VALUE ADDED TAX IN INDIA

Dissertation submitted in partial fulfillment of the requirements for the Degree of

Master of Law

Prepared under the guidance of

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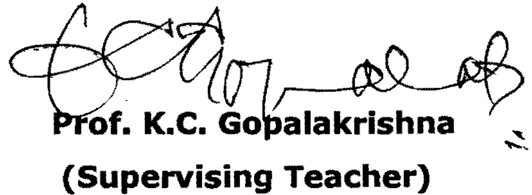
CERTIFICATE

This is to certify that this Dissertation "Value Added Tax in India", submitted by Sumitha. R, for the Degree of Master of Law of the National Law school of India University, Bangalore is the product of bonafide research, carried under my guidance and supervision. This Dissertation either in whole or any part thereof has not been submitted elsewhere, for any other degree.



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DECLARATION

I, Sumitha. R do hereby declare that this Dissertation " Value Added Tax in India" has been carried out by me in partial fulfillment of the Master of Law Degree of the National Law School of India University, Bangalore, under the supervision of Prof. K.C. Gopalakrishna. It has not been submitted either in whole or in part for any degree in any University. This work either in part or in whole has not yet been published.

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"The system of domestic trade taxes operating at present in the country is archaic, irrational and complex – according to knowledgeable experts, the most complex in the world. It interferes with the free play of market forces and competition, causes economic distortions and entails high costs of compliance and administration"

- National Institute of Public Finance and Policy.

of India cover the entire range of possibilities for levy of different types of direct and indirect taxes. The taxable events are also described in detail in the constitution. The fiscal needs of the Central and State Governments are periodically evaluated by the Finance Commission, which is a Constitutional functionary. Many of the present statutes are actually modified versions of the original enactments of the British government[3]. But the phenomenal expansion of the tax system has been an exclusive post-independence development.

The central tax ratio reveal that compared to direct taxes, revenue from indirect taxes improved considerably since independence till the nineties. The indirect taxes continue to be the main source of revenue for the exchequer. Out of the total tax revenue of the Central government in 2002-03, Central Excise Duties contributed 3.45 per cent while revenue from customs duties was only 1.80 per cent[4]. The total contribution of all direct taxes has improved to 3.25 per cent. Among the three major indirect taxes in India, the foremost one is still the central excise duties. During the last five years, there has been a steady decline in the contribution of central excise revenue. In view of the massive reduction in Customs duty rates to comply with WTO requirements the share of import revenue has been on a steady declining trend. But the real problem is the steady fall of tax to GDP ratio. Such a miserable collapse could be avoided if tax reforms were implemented on time to remove inefficiencies. Therefore, it is essential to know what those complexities and inefficiencies are of the present tax system.

Structural Deficiencies:

The Constitution of India has assigned the tax base of production/manufacture of commodities to central excise duties to be levied by the Central government. Certain specific exclusions are also provided in

[3] Supra note 1, at 31.
[4] Ibid, at 33 .

the Constitution. At the time of independence, only 14 commodities were dutiable[5]. But the levy was extended to 137 commodities by 1985. From 1986 excise tariff was aligned with the harmonized system of classification of commodities, which brought all identifiable and marketable commodities under the tax net[6]. Presently, the excise base consists of about 1,300 distinct commodities[7]. The data of additional revenue mobilization has indicated that almost 90% of the growth since independence reflected only the intensive tax efforts. This had led to indiscriminate taxation on inputs, intermediates and even on capital goods[8]. While the revenue had showed some buoyancy the immediate outcome was the severe cascading effect and low responsiveness to GDP growth.

In addition to the steady expansion of tax base, tax rates were also constantly hiked in the first four decades. Initially, specific rates dominated the tax structure as against rates based on the value of goods. But since, 1994-95, there has been a deliberate switch over to value based rates to improve the elasticity of revenue. Although a large number of goods are excisable, more than 50% of the revenue comes from just 15 commodities. The structural complexities of excise could be attributed to the indiscriminate expansion in the 70's and 80's[9]. But from 1994-95 onwards the invoice based assessment and ad-valorem rates were adopted and the tax system has been tuned for better performance in terms of revenue and compliance.

Low Buoyancy and Elasticity:

It has been well established that the elasticity co-efficient of central excise revenue has been less than unity since independence. But the buoyancy co-efficient had showed some periodical swings due to rigorous tax efforts for additional revenue. There have been several studies to identify the factors

[5] Supra note 1, at 33.
[6] Id.
[7] Ibid, at 34.
[8] Id.
[9] Id.

responsible for the low responsiveness of the central excise revenue. One study had revealed that less than 50% of the total tax revenue was obtained from the automatic growth of the tax. Another study had indicated that the excise revenue was not responsive to rate variations although it had showed some responsiveness to price variations.

The studies had revealed that ad valorem rates were more responsive than specific rates[10]. The low responsiveness of excise revenue in the early days was mainly due to the predominance of specific rates. At one point of time the specific rates had accounted for 60% of the aggregate revenue. The fascination for specific rates was probably on account of the convenience for levy and collection. This has been because ad valorem rates give rise to innumerable litigations related to the valuation of goods. The taxmen could not trust the price declarations of the manufacturers. This was because the taxmen were sure that the tax payers would always try to undervalue highly taxed goods for capturing market share and to avoid payment liability. With the introduction of invoice value and Maximum retail Price (MRP) based assessment, valuation disputes have been slowly disappearing[11]. The apprehensions of large scale manipulation of invoices have also been belied.

Price Effect:

The shifting pattern of tax burdens of excise duties with reference to pre-tax and post-tax commodity prices have been examined by experts. It has been stated that there has been uniform price shift across the different types of commodities and market conditions. The demand elasticity has been a major determinant in the shifting of the aggregate tax burden[12]. The tax incidence and the availability of competing products have also played an important role in deciding the quantum of tax burden being shifted to the consumers. Commodity taxation in India has resulted in extending

[10] Supra note 1, at 35.
[11] Id.
[12] Ibid, at 36.

consumer price much beyond the tax inclusive value of goods[13]. The multiple rate structure on inputs, intermediates and finished goods snowballed into a much higher final price which also included the interest on sales on credit basis. The hidden tax burden has always kept the final price misleading and the consumer could never get a complete breakup of the various elements of cost. Hence there is a need for a system in which there could be total transparency and remove confusions and keep the consumer fully informed about the exact tax involved in the final price.

Production effect:

The profitability of a firm and its choice of optimal production levels are always subject to the imposition of a fresh levy or change in the existing rates[14]. Many changes are required in the output levels and the new consumer price after ascertaining the post-tax market demand, availability of substitutable and competing products and so on. The producers find it difficult to decide the output levels as several factors influence the market. Since powers of taxation are vested in different agencies which frequently alter the rate and base for additional revenue, uncertainties of tax liability always affect the producer's choice. A study of the tax effects on production has indicated that production levels invariably increased when a tax incentive in the form of reduction in rates was given to boost output[15].

There was a higher production relief scheme in operation in the 70's in India, during which it was noticed that the output levels had improved considerably for most of the commodities during the incentive period. But this trend was temporary as the initial spurt in production had gradually declined for some commodities. If the pre-tax production was sluggish or the capacity was under-utilized for one reason or the other, the incentive scheme helped to improve the output level. But such schemes discouraged efficient units which had already reached the peak levels of production. The

[13] Supra note 1, at 36.
[14] Id.
[15] Ibid, at 37.

result was that the inefficient and badly managed firms cornered unwarranted and undeserving tax benefits.

Several tax induced distortions were created in the domestic industry in the first four decades of taxation. The rate structure complexities within the same industry was prescribed for achieving multiple tax objectives, affected the production pattern in many sectors. Excise and sales tax exemptions were liberally given to provide relief to essential commodities, specified sectors, products and firms, ostensibly for maximizing equity or for administrative convenience. It may not be possible to point out all tax induced distortions that affect production. But the conclusion from several studies has indicated that the excessive burden of taxes levied by different authorities that fall on the same base affect the optimal production[16]. There is a need for a tax system that would relieve production from unbearable tax burden. The producers should have the freedom to choose the output levels acceptable to the market on the basis of demand and supply factors rather than on tax induced distortions.

Tax Incidence:

Equity considerations enshrined in the Constitution of India make it imperative that the tax burden should be progressive in relation to the taxable capacity of the population. The progressive or regressive nature of the tax has been indicated by the quantum of tax burden in the consumption expenditure of different classes of the population[17]. Several studies have been undertaken in the past to ascertain the per capita consumption of taxed goods. The Indirect Taxation Enquiry Committee, 1978, had conducted a comprehensive incidence study covering State, Central and Local taxes found that excise duties were more progressive than State taxes[18]. About 70% of the tax incidence of rural sector and low income groups has been found to be on account of central excise duties.

[16] Supra note 1, at 39.
[17] Id.
[18] Id.

Essential consumer articles like textile, sugar, tea, kerosene and tobacco products have been found to be the main culprits for creating the regressive distribution[19]. The tax burden on the inputs and intermediates has been taking a large share of the total incidence on consumer goods. The multitude of taxes falling on the same base irrespective of the taxes paid at earlier stages is also yet another reason for the highly regressive nature of indirect taxes in India.

Tax Evasion:

The structural complexities of taxation inevitably lead to conditions conducive to large scale evasion. With the prohibitive tax rates, temptation to avoid payment becomes irresistible. One of the methods of evasion is suppression of actual production. In addition, under valuation and misclassification of commodities are important means for avoiding payment of taxes. Suppression of production is mostly prevalent in the small sector which enjoys tax concessions on the basis of a turnover criterion[20]. When actual production is understated, borderline units easily escape tax liability. The evader not only avoids excise, but also other taxes like income tax and sales tax. In the organized sector, where a large number of persons and different stages are involved in the production and sale of taxable goods, suppression is not possible. But even in this sector manufacturing products like cigarettes on which excessive rates are applicable, suppression of production is rampant to obtain huge monetary gains.

Under-valuation is another attractive means of evasion when the tax rates are based on the value of the goods rather than on specific characteristics like volume, number, etc[21]. In vertically integrated units, under-valuation is more prevalent as documents could be manipulated conveniently through all stages of production and sale. In such cases, it is easy to share the unaccounted money generated with the collusion of officers. Under-

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[19] Supra note 1, at 40.
[20] Id.
[21] Ibid, at 41.

valuation cases are difficult to discover as the real value seldom gets reflected in any document. In fact, manufacturers of identical goods create cartels for declaring similar prices to avoid detection. The acute problem of under valuation is the main cause for the prevalence of specific rates which are based on some physical criterion. However, this remedy for curbing under-valuation has resulted in considerable loss of revenue, as specific rates do not reflect the automatic growth of the tax base. With specific rates, suppression of production is the main source of evasion instead of under-valuation. Hence, there is a need for a system that could effectively combat the menace of under-valuation and suppression of production.

Another problem is that with multiple rates some evaders resort to incorrect classification of taxable products. It is particularly rampant in situations where differential tax structure gives preferential treatment to the same commodity based on some criteria like end-use, source of production, etc[22]. Some of the products prone to such modes of evasion are cotton, man made fabrics, yarn, etc. There is usually no reliable data for quantifying the extent of evasion of indirect taxation. Therefore, to counter these deficiencies we need tax reforms that would be effective and easy to administer for the taxman.

In India, the tax reforms have been confined mostly to cosmetic changes as the policy makers have always apprehended loss of revenue if any fundamental changes were attempted. Hence what we need is to put our priorities in order and cut down the weeds affecting a healthy growth. There is a need to improve domestic saving and investment. To achieve this objective, there is no alternative to reducing taxes to the minimum level, whether direct or indirect. If the Government appropriates more than 60 per cent of the value addition in the economy in the form of taxes, there is no disposable income left to invest in growth.

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[22] Supra note 1, at 41.

It is sad to note that even in the 2003-2004 Budget, no positive steps were taken for tax rate reforms[23]. The Central Government had appointed a Task Force headed by Dr. Kelkar for an in-depth examination of our ailing tax system. The recommendations of the Kelkar task force on administrative reforms have been accepted. They were timely and targeted to improve the efficiency of tax administration. But the rate structure was left untouched because of the fear of increase in revenue deficit. Such half hearted revenue neutral reforms cannot help our economy but if a daring and more positive approach to tax rates is adopted our economy would be empowered and its performance would be much better.

One such step towards this objective would be the introduction of a new tax system called the Value Added Tax. VAT was first introduced more than fifty years ago, remained confined to a handful of countries until 1960's. Today, it is a key source of government revenue in more than 120 countries. About 70 per cent of the world's population lives in countries with VAT. And no one has yet come out with another system that could outshine its attractions. The greatness of VAT is that it is the most modern and scientific method of collection of taxes. The spread of VAT throughout the world is largely based on the fact that VAT has raised more revenue than the Sales Tax it has replaced. In recent times the VAT has received wide acclaim as a fruitful source of revenue with relatively low administrative and economic costs.

In this research paper the researcher has made an attempt to study and understand the concept of Value Added Tax, its essential features, the problems of implementation of VAT in India, analyzed the experiences of two developing countries that have adopted VAT, and critically analyzed the recommendations given by the Veerappa Moily Commission Report, 2001 for Karnataka.

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[23] Supra note 1, at xxi.

RESEARCH METHODOLOGY

Aims and Objectives:

Firstly, to study and understand the concept of Value Added Tax and its essential features in general. Secondly, to analyze the problems of implementation of VAT in India. Thirdly, to analyze the experiences of two important developing countries, Korea and Brazil which have adopted VAT. Finally, to critically analyze the recommendations given by the Tax Reforms Commission, 2001.

Scope and Methodology:

The scope of this paper is comprehensive because the subject matter involved is an International aspect which is very broad. Hence, this paper covers both national and international perspectives. To that extent it is descriptive and analytical in nature. This research paper has been divided into six chapters.

The first chapter delves with the concept of Value Added Tax.

The second chapter delves with the features of VAT.

The third chapter delves with the evolution of VAT in India.

The fourth chapter delves with the problems of implementation of VAT in India.

The fifth chapter delves with the experiences of Korea and Brazil which have adopted VAT.

The sixth chapter delves with the recommendations of the Tax Reforms Commission, 2001.

The methodology adopted for this paper is doctrinal as the researcher has done a through library research by going through books written by both Indian and foreign authors, articles and the report.

Sources of Data:

Secondary sources of data have been used in the research paper which mainly consists of books, articles and the Tax Reforms Commission report, 2001.

Research Questions:

1. What is the concept of Value Added Tax?
2. What are the various features of Value Added Tax?
3. How did the concept of VAT evolve in India?
4. What are the problems faced in India and why there is a delay in implementing VAT?
5. How did Korea and Brazil introduce VAT in their respective countries? Do they offer any lessons for India to adopt VAT?
6. The recommendations of the Tax Reforms Commission, 2001. A critical analysis.

Mode of Citation:

A uniform mode of citation has been followed in the research paper.

THE CONCEPT OF VALUE ADDED TAX

Value Added Tax (VAT) is the most important fiscal innovation of the 20th century. France pioneered with the adoption of Tax sur la Valeur Adjoutee or Tax on Value Addition in 1954[24]. VAT has spread like a wild fire throughout the world. It has been accepted in most of the countries like Latin America, Asia, Africa and pacific countries. Such increasing popularity of VAT has primarily been due to its taxanomy and administrative expediency but countries like USA and India, are yet to implement it.

VAT is the tax levied on the actual value added by a firm or individual on goods and services purchased from others[25]. It is a tax on an economic activity rather than on the end products. In its comprehensive form, VAT is applicable to producers, wholesalers and retailers. In a federal set up the distribution of the powers of taxation is the deciding factor for introducing a suitable form of VAT. The main interest is to reduce the cascading and other adverse effects of indirect taxation. It has been stated that it is only remedy for removing the negative impact of multiple tax regimes. An important feature of VAT is its flexibility to adapt to the requirements of all socio-economic conditions, legal frameworks and the existing administrative institutions. While introducing any kind of VAT, modifications in the existing tax laws are necessary to give legal support for the smooth transition to the new system. Fortunately, VAT can adjust with all such requirements without endangering its basic features. The calculation of tax liability on a commodity or service is also easy and intelligible.

Variants of VAT:

There are three major varieties of VAT that could be adopted. They are Consumption VAT, Income VAT and Gross Product VAT. They can all be operated on either origin or destination principles.

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[24] Dr. SanjeevKumar, "Value Added Tax (VAT): Concept, Problems and Prospects" 29 Tax & Corporate Referencer 2003, at 45.

[25] Supra note 1, at 18.

Consumption VAT:

Consumption VAT is very popular among the many countries adopting VAT. It is applicable to value addition on goods and services consumed. The value added by a firm to the goods and services purchased from others becomes the tax base[26]. The value addition can be raw materials, intermediate goods or manufactured goods. It can also be extended to value addition at wholesaling or retailing points. Invariably, the final tax is collected at the retail point where the values added at all the previous stages of production and transactions converge. This variant of VAT allows deduction of tax on all purchases including capital assets. The base of this type of VAT is the total consumption in the country which is the chosen target for an ideal indirect tax[27]. An advantage of consumption VAT is that it does not interfere with investment decisions capital formation in any manner. Another advantage of consumption VAT is that it is totally neutral to methods of production, capital and current expenditure, savings and consumption. This quality of VAT enhances economic efficiency, as it does not distort consumer's preference or producer's choice. Besides, the transparency in transactions makes it the easiest tax for the administration to enforce. It allows total deduction of business inputs without discriminating between capital goods and consumption goods. It also exempts export goods to make them more competitive and takes full value of imports by making imports more costly[28]. Because of these advantages Consumption VAT is the most popular form of Indirect tax in the world.

Income VAT:

Income VAT is another variant of VAT, which collects tax on all sales but allows deduction only for the depreciation of capital goods[29]. The tax base of Income VAT is identical to that of comprehensive income tax that

[26] Supra note 1, at 19.
[27] K.C. GopalaKrishna, "Value Added Tax (VAT)" 9 Taxation of Corporations and Commodities 2003 (MBL Module), at 45.
[28] Ibid, at 46.
[29] Supra note 1, at 21.

includes investments and gives deduction only for the depreciation of capital goods. It is not popular and only a few countries like Argentina, Peru and the State of Michigan in USA have levied this tax[30]. It is generally not favoured for the practical difficulties in computing depreciation of capital goods. It also does not give any relief from the burden of cascading effect of multiple levies.

Gross Product VAT:

Gross Product VAT is the third variant of VAT, in which deduction is not allowed even for the replacement of capital goods. Relief is given only for purchases of current consumption goods. The main drawback of this VAT is its discriminatory treatment to capital goods[31]. It adversely affects investment and industrial growth. There is no relief from double taxation of capital goods. Consequently, the replacement of old and worn out plant and machinery is very slow, which leads to stagnation. Finland, Morocco and Senegal follow this type of VAT[32].

VAT Computation:

Value Added Tax is a versatile tax and hence it offers several methods to calculate the quantum of tax payable. The commonly used methods of calculation are addition, subtraction and tax credit.

Addition Method:

In addition method, all factors of payments including profits are aggregated to arrive at the total value addition. The applicable rate is then applied on the tax base to calculate the tax liability. This method is mainly used with income VAT. This method cannot easily accommodate exemptions of intermediate firms. It is also difficult to exempt exports and do correct

[30] Supra note 27, at 46.
[31] Supra note 1, at 22.
[32] Supra note 27, at 46.

valuation of imported goods. Another drawback is that it does not facilitate matching of invoices for detecting tax evasion[33].

Subtraction Method:

Subtraction method is another method of computing tax liability. In this method the value added by the firm is calculated by subtracting total purchases from sales. In the case of direct subtraction, tax is levied on the difference between the aggregates of tax exclusive sales and purchases. In an intermediate subtraction method, tax is levied on the inclusive values of purchases and sales.

Tax Credit or Invoice Method:

VAT operating countries mostly employ the tax credit or invoice method for computing the actual tax payable. In this method, deduction of taxes paid on inputs is allowed from the taxes payable on sales on the basis of the aggregate of the taxes indicated on all invoices[34]. The invoices received for the purchase of inputs and sale of value added commodities give correct indication of the actual tax liability. It eliminates distortion caused by a differential rate structure. Another advantage is that it can tax the full value of imported goods under the destination principle at the time of import or at any subsequent stage. This method allows easy access to auditors for matching invoices electronically[35]. With suitable software, tax evasion can be detected more quickly and efficiently by an error alert.

Principles of VAT:

Broadly they are Origin principle and Destination principle. For implementing s suitable VAT, we can choose from the two principles relating to trade.

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[33] Supra note 1, at 22.
[34] Ibid, at 23.
[35] Id.

Origin Principle:

Under this principle, the value added domestically on all the goods whether they are exported or internally consumed is subjected to tax[36]. Therefore, tax cannot be levied on value added abroad. The tax is confined to goods originating in the country of consumption. Thus exports are taxable and imports are exempted. This principle is not popular in a globalized economy and it is used normally in conjunction with income VAT.

Destination Principle:

The destination principle is opposite of the origin principle. The principle is that all goods consumed in country should pay the tax. Under this principle, the exports are exempt while the imports are invariably taxed[37]. It is normally used with consumption VAT and is preferred in a federal form of government. Unlike the origin principle, it treats imported goods at par with domestic products and does not give any indirect protection and preference to foreign products.

Exemptions under VAT:

Taxation may be an unavoidable evil but exemptions are its loyal accomplices[38]. General exemptions are given to essential goods consumed by low-income groups and also to export goods for achieving a beneficial foreign trade regime. Similarly, certain firms and sectors are excluded from the tax liability on account of low revenue potential as compared to the cost of production or for any other compelling reason. It is difficult to compute value addition particularly in case of some services like banking and insurance. For giving exemption under VAT either zero rating or direct exclusion is be applied. Generally tax exemptions are granted to firms falling below a specified turnover limit stipulated as the tax threshold. Exemptions can also be given because of social policies like for hospitals, charitable and

[36] Supra note 27, at 46.
[37] Supra note 1, at 24.
[38] Id.

cultural institutions, etc[39]. As economic incentives exemptions can be given to encourage small sectors.

Exemptions are of two types[40]:

- A trader is exempted to pay VAT on his inputs without being able to claim any credit for the tax paid on such inputs because he does not pay any tax on his outputs.
- Exemptions are with regard to sales and not purchases.

Rate Structure of VAT:

Rate structure is important on the cost and efficient working of VAT. VAT can operate on a single or multiple rates. But multiple rates have a serious impact on tax base, cost of administration, consumptive cost and have the ability to provide different treatment[41]. However, the determination of rates, whether single or multiple depend on the administrative capacity of each country. VAT rates are applied either on a tax base exclusive or inclusive of tax. In either case the revenue would be the same but the rate should be kept lower in the tax inclusive form to offset the price effect on account of the presence of tax in the price.

Operation of VAT:

The system of VAT helps to end the cascading effect which results in higher prices and avoid double counting that are the consequences of Indirect Taxes. The functioning of VAT can be understood from the following illustration that shows the cascading effect resulting in higher prices[42].

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[39] Supra note 27, at 47.
[40] Id.
[41] Id.
[42] Ibid, at 44.

Bread , Receipts , Costs and Value Added (in cents per loaf)

Stage of Production	Sales Receipts	Cost of intermediate Materials or goods	Value Added
	(1)	(2)	(1-2) = 3
Wheat	8	0	8
Flour	11	8	3
Baked dough	20	11	9
Delivered Bread	30	20	10
	69	**39**	**30**
			(sum of value added)

If India is taken as an example, under the indirect tax system Rs.69 is subjected to tax, whereas under Value Added Tax, only Rs.30 is subjected to tax. Thus value added tax avoids cascading effect which results in higher prices. In the present indirect tax system instead of paying tax on the value added by a manufacturer or wholesaler or a retailer, it is paid on an inflated value which includes the taxes paid already at the earlier stages.

This cascading effect leads to four major types of undesirable consequences[43]:

a. It leads to an uncontrolled pattern of incidence on final products. It places a greater burden proportionate to price on the varieties of products consumed by the poor than on those consumed by the rich.
b. Widespread taxation of inputs leads ultimately to an economically irrational tax structure, leading to inefficient rise of resources.
c. It leads to avoidable increase in costs and the prices of inputs as well as of final products.
d. It increases the cost of exports outside India. In a competitive world, exports have to be less costly and the present indirect system will not achieve it.

[43] Supra note 27, at 45.

Therefore there is a need for an alternate method of taxation which avoids the defects mentioned above and the ideal tax is VAT. It is claimed that VAT is the most effective remedy for all sorts of tax created problems in developing and developed countries. Conceptually VAT is unexceptional. It would provide a predictable stream of government revenues without punishing productive pursuits. It sets up a lamp post all along the value chain, thus bringing to light the entire geography of economic activity[44]. VAT has the potential to reward production and productivity, ensure transparency and neutrality in indirect tax, reduce consumer prices, make the industry competitive, increase the tax base and bring the economy into the fold of wealth creation. It would also provide level playing to domestic trade and industry. Finally the consumers will be benefited from VAT by getting commodities at competitive prices.

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[44] Sanjiv Agarwal, "Value Added Tax – What and Wait" 25 Tax & Corporate Referencer 2002, at 48.

THE FEATURES OF VALUE ADDED TAX

Since VAT has been accepted in most of the countries, it indicates that it has many attractive features which are not found in other tax systems. In the 70's and 80's there has been large scale tax reforms all over the world for accelerating GDP growth rates. Massive tax effort in the developing countries distorted the tax system, which tried to get maximum revenue from a narrow base. Following the American initiative, developing countries attempted to broaden the direct tax base and reduce the rates in anticipation of higher revenue collection[45]. But they slowly realized the limited impact of direct taxes for raising adequate resources, and thus tax reforms were focused on the evolution of a comprehensive and non-cascading indirect tax like VAT.

In recent times public finance reforms have become the main concern of governments all over the world. But the developing countries instead of reforming the tax system took the easy route of market borrowing from external and internal sources. The result was uncontrollable inflation and poverty. Many countries in Africa and Latin America are still in debt traps for want of suitable mechanism to reduce the fiscal deficits[46]. Thus VAT has been identified and acclaimed as the panacea for correcting the fiscal imbalances as it works well within all political and legal constraints. One important lesson that the developing countries have learnt from the tax reform experiences is that for a successful outcome in terms of revenue and other objectives it should apply to the entire economy[47]. A partial replacement of a few components of federal taxes with modern VAT may not achieve the objectives of tax reform. From the experiences of the VAT operating countries, it has been found that the revenue and the tax ratio to GDP increased considerably after the switch over from conventional taxes.

[45] Supra note 1, at 70.
[46] Id.
[47] Ibid, at 71.

Thus it has been seen that the features of VAT can correct the economic inefficiencies created by the archaic taxes.

VAT is the only tax that offers positive alternatives to the negative impact of indirect taxation[48]. It is an accepted fact that the commodity taxes create severe cascading effect as the taxes levied at the earlier stages of production and distribution get taxed again and again at subsequent points. Consequently, instead of paying the taxes on the value addition by a manufacturer, wholesaler or retailer, tax is paid on an inflated value, which includes taxes already paid at earlier stages. Such anomalies escalate prices and encourage vertical integration, where the manufacturer himself tries to wholesale and retail the goods. Vertical integration has been responsible for recession and unemployment in developing countries. As pointed earlier VAT has an inbuilt mechanism for reducing the cascading effect by restricting the levy to actual value addition. It encourages growth by confining tax burden to the net economic contribution of the tax payer. Capital investment also gets tax relief hence VAT can accelerate the economic growth by encouraging modernization and replacement.

Essential Features of VAT[49]:

Simple and Transparent:

There is no other tax that can be as transparent and simple like VAT. At every stage of transaction, VAT indicates the quantum of tax payable after adjusting tax credits. The tax payer, the ultimate consumer and the administration are all fully aware of all the details of tax payment. In the conventional system only the tax payer and the administration know the tax liability. If there is a nexus between the department and the payer, it is possible to distort the element of tax without the knowledge of the ultimate consumer. The transparency improves compliance as it becomes

[48] Supra note 1, at 71.
[49] Ibid, at 72.

difficult to evade the taxes successfully at every transaction stage. Cross checking of tax credit taken at the earlier stage can make it difficult to avoid payment. After deducting the tax credit, the tax payable is a small amount at any point of time. In conventional taxes there is ample scope for tax evasion because the documentary requirements are not as elaborate and inter-related as in VAT.

More Revenue:

The immediate objective of VAT in developing countries is to improve the tax to GDP ratio. It has been adopted when the conventional taxes have failed to provide elastic revenue for meeting the increasing demands of public expenditure. In all VAT operating countries, it has earned the reputation of being a dependable revenue raising instrument. VAT can easily access the incremental income generated by the expanding economic activities without altering the rate or base in every budget. The average revenue contribution of VAT ranges from 5 to 10 per cent of GNP depending on the rates and requirements[50]. VAT is definitely more costly to administer than other conventional taxes for its requirements of infrastructure and detailed documentation. The administration also has to invest heavily on automation to deal with the scrutiny of returns and matching of invoices. But once the infrastructure is provided, the cost of collection and compliance gradually decreases. If the VAT rates are low, it would not be economical to incur the cost of maintaining a huge establishment for revenue collection and tax payment. It has been estimated that any rate below 7 per cent would not be worthwhile for developing countries contemplating the adoption of VAT[51].

Price Neutral:

There has been serious apprehension about the inflationary impact of VAT. But the initial inflationary impact is found only in few instances.

[50] Supra note 1, at 72.
[51] Ibid, at 73.

Inflationary pressures are expected in VAT regime as it allows exemption to very few products, firms and sectors. The price effect of VAT depends mainly on the elasticity of demand and supply of the taxable products and the conditions in the factor markets. If traders pass on the entire tax, the consumer price index would rise exactly of the tax levied. The study conducted in 35 VAT operating countries showed that its introduction had very little effect on consumer prices[52]. If VAT substitutes an existing tax with no additional revenue objective in the short run, it would not have any inflationary impact. On the other hand a reverse effect could be felt due to the input tax relief which was not available earlier.

Equity:

Equity is an important aspect of VAT. To reduce the regressive impact of commodity taxes, VAT rate has to be less than that of the substituted taxes like central excise or sales tax. Some of the empirical studies show that the distribution of VAT burden indicates that its overall impact is marginally progressive[53]. This progressive effect of VAT is visible only in countries that totally exempt essential consumer articles like food and medicine. But its incidence is less regressive than that of other commodity taxes. In comparison to conventional indirect taxes, VAT can be more equitable by exempting articles of essential consumption. The tax policies will have to be adjusted to the requirements of the country having regard to the existing patterns of distribution of income of the population.

Neutrality and Economic Efficiency:

The most important feature of VAT is its neutrality, which is the benchmark of an efficient tax system. With uniform rate, VAT is neutral to producer's preferences and consumer's choice. It treats all inputs uniformly to avoid any tax induced distortion. It does not influence consumer's preferences for commodities whether they are taxed or not or

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[52] Supra note 1, at 74.
[53] Ibid, at 75.

even when they are taxed at different rates. It also keeps neutrality between the capital and labour. If the exemptions are kept at the minimum level the impact of neutrality would become more visible. But even if a few products are left untaxed, it does not alter the overall efficiency of the tax system. Conceptually, VAT is not compatible with differential rate structure based on optimal tax theory. The optimal tax theory seeks to tax different commodities at the most appropriate rate based on price elasticity[54]. The emphasis of VAT is more on reducing the cascading effect and improving neutrality rather than prescribing differential rate for improving economic efficiency. For understanding the tax effects, neutral taxes like VAT are preferable to the conventional taxes that may offer a differential structure based on price elasticity.

Tax Evasion:

With the adoption of VAT the tax evasion can be reduced drastically. The conventional commodity taxes are highly prone to evasion. Evasion is euphemistically called as legal avoidance. The evaders not only escape payment of commodity taxes with impunity but avoid all kinds of taxes related to the chosen base. Consumption type of VAT with tax credit method does not give much scope for evasion. Evader cannot escape detection with the thorough auditing of invoices unless all transactions uniformly reflect lower value addition. The clear possibility of detection at one stage or other is a deterrent for habitual offenders who may find it difficult to pay heavy fines and penalties. The evaders are not likely to be benefited individually, as large amount of tax does not get accumulated at any stage of transaction. With rigorous auditing of documents, chances of detection can be further increased. In conventional taxes audit is confined to manual, data checking but VAT uses the speedy electronic medium for matching of invoices. One major worry in the case of VAT in case of invasion is that computerized checks cannot easily capture cases of

[54] Supra note 1, at 76.

fictitious tax credit using forged invoices[55]. To deal with such cases of invasion VAT would have to be equipped with more stringent deterrents like black listing and deregistration.

Economic Growth:

The cause of economic growth can be served better if the tax system is left undisturbed to pursue its objective of revenue. A heavy tax burden restricts growth while lower taxes not only promote savings but also ensure better revenue and improved compliance. The increasing mobility of capital and the emerging E-commerce necessitates lowering of rates of income and corporate taxes. Tax rates would have to be attractive and its administration should be transparent enough to prevent migration of capital and improve foreign direct investment[56]. A uniform VAT is to be preferred to differential rates as it allows uninterrupted flow of economic activities. VAT can definitely achieve faster economic growth unlike other indirect taxes.

To have an efficient and effective taxation system it must be simple, transparent, easy to understand, unambiguous, devoid of much discretion to the officers, use of least forms and be fast. When we consider the features of VAT., it has every quality to be called as an efficient system of taxation. The fact that it has been accepted in most of the countries in the world shows that it can be easily adopted and effectively enforced. Thus the positive features of VAT have made it acceptable as an alternative even to the ubiquitous income tax.

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[55] Supra note 1, at 77.

[56] Supra note 1, at 78.

THE VALUE ADDED TAX IN INDIA

India is using VAT to streamline and rationalize its indirect taxes so far as it relates to sales tax and service tax. Levy of VAT is also an attempt to achieve unification of state level sales tax. It is imperative that central sales tax, entry tax, octroi and other local taxes must disappear for proper implementation of VAT. The VAT would enhance competitive strength of domestic trade and industry and further push up economic reform process. VAT in common man's language is a tax levied on the value added to any product or service each time it changes hands or value.

According to the definitions proposed in the proposed Bill, Value Added Tax means a tax on sale of a commodity at every point in the series of sale by the registered dealers with the provision of credit of input tax paid at the previous point of purchase thereof. Thus, the tax paid by a registered dealer would be netted and he would be actually subjected to a tax, a differential tax of tax paid and input credit received. It has also indicated that for the levy of VAT, the following tests must be satisfied[57]:

- The transaction must be of a sale.
- Sale must be of a commodity.
- Sale must be made by a registered dealer.
- VAT must be paid at every point of sale in a series of sale.
- Input credit would be allowed for input tax paid at immediately previous purchase point.

VAT presupposes homogeneity and as such it would be essential for the governments to ensure that rules and procedures are made uniform across the States, besides common date and rates of levy. This is essential for moving towards a value added tax regime. VAT has the potential to reward production and productivity, ensure transparency and neutrality in indirect tax, reduce consumer prices, make Indian industry competitive, increase

[57] Sanjiv Agarwal, "Value added Tax: Some Concerns" 28 Tax & Corporate Referencer 2003, at 46.

the tax payer base and bring the entire economy into the fold of wealth creation.

Constitutional Scheme:

The Indian Constitution has a federal structure and the power to tax has been divided between the Central Government and the State Governments through the mechanism of the Union List, the State List and the Concurrent List. These Lists are contained in the Seventh Schedule to the Constitution. Under the Central List the Central Government has the exclusive power to levy tax on items specified therein. Under the State List the States enjoy such powers. In respect of the items contained in the Concurrent List both the Central and State Governments can legislate. However, in case of conflict between the two legislations, the Central legislation will prevail.

Since the Constitution provides for a federal structure, the present scheme of allocating powers to tax between the Centre and the State has been retained. Thus flowing from the constitutional provisions there is a Central VAT System and State VAT System. The VAT system now in vogue in the Central Government is not a full fledged VAT system. It is only a modified VAT system. It was previously known as the MODVAT system. Now it is known as the CENVAT system. The CENVAT system is a system of credit of duty to be adjusted against liability for excise arising out of manufacture of goods. The Finance Act, 1994 introduced service tax in respect of select services. This tax was extended by subsequent Finance Acts to cover many more services. The Finance Act, 2002 has provided for a system of credit in respect of service tax. Therefore at present, there are two types of modified VAT, one in respect of the manufacturing sector and another in respect of the service sector[58]. The third VAT system would be in respect of States. Such a VAT would be levied on the turnover against which credit would be given in respect of tax due on purchases. Thus, by having these three sectors the ultimate goal would be to integrate the manufacturing, the

[58] R. Devarajan, " Uniform Value Added Tax – Some Critical Issues" 124 Taxman 2002, at 158.

services and the State sector and implement a unified VAT system throughout the country.

Evolution of VAT in India:

India has a system of tax collection wherein the tax is collected at one point from the transactions involving the sale of goods. The single point tax may be collected either at the first stage or at the last stage.

The system of collecting tax at first stage has the following disadvantages[59]:

- Since sales tax is levied and collected at the first stage of sale, the tax rate is usually higher. This encourages tax evasion and sales tax becomes a tax on honesty, which means more the honesty, more the tax liability.
- If somehow the goods escape the tax at the first stage, the goods escape tax net altogether since there is no way by which it can be caught at any subsequent stage.
- There is ample scope for under-valuation of the value of the goods at first stage, since there is no tax payable at any subsequent stages, even if the goods are subsequently sold at much higher prices.

In the system of collection of tax at the last stage also, there are some disadvantages[60]:

- The tax evasion is maximum since the price level at the last point of sale increases, which encourages evasion, even if the tax rates are low.
- It is difficult to track the goods evading tax since there is no record of their earlier movements and after the last point sale, the goods reach the consumers.
- This also encourages under-invoicing and involves generation of black money due to cash dealings at the last point of sale.

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[59] Supra note 24, at 45.

[60] Ibid, at 46.

Since VAT is collected in stages by installments from one stage to another, all the above disadvantages could be overcome; the cascading effect of taxes is eliminated. India has been slow in adoption of VAT. In domestic trade taxes, there is excise duty at the Central level and sales tax at the State level for this purpose. As stated earlier the Central Government attempted reforms in the central excise duty by introducing the principles of VAT in 1986 through the introduction of MODVAT. Over the period the rates have been rationalized, exemptions have been reduced and the coverage has been extended to almost all the commodities. MODVAT has now been converted into a central VAT and is called CENVAT. But the State Governments have been indifferent in undertaking any reforms in their sales tax system, although it accounts for approximately 60% of the states own tax revenue and it is confronted with many drawbacks as mentioned earlier.

The Task Force known as Kelkar Committee has observed that currently each State levies multiple taxes on the same item in different names or at different stages. Example: entry tax, luxury tax, etc. However, it has stated that it is necessary that State VAT should be the tax to unify all the State level taxes i.e., sales tax, purchase tax, turnover tax, works contract tax, entry tax, special additional tax, etc. should all be covered under State VAT[61].

Advantages of VAT System[62]:

The main advantage of VAT system is that it eliminates the defects and distortions in the operation of Indirect taxes, both at the Centre and the States. They are:

- It is broad based and is collected at all stages of production and distribution. Therefore, rates are relatively lower.

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[61] Supra note 24, at 46.
[62] Supra note 27, at 48.

- It enables identification of tax components separately. This is important when entire tax component needs to be rebated or refunded.
- Avoidance of cascading because Inputs do not suffer tax burden more than once.
- It is neutral because it does not distort or favour any method of production.
- Neutral treatment for exports and imports is ensured.
- Does not promote vertical integration.
- Encourages development of ancillary industries.
- Considered to be self-policing with minimum chances of evasion since chain is maintained from production to consumption.

The other advantages include the following[63]:

- Compliance with WTO requirements would enhance global competitiveness and exports.
- Uniformity in tax rates would facilitate single market in India.
- VAT would eliminate numerous forms, which take enormous time and manpower to complete.
- VAT maintains computerized records, resulting in greater accuracy, transparency and efficiency.
- VAT requires competent tax officials to monitor the system without causing harassment to the taxpayers.
- VAT regime compliance cost is about US$ 5 million per year, about one hundred times less than the current system.

[63] Naresh Kumar, "Value Added Tax in India – Vital Issues" 31 Tax & Corporate Referencer 2004, at 113.

Limitations of VAT System[64]:

The system of VAT does have some limitations. They are:

- The implementation of VAT is closely linked to the administration of other indirect taxes and it would cause impact on the tax to GDP ratio.
- There could be cases where the VAT is collected by the dealer, but not paid to the Government. As a result, the set off of such VAT paid by the purchaser may not be allowed to the purchasers.
- A situation of refund would arise if no VAT is payable on the final sale. As a result, the set off cannot be availed. In such cases, the tax paid becomes the cost or claim for refund arises, which is cumbersome.
- VAT would also contain multiple rates of tax due to multiple classes of items. In countries like India, sales tax covers a wide range of commodities, replacement of such tax by revenue neutral VAT may lead to inflationary consequences.
- The dealers would be required to maintain up-to date records of purchase and sales in order to claim set off. Many dealers maintain only primitive accounts which were earlier accepted by the department, but now this would become problematic.
- Since Central Sales Tax Act continues to remain in force, there could be conflict between the VAT and CST (Central Sales Tax).

The CENTRAL VALUE ADDED TAX (CENVAT):

In the year 2000-2001 budget, there was a revolutionary feature in the indirect taxes in the form of a unified rate of basic excise duty called as the Central Value Added tax or CENVAT[65]. It was proposed to rechristen the MODVAT Scheme as 'CENVAT SCHEME' to come into effect from April 1, 2000. Initially, Modified value added tax, popularly known as 'MODVAT' was introduced in India in 1986 as the forerunner of a full fledged VAT. It had

[64] Supra note 24, at 50.
[65] V. Pattabhiraman, "The CENVAT Revolution" 109 Taxman 2000, at 81.

consolidated various input relief schemes like proforma credit, set off and Chapter X procedure, etc., that were available in the excise system. In 1986 as suggested by a technical study team, a new set of rules was framed to simplify and bring together the various input exemptions in a legal framework of VAT. It was issued as Rule 57A of the Central Excise Rules. It is stated that experience over the past 14 years has proved that the MODVAT Scheme literally drove the beneficiaries mad, because of the verbose language used in the relevant rules, coupled with frequent amendments and issue of notification, trade notices and circulars. There were 2,220 cases relating to MODVAT provisions that had been reported. Actually the fault laid in not creating an atmosphere of trust, as well as in the attitude of the department in interpreting the provisions. The positive aspect of the CENVAT Scheme was that it contained just 11 rules couched in simple and easily understandable language as against 22 long winding rules in the MODVAT Scheme[66].

The striking improvements of the CENVAT Scheme over the MODVAT Scheme is that on going through the new set of rules 57A to 57-I relating to the CENVAT Scheme is the manner of drafting the rules. The rules start with the definition clause and then delineate the scheme in simple sentences, bereft of 'ifs' and 'buts'. There are no provisos, very few explanations and no provision worth the name relating to procedural aspects and department controls. Some of the striking improvements made are on the following aspects[67]:

- Under the MODVAT Scheme, inputs and capital goods were dealt with in separate sets of rules-Rules 57A to 57 JJ applied to inputs and rules 57Q to 57V applied to capital goods. This dichotomy has been removed in the CENVAT Rules and a common set of rules, applicable to both inputs and capital goods has been framed.

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[66] Supra note 65, at 81.
[67] Ibid, at 82.

- The terms 'input' and 'capital goods' have been given a very simple definition under the CENVAT Rules, while under the MODVAT Rules, the rules only empowered the Government to notify the inputs and capital goods, thereby necessitating the issue of notifications.
- The concepts of 'waste', 'residue', 'by-product' and 'intermediate product' have been totally removed in the CENVAT Rules. These were the items that created a lot of contentions in the MODVAT Scheme.
- The positive and negative lists of inputs earlier contained in rule 57B of the MODVAT Rules have been given a good-bye. This was because all the inputs, barring just one item, are proposed to be covered under the CENVAT Scheme.
- On the procedural side, the major change was the dispensing with the necessity of filing declarations, as it was another area which proliferated litigation under the MODVAT Scheme.
- Under the CENVAT Scheme, the manufacturers are left free to devise their own accounting system and other records, so long as they ensured that CENVAT credit is taken on the strength of an acceptable supporting document, whether it is an invoice, a bill of entry or any other document.
- No provision has been made in the CENVAT Rules empowering Government to restrict the admissible credit in specified cases, or to allow deemed credit. Under the MODVAT Rules, Government had such powers in exercise of which they introduced the system of deemed credit on textiles and steel products.
- The procedure for sending inputs or capital goods to the job worker, on the cumbersome and onerous lines indicated in rule 57F of the MODVAT Rules does not find a place in the CENVAT Rules.
- The manufacturer's are not required to submit any periodical returns or documents to the department.

- ❖ Prior intimations or approvals from the department are no longer necessary. Under the MODVAT Scheme, such a requirement was laid down in respect of certain items.
- ❖ Provisions relating to transitional credit, Rule 57H of the MODVAT Rules, were removed pursuant to the requirement of filing declarations was dispensed with.
- ❖ Time limit for availment of credit, which is 6 months under the MODVAT Scheme was removed. Under the CENVAT Scheme, credit can be taken as soon as the input/ capital goods are received in the factory. In respect of capital goods, controversy surrounding the requirement of installation and use of capital goods was removed.

However there are certain areas or provisions under the MODVAT Scheme which are not touched by the CENVAT Rules, some of them may still be relevant from the beneficiary's angle. They include[68]:

- ➢ The removal of inputs and capital goods as such for home consumption or for export under bond, on payment of duty equivalent to the MODVAT credit availed on those goods.
- ➢ Omission to include accessories in the definition of inputs that are supplied along with the final products on lines similar to the provision under the MODVAT Rule 57B (1)(iv).
- ➢ Upward downward revision of credit as provided under rule 57E of the MODVAT has not been provided in the CENVAT Rules. The upward credit is permitted whenever the supplier subsequently pays some differential duty and passes on the debit to the purchaser. Similarly, when the manufacturer obtains a refund of duty paid, the purchaser is required to make downward revision of credit.
- ➢ Credit on goods used exclusively in exempt final products- under the rule 57C (1) of the MODVAT Rules, no credit is allowable if

[68] Supra note 65, at 83.

the inputs are used in exempt final products exclusively. Under the CENVAST Rule 57D provides for the credit. The question is that whether the present rule 57D in the CENVAT Rules covers the cases covered under rule 57C (1) in the MODVAT Rules also.

- Refund of unutilized credit- under the MODVAT Scheme, cash refund of unutilized credit was available to exporters, subject to the condition that they would not avail duty drawback. This provision is provided in the CENVAT Rules.
- Deemed credit provisions – the deemed credit provisions relating to the processed textile fabrics and steel products provided under rule 57A of MODVAT Rules has not been provided under the CENVAT Rules.

One of the important features of the CENVAT Rules is that it has given more freedom to the manufacturers. Under the CENVAT Rules many procedural relaxations have been provided to the manufacturer so that he can carry on his job with out any necessity to obtain any approval from the department and also without any intervention by the departmental officials because the CENVAT Rules have placed the burden of proof on the manufacturer to ensure that credit has been availed and utilized in a proper manner and also proper records have been maintained for the transactions[69]. If any omissions or contraventions are detected by the department, the punishment is quite deterrent, as the CENVAT Rules also provide for recovery of wrongful and erroneous duty by invoking the provisions of sections 11A, 11AA, 11AB and 11AC of the Act, which has laid down the scales of levy of interest and penalty[70]. The department has placed a lot of trust on the manufacturers and it is expected that the manufacturer's in-turn would reciprocate that trust.

[69] Supra note 65, at 85.
[70] Id.

The tax system that has been in practice in India has many disadvantages. This tax system could be ably replaced only by VAT as it is more effective and efficient. Though it has some limitations, it is overshadowed by the advantages and the attractive features which it possesses. The Central Value Added Tax has been introduced in lieu of the Central excise duty. Considering the benefits it has provided, on the whole it has been considered to be an ideal system and has been functioning well in India. Similarly the states could also emulate the CENVAT provisions for introducing their variant of VAT. It has been a well trusted and tested tax welcomed by all concerned. Once VAT is implemented and gains experience the limitations that have stated above could be easily overcome by introducing appropriate measures.

VALUE ADDED TAX: THE PROBLEMS OF IMPLEMENTATION IN INDIA

The spread of VAT through out the world is largely based on the fact that VAT has raised more revenue than the Sales tax it replaced. Fiscal economists justify VAT on three theoretical grounds, which are claimed to be the following[71]:

- It is a neutral tax,
- It removes cascading,
- It achieves zero-rating of exports.

These claims are not wholly true and in any case they could be true only if a perfect VAT could be introduced. Once we take into account the imperfect VAT we find many of its virtues eulogized so often vanish both in theory and in the Indian context. All the virtues of neutrality, removing cascading, improving export- competitiveness all become unreal benefits if VAT is introduced in a very perfunctory and imperfect manner. That is precisely the problem with the way in which VAT is going to be introduced in India. Hence we have to try and make it as less imperfect as possible.

By no means is the introduction of VAT in a federation an easy task. Much of the imperfection in the introduction is because it is a federation. In India different parties rule different States and the Centre has very little control on the decisions taken by the States. In India every point regarding VAT is so hotly debated by the States that while the implementing authority knows quite well what would be the correct theory about inter-state trade in VAT, the States which would be adversely affected, would simply not agree to any such perfect solution.

[71] Sukumar Mukhopadhyay, "Value Added Tax - How implementation is going wrong" Economic and Political Weekly, September 2002,at 3700.

The structure of VAT that would be introduced in India has been discussed under the following heads:

Constitutional Problem:

As it is clear from the Constitution, there are three Lists in the Seventh Schedule. Entry 84 of List I empowers the Centre to levy excise duties, Entry 54 of List II empowers the State to levy sales tax and the List III entries are dealt by both the Centre and the State. Those matters that are not provided in the three lists are covered under entry 97 that deals with residuary power. As Entry 54 of the Constitution has given the States the power to levy sales tax, VAT would not conflict with this since, conceptually, any VAT would be charged at different points of sale. But the problem is that VAT has to be mentioned in State List for the State to impose VAT. Since VAT is going to replace sales tax it cannot be said that the State has the power to tax in the form of VAT. Otherwise it would come under the residuary power of the Union. Therefore, there is an urgent need to amend the constitution to put VAT under the State List.

As most of the countries have a VAT that includes both goods and services in the base, there is a constraint for Indian States as services are not mentioned as a taxable event in the Constitution except in the case of some specified cases such as entertainment, electricity, transportation of goods and passengers by road and inland waterways. Thus, most services fall in the residual category that is under Central powers. This issue of taxing power over services is required to be clarified by defining further the division of powers between the Centre and States.

State VAT law provides that sales tax credit would be available if inputs and capital goods are purchased within the State, but not when the goods are purchased from outside the State[72]. This provision is clearly discriminatory

[72] Supra note 24,at 58.

and against the provisions of Articles 303 and 304(a) of the Constitution. As per Article 286, the State Government cannot impose tax on sale or purchase during imports and exports or tax on sale outside the State. The VAT law provides that if goods are stock transferred to another State, input credit of tax would not be allowed. It is indirectly taxing a sale outside the State, which is unconstitutional. Hence this aspect of the Constitution has to be looked into by the policy makers.

Revenue- Neutral Rates or Uniform Rates:

Revenue- Neutral rate refers to the rate at which the VAT is to be introduced so as to protect the revenue loss that may arise to the States. This rate needs to be neutral and uniform for all the States on a particular commodity. This may, otherwise bring distortions in tax structure as well as in demand and supply. The proposed rates are as follows[73]:

0 per cent - 40 items, 1 per cent – 4 items, 8 per cent – 50 items (last item being not otherwise specified), 12 per cent – 37 items, 20 per cent – 5 items (motor spirit, including ATF, liquor, narcotics, molasses, rectified spirits).

While these rates have been more or less finalized, different States are claiming their revenue - neutral rates. The fact is that the number of rates, like 1, 4, 8, 12, and 20 seems to be too many and is certainly not suited for proper administration of VAT. Even rates like 12 per cent are not fixed but there is a variable band such as 10 to 12 per cent, which will incorporate several rates of VAT in different States. Imposition of such variable rates would distort trade and factor flows. The Raja Chelliah Committee recommended a general neutral rate of 8 per cent[74]. According to Mr. Ramesh Chandra, Member Secretary of the Empowered Committee on VAT and Principal Secretary, Finance, the Empowered Committee was in favour of capping the Revenue- Neutral Rate at 12.5 per cent with the floor rate of

[73] Supra note 71, at 3,700.
[74] Supra note 58, at 160.

10 per cent[75]. It is indeed a difficult proposition to require the States to maintain the floor rate at a uniform level. For example, the rates of motor vehicles are very low in Pondicherry when compared with say Karnataka. So people might go to Pondicherry to purchase vehicles as a result the state of Karnataka might loose revenue to Pondicherry. But Pondicherry might not loose any revenue. Hence there is a need for uniform rates.

In order to bring in uniformity of rates in all the States the Finance Ministers of all the states met twice but could not reach a consensus. The states did not agree for uniform rates as they wanted to have their own rates. More over the States did not want the abolition of Central Sales Tax. Central Sales Tax is imposed on the inter-state trade that is collected by the States on behalf of the Centre and the revenue is appropriated by the State. Hence if Central Sales Tax and the other local taxes like octroi, entry tax etc., which form part of the municipal revenue, the States and the municipalities would be losing a lot of revenue. Therefore the states are against the abolition of Central Sales Tax but if VAT is to be implemented in its full spirit the Central Sales Tax has to go.

Inter-State Trade:

This is the most complicated area, which is creating difficulty in coming to unanimous decision. Theoretically the ideal solution would be to regard the whole of India as one market and give input credit to the purchaser of goods in the importing State equivalent to the amount of VAT paid in the exporting State. For example, if raw material is purchased from Tamil Nadu, the VAT paid in Tamil Nadu should be credited to the purchaser in Rajasthan. This is exactly what is done in the case of CENVAT, which is the central tax and there is no tax barrier[76]. All the revenue goes to the Centre and the money is distributed according to principles laid down by the Finance Commission. However, in the case of State VAT, this is not found

[75] Supra note 58, at 160.
[76] Supra note 71, at 3701.

practical or acceptable by the different States since some are predominantly exporting States and some are predominantly importing States. Also, there is Central Sales Tax, which is paid on inter-state sale and is collected by the exporting States.

States like Maharashtra, Tamil Nadu, Andhra Pradesh, Haryana, Uttar Pradesh and West Bengal have a lot to lose if the CST is abolished. At the same time the above States being predominantly exporting States will collect more VAT and other States which are predominantly importing States will have to give more credit. This has made the destination principle, where the tax is credited at the destination State, more difficult to implement. The destination principle works in the European Union, but there are some adjustments which are done centrally by the European Union Headquarters[77]. In India the solution that has been found is a compromise principle of intra-state credit[78]. Under this arrangement it has been decided that input tax credit will not be provided in the consuming (importing) States of CST paid in the State of origin (exporting states). But VAT paid in the State of origin will be credited against CST payable in the same State. This is the result of consensus building which has to be done in a federation like India. In view of the disparity of the development situation where some States are predominantly exporting States and some predominantly importing States, it is natural for the States to cling to the existing origin-based distribution of intra-state tax proceeds and resist any attempt to move to the destination-based taxation. It would have been a better solution to have an intra-state VAT arrangement coupled with reduction of CST from 4 per cent to 2 per cent, which would bring down the tax burden on CST transactions and facilitate reselling across dealers in different States. What would be introduced is not a full fledged destination based VAT, but a multi-point tax with provision of input tax credit in intra-state trade. There would also be no assurance that there would be no other

[77] Supra note 71, at 3701.
[78] Id.

tax such as entry tax, luxury tax, etc. There will be no assurance that CST would be reduced gradually from 4 to 3 to 2 to 1. So we can say that what is going to be introduced is not a full fledged destination based tax but a semblance of VAT based on consensus.

Exemptions, Remissions and Deferrals:

Tax exemptions, remissions and deferrals are not compatible with VAT because it breaks the continuity of the VAT chain under which the manufacturer or dealer can claim input tax credit, only if he pays input tax. If he gets exemption or remission he cannot get an input credit[79]. It would be legally possible to remove all the exemptions since in the public interest the government is entitled to do so. Most of the State Government's, have not been able to substantially reduce the numbers. It would be legally possible to remove deferrals and remissions at the time of introduction of VAT. In general it can be said that the industries must be persuaded to realize that a simplified and transparent tax structure would be more business friendly than the patchwork of concessions given to them[80].

Resistance from the Business Class or Traders:

In India the traders are against the adoption of VAT because they will have to maintain records for all the transactions taking place. The system of VAT requires proper accounts. For that there is a need to maintain two accounts purchase and sales. In India, mostly the transactions that take place are through cash. Hence they can be easily manipulated without maintaining records. If VAT is implemented they will have to show the records. That is the traders are worried about the possibility of exposure of fudged transactions and massive tax evasion. They cannot make profit in the form of black-money. To protect this profit they oppose VAT. Since credit is available at ever transaction stage, if the chain is broken it is likely to be detected. Once VAT is implemented the traders would be get the credit for

[79] Supra note 71, at 3702.
[80] Id.

all the sales but they would end up paying more tax in the long run which means loss of profit.

Harmonizing the VAT laws:

Since new acts are being drafted it is but natural that they should be worded in the same manner so that there are no controversies in regard to interpretations in different States. This principle has not been followed. While a common draft has been prepared, which is termed as Model Value Added Sales Tax Bill, 2003, we can find that the even definitions given in this bill have not been followed by the different States[81].

In regard to the term 'dealer' there is wide spread difference in the definition in various State VAT Acts. In the definition of 'dealer' in the Maharashtra Act, the Department of Customs has also been mentioned as a dealer[82]. In the case of West Bengal Act, an occupier of a jute mill or shipper of jute has been included in the definition of 'dealer'[83]. This is not there in the case of other States. Therefore the definition needs to be worded in a general manner to cover all the States and be uniform.

Further in the definition of 'dealer' the words 'supplying or distributing' have been included in the Model Act as well as in the Acts of Uttar Pradesh, Madhya Pradesh, Maharashtra, Delhi, Goa and Haryana. The exception is West Bengal Act. In fact, all the definitions using these words have unwittingly included service tax since the act of supplying or distributing is not an act of sale[84]. Any tax on supplying or distributing would be tax on the service of supplying and distributing. Therefore necessary amendment needs to be done.

Some States have included the definition of 'capital goods' in their Acts and some have not included. In fact, it is not necessary to have a definition of capital goods, because all inputs and capital goods ought to be treated

[81] Supra note 71, at 3702.
[82] Supra note 24, at 58.
[83] Id.
[84] Id.

equally for the purpose of input credits. By having a definition of capital good States would be tempted to treat capital goods differently from inputs, which would be highly illogical[85].

The definition of 'capital goods' in the Model VAT Act also includes the expression 'manufacture'. There would be detrimental consequences if the concept is brought into VAT. Manufacture has always been a very controversial subject and the uncertainty about what is manufacture has been a source of litigation for decades. In fact, in 1994 in the report of the (NIPFP) National Institute of Public Finance and Policy on VAT, which is the basic work in India before the introduction of vat, there has been given a list of controversies about the term 'manufacture'[86]. It is important to note that VAT is a tax on value added and not on the act of manufacture. The taxable event is the addition of value and not the act of manufacture. Therefore the taxable amount should not be defined in terms of manufacture. And the taxable event should not be related to manufacture. Otherwise it would lead to a number of litigations, which is one of the reasons for which VAT is regarded as a better tax and was recommended by the NIPFP.

Therefore it can be stated that VAT is being introduced in India in an imperfect manner mainly because it is a compromise between the interests of different States, because there has to be a consensus between the States for VAT to be uniform implemented. Since now we know what are the problems in implementing VAT, the Centre and States must coordinate with each other without considering their individual interests and implement VAT in the national interest.

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[85] Supra note 71, at 3703.
[86] Supra note 24, at 59.

The Value Added Tax in Korea and Brazil and their Experiences

Indirect tax system plays an important role in the economic development of a country by influencing the rate of production and consumption. The Government of India has, after committing to the World Trade Organization (WTO) regime, decided to modernize and streamline its indirect taxation, in the light of the experience of other WTO member countries. Value Added Tax is prevalent in over 120 countries. In India, introduction of VAT would be a historic reform of the domestic trade tax system. It is expected to facilitate the states and union territories to transit successfully from the erstwhile sales tax system to a modern domestic tax system.

As Brazil and Korea have already implemented VAT in their respective countries, India could count on their experiences and learn from it, so that when it is going to be adopted in India there could be smooth transition from the present sales tax system to the VAT system. The researcher has selected Korea and Brazil because Korea is one of the leading Asian countries and also a republic like India and Brazil has a federal structure similar to India and also both these countries have adopted consumption-type VAT and also credit method for tax collection. As India is also going to adopt the same methods, it would be reasonable to study these countries experiences.

The Value Added Tax in the Republic of Korea:

In December 1976, the National Assembly of the Republic of Korea passed a law on tax reform that was mainly concerned with introducing the value added tax and a special excise tax[87]. The VAT law had come into effect on July 1, 1977 as it marked the arrival of a new indirect tax regime that had been planned for several years. The old indirect tax system was a

[87] Malcolm Gillis, Carl S. Shoup and Gerardo P. Sicat ed., Value Added taxation in Developing Countries (Washington: The World Bank, 1990), at 129 .

complicated one as there were eleven types of indirect taxes in 1976. The value added tax replaced eight of them like the business tax, the commodity tax, and the taxes on textile products, petroleum product, electricity and gas, travel, admissions and entertainment and food[88]. The other taxes on liquor, telephone and stamp taxes remain in effect today.

The initiative to study the VAT with the aim to eventually adopt it came from the Ministry of Finance in 1971 and was endorsed by the Office of the Senior Presidential Secretary for Economic Affairs. Tax experts from outside the country were invited to analyze the feasibility of adopting the VAT in Korea. Thus three studies sponsored by the Bureau of Taxation at the Ministry of Finance formed the groundwork for the adoption of the VAT in Korea. The Duignan's 1972 report on the feasibility of adopting the VAT and Tait's 1975 and 1976 report analyses of the possible impact of the VAT in Korea[89]. These studies reflected the experience of other countries with the VAT as well.

Preparation for Implementation of VAT:

Although the VAT was intended as a substitute tax and replaced eight existing taxes, the taxpayers regarded it as a complex tax and an additional burden. In order to remove their fears and dispel some of their uncertainty surrounding the adoption of VAT, the government had to educate the public and potential taxpayers in particular, about the new tax. The government had to train the tax officials about the new tax, administer prices and reorganize the tax administration. With the help of the Korean Chamber of Commerce and Industry and other economic associations, as well as newspapers, television and radio, the government had launched a public relations campaign for the VAT that included a series of articles, question and answer sessions, feature stories and lectures on the need for the VAT.

[88] Supra note 87, at 129.
[89] Ibid, at 130.

Three trial runs on filing tax returns were conducted before VAT was implemented[90]. These exercises not only helped the taxpayers who got a better understanding of the new tax but also the tax authority used the feedback from the three trials to refine the administrative details of the VAT system. The Ministry of Finance had formed a task force on the VAT composed of both government officials and representatives from the private sector. The group deliberated on the problem of implementation of VAT and also helped to draft the presidential decree and other administrative regulations on the VAT. To minimize any adverse impact on the prices, the government had enacted a price stability law, which controlled the prices of 41 items and gave price guidelines to more than 851 items[91].

Tax Base:

The VAT in Korea is charged on the supply of goods and services and the importation of goods. The word 'goods' covers all tangible and intangible objects which have the value of property[92]. The Example of tangible objects are commodities, products, raw materials, machinery and buildings. Examples of intangible objects are motive power, heat and other controllable forces of nature. The word 'services' includes all services and other actions that have the value of property other than goods[93]. The importation of goods covers goods that are brought into Korea from abroad, including marine products gathered on the high seas by foreign vessels. The tax base more than trebled within a span of five years while the Gross National Product (GNP) growth for the corresponding period was only 24 per cent[94]. The number of tax payers also increased by 25 per cent during the same period. This shows that the trade and industry had readily accepted VAT as its positive features were more favourable to higher value addition.

[90] Supra note 87, at 131.
[91] Supra note 1, at 91.
[92] Supra note 87, at 131.
[93] Id.
[94] Supra note 1, at 92.

Taxpayers:

In Korea any entity engaged in the supply of goods or services in the course of business, whether the business is motivated by profit or not, is liable to the VAT. The taxpayers include individuals, corporations - including state and local authorities and foundations which are not incorporated. The VAT taxpayers are divided into two groups. They are general taxpayers and special taxpayers. The general taxpayers are subject to a 10 percent tax on their value added. The special taxpayers are subject to a special rate of 2 percent on their gross sales[95].

Rate Structure:

The tax rate in Korea since the adoption of VAT in 1977 has been at 10 percent[96]. Although the VAT law specifies a basic VAT rate of 13 percent, it allows for a fluctuation of three percentage points, upward or downward in the rate. The rationale for the flexible rate structure has been to ensure that the tax system could be made responsive to changes in the national economy. But as there was pressure from business circles and government factions who opposed the adoption of VAT had played a larger role in determining the current rate. To neutralize the opposition the VAT was adopted at the lowest rate allowed by law. By using the Gross National Product data supplied by the Bank of Korea and tax data supplied by the Office of National Tax Administration, the Ministry of Finance estimated that the VAT rate would be 11.23 percent when based on national income statistics, 12.15 percent when based on national expenditures and 12.03 percent when based on national output. On the basis of this exercise, the Ministry of Finance had argued for a rate in the vicinity of 13 percent[97].

It is stated that though there are some advantages in adopting multiple rates for the VAT, in particular, to redress the problem of regression, most of the proponents of the VAT in Korea had favoured using a single rate. An

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[95] Supra note 87, at 133.
[96] Id.
[97] Ibid, at 134.

exception was made for small businesses. Those businesses whose annual gross sales did not exceed 24 million won are subject to a tax rate of 2 percent on their gross sales. People who engaged in brokerage or intermediary services whose annual turnover does not exceed 6 million won are subject to a tax rate of 3.5 percent on their turnover. The regression nature of the VAT rate when imposed at a single rate was corrected to some degree by the adoption of a special excise tax. Thirty three groups of items are subject to this special tax and the tax rates range from 5 percent to 100 percent.

Administration of the VAT:

The quality of Korean tax administration is stated to have been considerably improved after the introduction of VAT. As mentioned earlier, one of the eight indirect taxes that were replaced by the VAT in 1977 was the business tax. Korea's experience with the business tax has made it easier to introduce the VAT. As the business tax was a tax on turnover, the traders were already practicing some form of bookkeeping. The government had decided to use business tax as a stepping stone to the VAT and reformed it accordingly. The total number of invoices issued has showed a steady upward growth and the number of re-assessments of tax differences was greatly reduced after the implementation of VAT as only 13 percent of tax returns were collected by the government whereas it was 51 percent earlier. Stiff penalties were awarded for non-registration, non-issue of invoice, late submission of returns, matching errors in the invoice, etc. The possibility of easy detection and rigorous penalties has virtually removed all incentives for tax evasion.

Value Added Tax in Brazil:

Before the introduction of VAT in Brazil, the tax system consisted of mainly personal income tax levied and collected by the federal government[98]. The federal government also collected revenue from imports and excise duties

[98] Supra note 1, at 87.

on liquor and tobacco. The states were authorized to collect a sales tax on turnover basis. In 1966, the Brazilian tax was divided into four categories, namely (i) tax on external trade (ii) tax on income and wealth (iii) tax on production and, (iv) special taxes[99]. Each category was assigned to a specific authority of government. The turnover tax levied by the states was replaced by a state VAT. A federal VAT was introduced in place of the federal wholesale tax. The local bodies like municipalities were assigned a service tax on business and trade. Fuel, electricity, exports, imports and minerals constituted the tax base of the federal government.

Traditionally, the constitution and federal laws precluded taxation at lower levels of government in Brazil. This pattern of centralization was accentuated by the reform of 1965[100]. As a result of the reform, states lost the limited power they had to create new taxes. Further absurd rigidities were introduced in the law. Rates and exemptions of the state VAT's had to be virtually uniform across commodities and jurisdictions. Even though the Brazilian state VAT is fairly comprehensive and was meant not as a fundamentally new tax but as an improvement over its predecessor, the turnover tax, it did give rise to conceptual and practical difficulties. Disputes continue among the state representatives and between them and the central government concerning the proper composition of the tax base. But slowly most of the anomalies have been removed and VAT has become an efficient means of revenue collection.

Structure of the VAT:

The federal VAT is a selective tax on manufactured foods. Various rates apply - from 4 percent on cement to 365 percent on cigarettes and cigarettes, beverages and automobiles account for 60 percent of the revenue from VAT[101]. The credit method of tax collection is used. Imports are taxed, exports are exempted, cash rebates are usually granted. At the

[99] Supra note 1, at 87.
[100] Supra note 87, at 122.
[101] Id.

time of introduction of VAT, tax revenue had accounted for about 50 percent of the federal tax revenue. But other new taxes like gross revenue and wage contributions have reduced the revenue share of VAT to about 20 percent.

The state VAT applies to most stages of production and distribution, including retail sales. It is applied according to the credit method of tax collection. Cash rebates are not granted except for exports. In practice a consumptive-type of tax was imposed. The state VAT falls short of encompassing a comprehensive base. The service sector has been excluded, as are electricity, mining and other activities taxed as excises at the federal level. There is little preferential treatment in the form of explicit rate differentiation. A few exemptions have been granted by interstate covenants, which are subject to tight federal controls. The VAT, like its pre-reform predecessor, has been the only source of tax revenue administered at the state level. It is not that the states always depend exclusively on VAT or borrow. But most of the states, specially the poor states of the north and the northeast, count heavily on transfers of revenue from the federal income, value added and excise taxes to finance as much as half of their budget[102].

Rate Structure:

The rate of state VAT in Brazil was about 17 percent in the beginning and on inter-state sales, tax rate was about 10 percent[103]. The tax was paid to the state of origin and a set off was given against the tax payable in the state of destination. The importing state appropriates the difference between the internal and inter-state rate. Since no tax rebates were ever considered under the turnover sales tax, the origin principle was adopted for interstate trade. But due to unanticipated difficulties, shortly after the new tax took effect the Congress passed laws to introduce slight rate

[102] Supra note 87, at 123.
[103] Supra note 1, at 88.

differentiation among states classified by region and types of transaction internal or inter-state.

The southern states of Brazil were industrialized and have had perennial trade surpluses with the rest of the country and trade deficits with other countries. Poorer states of the north and the northeast are net importers from the south and net exporters abroad. To avoid revenue redistribution in favour of the southern producer states, Congress passed a law requiring that there be differential of three percentage points between the tax rate on goods traded internally in the importing states and the tax rate on interstate exports at the state of origin[104]. This gap, however, proved to be insufficient to redress revenue losses. Hence the rate differentials were gradually increased to the present eight percentage points.

Federalism and the Value Added Tax:

The principal sources of difficulty in administering the Brazilian state VAT are its constrained base and the country's centralized tax structure[105]. In the Brazilian VAT, the states were initially kept on a tight leash with a narrow base and no powers to alter the rate or give exemptions. Consequently, they did not have the fiscal autonomy. Since the taxes were destination based, it avoided problems of valuation in inter-state transactions. The more industrialized states in the south got better revenue from the VAT. There has been persistent demand from the state for more fiscal autonomy by restricting the federal VAT on items like cigarettes, beverages and automobiles.

It has been stated that the introduction of VAT has not solved many problems of the Brazilian tax system because of the spate of disputes between the centre and states. Since the state had no authority to change the rates and base, some of them have suffered serious setbacks in the

[104] Supra note 87, at 123.
[105] Ibid, at 126.

developmental efforts. Later, some consensus had been reached for giving more freedom to the state governments to legislate on VAT rates and extend the tax coverage[106].

Lessons for India from the Brazilian and Korean Experiences:

India has to learn a lot from the Korean model of VAT. The VAT that has been introduced in Korea has a very good procedural content. Even before VAT could be introduced there were several preparations made so that the people of Korea could get a clear idea has to how VAT would function. In Korea the Chamber of Commerce and the Ministry of Finance take major decisions on all aspects of trade and commerce. The adoption of a practical system for matching invoices through computers is one of the important facets of the Korean VAT because manual auditing and preventive operations can only increase the cost of compliance and administration without improving the revenue. The successful application of special rates on small and medium firms in Korea deserves emulation.

In India, if VAT should be implemented without any hiccups, it has to educate the people about the new tax system that is going to be implemented. People should be made aware of the positive aspects of VAT as compared to the present tax system. As technology is developing and with the introduction of computers at all levels maintenance of records would not be a problem. The problem lies where there are no records maintained. People must accept this fact as early as possible and maintain their records. Another problem we in India have is that of bureaucratic level. In India the legal lobby is very strong and every technical problem will be considered as a legal problem and taken to the court. It is difficult to resolve the problem at the lower level. Even the simplest of the cases would be taken to the highest court of the land. Example: The exercise of differentiating between paddy and rice and to fix their rates has been taken to the Supreme Court. If this problem existed in Korea the Chamber of

[106] Supra note 1, at 89.

commerce and the Ministry of Finance would sit together and decide. But in India such matters are taken to the Supreme Court of India. As a result it leads to excessive litigation's, cost of production increases and ultimately the consumer suffers by paying a higher price.

Considering the Brazilian VAT, it can be said that the Brazilian VAT is a relevant experience as it is perceptible in the Indian tax scenario. Similar to Brazil, in India we have at the Central level Central Excise Duties that are identical to the Brazilian consumption tax. At the state level, we have multi-point General Sales Tax and Central Sales Tax for intrastate and interstate sales. In Brazil, the states are not very powerful and there is fiscal autonomy and the Central government is very strong. But in India the powers of taxation are more specific in giving the states more freedom and fiscal autonomy. At present in India the states would not like to let go of their powers. In India, the Central government is a coalition of parties and it does not have a majority. If there was a majority in the Centre, it would have had better control over the states. As a result, each state wants to have its own policy in terms of VAT rates. They are not ready to agree for uniform rates because they are autonomous. They think that they would loose their identity if they agree for uniform rates. The political situation is not conducive in India as regards VAT is concerned and the Brazilian case is quite different from India. Hence effort must be made to bring about an understanding between the states and the centre and among the states to implement VAT.

THE RECOMMENDATIONS OF THE TAX REFORMS COMMISSION, 2001 IN KARNATAKA

In keeping consonance with Centre's action plan, Karnataka has also been trying to revamp its tax system ushering in VAT regime from April 1, 2002. In order to ensure that it adopts best of the system acceptable and complied by all stakeholders, the State appointed the Tax Reforms Commission under the chairmanship of former chief minister M. Veerappa Moily, that had put up a discussion paper on concepts, options available and concerns in preparation for the adoption of VAT. The move towards systemic reform of tax system has been undertaken to remove endemic problem of multiplicity and minimizing distortions in tax systems, improve revenue productivity, that would contain revenue and fiscal deficits and route much needed revenues for financing social and physical infrastructure. VAT is expected to ensure buoyant revenue flow, improve voluntary compliance and combat evasion and related corrupted practices and is being seen as equitable, simple and inherently highly compliant.

The first report of the Tax Reforms Commission was presented to the Government on 12th February to enable the recommendations to be considered while preparing the budget document for 2000-2001. Many of the suggestions that were made in the report have already been incorporated in relevant statutes and procedures. Recommendations of the final report of the Tax Reforms Commission that was submitted on 19th October 2001 with long term perspectives are still being analyzed within the current policy framework[107].

The Tax Reforms Commission report emphasizes on the 1994 report on the issues and options for reform of domestic trade taxes prepared by the study team of the (NIPFP) National Institute of Public Finance and Policy led by Dr. Bagchi at the instance of the Central Finance Ministry which had

[107] Tax Reform Commission Report, 2001.

considered in great detail the type of VAT to be adopted and whether it should be based on the origin or destination principles. The report had also considered three options for introducing VAT. The Bagchi report had opted for a VAT to be levied at both the governmental levels with a Central VAT on manufacturing alongside State VAT's on sales. The Tax Reforms Commission, 2001 had agreed with the 1994 report for a dual Vat considering the existing constitutional and practical realities and the significance of commodity tax revenues in overall tax for both the Centre and the states. They felt that this would be best solution mainly for two reasons[108]:

a) the federal fiscal framework of the country is substantially centralized and most states having a full fledged administrative arrangements and procedures for commodity taxation, that has now been taken up for rationalization and harmonization purposes recently. It is inconceivable that States could be induced to give up their substantial autonomy in the near future.
b) There are vast variations in the resource raising capacities of states which calls for active Central intervention to equalize fiscal capacities through different kinds of intergovernmental transfers. Commodity tax is a major source of Central revenue, which enables the Centre to discharge the critical equalization function. As long as such inequalities persist, removal of Central excises would neither be feasible nor desirable.

The Bagchi report had culminated in the constitution of a committee of State Finance Ministers, with Dr. Chelliah as convenor, to look into the operational mechanisms for introducing VAT[109]. The committee had achieved a broad consensus on reform of existing State sales tax structures by harmonizing floor rates, removing exemptions and ending the practice of extending tax incentives

[108] Supra note 107, at 33.
[109] Id.

for industrial investment. It had also dealt with measures to be taken for preparing the administration and taxpayers for VAT but could not achieve consensus on the mechanism for taxing inter-State trade. A group of experts and officials under Dr. Parthasarathi Shome was constituted by the Central Finance Ministry and a report was prepared in December 1996 which incorporated suggestions given by the Bagchi report for eventual transition from origin based taxation of inter-State sales to destination based taxation. The Committee of States Finance Ministers initially finalized 4 floor rates for sales taxes - 2%, 4%, 8% and 12% and the NIPFP also framed a model VAT law and drafted a VAT manual and primer. For operationalizing VAT at the State level, an Empowered Committee of State Finance Ministers was set up which decided to introduce VAT in all states[110].

The Tax Reforms Commission report of 2001 has dealt with major areas of concern where action needs to be taken within Karnataka and the degree of internal preparedness for adopting VAT. At the inter-State and Centre-State levels also, some major concerns have been dealt which relates to the taxation of inter-State trade, the relative tax room for the Centre and States within the overall consumption tax structure in the country, other action to be taken by the Central Government of India to provide revenue support and amend Constitutional and Central statutory provisions and service taxation.

Recommendations for the State of Karnataka

Harmonization of Tax Structure:

When a VAT is introduced in a federal country, harmonization of commodity tax structures is necessary from the efficiency and equity point of view to eliminate tax exportation and reduce spillover effects of the tax policies of different jurisdictions. The extent and degree of harmonization required would depend upon scope for trade diversion. Basically, harmonization applies to tax bases, the number of levies as well as tax rates. State governments have been trying to

[110] Supra note 107, at 34.

harmonize bases by creating a common commodity classification based upon the modern classification used by the Central excise department[111]. Action is now being taken to align commodity classifications for State VAT's with the Brussels classification which is used by the Central excise department. Unless this is done quickly it would not be feasible to operate a dual State level VAT within the country, even it the tax is restricted to intra-State commerce. The commission has recommended that the preparation of the common classification should be completed very early so that it could be used for training departmental personnel and assisting taxpayers.

The number of commodity levies in Karnataka and other states are many. This is partly due to the manner in which commodity tax administration has developed since independence, with the Central government appropriating some of the powers of States through mechanisms like goods subject to additional excise duties and declared goods. Such measures have led the states to employ other tax handles available in the Constitution like entry tax and luxury tax. The report recommends that the plethora of levies should be rationalized into a single simple VAT[112]. This has already been agreed to by the States at meetings of the Empowered Committee. For the state of Karnataka, rationalization must commence with the merger of several levies like sales tax, turnover tax, purchase tax, entry tax and infrastructure cess into one common tax with wide coverage, few moderate rates and no exemptions[113].

In the case of tax rates, the consensus is to lay down a few floor rates and group together commodities which would fall under each rate. There is also a need to a have a small list of exempted commodities and goods taxed at special high rate outside VAT structure which must be prepared by agreement among states. The Empowered Committee of State finance Ministers has been toiling since inception to perform this task. Starting with floor rate of 2%, 4%, 8% and 12%, the Committee has agreed on a single basic rate of 10% and a lower rate of 4% for

[111] Supra note 107, at 35.
[112] Ibid, at 35.
[113] Id.

50 commodities, 22 commodities are to be exempted from tax and 3 commodities to be kept under special rate of 1%. Petrol, diesel and aviation fuel would be kept out of VAT and would be taxed at 20% and liquor would be taxed at a high rate[114]. The Empowered Committee has also recommended that those states that do not adhere to these rates would not get Central assistance. By welfare enhancing tax competition it is expected that the rates of most States would converge towards basic rates.

It has been stated in the report that the extent of harmonization that has taken place across the States cannot be gauged solely from commitments made by them at the meetings of the Empowered Committee. In Karnataka, there are 10 sales tax rates under the schedule and notifications. In addition there are 3 graded turnover tax rates depending on the value of turnover of the dealer. Since turnover tax is a multiple stage levy the tax rate depends on the number of stages through which the commodity is transacted before reaching the final consumer. Entry taxes are also levied at 4 different rates varying from 1% to 5%. There is also infrastructure cess. When all levies are taken into consideration there would be inordinate number of commodity tax rates in Karnataka. This would result in increases in compliance cost, opens up avenues for tax evasion and avoidance, violates canon of horizontal equity and creates distortions.

Though the prescribed floor rates have been accepted in theory by Karnataka, it is hampered by fears of revenue loss and perhaps the fear of reform itself. Claims are made that the floor rates have been adopted but the tendency is to do only marginal tinkering and retain several additional rates for special reasons. The floor rates seem to be used merely as a safeguard against competitive rate reduction, not for rationalizing tax rates. In order to tackle the fears and reservations the tax Reforms Commission, 2001 had in the first report formulated a complete frame of reference for Karnataka bringing all commodities within the three floor rates of 4%, 8% and 12%, removing exemptions and merging commodity taxes. A special rate of 2% was retained only for bullion, specie and gold ornaments and 25% for

[114] Supra note 107, at 36.

petroleum products and alcoholic beverages. The report had recommended that it was possible to rationalize the commodity tax system with little revenue loss or inequity[115].

Removal of Exemptions and Tax Base Expansion:

In Karnataka, as in other States, there are a large number of exempted commodities, some exemptions are user specific and there are end use exemptions as well. These exemptions complicate the tax and provide avenues for tax evasion. Though a list of exhaustive tax exempt categories under various commodity taxes has been given in the first report, keeping in mind the VAT imperative of generalized commodity taxation with minimal exemptions, the exemption list has already been pruned and rationalized in the first report. Hence the Tax Reforms Committee, 2001 has recommended that the proposed expansion base by removal of exemptions be implemented.

A major source of complexity and distortion in sales tax systems that needs to be remedied is the incentive structure for industrialization[116]. Tax incentives provide undue benefits to industrial units with high value output to capital ratios. They have also contributed to the high mortality rates of industrial units by inducing entrepreneurs to undertake otherwise non-viable projects and manipulate incentive schemes by closing down units after concessions and start fresh ones[117]. Tax incentives for industrial investment have been adopted by most Indian States. In Karnataka, such schemes have been operational from 1969. Initially, they were conceived of as refund of tax paid on the purchase of raw material within the state. From 1981, they were replaced by exemptions for the payment of sales tax on sale of goods produced by such industries. Exemptions were also given subsequently for entry tax payable on input purchases. From 1988, tax deferrals were also permitted. After prolonged discussion, the Empowered Committee of State Finance Ministers had resolved to discontinue the practice of tax benefits for fresh industrial investments and was implemented by the

[115] Supra note 107, at 37.
[116] Id.
[117] Id.

Karnataka government[118]. Estimates of commodity tax revenue lost by tax incentives for industrial investment have been made by the department which stands at annual loss of over Rs. 4000crs and committed incentives in respect of 41 mega industries at more than Rs. 2000crs[119].

In the report it is stated that Industries entitled to the deferral benefit should be given the option of adopting the normal VAT regime like the rest of their competitors. It has been considered that due to the conditions of low and declining interest rates, there would be little incentive for industries to reduce costs by using the tax deferral mechanism to cut down drawals on working capital limits from banks as it would make them ineligible for VAT credits on inputs. By keeping the door open for industries entitled to tax incentives to voluntarily move to VAT, it would be possible to remove incentives.

Decisions on Major VAT Issues:

Some of the decisions are still pending on critical matters relating to the State VAT structure for Karnataka. The most important is the determination of revenue neutral rates. The appropriate VAT rate has to be selected for the State in the context of the basic rate floor of 10% as laid down by the Empowered Committee. Theoritically, VAT implies only change in tax structure and States have been making attempts to arrive at revenue neutral rates which would ensure that budgetary inflows are not affected by the shift to VAT. It is difficult to estimate the existing effective commodity tax rate because of the complex, non-transparent, multiple rates and levy structure. That is possible only by computing the tax base for commodity taxation. The NIPFP had developed two methods to arrive at the commodity taxation base. They are the consumption expenditure approach and the tax turnover approach[120]. The former estimates the potential tax base while the latter looks at the existing actual base itself.

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[118] Supra note 107, at 38.
[119] Id.
[120] Ibid, at 40.

Latest estimates of a revenue-neutral rate for VAT in Karnataka are around 13.5%. With harmonized bases, a single basic rate, an agreed limited list of commodities subject to special rates and removal of most exemptions particularly industrial investment, tax competition across the States would have snowballing effect and tax rates converge towards basic rate. That would enhance efficiency and economic welfare. Existing divergences in inter-State tax structures have not had this effect due to selective and non-transparent administration of rates and exemptions.

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

The recommendations given by the Veerappa Moily Commission report are theoretically good. But when it comes to practical implementation there would be a lot of problem. This is because common commodity classification, single levy of tax and uniform rates prescribed should not only be introduced in Karnataka but other States as well. As regards exemptions are concerned relating to incentives to industrial establishments it is difficult to remove them. Because they are provided to a) specified class of sales or purchases for promoting – the scheme for special economic zones, 100% export oriented units, export, inter-state trade and commerce and b) tax payable on purchases or sales of motor spirits, if tax is paid on previous sale or purchase of the very goods or inter se transactions between notified oil companies[121]. But such exemption should be limited. In fact the lesser the exemptions the better to administer VAT. Therefore, there is a need for coordination among all the States and acceptance between them in the

[121] Chandrakant T. Shah and Pradeep S. Shah, Value Added Tax (Mumbai: Snow White Publications, 2003).

national interest. They cannot quarrel over their self interests. For which there is a need for consensus. Only then VAT could be implemented in India.

Recommendations for Centre-State Issues:

VAT and the Inter-state trade issue:

The extensive Constitutional amendment of 1956 introduced the origin principle into the State level commodity tax structure and led to the imposition of the Central sales tax on inter-state transactions. The State governments levy central sales tax on inter-state sales originating within their territories at the rate of 4% and retain the proceeds within the cap prescribed by the Centre. The upper limit was meant to ensure that States do not export high tax rates to consuming States and yet realize revenue from sales of goods originating within their frontiers.

The Central sales tax like the intra-state taxes adds to the cascading effect of commodity taxation. The major stumbling block in the changeover to VAT at the inter-state level is the scope available for exporting states to curtail tax room of importing states[122]. Since the existing commodity tax structure is based on the origin principle, a predominantly producing State has been able to raise revenues from early stages of the production and distribution chain and shift tax incidence to consuming states. There is also the problem of valuation of inter-state sales since inter-state sales tax is not rebatable, dealers in both the states are encouraged to undervalue goods.

Consignment or branch transfers are extensively resorted to by the dealers to get around the Central sales tax hurdle. Sales consequent to a consignment implies transfer by the manufacturer or dealer himself or his agent out of own premises in a state other than the state of origin. This kind of transfer add to costs since it implies transport of goods by the exporter to the importing state and provision of local storage facilities. It could also lead to uneconomic location of production units for components used in an industry. Consignments provide avenues for

[122] Supra note 107, at 43.

evading sales tax in the state of origin by routing goods back and selling them in the state of origin or selling them in the destination state to an unregistered dealer. Tax authorities do not treat a transaction as a consignment if goods move across state borders against specific orders. The consignor does not pay commodity taxes in the state of origin nor the central sales tax.

Thus from the point of view of long term sustainable reform, the effort required to bring out a consensus on the management of value added taxation of inter-state trade at the commencement of VAT appears to be justified. Such an effort would help to bring to the fore the apprehensions of tax–exporting states, identify feasible mechanisms for providing safety nets in the transitional period and draw forth the commitments from the Centre for meeting the revenue gaps. Though the states are beginning to accept the need to shift from origin-based to destination – based taxation, there is justified apprehension about substantial loss of revenue from some states when the change takes place[123].

On the positive side, resistance to destination-based taxation seems to have been diluted as states are slowly becoming sensitized to the distortions induced by the origin principle of commodity taxation. Even the states which earn substantial revenue from the central sales tax are increasingly inclined to admit that the returns due to them for the use of facilities provided to manufacturing units are not to be realized from cascading levies. They are also becoming aware of the indirect benefits that they would derive from faster economic growth resulting from a more efficient fiscal system.

Delay in moving to VAT on inter-state transactions in our country is not merely due to administrative inertia, but also the extent of inter-state coordination required for effectively running an inter-state VAT or fear of radical change and revenue loss. The major difficulty is lack of clarity among academicians and policy

[123] Supra note 107, at 43.

makers about the most appropriate form of inter-state VAT for Indian conditions. An appropriate choice for India should satisfy the following requirements[124]:

- It should not be susceptible to evasion by a break in the VAT chain.
- It should not be cumbersome for the administration and the taxpayer.
- There should be inbuilt collection incentives for the importing and exporting state to make the tax easily enforceable.
- It should be fairly easy to manage while shifting to a full-fledged VAT.

There have been many suggestions that are under discussion for the most suitable inter-state VAT mechanism for federations and they fall broadly into three groups: the zero-rating method, the clearing house approach and the intermediate tax approach.

➢ **<u>Zero-rating taxes collected in the State of origin:</u>**

The procedure that is easiest to implement from the administrative point of view is zero-rating taxes paid in the state of origin when transactions relating to inter-state trade takes place. Zero-rating could be done unilaterally by individual state and it implies that there would be no payment of tax on the inter-state transaction and refund of tax already collected by the state of origin at the inter-state transaction point[125]. Inter-state transactions would thus be taxed in the same way as exports. In this method the dealer is expected to produce account-based proof of dispatch of goods to the registered purchaser. However, it would not be practical as it would cause harassment by locking up dealers funds for long periods of time and might not prevent fraud. It might not also be feasible to make tax refund conditional on receipt of goods in the importing state and subsequent sale.

The advantage of this system is its administrative simplicity since there would be no need for a clearing house with all that it entails in terms of expense and management[126]. There would be no need for states to collect revenue on behalf of on another and pass them on either to a pool or to the consuming state. It would

[124] Supra note 107, at 48.
[125] Ibid, at 49.
[126] Id.

also give both importing and exporting states a financial stake in monitoring inter-state trade. The major drawback of this procedure is the scope for tax evasion since the VAT chain is broken and exporting firms could pass off intra-state sales as inter-state sales and escape VAT on transaction as well as claim false refunds[127]. Though under this method transitional arrangements would be less onerous in the absence of a clearing house or inter-state fund movement, on the other hand foolproof information and verifications systems would have to be set up to the extent possible or there could be substantial revenue leakages, which would drain state revenues and discredit the VAT system itself. It is stated that Provisions will have to be made for the inter-state component in data processing systems at this stage, otherwise it might be difficult to overhaul them to provide for integration of the intra-state and inter-state components in future.

- **Tax credit by consuming States and clearing house arrangements[128]:**

This method is a system of tax credit provided by the importing state for the VAT paid to the exporting state. The exporting sate would be expected to credit such revenues to a pool from which funds would be routed to the exchequer of the consuming state through a clearing house mechanism. This method requires elaborate administrative machinery and uniform tax rates throughout the country. If such a method is to be adopted in our country, there might be apprehensions that the state of destination may not give credit for tax paid elsewhere or that the state of origin might not credit revenues realized at earlier points to the common pool. The distribution formula cannot be based on trade data as it would be too voluminous to keep track of, particularly if there is substantial rate differentiation among states. Consumption data would also not be regularly and reliably available.

[127] Supra note 107, at 49.
[128] Ibid, at 50.

- **Levy of an intermediate tax on inter-state transactions:**

The third method is the levy of a 'stand alone' or 'compensating' VAT (CVAT) on inter-state sales preferably by the federal government with zero-rating of the VAT of the state of origin[129]. The tax would be levied at a rate not lower than the lowest VAT rate in any participating state. This levy has been restricted to sales to registered dealers because if it is extended to unregistered dealers it would be necessary to share revenues realized on some formula- that is the share of states in all states sales tax revenue after correcting for differences in tax rates among them. The CVAT was mainly proposed mainly to offset the possibility of fraud that is the chief risk attached to simple zero-rating. It was meant for the dual VAT situation where the federal government would be expected to collect the tax along with its own federal VAT and ensure that inter-state transactions do not escape taxation. Under this arrangement, zero-rating of the inter-state sale continues but the transaction would be subject to CVAT that is collected by the importer from the exporter.

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

Solution for Inter-state VAT:

The Tax Reforms Commission considered the three major mechanisms available for an eventual inter-state VAT with their advantages and drawbacks. The commission has held that the zero-rating method even if it breaks the VAT chain could be easily adopted by a single state[130]. This could create snowballing effect and influence neighbouring jurisdictions to move over to a similar system. It also does not require setting up of an elaborate inter-state or Central monitoring agency. But still substantial preparatory work has to be done to access data

[129] Supra note 107, at 51.
[130] Ibid, at 52.

relating to registered dealers in destination states, since the system could be susceptible to evasion and fraud.

To ensure a smooth transition to inter-state VAT, the Veerappa Moily Committee has recommended for a network of information system to be developed for online sharing of inter-state data on registered dealers and their transactions[131]. Agreements are necessary with the concerned states for ensuring the authenticity of transmitted data and there should be provisions for excluding state, which do not rapidly provide reliable information. Technological innovations have to be utilized for electronically verifying the vouchers and dealers records when returns are filed and during random checks. Provision for data processing should be made available for the inter-state component to avoid problems when inter-state VAT comes into effect. To deter evaders, a higher selection percentage of audit cases in respect of dealers with inter-state transactions and severe penalties for evaders has also been recommended.

The "Tax Room" issue: Harmonizing Central and State taxation

Over the last decade substantial professional expertise has been invested in sensitizing the States to reform and achieve consensus on the methods of harmonizing sales tax structures. As a result, the need to reform the Central excises to convert them into a true federal VAT has been pushed to the background. Committees have recommended to reform the central excise into a full fledged CENVAT. Unfortunately, State VAT's are being proposed to be introduced without clarity about the corresponding reform required in CENVAT- its objectives, methods and time frame. It is stated that delay in CENVAT reform could have adverse consequences for trade and industry[132].

In several matters, a common framework has to be laid down for commodity taxes at both levels, Centre and the States. An issue that arises in this area is that of harmonizing Central and State VAT structures and sharing the commodity

[131] Supra note 107, at 53.
[132] Ibid, at 56.

"tax room' between both the levels[133]. There is a need for substantial freedom at both levels with mechanisms for continuing co-ordination, otherwise there would be serious distortions to the detriment of the economic agent. The experiences to date of cooperative fiscal federalism in other overlapping areas like motor vehicles legislation and taxation, royalties on minerals, etc, are said to be largely within the area of Central initiative and control. Tax bases in such cases have also been Centrally determined and rates subject to Central approval. For levies like profession tax, limits to the State's taxing powers have been given in the Constitution itself. It is provided that dual VAT cannot be operated on such a basis, neither can the Central tax room be left open ended. The Veerappa Moily Commission has recommended that there should be a broad overall tax rate ceiling for both levels on most commodities, which could be modified after consultations among all players.

It is recommended that in the interests of simplicity and transparency, it would be advantageous for taxpayers if the commodity groups subject to different rates in Central and State VAT statutes could be similar[134]. Definitions, threshold limits and exemptions might require standardization between the Centre and the State VAT's. The manner in which coordination between the Centre and States should be ensured and administrative arrangements required for the purpose has also to be sorted out before a true VAT comes into effect at the Central and State levels. Therefore, it has been recommended that the State government should take up this matter urgently with the Central government because the benefits of VAT cannot be fully reaped by manufacturers and dealers without CENVAT reform.

Other Action to be taken by the Central Government:

For introducing a nationwide VAT, the role of the Central Government is not restricted to modifying the structure of Central excises. There is a need for significant statutory and constitutional changes which could only be undertaken

[133] Supra note 107, at 56.
[134] Ibid, at 57.

under the Central initiative apart from overall leadership and guidance as well as provision of financial support during the transition period.

- **Statutory Amendments:**

The legal framework for a national VAT is being discussed today purely in the context of State laws co-existing side by side with an independent Central law. From the point of long term conceptual and practical perspective it might be necessary to consider a Central framework statute under which the States and the Centre would be bound to move towards VAT within a system of prescribed rates and practices. It is still not clear whether most of the major States would be willing and ready to make the transition at the appropriate time. The States like Maharashtra, Andhra Pradesh, Madhya Pradesh, Uttar Pradesh and West Bengal have been professing their readiness to shift to VAT, while States like Gujarat, TamilNadu and Kerala have been more reticent. This is another worrying factor, since it might not be practical under the present institutional setup to expect the Central government to actively discipline States which do not change their systems. It is stated that coordination at the level of inter-state committees where the centre is also a participant may not be sufficient to bind all parties to implement consensus decisions. There is a need for Central intervention by legal methods which would be cleared by states, desirable to ensure that different governments do not withdraw from the VAT process after commencement[135]. Hence it has been recommended that this issue has to be pursued by the State of Karnataka at the national level.

All committees and experts as well as many States have sought for the rationalization of existing constitutional anomalies in sharing the power to levy commodity taxes.

In the Indian federal structure, the states and the Central governments share the responsibility of commodity taxation under the Constitutional division of tax powers. The power to tax goods at the production and distribution stages has been allocated respectively between Central and State governments under Entry

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[135] Supra note 107, at 57.

84 of List I (Central List) and Entry 54 of List II (State List) of the Seventh schedule. The former empowers the Centre to raise excise duties on tobacco as well as other goods manufactured and produced in the country while the latter empowers States to levy taxes on the sale or purchase of goods other than newspapers. The only production excises allowed to States are those on demerit goods like alcoholic liquor and narcotic preparations.

It is stated in the Veerappa Moily report that in the Constitution itself, there are two main violations of the above broad principle of division of the powers of commodity taxation. Production excises on demerit goods like alcoholic liquor and narcotic preparations are left to the states but those on tobacco continue with the Centre[136]. There is little economic logic in excluding this item from the States sales tax. Again declared goods are a classic example of State sales tax powers getting ceded to the Centre over time[137]. Initially, by a tax rental agreement in 1956-57, states transferred the right to levy tax on sugar, textiles and tobacco to the Centre, which had then imposed additional excise duties on these commodities and distributed the proceeds among States on the basis of formulae recommended by Finance Commissions. However, the freedom for States to opt out of the agreement was severely curtailed by bringing these goods within the list of "declared goods" so that the States which withdrew from the tax rental could not levy tax on these goods at more than one point or at a rate above the Central sales tax rate ceiling of 4% and also over a period of time other commodities were also added to the declared goods list. Hence there has been opposition by some States and lobbying exercises that resulted in the decision to permit States to tax declared goods at 4% at multi-point basis. The Central government is expected to give a decision on this matter.

As the Central government has not decided upon this matter, there is a need to show some urgency by the Centre in this regard. This is because originally the commodities that were notified as declared goods were under the State List. And

[136] Supra note 107, at 23.
[137] Ibid, at 24.

this is in a way taking over the powers of the state by the Centre. The States would not like to give up their power to tax on a commodity and act according to the Centre's discretion. Hence the Centre should consider this problem quickly so that there is no ill-will when the State VAT is introduced.

Leadership and guidance in the reform process:

It has been pointed out that action must be taken at the Central level to draft a countrywide framework statute for VAT. This statute should be supplemented with effective institutional mechanisms for continued coordinated functioning of all governments. Existing arrangements like the inter-state council may not suffice for constant interaction on administrative and procedural matters. It has been recommended that the institution for managing a functioning VAT should be put on the agenda of all State and Central governments[138].

Another major Central responsibility relates to the "tax heavens" that have developed in Union Territories. The tax heavens have undermined the efforts made by the States to improve their tax effort. They have also been responsible for undesirable retaliatory fiscal measures like entry taxes on motorcars. As the Central government has not yet taken a firm decision on this matter, the Tax Reforms Commission, 2001 has recommended that Karnataka must take a step forward and demand conformity by Union territories to consensus decisions of the Empowered Committee relating to basic VAT rates, removal of exemptions, etc.

It is true that the Centre must lead from the front by drafting a framework statute so that the states would follow the centre when the states enact their own legislations, so that there could be uniformity in all the State legislations without any distortions. Otherwise each State would have a VAT statute which is different from the Central Statute and that it would suit according to there interests. The problem of tax heavens brings to the fore the need for uniform tax rates in all the States. Thus, unless there is a consensus among the States and Union territories

[138] Supra note 107, at 58.

it would be practically impossible to implement VAT to derive the benefits and that is why the new tax system is under consideration.

Financial support for dislocation of commodity tax revenue:

Dislocation of revenues could be inevitable while shifting to VAT in any country. For the state of Karnataka, dislocation of revenue could arise from removal of cascading through input tax credit and rationalization of the existing levies into one[139]. These matters are being considered while determining revenue-neutral rates under VAT. Such a dislocation is sure to take place in a federation like ours by the required shift from origin-based to destination-based taxation as it would substantially alter the relative revenues of States. A fall back fund to take care of such contingencies is unavoidable while introducing State VAT's.

The Tax Reforms Commission, 2001 has recommended for a fund or resource to be arranged to manage the transition to VAT to induce States to agree to what is in the interest of the economy[140]. The problem is to see how to insulate States against revenue loss without draining the Centre's own strained resources. In the long term, States as a whole should be given access to productive additional revenue sources. Compensatory tax source to offset immediate revenue losses on account of Central sales tax reduction or abolition would have to be found. As the State governments are demanding compensation from the Centre as a price for Central sales tax abolition, the Centre has committed itself to working out the expected revenue loss and the manner and quantum of compensation in consultation with States. The Veerappa Moily report has suggested that the only solution is to enable the States to levy service tax concurrently with the Centre and induce them to use this tool to fend for themselves[141].

The recommendations given for the Centre-State issues are all theoretically fine. But the question is would they be good when practically enforced. As far as the Centre- State relations are concerned, until and unless there is agreement

[139] Supra note 107, at 58.
[140] Ibid, at 59.
[141] Id.

between the Centre and the States and among the States, VAT implementation is going to be very difficult. Though they have agreed to have classification of commodities based on Harmonious System of Nomenclature which is followed worldwide, it is to be seen how far it is going to work[142]. Even if the rates are more than one, they have to be uniform. The most important of all is the stability of the Central government. Only if the Centre is strong it can have the capacity to formulate the right policies and would be in a position to convince the states to agree to the requirements for a proper implementation of VAT. The recommendation also stresses upon the reform in CENVAT which has to be done as early as possible. There should be coordination between the CENVAT and the State VAT. The CENVAT is not a full-fledged VAT and hence the CENVAT reform is required to make it a true VAT so that they could complement each other once all the states implement VAT. Until then, we will have to wait and watch what the Centre and the States do to this critical problem and that is implementation of VAT.

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[142] Supra note 121, at 29.

CONCLUSION:

In India, the process of switchover to VAT from a single point of levy of tax was initiated in 1994, but it progressed in the last three years only. The Government was to levy VAT regime in 2001 but unprepared ness led to its shift by two years to April 2003 and then to June. But now it is confirmed that it would be introduced in 2005 as there is no strong political will to implement VAT in the country as the general elections was over just recently in the month of May. Until and unless the new government is formed at the Centre, VAT will have to wait.

The system of VAT, in the long run would certainly usher in the competitiveness by eliminating the cascading effect of homogeneity in the States, wide divergence would affect growth and competitiveness. It is expected that the adoption of VAT would not only help in avoiding the cascading or pyramiding effect of indirect taxation, it would also help in reducing tax evasion as it would have a built-in anti-evasion device. For global free trade, we need free domestic trade as a pre- requisite for which there is a need for a tax system like VAT. But implementation of VAT in a federal economy is a real challenge and there cannot be any general prescription. Each country has to evolve its own system depending upon the circumstances prevailing in that country.

VAT is being introduced in India in an imperfect manner without adequate preparation and motivation. There is lack of uniformity in the law, which may lead to controversies and litigation. It is necessary that the implementation is done by gradual induction method and before enforcing the VAT law, awareness and education campaign should be launched. In this regard it is important to consider the recommendations of the Kelkar

Committee for the smooth implementation of VAT system, as some of the recommendations have been accepted by the Government[143]. They are:

- 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.
- The immediate removal of the plethora of exemptions granted on import and excise duties for various reasons[144].
- To abolish the distinction between the capital goods and inputs and allow credit on all inputs brought into the factory.
- Publicity and awareness programmes should be started jointly by the Central and the State Governments and the former should extend financial support for this, if required.
- Attempt should be made for uniformity of definitions, procedures and documentation in the State VAT laws.
- Compensation on transition to VAT, if it arises, must be tackled through mutually acceptable mechanism of additional resource mobilization through Service tax and not through Budgetary support.
- With the introduction of VAT, all other local taxes should be discontinued, and the same should be taken into account in determining the Revenue-Neutral Rate.
- Additional Excise Duty may continue for textiles till 2005. It may continue even thereafter for cigarettes, which should not be subjected to VAT.
- 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.

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[143] Supra note 24, at 59.
[144] Supra note 1, at 54.

- An indirect tax ombudsman to be appointed for resolving tax related grievances of the public[145].

The VAT system would succeed in India only when there is adequate and correct documentation. For this purpose extensive computerization is necessary. Hence the State Governments would have to go for quick computerization. Otherwise the implementing machinery may not be effective and would face an uphill task in implementing the State VAT. To conclude it can be said that the important requirements for the implementation of VAT are common commodity classification, uniform tax rates throughout the country, required Constitutional amendments and most importantly a strong and stable Government at the Centre which has a majority. Apart from that proper coordination and cooperation between the state governments is also required. But going by the present political situation in the country it is unlikely that there would be a strong Government at the Centre because as per the exit polls no party would have a resounding majority and again there would be a coalition government which is bad news for VAT supporters. And moreover it would be difficult to say how far the States would agree to work together to implement VAT by giving importance to national interests and for how long their self interests would take the back seat.

Presently our overall tax to GDP ratio is around 15 per cent, which is rather low in the world. This has to increase to at-least 18 per cent over the next five years through comprehensive tax reforms. Hence VAT holds the key. All over the world the thrust is to establish a tax structure, which is simple, moderate, rational and easy to administer and comply with. The introduction of VAT is both an opportunity and challenge to streamline and rationalize the indirect taxes.

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[145] Supra note 1, at 64.

Therefore, it can be said that the road to a full VAT system is not smooth but since a majority of the world have accepted this system, in order to keep in pace with the global economy and in its own interest, India must take the necessary action to bring the change in its tax administration by providing the required infrastructure and prepare itself thoroughly to introduce VAT for the benefit of the people and its economy.

The Position in Karnataka:

Karnataka is also trying to revamp its tax system by introducing VAT and has been taking all the necessary steps in this regard. The State appointed the Tax Reforms Commission under the chairmanship of former chief minister M. Veerappa Moily in 2001, to discuss the various options available for the adoption of VAT in the State. The move towards systemic reform of tax system has been undertaken to remove endemic problem of multiplicity and minimizing distortions in tax systems, improve revenue productivity, that would contain revenue and fiscal deficits and route much needed revenues for financing social and physical infrastructure. VAT is expected to ensure buoyant revenue flow, improve voluntary compliance and combat evasion and related corrupted practices and is being seen as equitable, simple and inherently highly compliant.

Federation of Karnataka Chambers of Commerce and Industry (FKCCI) President K. Ramaswamy has stated that while a centralized VAT system with a single rate structure across the country would avoid all complexities that would arise if different States enforce different VAT rates, this would deprive States of their main source of revenue making them even more dependent on central funding and favoured a dual VAT system as the only practical option. Thus, a herculean task lies ahead for the State Government as it tries to accommodate the sentiments of various stakeholders to bring in an ideal VAT in the State. However, the framework for an ideal VAT has already been laid down in the State.

The Ideal VAT:

When the State implements VAT in its pure form it is expected to have the following features:

- It would be based on the destination principle of commodity taxation.
- It would be of a consumption type extending the point of levy to the retail stage and allowing tax credits for the tax paid on the previous points.
- It would be computed on the basis of an invoice credit method.
- It would be a single rate of tax to make the calculation for payment, refund and rebating easy.
- It would tax all types of services.
- It would provide input rebate on the sales of manufactured goods
  - Sold locally
  - Sold in the course of inter-State trade
  - Stock transfers to branches
  - Consignment transfer of exports
- Inter-State sales would be zero rated.
- It would remove the curbs on taxing declared goods only once and at 4 per cent.
- As VAT is a multipoint levy
  - Exports would be zero rated.
  - The existing turnover tax, entry tax and infrastructure development cess would be abolished.
  - New industrial units availing concessions would be brought under VAT for the unavailed period.
  - It would provide for the payment of taxes by dealers on self assessment.

Thus is can be said that the State of Karnataka is all set to enter the VAT regime and is preparing itself perfectly to implement the new tax system in the State.

Suggestions

The researcher has dealt with concept of Value Added Tax in India and after a detailed study has some suggestions to provide. They are:

- It is apparent that for any tax law to be passed the consent of the parliament is necessary, especially with regard to the Constitutional amendment. Therefore, the Constitution has to be amended in order to introduce VAT law in India at the State level.
- Coordination and cooperation between the States is essential to implement VAT successfully. In this regard the Centre has to take the initiative in full swing.
- To avoid any confusion between the Centre and State, there is need for consensus on all aspects of VAT related issues.
- There is a need for a strong Central government to take control of all matters relating to VAT. But at present the political situation in the country in not feasible for VAT implementation because the new government has been just formed at the Centre which is a coalition government and it would need the support of the allies to take any decision. It would be difficult to say how well the present government would cope with the pressures of its allies and implement VAT, though it has promised to do so.
- There is a need for educating the people about the system of VAT and how it functions. Because during my research I happened to talk to some businessmen who either had a vague idea about VAT or knew nothing about it. All that they knew was that a new system of sales tax would be introduced.

- **Sukumar Mukhopadhyay, "Value Added Tax – How Implementation is going wrong" 37 Economic and Political Weekly, 2002.**
- **V. Pattabhiraman, "The CENVAT REVOLUTION" 109 Taxman, 2000.**