Chapter 2

REFORMS IN SALES TAX STRUCTURE

The reform is an integral part of the economic reforms programme. This is because in the pre-Reform era, tax policies in India as in many other countries had retarded growth as a result of creating distortions in the allocation of resources and adversely affecting incentives. The tax systems that had evolved over the years had also become complicated, while there was no sufficient modernization of the tax administration. Consequently, tax compliance and tax enforcement had become extremely difficult. Much of the national resources were being used up for compliance as well as in enforcement.

A tax system is intended to bring in revenues to the government, but tax revenues can be raised in many ways. The theory of taxation deals mainly with the question of what would be the best and proper way of raising taxes for the government. The features of a good tax system-
- should be fair or equitable.
- should cause the least possible harmful effects to the economy and to promote its growth to the extent possible.
- should be simple both for administration and compliance; and
- should be income-elastic.
Again, the most important criteria of taxation are those of equity and economic rationality. However, the extent to which these criteria can be fulfilled may be limited by the requirement of simplicity and income elasticity. Everyone would agree that a system that is put forward should be administrable. The characteristic of income elasticity is also important because we really need a system which will automatically generate more revenues as the economy grows.

It is generally agreed that since taxes are unilateral payments for which there is no direct quid pro quo, citizens should be required to pay taxes on the basis of a rule of equity; and that rule may be the principle of ability to pay. An individual’s ability to pay can be measured on the basis of his income or his consumption. However, owing to constraints in measuring the total annual consumption of an individual in practice, a direct personal consumption tax is not being levied in any country now. Furthermore, in a country like India, where the majority of the population has rather low incomes and consumption, we can rely only on indirect taxes for taxing that section of the population. Hence, we need to have a combination of an income tax to be levied on the better off individuals and a tax on consumption on all citizens to be measured indirectly through the expenditure on goods and services.

As is well known, taxes tend to affect economic incentives, willingness to work and earn, willingness to save, willingness to take risk, etc. Very high rates of personal income tax, for example, can alter the choice between leisure
and work, between savings and consumption or between risky and safe occupations/investments. As regards indirect taxes, taxation of consumer goods and exemption of capital goods would tend to promote investment. This may be desirable in the overall social interest.

**Indirect Taxes System in India**

Sales tax in India was introduced for the first time by the then C.P. & Berar Province (now known as Madhya Pradesh State) in 1938. The nomenclature of the tax was “Petrol Tax”. However, Madras was the State which made the first legislation in the field of sales tax known as Madras General Sales Tax Act, 1939. Subsequently, by the year 1948 almost all the States enacted laws for taxing the sales and purchases of various commodities. Under the government of India Act, 1935, the power to levy tax on the sale of goods was given to the states under entry 48 of the list II of the seventh schedule which reads as under:

“Taxes on the sale of goods and on advertisements”.

When the Constitution of India was adopted, the States were empowered to levy tax on the sale of goods under entry 54 of list II to the VIIth schedule. Thus, the States were authorized to levy tax on the sales and purchases of goods, as also on the advertisement. Within indirect taxes, the central government is assigned mainly excise and customs duties and the tax on railway fares. The States have been given the power to levy excise on alcohol, sales tax, octroi, electricity duty, entertainment tax and tax on passengers and
goods carried by road or inland waterways. The local bodies, however, do not have constitutional powers to levy any tax. The only powers they have are delegated by State governments, which retain control over the structure of such taxes. Among the delegated powers lie the octroi and property tax.

At the time of independence, the central government levied excise duties on only about a dozen articles including motor spirit, tobacco, salt and matches. By and large, inputs into production were out of the excise tax net. Since excise was levied only on a limited number of goods, the inherent problems of an excise tax at the manufacture’s level were not very apparent or troublesome. However, in the post independent era, as revenue requirements began to mount and domestic output from protected industries increased, excise duties gradually extended to cover more and more commodities, both inputs and final goods. Then the shortcomings of a cascading type of tax on gross value of output of goods confined to the single stage of manufacture became manifest.

Meanwhile, the sales taxes levied by the State governments have also steadily increased in importance. Their coverage had by the 1970s been extended to include not only consumer goods but also new materials and components and other inputs that go into the production of consumer goods as well as capital goods. The rates of sales taxes, which were moderate originally, had also been raised substantially. The system of levy of sales tax varied across the States – some had the first point while others had the last point sales tax or a turnover tax. A mixture of these types was also found in several States.
In addition to the sales tax, in several states, the octroi or equivalent entry tax being a duty on goods entering a local area for consumption or use was levied.

Obviously, these three taxes fell on overlapping bases and led to cost escalations, distortions and unplanned and uncontrolled total incidence on different products. Realizing that a reform of the indirect tax system had become necessary, the central government appointed an Indirect Taxation Enquiry Committee in 1976 under the chairmanship of L.K. Jha to make recommendations on a thorough overhaul of the system of indirect taxes. The committee, which submitted its final report in 1977, recommended that the central excise be gradually transformed into a value added tax at the manufacturer’s level (with zero rating of exports), while the states were advised to adopt a retail sales tax. No important action was taken on the recommendations of the committee either by the central government or the State governments until 1986. Meanwhile, rates were raised or changed almost every year in quest of revenues. On the other hand, rate competition on particular commodities began to take place among the States. The rate of Interstate Sales Tax (IST) had reached the level of four per cent leading to high tax exportation and further cascading.

The first major act of reform at the central level was undertaken in 1986 through the introduction of the scheme of Modified Value Added Tax (MODVAT) under central excise, under which manufacturers could get credit for taxes paid on inputs against the tax payable on output. All goods, however,
were not covered by the MODVAT scheme and originally the duties paid on plant and machinery (capital goods) was not eligible for credit. Further reforms had to wait until the initiation of overall Economic Reforms in 1991.

On the recommendations of the Tax Reforms Committee further reforms were carried out in the system of excise taxation. The system of MODVAT credit was extended to more goods (with the notable exception of textiles, petroleum products and tobacco) and in 1994-95 MODVAT credit was made available to the tax paid on machinery. With this step, the problem of cascading under excise taxation has been reduced significantly and the Indian industry has been relieved of a considerable handicap in their competition with foreign producers. Whereas formerly, the cost structure was affected by the fact that at every stage of production a non-rebatable sales tax was to be paid, now with the introduction of MODVAT at least the excise is rebated throughout.

No comparable reforms have taken place in the area of State sales taxes. Sales tax is a tax levied when goods are either sold or purchased. The tax is levied on and collected from the seller or the purchaser. In fact sales tax is a tax on a single transaction; sale and purchase are merely two sides of the same coin. The only difference is that sales tax is levied on the seller while purchase tax is levied on the buyer. The buyer may be a manufacturer or last purchaser within the State effecting sale to outside the State. Whether the tax is collected from the seller or the buyer, its ultimate burden or incidence falls on the consuming public. The reason is that the tax element is added to the price, tax
being an addition to the cost. Sales tax is a regressive tax. The burden is more on the poor than on the rich. Income tax, on the other hand, is a progressive tax; the rate of levy rises with the income. Sales tax is also called an indirect tax in contradistinction to direct tax. Its incidence is passed on to the consumer. The consumer is not often conscious of its rigour as the tax element is assimilated into the price.

Over the years, the uncoordinated and independent development of the sales tax systems by the different States led to increasing complexity, rate and procedural differences, tax exportation and tax competition. Economic efficiency considerations had little role in the formulation of tax structure.

The major characteristics of the State sales taxes as they existed at the beginning of the 1990’s include:

1. Initially, the system of sales taxation took two main forms: the multi point system and the last point system. By the end of the Eighties most States had gradually shifted to the first point tax, i.e. tax levied only on the first sale in the State, usually by a manufacturer or the importer. However, in order to raise additional revenue several States levied additional tax or surcharge on selected dealers and /or a turnover tax at a low rate. A few states like Punjab stuck to the last point system. While the main form in most States was the first point, there were usually some commodities that were subject to tax at other points.
2. Since the maximum rate of inter-state sales tax had been fixed at four per cent, the states brought down the rate of tax on current inputs bought by manufacturers generally to four per cent.

3. There was multiplicity of rates with a large spread.

4. There were a large number of exemptions.

5. Apart from general exemption, the States provided for industrial incentives in the form of sales tax exemption or deferral for a specified period, which resulted in unproductive inter-State competition.

6. Inter-State competition led to “rate wars” between the States.

7. Because of the diversity in structure, rates and procedures, there were severe problems of compliance for trade and industry.

During the Nineties, the States introduced some reform measures. For example, the number of rates has been reduced in several States. In some States, the rate of tax on some inputs was reduced to a rate below four per cent. The multipoint tax has been given by some of the States, which had levied it earlier. In a few states an attempt was made to introduce the principle of VAT to a limited extent, but the attempt was given up everywhere.

It can be said that there has not been much progress in the reforms of the structure of sales taxes. The state sales taxes, being levied on gross value at successive stages of production, lead to considerable cascading, except in Haryana, Himachal Pradesh and Punjab where manufacturers can buy inputs including capital goods free of tax. The consequences of cascading include:
1. Cascading results in higher levels of cost of production in the economy. Since cascading results when inputs of a business are taxed and no set-off is available when computing the tax due on the output sold, such a tax inflates the input costs of the business both directly and through inflated interest cost for financing the business activity. Higher costs imply higher prices for the output along the chain of production. This puts the domestic industry at a disadvantage against imports as well as in the export market.

2. Mark-up pricing accentuates this problem. Since the mark-up, under such a pricing rule, is on total cost, the resultant price will include a mark-up on the tax component of cost as well.

3. Tax exportation with cascading, since the taxes on inputs get embedded into the costs of production, the price of output is correspondingly higher. Consequently, in the event of sale of such commodities outside the boundaries of the State, either through export out of the country or through the inter-State trade, the taxes on inputs are ultimately at least partially borne by the purchaser, i.e. an entity outside the State. In other words, there is “tax exportation” even when the commodity being exported is not subjected to tax.

This process has three adverse consequences, viz.

a) International competitiveness of the domestic industry is undermined, because of high costs and resultant high prices.
b) Tax exportation in inter-state trade acts as a barrier to such trade. With higher costs, trade will be reduced, other things being equal.

c) Furthermore, tax exportation enables one State to impose taxes on the residents of the other states. Taxation of inter-state sales in the form of central sales tax considerably worsens the situation.

In addition to the problems resulting from cascading, both the first point and the multipoint tax induce vertical integration. Since the tax applies to sales, the firm has an incentive to vertically integrate its activities to reduce the number of sale transactions and to minimize the payment of tax.

There is gain from integration in terms of saving of tax, whatever be the rate of tax. Under the first point tax, there is an incentive to integrate the various stages of manufacture and under the multipoint or turnover tax; there is an incentive to integrate, wherever possible, all along the production and distribution line.

Further, under the first point tax, since the subsequent sales are not subject to tax, there is an incentive to the producer to shift value added to those stages, in order to avoid or minimize the burden of the tax as a proportion of prices. While this does not directly distort production decisions, a bias is created by the first point tax in favour of goods in respect of which there is greater proportion of value added at the later stages.
Under the first point tax as well as the multipoint tax, the effective rate of tax on any commodity is a weighted average of the rates of the tax on the inputs and on the commodity itself. The rate applied at the final stage is, therefore, no indication of the actual effective rate on the commodity. Thus, it is not easy to determine the effective incidence of tax by different consumption income groups. This means that, if a government aims at a progressive tax system, it is ill equipped to design such a system with first point or multipoint taxes, even with multiple rates.

Since each of the States operates its own system of taxes, the result is that any single commodity could be taxed at completely different rates across the States. This encourages the States to indulge in tax competition, which triggers off a rate war and results in loss of revenue to the tax departments, with not much change in the aggregate level of economic activity in the national economy. This process is aggravated by competition in tax exemptions and concessions in order to attract investment into the State.

As with any tax, there are grey areas in the structure of sales tax as well. The approach so far has been to use section/chapter notes to provide clarifications. Generally, this process has generated a very complex legislation, in many cases introducing also a significant amount of irrationality in many a case. This simply compounds the complexity in legislation, and enlarges the scope for disputes and uncertainty. Conflicts arise not only over whether or not certain sales/activities should be subject to the tax, but also over which tax rate
should be applicable. In most of these cases, judicial rulings generate “notes” to the law, which constitute piece-meal changes, without necessarily addressing the root cause. In some instances, it also compounds procedural complexity. In the process, a system with high cost of compliance and enforcement gets generated with high uncertainty both for the tax authority and the tax payer.

Another feature of the sales tax system has been the presence of a large number of rates. This, along with the problems of exemption and other concessions, once again widens the area for dispute and makes compliance very expensive and administration difficult. The recent agreement between the States to harmonic tax rates by fixing floor rates for sales tax and to phase out sales tax incentives to new and expanding industrial units makes a significant reform in this area. In this context, the reform of the sales tax has to concentrate on the following:

1. Total removal of cascading through full rebate of tax on inputs;
2. Zero rating of inter-state sales;
3. Reduction in the number of rates and adoption of at least uniform floor rates for specified groups of commodities;
4. Reducing the number of exemptions to a few items of goods;
5. Phasing out sales tax incentives and
6. Extending the tax to resellers on a value added basis.
Value-Added Tax (VAT)

VAT, as the term suggests, is a tax on the value added to the commodity at each stage in the production and distribution chain. The production-distribution chain, popularly known as supply chain in the modern day system, starts from manufacturer producing an item. This item passes through various agencies like distributor, wholesaler and retailer, before it reaches the final consumer. The value added at each stage in the supply chain is determined by the difference in the sale prices of that entity and purchase values of bought out items of the same.

In contrast to the existing system of taxation of goods and services at single or multiple points, VAT is a tax levied on the commodity or service at each point of value addition. Under this system, tax is collected on a commodity or service on a piecemeal basis starting from the producer to the retailer. The total tax collected by the government on a commodity or service under the VAT system will be exactly equal to the tax collected on the retail-selling price of the product or service by the retailer. At each stage, starting from the producer, tax will be collected on the sale price at the rate applicable to the commodity. From the tax so collected, the seller will retain the amount of tax paid on purchases and remit the balance alone to the government. This process will continue till the commodity or service reaches the final consumer. In this system, the tax remitted to the government at each stage will be the tax on the value addition to the product or service made by the seller. Thus, a value added tax is a tax levied on the value added to a commodity or service as
it passes through different stages of production and distribution, until it reaches 
the final consumer.

Historical Background

The origin of VAT can be traced back to the first quarter of the 20th 
century. The concept of VAT was born in 1921 in Germany, when F. Von 
Siemens proposed VAT as a substitute for the then newly established German 
Turnover Tax. Later the European Economic Community (EEC) accepted 
VAT as an instrument of tax harmonization. In 1954, France became the first 
country in Europe to adopt VAT. The popularity of VAT went on increasing 
and many non-EEC countries like Finland, Greece, Turkey and some Latin 
American countries like Brazil and Mexico adopted the system. At present 
there are more than hundred and thirty countries following the system, 
including our neighboring countries like Bangladesh, Sri Lanka, Nepal and 
Pakistan. 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.

Theories of Taxation Justifying VAT

The imposition of VAT is based on the theories listed below:
1. **General Welfare Theory (GWT)**

   GWT postulates that tax is collected from the citizens as a price for the general welfare services performed by the State. These services are enjoyed by the citizens either in their capacity as consumer or producer. This theory assumes that:

   a) Benefits of general welfare services can be allocated among citizens.
   b) Recipients of benefits should be made to pay for them, and
   c) Tax is equivalent to the price for the general welfare services.

   Thus, GWT applies the cost-benefit technique, justifying VAT. GWT has serious limitations, as it is impracticable to identify and to allocate the benefits of State services. Hence, the levy of VAT cannot be justified according to this theory.

2. **Social Expediency Theory (SET)**

   SET represents that a general business tax is more expedient and advantageous to be imposed than other taxes. General business tax is imposed for the following reasons:

   a) Business taxes are the appropriate sources of revenue
   b) Administration of these taxes is comparatively easy.
   c) The businessmen do not oppose the imposition of this tax more strongly as they hope to pass on the burden of these taxes to the consumer.
d) As regards the consumers, they are ignorant of the final burden on them, and even if they are aware of, the full extent of the burden will not be taken in.

This theory cannot be regarded as an appropriate base to justify VAT due to its unrealistic assumptions like the prevailing distribution of income is just. This theory also lacks conceptual clarity, as the term ‘expediency’ is too vague to define. Rather than a precise theory, social expediency theory can be termed as an opportunistic theory, due to its supporting of different bases at different times.

3. **General Benefit Theory (GBT)**

GBT postulates that the Government acts as a factor of production for the business community. Therefore, the value added by each producer includes the cost of services rendered to the State also. Taxes are the cost of services recovered by the State from the citizens. It is also states that the value addition by individual firms provides an objective index to the extent of utilization of these services. Thus the costs can be allocated on the basis of value added. There are two versions for this theory-

According to the first version, the State is a partner of the business, actively participating in the business. As such, the State is also entitled to its due share of profits earned, which is collected through taxation. As per this version, the primary object of State’s participation is to help the producing
community, while earning profits out of such business is only incidental. Here, if the enterprise operates on the dark side, the State is denied of its share for the services being rendered. The second version assumes that the State is only an external agent supplying services to the enterprise. As an external agent, the State is not bothered whether it makes profit or incurs loss. The State is entitled to the payment thereof for the cost of services. The cost of services of the State is utilized by the enterprise in relation to the size and value of operations.

Both the above versions are skeptic in the sense that it is difficult to assess the benefits of government services and also impossible to allocate them to different enterprises. Also, the State will take a risk aversion attitude in the case of production processes of venture type, unlike in the case of usual production process.

Considering the above difficulty in cost allocation and the risk aversion nature of the State, the second version forms an absolute basis for justifying VAT. A greater part of the State activity is concerned with the development and efficiency of the business community at large. The services rendered by the government to the business community constitute a significant factor of production. The value added tax, which is based on the value addition of each enterprise, is a return for the services of the State as an agent who supplies services. Thus GBT, especially its second version, forms an ideal basis for the justification of VAT.
VAT in Other Countries

Interest in VAT has waxed and waned over the years and, of late, it has again emerged as one of the most important fiscal innovations of the century, evident from the fact that more than 130 countries have already adopted this form of tax and many more countries are going to switch over to it in the years to come.

The rationale for the adoption of VAT lies in the fact that it is considered a relatively superior form of tax. It avoids cascading, has a simple structure, does not distort the allocation of resources, and is neutral among labour-incentive and capital-intensive techniques.

1. European Union Value Added Tax

The European Union Value Added Tax (EUVAT) is a value added tax encompassing member states in the European Union Value Added Tax Area. Joining in this is compulsory for member states of the European Union. As a consumption tax, the EUVAT taxes the consumption of goods and services in the EUVAT area. The EUVAT’s key issue asks where the supply and consumption occurs, thereby determining what member state will collect the VAT and what VAT rate will be charged.

Each member state’s national VAT legislation must comply with provisions of EUVAT law as set out in Directive/2006/112/EC. This directive sets out the basic framework for EUVAT, but does allow member states any
degree of flexibility in implementation of VAT legislation. For example, different rates of VAT are allowed in different EU member states. However, directive 2006/112 requires member states to have a minimum standard rate of VAT of 15% and one or two reduced rates not below 5%. Some member States have 0 % VAT rate on certain supplies- these member States may have agreed to this as part of their EU Accession Treaty. The current maximum rate in operation in the EU is 25%, though member states are free to set higher rates.

VAT that is charged by a business and paid by its customers is known as “output VAT” (i.e. VAT on its output supplies). VAT paid by a business to other businesses on the supplies it receives is known as “input VAT” (i.e. VAT on its input supplies). A business is generally able to recover input VAT to the extent that the input VAT is attributable to its taxable outputs. Input VAT is recovered by setting it against the output VAT for which the business is required to account to the government, or, if there is an excess, by claiming a repayment from the government.

The VAT directive required certain goods and services to be exempt from VAT (for example, postal services, medical care, lending, insurance and betting) and certain other goods and services to be exempt from VAT, but subject to the ability of an EU member State to opt to charge VAT on those supplies (such as land and certain financial services). Input VAT that is attributable to exempt supplies is not recoverable; although a business man can
increase the prices of his products, it is the customer who has to bear the cost of the ‘sticking’ VAT (the effective rate will be lower than the headline rate and depend on the balance between previously taxed input and labour at the exempt stage).

In Denmark, VAT is generally applied at one rate and with few exceptions is not split into two or more rates as in other countries (example, Germany), where reduced rates apply to essential goods such as foodstuffs. The current standard rate of VAT in Denmark is 25%. This makes Denmark one of the countries with the highest value added tax, alongside Norway and Sweden. A number of services are not taxable, for instance public transportation of private persons, health care services, publishing newspapers and travel agency operations.

In Finland, the standard rate of VAT is 22%, but will rise by one percentage point to 23% in July 2010, along with all other VAT rates, excluding the zero rates. In addition, two reduced rates are in use: 12% (reduced in October 2009 from 17% for non-restaurant food, from July 2010 will encompass restaurant food also), which is applied on food and animal feed, and 8%, which is applied on passenger transportation services, cinema performances, physical exercise services, books, pharmaceuticals, entrance fees to commercial cultural and entertainment events and facilities. Supplies of some goods and services are exempt under the conditions defined in the Finnish VAT Act: hospital and medical care; social welfare services;
educational, financial and insurance services; lotteries and money games; transactions concerning bank notes and coins used as legal tender; real property including building land; certain transactions carried out by blind persons and interpretation services for deaf persons. The seller of these tax-exempt services or goods is not subject to VAT and does not pay tax on sales. Such sellers therefore may not deduct VAT included in the purchase prices of their inputs.

In Iceland, VAT is split into two levels: 24.5% for most goods and services but 7% for certain goods and services. The 7% level is applied for hotel and guesthouse stays, license fees for radio stations (namely RUV), newspapers and magazines, books; hot water, electricity and oil for heating houses, food for human consumption (but not alcoholic beverages), access to toll roads and music.

In Norway, VAT is split into three levels: 25% is the general VAT, 14% (formerly 13%, up on January 1, 2007) for foods and restaurant take-out (food eaten at a restaurant has 25%), 8% for person transport, movies tickets, and hotel stays. Books and newspapers are free of VAT, while magazines and periodicals with a less than 80% subscription rate are taxed. Svalbard has no VAT because of a clause in the Svalbard Treaty. Cultural events are excluded from VAT.

In Sweden, VAT is split into three levels: 25% for most goods and services including restaurants bills, 12% for foods (incl. bring home from
restaurants) and hotel stays (but breakfast at 25%) and 6% for printed matter, cultural services, and transport of private persons. Some services are not taxable, for example education of children and adults in the case of public utility, and health and dental care, but education is taxable at 25% in the case of courses for adults at a private school. Dance events (for the guests) have 25%, concerts and stage shows have 6%, and some types of cultural events have 0%.

2. Gulf Cooperation Council (GCC)

With increased growth and pressure on the GCC’s governments to provide infrastructure to support growing urban centers, the Member States of the Persian Gulf Cooperation Treaty, who together make up the Gulf Cooperation Council (GCC), have felt the need to introduce a tax system in the region. In particular, the United Arab Emirates (UAE) has clarified that government officials are studying the situation and considering implementation of a Value Added Tax.

3. Mexico

Impuesto al Valor Agregado (IVA, “value-added tax” in Spanish) is a tax applied in Mexico and other countries of Latin America. In Chile, it is also called Impuesto al Valor Agregado and in Peru it is called Impuesto General a las Ventas or IGV.

Prior to the IVA, a similar tax called impuesto a las ventas (“sales tax”) had been applied in Mexico. In September, 1966, the first attempt to apply the
IVA took place when revenue experts declared that the IVA should be a modern equivalent of the sales tax as it occurred in France. At the convention of the Inter-American Centre of Revenue Administrators in April and May, 1967, the Mexican representation declared that the application of a Value Added Tax would not be possible in Mexico at that time. In November, 1967, other experts declared that although this is one of the most equitable indirect taxes, its application in Mexico could not take place.

In response to these statements, direct sampling of members in the private sector took place. This tax was applied or it was soon to be applied to field trips to the European countries. In 1969, the first attempt to substitute the mercantile-revenue tax for the value-added tax took place. On December 29, 1978, the Federal government published the official application of the tax beginning on January 1, 1980 in the Official Journal of the Federation (Diario Oficial de la Federacion).

As of 1st January 2010, the general 15% VAT rate will be increased to 16%. This rate is applied all over Mexico, except for the Mexican region bordering the US states of California, Arizona, New Mexico and Texas, where the VAT (IVA) tax is 10% (to be raised to 11% as of 1st January 2010). The main exemptions are books, food and medicines on a 0% basis. Also some services are exempt like medical doctor’s attention.
4. New Zealand

Goods and Services Tax (GST) is a Value Added Tax introduced in New Zealand in 1986, which is currently 12.5%. It is notable for exempting a few items from the tax.

5. Australia

Goods and Services Tax (GST) is a Value Added Tax introduced in Australia in 2000, which is collected by the Federal Government, but given to the State governments. The Australian Constitution restricts the ability of individual States to collect excises or sales taxes. Whilst the rate is currently set at 10%, there are many domestically consumed items that are effectively zero-rated (GST-free) such as fresh food, education, and health services; as also exemptions for government charges and fees that are themselves in the nature of taxes.

6. Canada

Goods and Service Tax (GST) is a Value Added Tax introduced by the Federal Government in 1991 at the rate of 7%. The rate is currently 5% and is imposed in addition to provincial sales taxes, except in Alberta, where there is no provincial sales tax; and in New Brunswick, Newfoundland and Nova Scotia, where a Harmonized Sales Tax (5% GST + 8% PST = 13% HST) (combined GST and provincial sales tax) is collected. The Provinces of British Columbia and Ontario are planning to harmonize their provincial sales taxes with the GST effective July 2010.
7. United States

Most states have a retail sales tax charged to the end buyer only. Unlike in the VAT, sales to other businesses are untaxed. State sales taxes range from 0%-13% and municipalities often impose an additional tax in the form of a local sales tax. In many states, the price tags and/or advertised prices do not include the taxes, and the taxes are added at the cash register before the customer pays. In some States, no sales tax is charged for services. This is a key difference between most sales taxes levied throughout the United States and the value added tax system in many other countries.

In the United States, the State of Michigan used a form of VAT known as the “Single Business Tax” (SBT) as its form of general business taxation. It is the only State in the United States to have used a VAT. When it was adopted in 1975, it replaced seven business taxes, including a corporate income tax. On August 9, 2006, the Michigan Legislature approved voter-initiated legislation to repeal the Single Business Tax, which became effective January 1, 2009.

House Speaker Nancy Pelosi stated in October of 2009 that a new, national VAT was “on the table” to help the federal government garner needed revenues. Following this the Americans for Tax Reform Group urged the public to contact their members of Congress to oppose this potential measure.
8. South and East Asia

South and East Asia are particularly fast developing world economic areas, and are becoming increasingly more economically integrated. These countries, however, are not homogeneous, and are lacking in any supranational Authority. The total fiscal pressure of South and East Asian countries looks somewhat low when compared to that of countries with a similar per-capita income, pertaining to other economic world areas. However, a smooth Wagner law is confirmed by the data so that fiscal pressure is destined somewhat to increase as growth continues. With regard to similar experiences of developing and transition countries, indirect taxes prevail over direct ones. Low tax wedges on labour improve efficiency, by inducing both the supply and demand of labour. The heavy burden on consumption lessens equity and increases welfare losses.

Any further uniform analysis of South and East Asian countries’ tax policy issues would however be quite fruitless. It is far better to consider tax policies issues which rise inside the whole area separately from those more specific to each cluster made up by similar countries. Infra-regional economic integration poses severe challenges to the tax structure in the Asian area. Three tax policy issues seem most problematic: the building of intra-countries agreements on reducing trade tariffs; the sequential revenue consequences of reduction in foreign trade taxes; the increasing tax competition for FDI. Intra-countries clusters’ tax policy issues differ from each other. In Japan and in S. Korea different choices have been made regarding the comprehensiveness of
the PIT’s basis, whose burden as a consequence ends up being more fairly
distributed in S. Korea. The two countries are facing the common problem of
an ageing population and consequently, social contributions, and eventually
VAT are being raised. Malaysia’s direct taxes look higher than Thailand’s, but
this is only because of the taxation of oil companies. Thailand has adopted
VAT, while Malaysia has not changed its traditional sales tax. Both the
countries are engaged in the recovery of revenue by improving tax
administration. Both in China and in India income tax are light and poorly
redistributing. Also, India has just moved from a scheduler to a comprehensive
tax basis. VAT is well established in China, while it is just arriving in India, as
a consequence of a long awaited but challenging reform, especially regarding
the tax relationships among various levels of government. Taxing power is now
more centralized in China, but this needs to be corrected in order to avoid a
lack of accountability on the part of the provinces.

9. ASEAN Countries

Among the ten member-countries of the ASEAN, five countries are
introducing the VAT. With the recent abolition of the highest 20% VAT rate
for Vietnam, the Philippines now has the highest standard VAT rate of 12%. In
the case of Indonesia, it has a regular VAT rate of 10%, but it could go to as
low as 5% or to as high as 15% with just the issuance of a government
regulation. Cambodia also imposes a standard rate of 10%, while Thailand
imposes the lowest VAT rate at 7%.
Generally, these VAT-imposing ASEAN countries impose a 0% VAT rate on export. With regard to VAT exemptions, Vietnam has the least number of transactions. This is probably due to its multi-tiered VAT structure that covers more goods and services. The rest of the ASEAN countries do not impose VAT, but collect business taxes in the form of sales and business taxes; goods and services taxes (GST); turnover tax; and commercial tax. The rate ranges from as low as 5% to as high as 200%. It is only Brunei Darussalam that has no VAT or VAT-like imposition.

**VAT in India**

The Maharashtra State was the first to adopt the VAT system under the sales tax law. In Maharashtra, the system has been in operation since 1960, in a limited form of set off. Under its provisions, manufacturers and certain dealers were entitled for set off, in specific circumstances. The scheme was expanded in 1981 under which full set off was made available to manufacturers of specified products like iron and steel, non-ferrous metals, and partly for other products. The majority of the States had worked out systems to reduce the cascading effects of taxes on prices. In 1994 National Institute of Public Finance and Policy (NIPFP), New Delhi, conducted a study on VAT and submitted its report recommending introduction of VAT in the country. The Empowered Committee of the State Finance Ministers constituted by the Ministry of Finance, government of India, on the basis of the resolution adopted at the conference of the Chief Ministers on November 16, 1999 under the chairmanship of Asim Das Gupta came out with a White Paper on state-
level VAT, which was released on 17th January 2005 by P. Chidambaram, the Finance Minister, government of India and decided to implement the Value Added Tax in all states w.e.f. 1st April 2005.

The Finance Minister P. Chidambaram in his budget 2005-2006 speech made on 28th February 2005 submitted the VAT proposal as under:

“In a remarkable display of the spirit of co-operative federalism, the States are poised to undertake the most important tax reform ever attempted in this country. All States have agreed to introduce the Value Added Tax (VAT) with effect from April 1, 2005. VAT is a modern, simple and transparent tax system that will replace the existing sales-tax and eliminate the cascading effect of sales-tax. It is in force in more than 130 countries ranging from Sri Lanka to China. India too has a VAT at the Central Level (CENVAT), but only for goods. In the medium to long term, it is my goal that the entire production distribution chain should be covered by a national VAT, or even better, a goods and services tax, encompassing both the Centre and the States. The Empowered Committee of State Finance Ministers, with the solid support of the Chief Ministers, has laboured through the last 7 years to arrive at a framework acceptable to all States. The Central government has promised its full support and has also agreed to compensate the States, according to an agreed formula, in the event of any revenue loss. I take this opportunity to pay tributes to the Empowered Committee, and wish the States success on the introduction and implementation of VAT.”
Objectives of VAT

The existing tax system in India is accused of various drawbacks like cascading effect, multiple tax rates, complex administration, excessive exemptions, etc. Implementation of a Value Added Tax System is expected to get rid of this defects and move towards a self complying, self-policing tax regime. A Value Added Tax System seeks to attain the following objectives from its implementation.

1. Overcome the Cascading Effect of Taxation

In the existing sales tax structure, there are problems of double taxation of commodities and multiplicity of taxes, resulting in a cascading tax burden. For instance, in the existing tax structure, before a commodity is produced, inputs are first taxed and then, after the commodity is produced with input tax load, output is taxed again. This causes an unfair double taxation with cascading effects. On the other hand, the goods which are taxed at a single point cause loss of revenue to the exchequer, by not taxing the value addition at subsequent points. Hence in both the cases, the system is not justifiable.

In order to avoid this cascading or pyramiding effect of taxation, VAT seeks to tax goods and services on the basis of value additions made at different points along the supply chain. The cascading effect is eliminated by giving credit for the tax paid on inputs while calculating the tax payable on output. With the introduction of VAT, the other taxes like turnover tax, surcharge on
sales tax, etc. are also abolished. In addition, central sales tax is also going to be phased out.

2. Diluting the Complexity of the Tax System

In the present system, there are multi rates and innumerable concessions/exemptions leading to classificational problems of commodities and sectors which in turn breed disputes and corruption. Besides, there are different types of tax such as entry tax, purchase tax, turnover tax, etc. This leads to definitional problems and ultimately to tax evasion. The legislation dealing with the tax is also very complex. This complexity is further vitiated by frequent amendments. This results in higher interference by the judicious and piecemeal changes to the law. This increases the complexity of the system and the more complex the system is, the lesser the transparency is. Under such a system, the cost of compliance will go up and enforcement becomes difficult.

The above problems of the existing system are overcome by introducing VAT across the country. A uniform simple and transparent legislation which is certain, finite and free from complications is to be implemented in all States. Under the VAT regime, no tax exemptions/concessions will be given, leaving no room for classificational problems and ambiguity. The number of rates in a VAT system will be reduced to the minimum and the variants of tax will also be reduced.
3. Reduction of Tax Evasion

The scope for tax evasion is considerable in the present system of taxation, which levies tax at single points and has cascading effects. According to some studies relating to sales tax evasion in India, the evasion ranges between 5% and 85% of the base depending upon the type of commodity. Different States have different tax rates on the same goods and it leads to smuggling/tax evasion which requires stringent check post regulations. Moreover, rather than encouraging self-compliance, the present tax system is regarded as an imposed one. It has no incentives for the honest taxpayer, in given the rampant scope for evasion and corruption.

The levy of tax in a VAT regime will be on an installment basis. As VAT insists on producing the tax invoices for claiming set off against the tax payable on sales, it forces all the levels to pay tax, thereby bringing in self-enforcement of tax payment. Self-compliance is encouraged in the system as it is based on self-assessment of the assessee. Moreover, the legislation is made uniform, simple and transparent across the States, leaving no room for smuggling due to rate disparities.

4. Widening of Tax Base

Most of the prevailing sales tax systems in the country tax the majority of goods at the first point of sale. Consequently, subsequent sales in the State are not charged to tax. The tax base, as a result, is narrower, as tax is levied only at the origin. A narrow tax base, forces the State to resort to additional
levies like the additional sales tax, surcharge, turnover tax, etc. frequently making the system arbitrary, non-transparent and high tax incident.

As VAT is a destination-based tax, which is collected on the same goods at different stages, all the links in the supply chain are brought to the tax net. This in turn broadens the tax base and hence revenue collections.

5. Augmenting Revenue Collections

The existing system of commodity taxation creates avenues for evasion of tax, mainly because the tax collection machinery is concentrated in the initial stages of transactions, i.e. at the manufacturing at the wholesale level. Evasion of tax is primarily possible, because the first dealer is the only entity answerable to the government. Once the first dealers escape the system through bogus transactions, there is no trace of tax liability in the entire chain of transactions.

Under a VAT regime, the government will receive its due tax at different stages all in the supply chain. The possibility of revenue leakage is reduced to the minimum, since the tax credit will be given only after the proof of tax paid at an early stage is produced. This means that if tax is evaded at one stage, full tax will be recoverable from the person at the subsequent stage or from a person unable to produce proof of such tax payment. This self-enforcing character of VAT pushes up the government revenue.
Advantages of VAT Over Conventional System of Taxation

The growing popularity of VAT is due to its simple tax structure and transparency. VAT has a novel advantage of transparency of incidence of tax, as the tax component in any transaction is easily identifiable/computable. So it is easy to analyze the tax effect on various investment/economic decisions of the producers or consumers.

Even if tax is levied at every stage, it avoids cascading effect. This is because a dealer gets full credit (i.e. set off) of tax paid on his purchases. It is also neutral regarding the choice of production technique as well as business organization. It also helps in better pricing of the products by the manufacturers/traders especially exporters; this would make their products more competitive.

Benefits of VAT

The concept of VAT is to bring in an equitable position for everybody in the trade including the consumer. The category and their benefits are given below:

1. Benefits to Manufacturers

Manufacturers will be benefited the most since they will be reimbursed fully for the tax paid on their purchases.
2. Benefits to Exporters

Those manufacturers, who export goods will also be benefited with zero rated exports since they will be reimbursed fully for the tax paid on their purchases within the State.

3. Benefits to Traders/ Retailers

The distributors/ retailers will have to pay tax on their profit margin instead of resale tax, as no input tax credit is allowed against resale tax paid. However, under VAT, everybody will have a tax credit and so the overall tax burden will be minimized.

4. Benefits to Consumers

There will be no hidden taxes thanks to transparency in the system. In view of standardization of VAT rates, it is possible that prices of some commodities will increase while prices of some commodities will actually be reduced. The prices of commodities in general are expected to go down in the long run.

White Paper on State Level Value Added Tax

The Empowered Committee of the State Finance Ministers issued a White Paper on State level VAT on January 17, 2005. The White Paper mentions the working out of the consensus on the VAT and strikes a balance between what is possible in the VAT regime to begin with and what can be improved upon in specific areas. The White Paper gives the justification for
The White Paper has set out the design of the State level VAT and has explained in detail the basic concept of VAT. It has also explained the set off mechanism. The White Paper sets the necessity of issuing the tax invoice in the VAT scenario and the accounts book if the goods are sold to other VAT dealers. The White Paper also spells out the threshold limit and also delegated to the State government to decide the threshold limit depending upon the VAT collection. The White Paper also describes certain procedures and methods which will be followed by the sales tax department in the country. The importance of filing a return in the VAT scenario is well recognized and the White Paper states that the return forms will be simplified.

The essence of VAT is self assessment. One of the welcoming features of the VAT system is abolition of declaration forms. The other taxes such as turnover tax, surcharge and additional sales tax would be abolished and a single VAT system would be applicable in most of the States. The penal provisions as existed in the sales tax law would continue in the VAT regime as well. However, they are not so stringent as what they were in the sales tax regime.

The central sales tax would continue to be levied on the inter-state transactions and will be phased out in the years to come. The decision on VAT
on imports and services, which the State governments are eagerly looking forward to, is also expected to be taken in due course.

The highlights on VAT as given in the White Paper are furnished below:

a) **Tax Credit:** Manufacturer will be entitled to credit of tax paid on inputs used by him for manufacture. A trader will be entitled to get credit of tax on goods which he has purchased for re-sale.

b) **Input Tax Credit:** Credit will be available on tax paid on inputs purchased within the State. Credit will not be available on certain goods purchased like liquor, petrol, diesel and motor spirit. Moreover no credit will be available in the case of inter-state purchases.

c) **Credit of Tax Paid on Capital Goods:** Credit will be available on tax paid on capital goods purchased within the State and used in manufacture or processing. The credit will be spread over three financial years and not in first year itself. There will be a negative list of capital goods.

d) **Instant Credit:** Credit will be available as soon as inputs are purchased. It is not necessary to wait till these inputs are utilized or sold.

e) **No Credit of CST Paid:** Credit of central sales tax paid on inputs and capital goods purchased from other States will not be available.

f) **Transitional Credit of Stock as on 1-4-2005:** Input tax as already paid on goods lying in stock as on 1-4-2005 (which are purchased on or after 1-4-2004) will be available to the dealer. Detailed stock statement will have to be submitted to sales tax authorities. This credit will be available over a period of six months after an interval of 3 months needed for verification.
g) **Very Few Sales Tax Forms**: Most of the present sales tax forms will disappear. However, forms relating to EOU/SEZ may continue. Forms under CST Act will also continue.

h) **One-to-One Correlation Not Required**: VAT does not require one to one i.e. bill to bill correlation between input and output. Credit is available as soon as inputs/capital goods are purchased. The credit can be utilized for payment of VAT on any final product.

i) **Policy regarding Turnover Tax, Surcharge, and Additional Tax etc. of the State Governments**: The above taxes will be abolished. However, octroi and entry tax (which is in lieu of octroi) will continue.

**Tax Rates under VAT**

There are only two basic rates 4 per cent and 12.5 per cent plus a specific category of tax exempted goods and a special VAT rate of one per cent only for precious stores, bullion, gold and silver ornaments, etc. Thus, the multiplicity of rates in the existing structure has been done away with under the VAT system.

**1. 4 Per Cent VAT Rate**

Under this category, there will be the largest number of goods (about 330) common for all comprising items of basic necessities, such as medicines and drugs, all agricultural and industrial inputs, capital goods and declared goods. Section 2(c) of the Central Sales Tax Act defines declared goods to
mean “goods declared under section 14 to be of special importance in inter-
state trade or commerce”.

2. **12.5 Per Cent General VAT Rate**

The remaining commodities in all the States will fall under the general 
rate of 12.5 per cent (residuary category).

3. **1 Per Cent Special VAT Rate**

The special rate of one per cent is meant for precious stones, bullion, 
gold and silver ornaments.

**Exempted Category under VAT**

Under this category, there will be about 50 commodities comprising the 
following:

- a) Natural and unprocessed products in the unorganized sector.
- b) Items which are legally barred from taxation.
- c) Items which have social implications.

Earlier the Empowered Committee has finalized a list of 36 
commodities. At a meeting held on 26th April 2005, the Empowered 
Committee added 14 more commodities in this category making a total of 50 
commodities under the exempted category. In all States, these commodities 
would be exempt from tax. In addition, the Empowered Committee has also 
finalized the list of local goods which are of local social importance for the
individual States. This list is also enlarged by adding seven more commodities. The State governments are authorized to exempt a maximum of 10 commodities flexibly chosen from the above mentioned list of goods.

Non-VAT Goods

Petrol, diesel, Aviation Turbine Fuel, other motor spirit, liquor and lottery tickets are kept outside the VAT. The States may or may not bring these commodities under VAT law. The Empowered Committee has decided to exempt food grains from VAT for the first year. As the food grains are classified as local goods the States have been given the option of keeping food grains in the exempted list or 4 per cent category.

Emergence of Goods and Services Tax (GST)

The next revolutionary reform in indirect taxes will be in the form of Goods and Service Tax, which will not only integrate goods and service tax structure but also integrate tax structures of the government of India and the State governments; this would result in removing distortions in the existing tax structure.

Several State level and Centre indirect taxes such as Value Added Tax, entry tax, tax on consumption of goods, luxury tax, entertainment tax, central sales tax, central excise duty, service tax and CEN-VAT on imports are likely to be subsumed in Goods and Service Tax. Besides, goods and service tax also aims at completing the process of destination-based tax. Tax base is also likely
to expand significantly in the case of number of goods and services under exempted category and /tax exemptions granted under Central and State laws, area based or goods and services based, are likely to be withdrawn prospectively. The basis of taxation is proposed to be shifted completely from the origin based to destination based tax besides tax incidence being shifted completely from manufacture to sale in the case of Central Excise Duty. At the same time, the cascading effect of various taxes will also go away and tax structure will become extremely transparent.