

BACKDROP FOR STATE-LEVEL VAT IN INDIA

6.1 INTRODUCTION

A really progressive and welfare oriented country should balance the requirements of direct and indirect taxes in a fair manner. Too much dependence on direct taxes will be repressive but at the same time passing heavy burdens to the general public by way of indirect taxes will constitute hardships to the common citizen. Therefore, economic administrators throughout the world have been constantly engaged in the exercise of lightening the burden of indirect taxes on the ultimate consumers.

Suppose, for manufacturing a product A, the manufacturer has to purchase four types of commodities B, C, D and E on which he pays excise duty. When ultimately he sells his manufactured product A on which he has to discharge his liability towards excise, the excise duty leviable on such product will be on a tax base which will include excise duties paid by the manufacturer on products B, C, D and E. Thus, the final excise duty is a duty on duty, which will increase the cost of production as well as the price of the final product.

Suppose, we find a method by which the excise duties paid on commodities B, C, D and E are allowed to be set-off from the final duty liability on product A, it is obvious that the manufacturer will not only be able to avoid payment of duty on duty but the cost of the product will also be reduced leading to a benefit to the consumer. This is the origin of Value added tax (VAT).

In simple words, the tax will be levied and collected at each stage of manufacture only on the value added by the manufacturer represented by the purchase value and the value of the work performed on such purchased commodities. This will not only result in cost reduction but will also ensure equity. What we have talked about is a value added tax on manufacture. In the same way, there can be a value added tax in respect of trading in commodities also.

In other words, the various taxes paid on inputs purchased will be allowed as a credit and will be allowed to be set off against the tax liability on the value of sales of the commodity. Thus, there can be a system of VAT in respect of manufacture and in respect of sales. In

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the same way, one can think of a system of VAT in dealing with input and output services. When the individual systems of manufacturing, sales and services VAT are ultimately combined to form a grand system of VAT on goods and services, such a VAT system will be applicable throughout the country as a common market.

6.2 HISTORICAL BACKGROUND

Ever since 1954, when the tax on value added was introduced in France it has spread to a large number of countries. This tax was proposed for the first time by Dr. Wilhelm Von Siemens for Germany in 1919 as an improved turnover tax. In 1921, VAT was suggested by Professor Thomas S. Adams for the United States of America who recommended "sales-tax with a credit or refund for taxes paid by the producer or dealer (as purchaser) on goods bought for resale or for necessary use in the production of goods for sales." VAT was also recommended by the Shoup Mission for the reconstruction of the Japanese Economy in 1949. However, the tax was not introduced by any country till 1953. France led the way in 1954 by adopting a VAT that covered the industrial sector alone and the tax was limited up to the wholesale level. The tax was limited to the boundaries of France until the fifties.

VAT has, however, been spreading rapidly since the sixties. The Ivory Coast followed France by adopting VAT in 1960. The tax was introduced by Senegal in 1961 and by Brazil and Denmark in 1967. The tax has gathered further momentum as it was made a standard form of sales-tax required for the countries of the European Union (then European Economic Community). In 1968, France extended VAT to the retail level while the Federal Republic of Germany introduced it in its tax system. The Netherlands and Sweden imposed this tax in 1969 while Luxembourg adopted it in 1970, Belgium in 1971, Ireland in 1972, and Italy, the United Kingdom, and Austria in 1973. Of the other members of the European Union, Portugal and Spain introduced VAT in 1986, Greece in 1987, while this tax was adopted by Finland in 1994. Many other European countries have adopted VAT. Similarly, many countries in the North and South America, Africa and Oceania have introduced VAT.

VAT has been spreading in the Asian region as well. The Republic of Vietnam adopted VAT briefly in 1973. (VAT was abolished soon but it was reintroduced in 1999 in Vietnam.) South Korea introduced VAT in 1977, China in 1984, Indonesia in 1985, Taiwan in 1986, Philippines in 1988, Japan in 1989, Thailand in 1992, and Singapore in 1994 while Mongolia has been implementing this tax since 1998.

In the South Asian Association for Regional Cooperation (SMRC) region, VAT has been considered in great depth in India. In 1986, India introduced VAT in a different way under the name of Modified Value Added Tax (MODVAT). Unlike the VAT system of other countries, the Indian MODVAT system was designed to cover manufacturing of goods by giving credit of excise duty paid on inputs. The scope of MODVAT has been extended

over the years and has since been renamed as Central Value Added Tax (CENVAT), which covers services also.

Pakistan adopted VAT in 1990, Bangladesh in 1991, and Nepal in 1997 while Sri Lanka introduced VAT in 1998.

As VAT is less distortive and more revenue-productive, it has been spreading all over the world. As on today, about 130 countries have adopted the same.

6.3 VAT IN INDIAN CONTEXT

The Indian Union is a federal structure under the Constitution of India. The Central Government and the State Governments derive their powers through the instrumentality of the Union List, the State List and the Concurrent List. So far as powers of taxation are concerned there are clearly specified areas over which the Central Government and the States can exercise their jurisdiction.

While Income-tax, excise duty and customs duty constitute the major sources of tax revenue to the Central Government, the State Governments substantially depend on sales-tax as the main source of revenue. The Central Government undertook a series of reforms in indirect taxes, the major among which was the introduction of Modified VAT, which is currently in operation as CENVAT. However, in view of the constitutional constraints, CENVAT applies to goods and services but not to sales tax.

6.4 COMMITTEE OF STATE FINANCE MINISTERS

After the introduction of VAT in the area of manufacture and services, a need for uniformity arose wherein similar system was proposed to be incorporated in the area of sales thereby replacing the existing sales tax system. To materialize this concept, the then Union Finance Minister called a meeting of the State Finance Ministers in May 1994 and a Committee of State Finance Ministers was constituted on sales tax reform following this meeting. The Committee had to examine all aspects of sales tax reform, including the introduction of VAT.

The Committee recommended several measures to rationalize the existing sales tax with the ultimate aim of introducing VAT at the State level. The major recommendations included simplification of the rate structure, minimization of the exemptions and enhancement of transparency. To this end, the Committee recommended:

- (i) the adoption of four general floor rates (0, 4, 8, 12) and two special floor rates (1 and 20) in place of the existing multiple rates being levied in different States;
- (ii) keeping the exemptions to a minimum;
- (iii) preparing a list of exempt goods and fixing a target date beyond which no State/Union Territory should exempt goods other than those mentioned in the list, and;

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- (iv) doing away with sales tax incentives for industrialization. No new tax incentives should be given after 1 April, 1997, and the existing ones should be allowed to lapse in due course.

For implementing the above decisions, an Empowered Committee of State Finance Ministers was set up.

6.5 EMPOWERED COMMITTEE OF STATE FINANCE MINISTERS

The Empowered Committee met regularly, attended by the State Finance Ministers, and also by the Finance Secretaries and the Commissioners of Commercial Taxes of the State Governments as well as senior officials of the Revenue Department of the Ministry of Finance, Government of India. Through repeated discussions and collective efforts of the Empowered Committee, it was possible within a period of about a year and a half to achieve remarkable success in the first two objectives on harmonization of sales-tax structure through implementation of uniform floor rates of sales-tax and discontinuation of sale-tax-related incentive schemes. As a part of regular monitoring, whenever any deviation was reported from the uniform floor rates of sales-tax or from decision on incentives, the Empowered Committee took up the matter with the concerned State and also the Government of India for necessary rectification.

After reaching this stage, steps were initiated for the systematic preparation for the introduction of State-Level VAT. In order to avoid any unhealthy competition among the States which may lead to distortions in manufacture and trade, attempts had been made from the very beginning to harmonize the VAT designs in the States, keeping also in view the distinctive features of each State and the need for federal flexibility. This had been done by the States collectively agreeing, through repeated discussions in the Empowered Committee, to certain common points of convergence regarding VAT, and allowing at the same time certain flexibility for the local characteristics of the States.

Along with these measures at ensuring convergence on the basic issues on VAT, steps had also been taken for necessary training, computerization and interaction with trade and industry, particularly at the State level. This interaction with trade and industry was being specially emphasized.

6.6 DR. VIJAY KELKAR'S VIEWS

The report submitted by Dr. Vijay Kelkar, Advisor to the Union Finance Minister, in the year, 2002 on direct and indirect taxes had significant observations on the issue of VAT. At the very outset he said that VAT eliminates the cascading effect of taxes, it promotes competitiveness of exports, it has a simple and transparent culture and it improves compliance. Economists have generally shared the view that VAT is best suited as a federal or central tax and not at the State level.

Dr. Vijay Kelkar made the following recommendations in regard to State-Level VAT-

- (i) A publicity awareness programme should be started jointly with the Central Government and the State Governments and the former should extend financial support for this, if required. It is also necessary that the publicity awareness programme should be implemented at the earliest.
- (ii) An attempt should be made towards uniformity of all State legislations, procedures and documentation relating to VAT.
- (iii) The issue of compensation to States must be primarily tackled through mutually acceptable mechanism of additional resource mobilization through service tax and not through budgetary support.
- (iv) 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.
- (v) Whereas additional duties of excise may continue for textiles up to 2005, it may continue even thereafter for cigarettes, which should not be subjected to VAT.
- (vi) The VAT schemes should provide for grant of credit of duty by the importing States for the duty paid in the exporting State, in the course of inter-State movement of goods.
- (vii) For the stability and continuity of VAT, the setting up of 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.

6.7 WHITE PAPER ON STATE-LEVEL VAT IN INDIA

The Empowered Committee of State Finance Ministers met regularly and with the repetitive discussions and collective efforts brought out a White paper on 17.01.2005, which provided a base for the preparation of various State VAT legislations. It has been recognized that VAT is a State subject and therefore, the States will have freedom for appropriate variations consistent with the basic design as agreed upon at the Empowered Committee. Broadly, the White Paper consists of the following:

- a) Justification of VAT and Background
- b) Design of State-Level VAT.
- c) Steps taken by the States.

6.8 PRESENT POSITION

Finally, State-Level VAT was introduced on 01.04.2005 by majority of the States, though

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few States had already implemented it by that time.

The States have passed State-Level VAT legislations which are modeled on the draft model VAT law, prescribed by the Central Government. The legislations also incorporate the various principles of State-Level VAT as contained in the White Paper released by the Empowered Committee. However, depending upon the requirements of the States appropriate variations have been made in these legislations. The concepts relating to VAT dealt in subsequent chapters are largely based on the principles laid down by the White Paper on State-Level VAT.

6.9 DISCONTINUANCE OF THE CENTRAL SALES TAX

With the introduction of State-Level VAT system, it is proposed to phase out the Central sales tax (CST). However, since the States will stand to lose large revenue on account of its discontinuance a mechanism is being thought of for compensating the States for such loss of revenue.¹

6.10 GOODS AND SERVICE TAX

The ultimate system of indirect taxes in India will be a goods and service tax. Under such a system there will be one central authority administering a uniform goods and service tax. Input tax credit will be available between goods and services throughout the country. However, such a development will require constitutional amendment. Under such a uniform tax system, there will be no trade barriers like octroi and entry tax. There will be a free flow of trade and commerce through out the length and breadth of the country. India will then become a vast common market. The Union Finance Minister in his Budget speech for the year 2006-07 has announced 1st April, 2010 as the target date to introduce GST.

Self-examination questions

1. Briefly explain the concept of value added tax through a illustration.
2. Write a brief note on the historical background of VAT.
3. Discuss the recommendations made by the Committee of State Finance Ministers in relation to introduction of State-Level VAT.
4. Explain the recommendations made by Dr. Vijay Kelkar in regard to State-Level VAT.
5. Write a short note on the White Paper on State-Level VAT in India.

¹ The concepts relating to central sales tax and VAT have been dealt in Chapter 12 of Section B of this Study Material.