In our country the entire trade margin is found to average about 10%, with around 7% going to the retailers, who number about 2 million and most of whom would be below the threshold limit for VAT. Considering that the excise duty on cigarettes is as high as 100 to 130% in assessable value terms, the VAT on cigarettes would chiefly be a tax on excise. Further, cigarettes constitute one of the most important sources of excise revenue (over Rs.5000 Cr. in 2001-2002) and in addition, the AED on cigarettes, through a specific rate structure, has achieved a stable and substantial revenue stream. It has also completely eliminated the scope for cross-border arbitrage in an otherwise high evasion-prone category of goods. Thus, there is a justifiable case for keeping cigarettes outside VAT.

6.3 In so far as textiles are concerned, India is bound by the MFA and from 2005 competition would increase. Therefore, while proposing to keep the central excise duty at 12% no doubt the idea had been to allow the industry to upgrade and modernize. To further this objective it appears necessary that the tax rates on the item must not increase, a likelihood with the removal of AED and subsequent multiplicity of State level taxes. Hence, it appears that while conceptually AED must go there is sufficient merit in maintaining status quo for this item upto 2005.

6.4 It is recommended that that whereas AED may continue for textiles upto 2005, it may continue even thereafter for cigarettes which should not be subjected to VAT.

7. Credit on Inter-state transactions

7.1 An important issue is the grant of credit of the tax paid in one State by another State in the course of inter-State movement of goods. There is one view that the States into which goods are imported from other States, may find it difficult to allow credit of tax already paid on such goods. However, if the credit is not given there is apprehension of cascading effect besides placing the 'imported' goods at a competitive disadvantage vis-

à-vis the local goods with resultant effect of dividing the common market, since investment decisions will tend towards States where the market within that State is larger than that outside.

7.2 In this regard experience of other federal countries like Brazil and Canada reveals that either the inter-State transactions are zero-rated or the tax paid in the exporting State is allowed to be set off by the importing State. The same is the case between the European Union members also. It appears that in our context once the Central Sales Tax is phased out, as presently contemplated, this would cease to be an issue. However, the denial of credit in inter-State transactions appears to have legal implications, inasmuch as it could well attract the provisions of article 304(a) of the Constitution which prohibits any discrimination between local goods and imported goods in the matter of taxation.

7.3 It is recommended that the VAT scheme should provide for grant of credit of duty by the importing State for the duty paid in the exporting State, in the course of inter-State movement of goods.

8. Stability and continuity of the VAT regime

8.1 VAT is going to be a reality soon chiefly on account of the commitment of the States which have after years of painstaking deliberations built a consensus. As earlier observed, this was possible only due to the tremendous efforts of the Empowered Committee. Thus, it appears that stability and success of VAT will, equally, depend on the States' continued commitment to the interest of all stakeholders. In this regard, it appears desirable to consider having in place an arrangement which ensures stability and continuity of the VAT regime.

8.2 The creation of a truly unified domestic common market is the ultimate objective of the tax reform process. A related and equally important issue is that of a mechanism to eliminate internal barriers to trade and commerce. In this regard it is learnt that the Empowered Committee is contemplating setting up a VAT Council which could continue the work done so far by the Committee itself. In view of the fact that the Empowered Committee has achieved so much it can only be expected that the VAT Council would

further consolidate the tremendous work, especially if it also includes representation of the Central Government. An alternate view is to explore the possibility of a consensual agreement taking support of a Constitutional provision, such as Article 307. The Task Force would leave this thought with the Empowered Committee for consideration since it is the body most concerned with the long-term stability of the proposed VAT.

8.3 It is recommended that for the stability and continuity of VAT, a VAT Council or a permanent suitable alternative vested with adequate powers to take steps against discriminatory taxes and practices and eliminate barriers to free flow of trade and commerce across the country should be explored.
