VALUE ADDED TAX – AN IDEA WHOSE TIME HAS COME

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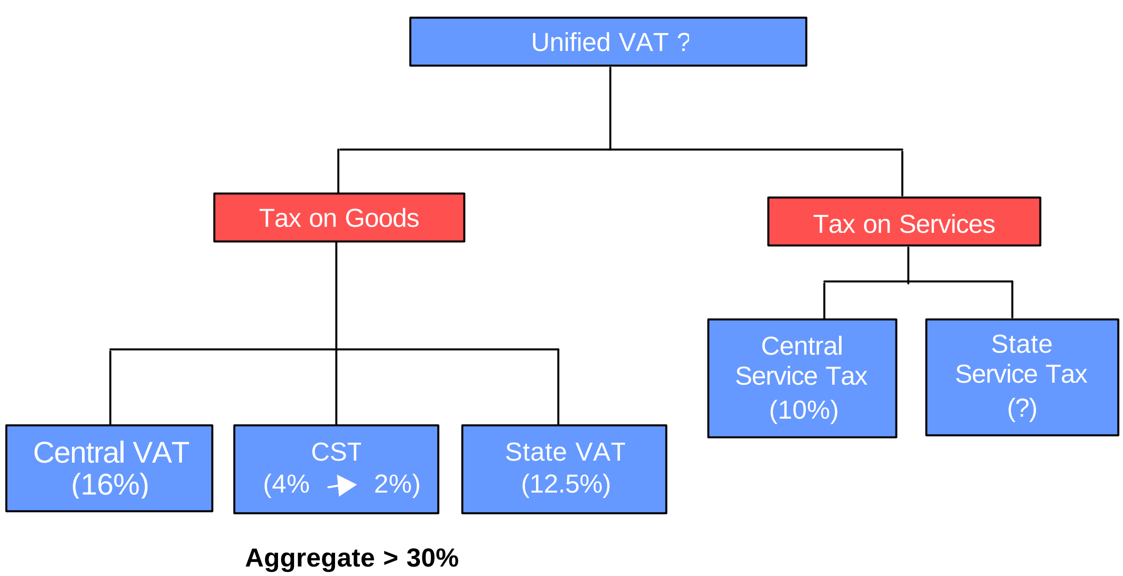
INTRODUCTION

Value Added Tax (VAT) is a multistage tax, levied on value added at different stages of production and distribution of a commodity or the supply of a service. Since it is a tax on both goods & services, it is also known as a Goods & Services Tax. However, India would currently maintain a distinction between the taxes on goods and the taxes on services and the integration of these taxes into one all India VAT is sometime away. This is for the reason that India has historically had a tax on goods alone and the tax on services is of relatively recent origin. Yet another reason for this distinction is the prevalence of a multiplicity of taxes on goods. There is, at present, just the one tax on services but it could be that there would be a second tax on services at the State level. This would further exacerbate the problem relating to integration. However, there has been a slow but sure move towards this goal of an integrated VAT, in terms of the recent proposals in Budget 2004 on integration of input credits across goods and services.

However, the prime mover in all this will be the impending introduction of the VAT at the State level, in lieu of the sales tax, with effect from 1/4/2005. This note will hereinafter focus on the State VAT. However, it needs to be mentioned here that India will adopt a dual VAT system i.e. a Central VAT and a State VAT. Thus, manufactured goods will continue to be subjected to both CENVAT and the State VAT. The central sales tax, which is the tax on the inter State sales of goods, is intended to be slowly phased out. The following is a diagrammatic representation of the aforesaid discussion:-



IMPACT OF VAT

Since the VAT that is intended to be introduced at the States with effect from 1/4/2005 is fundamentally different from the present sales tax, the impact of its introduction will be significant and varied, across industry sectors. The parameters of the VAT as they are known at the present are such that the implications could be significant and adverse for companies with an all India presence with extended supply chains, starting from procurement and manufacture through distribution. Typically, companies with pan India distribution structures such as in the FMCG and pharma sectors would be majorly impacted. However, given that the introduction of the VAT will have such fundamental implications, this note will limit itself to listing out some of the implications alone. However, it is not only industry that is affected by the introduction of the VAT. There are implications for both the Central Government and State Governments as well. Here again, a brief listing of these implications is given below:-

IMPLICATIONS FOR INDUSTRY

Substantive

- supply chain modifications
- product pricing
- distribution channel dynamics/dealer and distributor management
- market share and comparative competitiveness among players

Procedural

- admissibility to input tax credits on transition to VAT
- other transitional issues
- documentation and record keeping
- modifications in ERP and other IT systems

IMPLICATIONS FOR CENTRAL GOVERNMENT

- budgeting for possible loss of revenue and financing/funding the compensation payable to States.
- loss of revenue at the Central level as a result of phasing out of CST and additional excise duty

- impact on CENVAT and the central Service Tax
- possible impact with regard to the large scale computerisation initiatives at the State level.

IMPLICATIONS FOR STATE GOVERNMENTS

- stakeholders acceptability
- transitional issues for trade and industry
- revenue considerations arising from possible loss of revenue
- mindset change at all levels of the bureaucracy
- staff capacity building
- large scale computerisation
- procedural issues relating to return filing, validation of input credits, other documentation and record keeping.

IMPLEMENTATION

Clearly, the switchover to VAT is a mammoth exercise and there are major implementation issues. In order to successfully implement VAT, States must realise that the two focus areas of training and re-orientation of staff, as well as computerisation of the sales tax department, must be addressed. The training effort is a huge one consisting of a mass rollout of knowledge on VAT, with all its attendant details. The training effort is also critical since a fundamental change in mindset is required of the sales tax officials, if the VAT is to be implemented in the right spirit. States have certainly understood the necessity for training and had already achieved significant progress in this area, but much more needs to be done. As regards computerisation, it is a truism to state that computerisation is critical for a successful transition from sales tax to VAT. Indeed, the VAT by its very nature will extend throughout the supply chain thereby resulting in massive incremental registration requirements. Moreover, the tax places considerable emphasis on documentation. Hence, the imperative of computerisation.

If one were to assess the state of readiness on this critical dimension, many States are lagging far behind, although there is now a realization to push ahead quickly. Clearly, successful VAT implementation will largely depend on a broad and deep computerization in the Indian States, ahead of the switch over from sales tax to VAT. It is hoped that States will vigorously pursue their efforts in this area. The realisation is there, yet the task is enormous and it is hoped that the sheer scale of the exercise does not defeat the will and initiative of the States Governments.

Significant financial resources are required to be committed to this key task and collaborative efforts between the Centre and the States are essential in order that a modern, tax payer friendly and easy to administer VAT is brought about by the judicious and imaginative use of information technology.

GLOBAL VAT STRUCTURES

European Union (EU)

The EU, as indeed most countries of the world, has a single VAT across goods and services. The scope of the VAT in the EU, comprising 25 members States at present, is as follows:-

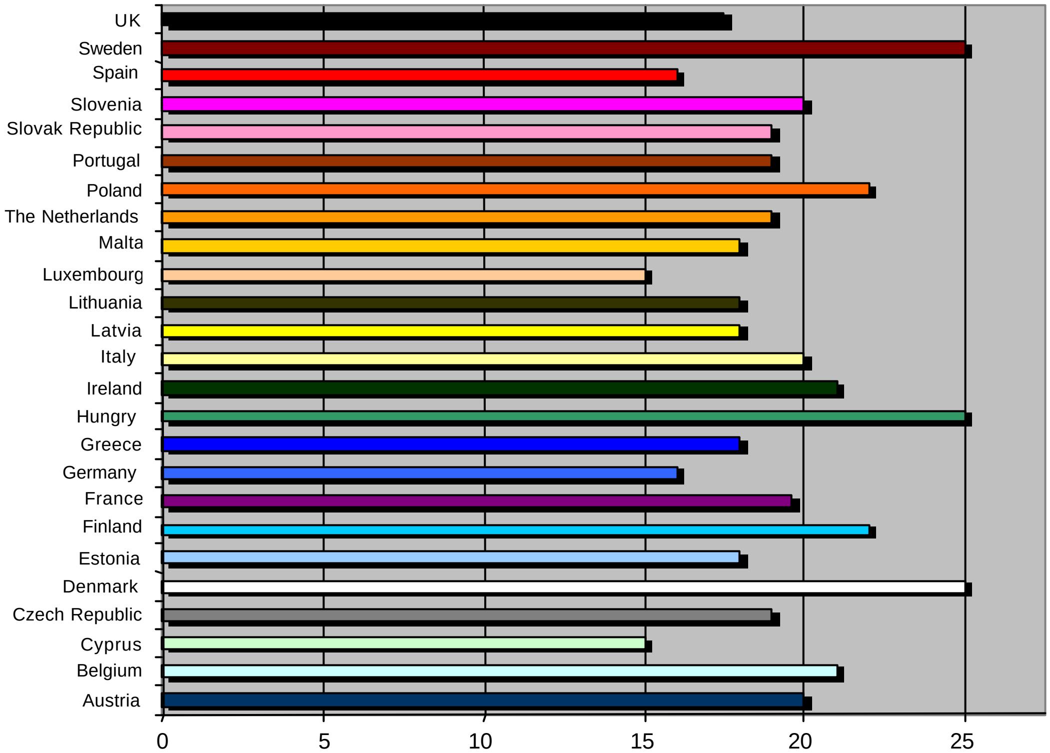
VAT is charged on :

- the supply of goods, for a consideration, within the Territory of a Member State, by a taxable person;
- the supply of services, for a consideration, within the Territory of a Member State, by a taxable person;
- the importation of goods;
- intra-Community acquisitions of goods by a taxable person acting as such or by a non taxable legal person

A taxable person is any person who independently carries out, in any place, any economic activity, whatever the purpose or results of that activity.

Economic entities include producers, traders and persons supplying services.

Although the Member States have not harmonized their VAT rates, they have agreed to adopt a minimum standard rate of 15%. This rate applies to the supply, intra community acquisition and importation of goods and services. Member States may also apply one or two reduced rates for goods and services that are seen as basic necessities or are of a social or cultural nature. A reduced rate may also apply to natural gas and electricity, provided there is no risk of distortion of competition. Tax rates in the member States of European Union are shown below:-



Canada/Brazil

Canada has a dual VAT. Both a VAT imposed by the federal government as well as a provincial sales tax are present. India has largely patterned its dual VAT on the Canadian model. Similarly, Brazil also has a dual VAT which operates in a fundamentally different fashion than in Canada.

WHY VAT?

The intended introduction of the VAT in the States is set to achieve many objectives, besides removing the deficiencies present in the sales tax regime. Some of the immediate benefits of the VAT are outlined below:-

a) **Growth objectives -** An indirect tax should be able to raise resources for the development of the State. It is seen from the experience of other countries, which have adopted VAT, as also from the experience of VAT implementation in Haryana, that VAT has aided tax buoyancy.

b) **Equity considerations -** Since the proportions of value-added at later stages and at earlier stages of production differ from commodity to commodity, the present first point sales tax is biased against those commodities which have larger value added at the earlier stages of production. VAT is intended to iron out such distortions and bring equity in the tax system.

c) **Neutral Structures -** The tax system should be neutral in its impact on producers and on consumers choices. The existing sales tax system suffers from many distortions such as cascading effect of taxes, irrational location based incentives, high inventory holding costs, differential tax rates/ structures in different States etc. The VAT system addresses such anomalies and distortions and brings in the desired neutrality in the fiscal regime.

d) **Administrative expediency -** The introduction of VAT will rationalize the indirect tax regime on transactions, which may have the positive impact of neutralising the pyramiding effect of taxes. It will also do away with the system of granting sales tax exemptions, besides reducing the multiplicity of rates. Rationalization introduced by VAT would lead to better compliance and lower revenue leakages. Consequently, both the consumer and the States could benefit.

The business case for a VAT has long been made. The present sales tax is an anachronism and must be discontinued. VAT provides a level playing field and is a transparent, modern, user friendly and relatively simple to administer tax. The VAT is simply an idea whose time has come and it is now only a question of time before its introduction.