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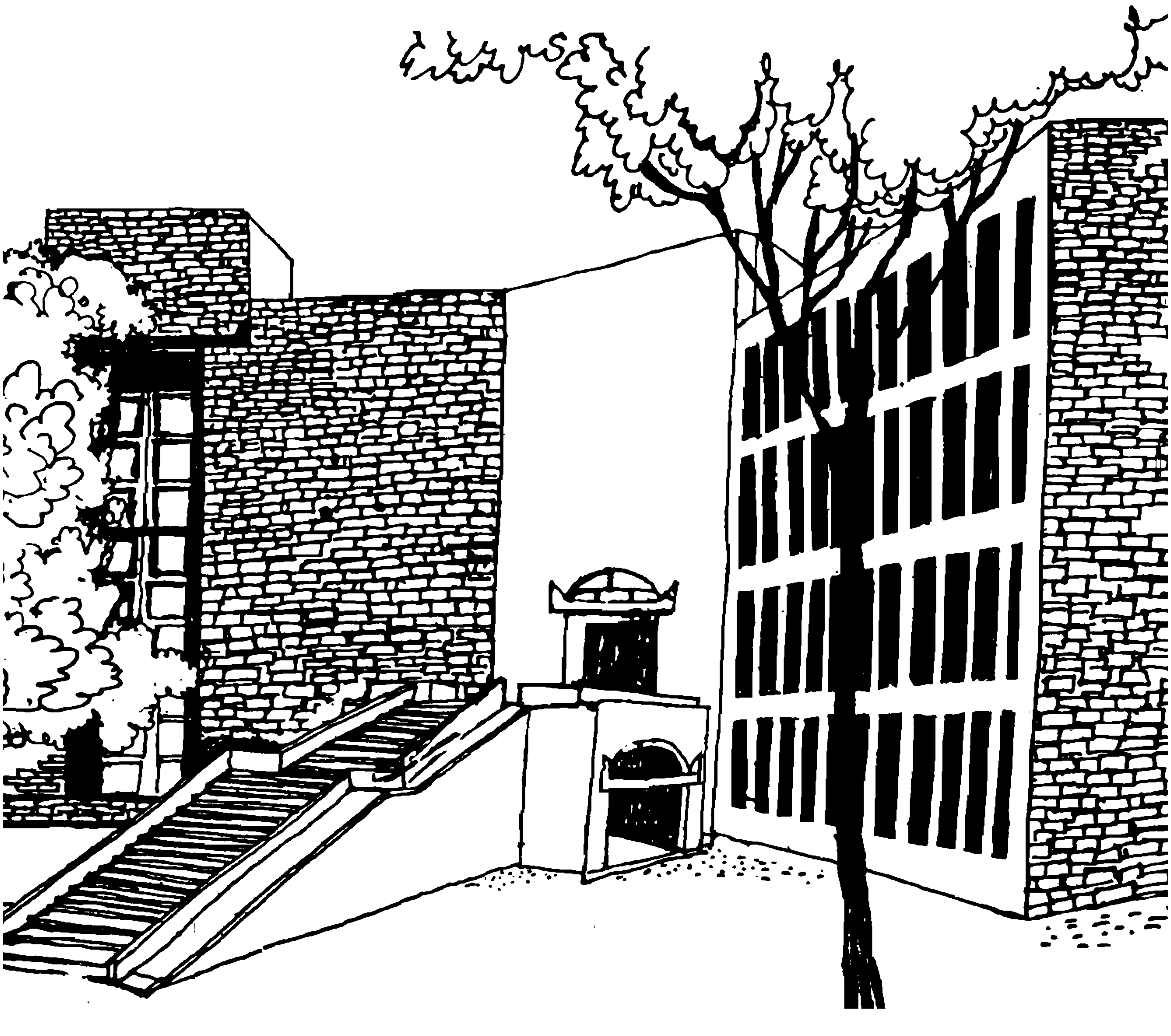

SOME ASPECTS OF VALUE ADDED TAX IN INDIAN ECONOMY

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SOME ASPECTS OF VALUE ADDED TAX IN INDIAN ECONOMY

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I. Introduction

The last decade has witnessed far reaching economic policy reforms in many developing countries spread all over the world. Comprehensive tax reform has always been an integral part of the overall package of economic policy reforms introduced in a large number of developing and newly industrialising economies. A crucial ingredient of the tax reform is a large scale reform of the existing system of indirect taxation through the introduction of Value Added Tax (VAT). By now, it has been well recognized and widely accepted that there exists a strong case for adoption of VAT as a comprehensive non-cascading and non-distorting type of indirect tax.

The need for introducing VAT has been taken for granted the world over as evident from the fact that more than 70 countries have already implemented VAT quite successfully by now. However, it also remains true that in every country where VAT has been introduced or its introduction is being contemplated, there have been skeptics and critics expressing doubts and concerns about adoption of VAT. In this context, it may be useful to examine the rationale for introducing VAT in Indian economy as a part of the overall process of fiscal reform and also examine some aspects of Value Added Tax such as the international experience in this regard as well as some specific issues in implementation of VAT in India.

II. Basic Features of VAT

Value Added Tax represents a multi-stage sales-tax levied as a proportion of the value added at each stage. Basically there are three alternative variants of VAT, viz., (a) gross product variant; (b) net product variant; and (c) consumption variant. Under the gross product variant, deductions are allowed for all purchases of raw materials and components but no deduction is allowed for the purchase of capital goods nor is the depreciation deductible in the subsequent years. It is, therefore, obvious that under the gross product variant of VAT, there is a double taxation of capital goods and this could adversely affect the decisions regarding modernisation and technology upgradation. Under the net product variant, deductions for cost of raw materials & components and also depreciation charges are allowed. However, the difficulties associated with an accurate measurement of depreciation create serious operational problems in the application of this variant. Under the consumption variant of VAT, which happens to be the most commonly used variant across different countries, all purchases including capital assets are allowed as deductions. This variant is easy to implement because it does not distinguish between capital expenditure and current expenditure. Moreover, the consumption variant of VAT also has an added advantage because, from a purely economic angle, it turns out to be neutral between alternative methods of production.

The tax liability under a generalised system of VAT can be computed by following any one of the three alternative methods, viz., (a) addition method, which involves summation of all components of value added, such as wages, rent, interest and profits; (b) subtraction method, which involves estimation of value added as the difference between the value of outputs and deductible inputs; and (c) tax-credit method, which involves deduction of tax already paid on purchase of inputs from the tax on final sales. Most countries which have implemented VAT employ the tax-credit method, which also appears to be more appropriate and easy to implement in a country like India.

III. Role of Indirect Taxation

In a developing economy with significant incidence of poverty, the tax base for Direct Taxes will always be small. For instance, even as of now, the total number of income-tax payers in India are only around 10 million, which would represent an insignificant proportion of the country's population of more than 900 million. It is evident, therefore, that a large proportion of the tax revenue will have to be raised through indirect taxation. Given our federal structure, levy of indirect taxes at multiple stages is inevitable. Moreover, the need for broadening the tax base within the framework of indirect taxation would also invariably lead to multiple-stage taxation.

Once we accept the inevitability of raising a large proportion of our tax revenue through multiple-stage indirect taxation involving manufacturing, wholesaling and retailing stages, it is necessary to evaluate such a system of taxation from the viewpoint of the overall impact it would have on the economy. In this context, two crucial aspects of such a tax system need to be carefully examined, viz., the cascading effects arising from taxation at multiple stages and the unwarranted distortions in economic decisions caused by such interference in the operation of free market forces. The overall cascading effect of such a tax system consists of two elements : (a) The taxes paid at the earlier stage constitute a part of the tax base at the subsequent stage and, hence, it leads to a levy of taxes on taxes; and (b) The taxes paid at the earlier stage constitute a part of the overall cost of production at the subsequent stage which, along with the taxes paid at that stage, result in a further increase in the cost at the next stage. Thus, this kind of a multiple stage tax system would lead to a significant cost increase across the board and thereby create a high cost economy.

IV. Limitations of the Existing Tax System

The existing system of Excise & Sales Taxation in India suffers from several limitations. Some of the serious limitations of the existing tax system, which can be easily overcome by introducing a generalised system of VAT, are as follows :

(a) Under the present system of excise and sales tax, it is quite difficult to ascertain the actual effective burden of tax on any given final product. As a result, the total effective tax incidence generally varies substantially across products for the same given nominal rate of excise or sales tax. It is hardly surprising, therefore, that under the present tax system, the policy makers would actually find it difficult to design and implement a pre-determined and properly controlled pattern of effective tax incidence on a wide range of final products.

(b) Another major limitation of the existing tax system is that it introduces a tax-driven bias in crucial economic decisions involving choice of location, input-mix, product-mix and even technology. Thus, differential rates of taxes on various inputs at multiple stages lead to unintended changes in relative input prices which in turn require the producers to continuously evaluate and change their decisions about the choice of inputs even with the same basic technology. This creates serious economic distortions leading to inefficiency in resource allocation which can ultimately damage the country's overall competitiveness.

(c) Under the present system, the final increase in price paid by the ultimate user turns out to be much greater than the total yield from multiple stages of taxation that actually accrues to the government. Thus, for instance, levy of taxes on basic raw materials leads to higher working capital requirements for the manufacture of intermediate inputs and this in turn leads to higher interest cost at that stage of production. As a result, the overall interest cost as well as the margins charged on intermediate inputs turn out to be higher eventually leading to a higher price. The same process works all over again when these intermediate inputs are purchased by the producer of the final product. Hence, if we compute the additional amount that is actually paid by the final user of the product under the present tax system, it would turn out to be significantly higher than the additional revenue collected by the government. It is evident that this kind of anomaly would not exist under a generalised system of VAT.

(d) Another major defect of the present excise and sales tax system, which does not provide for any set-offs for the taxes paid on inputs is that it seriously affects the international competitiveness of our exports of manufactured goods. In a generalised system of VAT, which is adopted by many of our competitors in the international market, exports are usually zero-rated. As a result, such exports are completely free from the incidence of all forms of indirect taxation and this phenomenon is fairly well established and accepted as a normal practice under GATT. In order to achieve the same situation without introducing VAT in India, it would be necessary to evolve a very elaborate and complicated system of duty drawback, which would require (i) accurate calculation of specific duty drawback rates (intrinsically a very difficult exercise in itself); (ii) fairly efficient administrative machinery to effectively implement it; and (iii) a well-established mechanism to avoid the commonly occurring delays and disputes in the settlement of duty drawback claims. Our past experience clearly shows that these features of our present tax system create a major hindrance in our export thrust. In fact it is interesting to observe in this connection that the main reason why France pioneered in introducing VAT (as early as in 1954) was to boost exports.

While stressing the need for the structural reforms of the present excise tax system in India, Chelliah Committee on Tax Reforms has argued that the introduction of a generalised system of VAT extending to the retail stage in replacement of the existing system of indirect taxes levied by the Central Government, the State Governments and the local governments would effectively overcome most of the above-mentioned defects of the present tax system. Available empirical evidence, based on the experience of many countries where VAT has already been introduced, also corroborates this view.

V. International Experience of VAT

A recent indepth study by Mahesh Purohit [1993] on the structure and operation of VAT in various countries has brought out several interesting aspects of the international experience in this regard. Purohit's study covers 63 countries (which adopted VAT) based on the information available as of January 1993. Out of these 63 countries, 16 countries levy VAT at a single rate, 21 countries levy VAT at two or three rates, while the rest levy VAT at four or more rates. Thus, the introduction of VAT has been accompanied by a significant degree of standardisation and simplification of the tax rate structure in most countries.

It is interesting to observe that in most countries the rates of VAT range from 5% to 15%, while very few countries have relatively high rates of VAT. In fact, only four countries have VAT rates of 25% or more. However, in most countries the rates of tax have increased with the passage of time, though the extent of increase (since the year when VAT was introduced in the country) has been moderate in majority cases. In most countries where multiple rates of VAT are in vogue, luxury goods are taxed at higher rates while food items are either exempt from tax or are taxed at very low rates. According to Purohit, the revenue implications of differential VAT rates have not been consequential in most countries. On the whole, the countries having multiple rates of VAT, derive a large proportion of revenues from the items having the standard rate. However, a significant conclusion emerging from Purohit's study is that the system of VAT based on the differential treatment of various commodities is not an effective way to introduce an element of progressivity into the tax system. Specific empirical studies on the impact of VAT undertaken in the United Kingdom and the Netherlands have shown that the differential VAT rates have only a nominal effect on the actual VAT burden borne by the rich vis-a-vis the poor.

It is interesting to observe that regardless of the form of VAT, the base of the tax in most countries includes services. In this regard, the two alternative approaches that are generally adopted are: (a) the integrated approach under which all services are taxed except those specifically exempted; or (b) the selective approach under which only a few specifically stipulated services are included in the tax net, while the rest of the services are exempted. An analysis of the available data for OECD countries shows that there are wide variations in the treatment of services under VAT. Purohit's study also reveals that VAT has so far not been adopted in most of those countries which have a federal structure. Thus, major countries with a federal structure, which have not adopted VAT so far, include Australia, Canada, United States and Switzerland. In fact, Brazil is the only federal country which has adopted VAT both at the federal and the state level. In Brazil, the federal level VAT is a selective tax levied on a list of specified manufactured goods, while the state level VAT covers most stages of production and distribution including retail sales. Purohit's analysis of Brazilian VAT shows that the prevailing VAT rate for intra-state sales is 17%, while the rate for inter-state sales is 12%. Moreover, the inter-state VAT rate is set off against the tax liability in the State of Destination, and the importing State appropriates the difference between the intra-state and the inter-state rates. It is obvious that a detailed analysis of the Brazilian experience would be relevant and useful in the Indian context.

VI. Some Apprehensions About VAT

The critics of VAT often put forward various arguments focussing on what could be regarded as some of the undesirable consequences of introducing VAT. Thus, for instance, it is argued that VAT is inflationary or VAT implies higher tax rates or introduction of VAT at the state level would impose additional administrative burden. However, if we examine such arguments in detail, we find that they suffer from some basic misconceptions about VAT and in reality most of these arguments are not valid.

The argument that VAT is inflationary is essentially based on a comparison of the price before the levy of VAT and the price that would prevail after VAT is imposed. What needs to be noted, however, is that all forms of indirect taxes by their very nature lead to an increase in the price of the final product. The relevant point of reference for the purpose of comparison should, therefore, be the relative price effect of alternative forms of indirect taxes and not the absolute price effect of VAT as such. As already indicated earlier, given the revenue neutrality of alternative tax systems, the relative price effect (with respect to the final product) would be negative in the case of VAT when compared with the present system of excise and sales tax, because the additional price paid by the purchaser of the final product significantly exceeds the amount of additional revenue collected by the government under the present system of taxation. Moreover, since VAT would effectively avoid the cascading effect of indirect taxation and would also lead to some improvement in the overall economic efficiency, the generalised system of VAT could actually contribute positively to contain the general inflationary pressure in the economy as compared to the existing tax system.

The argument that levy of VAT would lead to higher rates of tax is based on a simplistic and essentially misleading comparison of the nominal rates of tax on the final product under VAT in relation to the present system. Any comparison of tax rates should necessarily be based on the principal of revenue neutrality and it should involve a comparison of the effective rate of total tax under the two alternative systems rather than a comparison of the tax rate levied only at the final stage. It has already been conclusively established that the effective rate of total tax actually paid by the final user of any product would be lower under a generalised system of VAT as compared to the present system of excise and sales tax, under the conditions of revenue neutrality of the two alternative tax systems. Moreover, since VAT is likely to result in a better tax compliance on a wider tax base, the generalised system of VAT would eventually start yielding much greater revenue with the same given rates of tax, which essentially implies that the need to increase the tax rates to raise more revenue would be less under VAT as compared to the existing tax system.

Finally, the argument that introduction of VAT at the state level would impose additional administrative burden on the state bureaucracy and also need more staff is again based on a misconception about the system of VAT. What needs to be remembered in this context is that the existing system of excise & sales tax is quite complex involving several product groupings, proliferation of tax rates and plethora of exemptions. Moreover, all of this is more or less manually handled and the actual work increases not only on account of the complexity of the tax system but also on account of endless litigations and the resulting loss of efficiency. What is essentially being proposed under the system of VAT is a considerable simplification and rationalisation of the tax system with only a few rates of tax (may be only three or four) and practically no exemptions barring only unavoidable exceptions. Thus, the new VAT system would effectively extend the tax base without increasing the administrative work load. In fact, the actual magnitude of work involved in tax administration under VAT may turn out to be less than what is required under the present system. Moreover, the programme of computerisation of tax administration would not only be easier under VAT but would also turn out to be far more effective and this would also imply lower administrative burden requiring less staff.

VII. Issues in Implementation of VAT in India

The need for a major reform of the system of excise and sales taxation in India has been recognized by the Finance Ministry for a long time now. Thus, the long term fiscal policy statement of 1985 clearly indicated that the most comprehensive and theoretically appealing way of providing set-offs for taxation of inputs is to adopt VAT in place of the existing system of domestic indirect taxes. However, the policy statement also emphasised that a number of formidable practical problems of implementation including the problems involved in incorporating the sales taxes levied by different state governments into a centrally administered VAT made this solution impractical. It was against this background that a decision was finally made to move towards an extension of the system of proforma credit to all excisable commodities except a few like petroleum, tobacco and textile products. Accordingly, a Modified Value Added Tax (MODVAT) was introduced with effect from March 1, 1986 to cover initially 37 chapters of the central excise tariff. By 1987, the scheme was extended to cover almost all the chapters of the central excise tariff, except those relating to petroleum products, textile products, tobacco products, cinematographic films and matches. It may be noted that the excluded items account for nearly half of the excise revenue collected at that time. The main limitation of this MODVAT system has been that the benefits of MODVAT credit are available only when the inputs as well as the final products are both covered within the chapters of the central excise tariff to which this scheme has been extended and when the final products are not exempted from excise duty. Thus, the present system of MODVAT covers only a part of the central excise revenue and completely bypasses all other indirect taxes levied on various products by the state governments and the local governments. To that extent introduction of MODVAT can at best be considered a small first step towards the adoption of a full fledged VAT system in the country.

Chelliah Committee on Tax Reforms has now recommended that the present central excise tax system should be gradually transformed into a comprehensive VAT system. Their main recommendation in this regard is as follows :

> "The ideal solution, from the economic point of view, would be to have a single VAT at the Central level, reaching down to the retail stage in replacement of most indirect taxes other than protective duties and sumptuary excise duties - the Central excise, the State sales taxes, the Municipal octroi, the goods and passengers tax and the electricity duty. The proceeds of the VAT will be shared among the three levels of Government. Having only two major taxes, the income tax and the VAT, would also mean greatly reduced cost of compliance to business and industry as well as lesser obstacles to the fast growth of the economy. For the smaller business in particular, the elimination of the obligation to deal with multiple tax departments would be a great boon.

> While the reluctance of the State governments to give up or delegate their tax powers is understandable, it will be legitimate for trade and industry and the people in general to insist that the economic distortions caused by the sales tax structures should be removed. Given the imperative need to increase economic efficiency and to improve export competitiveness, the country cannot afford to let the Central and State governments continue with the complicated and distortionary tax structures that have grown up. Therefore, even if a single VAT extending to the retail stage is not feasible at the moment, it is imperative to carry out the second-best reforms which we have advocated."
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> (*Tax Reforms Committee, Final Report - Part I*, August 1992; p. 46.)

Under the present circumstances, the introduction of a single central VAT replacing all types of indirect taxes does not appear to be feasible. Currently, the states derive about 68% of the tax revenue from their own sources (mainly sales tax), while the remaining 32% accrues to the states through the devolution of income tax and excise from the Centre. It is evident that under the central VAT system, the States would have to depend almost entirely on the Centre and for all practical purposes surrender their powers of taxation, which would be obviously unacceptable to the States. Moreover, under the central VAT, system the Centre will have to critically depend on the state governments for tax administration simply because the Centre would not have the required machinery to handle a large number of dealers who would come within the ambit of VAT. Thus, the implementation of a central VAT would create a peculiar situation in which the tax revenues would be primarily collected by the States, but the same would be subsequently pooled and distributed through a revenue sharing formula. It is quite obvious that under such conditions the States would have very little incentive to undertake the responsibility for effective tax administration, unless the actual distribution is made largely on the basis of tax collection effort at the State level. In any case, it is quite clear by now that most States are unwilling to part with their existing powers of taxation.

In view of several practical considerations involved in the formulation and implementation of the VAT system in the Indian context, it is now being suggested that there is a need to evolve the concept of a dual VAT system in India. A recent study by Burgess & Nicholas [1993] on the problems and options of VAT system in India, the following specific suggestions and observations have been made:

> India should opt for a combination of State value added taxes and Central Excise and put an end to the current revenue sharing arrangement in the long term.
>
> The dual Centre-State VAT and Central VAT are unsuitable for India. The first step should be for the states to begin replacing their sales taxes by VAT. The choice of a system is likely to be politically attractive for States since most States prefer to be self-sufficient instead of depending on the Centre for funds.
>
> Despite the widespread usage of centrally administered VAT system the world over, the option would be a non-starter for India on account of the federal polity.
>
> In return for decentralised VAT, the Centre might also be able to negotiate a number of binding arrangements with States on harmonisation of bases and simplification of rate structures.

It is heartening to note that, despite several practical problems, a general consensus seems to have emerged at various levels by now that the country should switch over to a system of VAT. The discussion is now shifting more towards raising the issues of the timing and manner of introduction of a comprehensive VAT system rather than raising the basic question as to whether such a system should be introduced or not. Several States have already started thinking in terms of introducing VAT at the State level and it now appears most likely that this process would gather momentum and work itself out in due course of time.

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