CHAPTER - I
INTRODUCTION

Economic development has been one of the most popular slogans in almost all the developing countries all over the world. Similarly, achievement of high rate of economic growth rate, reduction of income disparities and poverty, and improvement of living standard of people are some development strategies towards which most of the government efforts have been directed in developing countries.

It is known that government needs more revenue mobilization for overall economic development and state welfare. Besides this, for meeting day-to-day expenditure, the government also requires some sources of income which is called revenue.

The role of revenue in the development of a country is not less important than the role of oxygen for the existence of human body. In this context, a government needs to mobilize a lot of internal resources to fulfil its responsibility towards its nation and people. In a developing country like India, there is a necessity for raising a larger volume of funds for the development and administration expenses.

The revenue collection is a challenging task in itself which demands increasing necessity of regular expenditure in general and development expenditure in particular. However, resource mobilization is very low compelling the government to rely on foreign assistance. External assistance is uncertain, precarious, inconvenient and not conducive to the healthy and overall development. The foreign aids are not bad for economic
development of the nation per se. But the experience of the most of the developing countries shows that there are negative effects of increasing international grants and loans to finance the public development activities. Thus, the government should depend on its own resources for generating revenue in order to finance these regular and development activities.

The government can collect revenue from taxable and non-taxable sources. Tax is a key source for revenue generation and mobilization. Different persons have defined taxation in different ways. In this respect, it would be better to take the definition given by Prof. Seligman. In his words, “Tax is the compulsory contribution from a person to the government to defray expenses incurred in the common interest of all without reference to special benefit conferred.”

From the definition given above, it can be said that firstly, a tax is a compulsory levy and those who are taxed have to pay it without getting corresponding benefit of services or goods from the government. The taxpayer does not have any right to receive the direct benefit from the tax paid. Due to this compulsory nature, people have expressed different views in a satirical way about the taxation. In this respect, some say “Nothing is certain in this world but death and taxes”, some say “Death and taxes are both certain... but death is not annual”, while others say “Death means stopping to pay tax”. Here, it should be noted that all compulsory payments are not taxes. For example, fines and fees are also compulsory payments without having direct benefit to the payer but they are not taxes because the objective is not

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1 Essays in Taxation, p. 432.
to collect revenue but to curb certain types of offences. Secondly, the taxpayer cannot receive any quid pro quo for the payment of tax. The taxpayer does not receive equivalent benefit from the government. A tax is not a price paid by one for which he can claim for goods and services. The charge of price for goods and services by public authority is not a tax. Thirdly, the tax is paid to the government for running it. Fourthly, the amount is spent for common interest of the people. The tax is collected from haves and basically, spent for the interest of have-nots in the society.

In conclusion, it can be said that a tax is a liability to payee an amount to the state on account of the fact that the assessees have income of a minimum amount from certain specified sources or that they own certain tangible or intangible property or that they carry on certain economic activities or they consume certain goods and services which have been chosen for taxation.

Taxes are major fiscal policy instruments and important government policy tools have an important role in increasing the rate of capital formation and thereby a high rate of economic growth can be achieved. Increase in taxes may be directed to increase in saving through the postponement of consumption. The increase in saving means a higher volume of resource is available for making useful and productive investments. Taxation may also play a dual role. On the one hand, it may be used to make the maximum volume of resource available to the public sector. On the other hand, taxation may be used to promote useful investment in the private sector and to prevent
the resource from being dissipated over speculative and unproductive investment as well as over lavish and luxurious consumption. Thus, taxes in developing countries serve as the severe means of raising revenue. Therefore, taxation may be utilized by the government as an effective tool for giving incentive to the proper growth of saving, investment and gross domestic product.

Because there are so many effects of taxation, no single tax is completely perfect. Consequently, there must be a structure of taxation, combining a number of taxes, which the government can vary from time to time according to changes in emphasis on different objectives.

Tax is a permanent instrument for collecting revenues. It is a major source of revenue in developed world and has been appearing as an important source of revenue in the developing world like India as well. It has been an instrument of social and economic policy for the government. However, the objective of taxation has been different for different periods. In ancient times, its objective was to strengthen the muscle of the state by raising more revenues for mobilizing these in security to an individual and society from violence, invasion, injustice and maintaining public institutions which can never be for the interest of an individual.

In modern days, the objective of tax is shifted from the security perspective to the economic development. The modern objective of taxation is not only to maintain peace and security, but also to conduct development activities.
From the above facts, we can enumerate the objectives of tax as given below:

- To raise revenue for ensuring resource mobilization
- To distribute equally wealth and income in the society
- To encourage the production of certain products
- To encourage employment
- To ensure saving and investment
- To contribute to the enforcement of government policy
- To remove regional disparities and imbalances.

**Value Added Tax**

In developing countries like India, the role of indirect tax is seen to be more important. Of the indirect taxes, VAT is probably the best tax system and the most important innovation of the second-half of the twentieth century, which is considered as an effective means to collect revenue as a reformed sales tax of indirect tax system.

The lesson learnt from tax reforms in developing countries proves that VAT is the most important choice and ingredient of tax reform. It may be adopted by a developing country with no difficulty and is an important instrument for the mobilization of internal resources and the pressure of VAT on economic activities is minimal or not at all. The tax reform and adoption of VAT is, therefore, essentially connected with the efforts of many underdeveloped countries to achieve the goal of economic development.

**Justification of VAT in India** : Sales tax system in India has always been very dynamic and undergoing changes from time to time and quite often too frequently.
The system that was operating in Indian states was archaic, irrational and the most complex in the world. It interferes with the free play of market forces and competition, causes economic distortions and entails high cost of compliance and administration.

After independence of India in 1947, no serious efforts were made to reform the sales tax structure in India. But during the period un-coordinated and independent efforts were made by a few states, but these led to more complexity, rate and procedural difference and unhealthy tax competition. In the beginning of the 1990s, a few efforts have been made to streamline the tax structure. Originally, Sales tax was in two forms, the Madras System (Multi-point) and the Bengal System (Retail Sales Tax), i.e., single point. In both these systems, the defects are common with a slight variation here and there. Main defects in the sales tax system were:

- From the multi-point tax system a few states shifted to the first-point sales tax, but viewing the economic condition of the State additional sales tax or surcharge were added to the tax rates.
- The rate structure in various States was ranging from 0% to 20% and the special rates like 2%, 3%, 3.5%, 4%, 8% 10%, 12% and so on were existing.
- There were large number of tax exemptions of the commodities (tax free) in the States, e.g., in the State of Punjab the Schedule `B’ represented such rebates although these sales were subject to certain conditions.
- Lack of compliance of the system.
Apart from these general exemptions from the payment of sales tax, the incentives in the form of tax deferment, concessional rate of tax, purchase tax exemption, etc. were in vogue which led to eating away the major chunk of the State revenue besides creating an unhealthy competition amongst the existing non-exempted units and the new exempted units.

- Non-interaction between the Central agencies and the Sales tax administrative agencies.
- Narrow tax base, i.e., number of identified dealer is lesser.
- No tax on value addition after first-point of sale.
- Avoidance at first-point on some portion of price.
- Evasions at first-point by bill trading, i.e., bills are returned or destroyed at destination.
- Trade diversion, if tax rates are lower in other State.
- Lack of transparency in the system.
- Excessive discretion to the administrative authorities.
- Compulsory annual assessment and stringent penalties.
- Lack of confidence between the trading community and the administration.
- Excessive delegation of powers to the taxing authorities.
- Undue competition among the states on account of undesirable exemptions and undue tax competition amongst the States concessions to the industries.

CASCADING EFFECT

The most disappointing factor in the present tax system is the cascading effect, which means no set off is available on the raw material purchased by the manufacturers, and hence,
leading to increase in the cost of the product. This has a serious effect on the State economy, which results in high cost of production. Higher cost of production implies higher price for the output, and hence, leading to less export of the commodity. This effect also causes higher prices of product in the inter-state trade. On account of higher prices the international competitiveness of the domestic products goes down and hence the indigenous industry suffers.

The present system of tax administration is very complex and leads to the economic distortion and the above-said effect being the major disadvantages.

The existing system results in an uncontrolled incidence of the tax. At the end of the chain of the production-distribution process, the total effective incidence on any given final product would be fortuitous. This is, however, not very clearly seen by the consumers because the tax system lacks transparency.

There is the problem of multiplicity of rates. Prior to the reforms in the sales tax system, all the States had a plethora of rates necessitated by the need to have fine gradations between necessities and luxuries. Quite a few states had as many as 17 rate categories. In recent months, the State have attempted to adopt floor rates that have reduced the number of rate slabs considerably. However, a large number of rate slabs are still in existence under the present sales tax system. The rate slabs range from 6 to 15 in many States. It is useful to recall that the Report of the Finance Ministers Committee (1995) pointed out that by having floor rates, in the medium run, the competition may be expected to lead to a convergence of rates. It is also
agreed that the rate categories would automatically be reduced to four. While the market forces might take some time, the concept of a few rate categories needs to be adhered to.

One of the reasons for the large number of rate slabs is the differential treatment given to the goods falling in the residuary entry (8 per cent rate). While the report of the Finance Ministers Committee has implied only one rate on all those goods “not classified elsewhere”, the States have adopted “the existing rate” or “any rate” on the items not specified in the List.

Another factor adding to this phenomenon is the application of a higher rate than the floor rate. While in principle, the States have the legitimate right to introduce higher rates, the number of rate categories need to be kept in mind. As these have to be as few as possible for the introduction of VAT, if the States want to have a higher rate, it should be in the next rate slab. Here, it is important to bear in mind that the multiplicity of rates not only blunts the progressivity, but also increases compliance costs of the dealers.

Heterogeneity prevails in the structure of this tax. In addition to general sales tax (GST), most of the sub-national governments levy an additional sales tax, turnover tax or a surcharge. Additional tax is based either on their total turnover or on the graduated turnover with different rates for different slabs of turnover. Similar practices prevail in regard to turnover tax as well as surcharge. Owing to heterogeneity in rates and structure of tax, there is an increase in the cost of compliance.

The economic consequences of widespread taxation of input leads to vertical integration of firms, i.e., the existing
system of taxes operates against ancillary industries and encourages firms to produce more and more of the inputs needed rather than purchase them from ancillary industries.

The existing system of sales tax lacks neutrality. It interferes with the producers’ choice of inputs and outputs as well as with the consumers’ choice for consumption. This inevitably results in severe economic distortions.

To overcome such difficulties and to streamline the tax administration in India as a single unit of market various efforts were made effectively after 1990 and the conference of ministers resolved the following points in November 1999:

1) Implementation of uniform Floor rate of sales tax.
2) Withdrawal of sales tax incentives from new industries.
3) Implementation of VAT by States.

The benefits of VAT are as follows:

1) A set-off will be given for input tax as well as tax paid on previous purchases.
2) Other taxes, such as turnover tax, surcharge, additional surcharge, etc. will be abolished.
3) Overall tax burden will be rationalized.
4) Prices will, in general, fall.
5) There will be self-assessment by dealers.
6) Transparency will increase.
7) There will be higher revenue growth.

The VAT will, therefore, help common people, traders, industrialists and also the Government. It is indeed a move towards more efficiency, equal competition and fairness in the taxation system.
In India, there has been a VAT system introduced by the Government of India for the last about ten years in respect of Central Excise Duties. At the State level, the VAT system as decided by the State Governments would now be introduced in terms of Entry 54 of the State List of the Constitution of India.

The first preliminary discussion on State-level VAT took place in a meeting of Chief Ministers convened by Dr. Manmohan Singh, the then Union Finance Minister in 1995. In this meeting, the basic issues on VAT were discussed in general terms and this was followed up by periodic interactions of State Finance Ministers. Thereafter, in a significant meeting of all the Chief Ministers, convened on November 16, 1999 by Shri Yashwant Sinha, the then Union Finance Minister, three important decisions were taken. First, before the introduction of State-level VAT, the unhealthy sales tax rate “war” among the States would have to end and sales tax rates would need to be harmonized by implementing uniform floor rates of sales tax for different categories of commodities with effect from January 1, 2000. Second, in the interest of harmonization of incidence of sales tax, the sales tax-related industrial incentive schemes would also have to be discontinued with effect from January 1, 2000. Third, on the basis of achievement of the first two objectives, steps would be taken by the State for introduction of State-Level VAT after adequate preparation. For implementing these decisions, an Empowered Committee of State Finance Ministers was set up.

Thereafter, the Empowered Committee met regularly, attended by the State Finance Ministers, and also by the Finance
Secretaries and the Commissioner 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 in the Empowered Committee, it was possible within a period of about one and a half year to achieve nearly 98 per cent success in the first two objectives on harmonization of Sales tax structure through implementation of uniform floor rates of sales tax and discontinuation of sales tax-related incentive schemes. As a part of regular monitoring, whenever any deviation is reported from the uniform floor rates of sales tax, or from decision on incentives, the Empowered Committee takes up the matter with the concerned State and also the Government of India for necessary rectification.

After reaching this stage, steps were initiated for 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 manufacturing and trade, attempts have been made from the very beginning to harmonise the VAT design in the States, keeping also in view the distinctive features of each State and the need for federal flexibility. This has 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 have also been taken for necessary
training, computerization and interaction with trade and industry, particularly at the State level. This interaction with trade and industry is being specially emphasized.

It may be noted that while such preparation was going on, the Chief Ministers of all the States in an important meeting on State-level VAT convened by the Prime Minister on October 18, 2002, where Shri Jaswant Singh, the then Union Finance Minister was also present, clearly stated their intention of introducing VAT from April 1, 2003. About 29 States and Union Territories had expeditiously sent their Bills to the Ministry of Finance, Government of India for prior vetting. The Union Ministry of Finance had considered these bills of States and Union Territories, and sent their comments/suggestions to the States and Union Territories in line with the decisions of the Empowered Committee of the State Finance Ministers for incorporating the same in VAT Bills to be placed in the State legislatures and subsequent transmission to the Government of India for Presidential assent. At this stage, there were certain developments which delayed the introduction of VAT. Despite these developments, most of the States remained positively interested in implementation of VAT. Madhya Pradesh VAT Bill had already been accorded Presidential assent in November 2002. One state, namely, Haryana, had already introduced VAT on its own with good results on revenue growth. It is important to note that in the meeting of Empowered Committee on June 18, 2004 when Shri P. Chidambaram, the Union Finance Minister, was invited all the States, once again categorically renewed their commitment to the introduction of VAT from April
1, 2005. By now nearly all the States had finalized their VAT Bills.

Conceptual Framework

Introduction to Value Added Tax (VAT)

Value Added Tax is the most recent innovation in the field of taxation. Actually, VAT is considered one of the most important tax reforms of the second-half of the twentieth century. It is a scientific tax system, which was first introduced in 1954 in France. VAT is a family member of indirect tax. Indirect tax is primarily so called because the real burden of tax under this type can be shifted forward to the consumers or in other words, it is not borne directly by the person who pays it. As long as the burden of tax can be shifted forward, it is indirect. The exact definition of VAT in its practical and precise meaning has been attempted in the following section.

Meaning of VAT

Different experts and institutions have endeavoured to give the meaning of VAT in their own way. However, some of the important definitions have been mentioned here. In the words of Ishwar Bhattarai & Girija Koirala, “VAT is a general consumption tax assessed on the value added to goods and services. It is a general tax that applies, in principle, to all commercial activities involving the production and distribution of goods and the provision of services. It is a consumption tax because it is borne ultimately by the final consumer. It is not a charge on companies. It is charged as a percentage of price, which means that the actual tax burden is visible at each stage in the production and distribution chain. It is an indirect tax, in that
the tax is collected from someone other than the person who actually bears the cost of the tax (namely the seller rather than the consumer). As VAT is intended as a tax on consumption, exports (which are, by definition, consumed abroad) are usually not subject to VAT or VAT is refunded”.2

The Economy Watch defines Value Added Tax (VAT) as a special type of indirect tax in which a sum of money is levied at a particular stage in the sale of a product or service (www.economywatch.com/business-and-economy/vat.html).

Value Added Tax (VAT), or goods and services tax (GST), as defined by Wikipedia, is tax on exchanges. It is levied on the added value that results from each exchange. It differs from a sales tax because a sales tax is levied on the total value of the exchange. For this reason, a VAT is neutral with respect to the number of passages that exist between the producer and the final consumer. A VAT is an indirect tax, in that the tax is collected from someone who does not bear the entire cost of the tax.

To avoid double taxation on final consumption, exports (which by definition, are consumed abroad) are usually not subject to VAT and VAT charged under such circumstances is usually refundable (en.wikipedia.org/wiki/value_added_tax).

The definitions given above clearly explain that VAT is an indirect tax which is the newest and significant experiment done on the modern tax system. Like the sales tax, VAT is also levied on the sale of goods and services. VAT is a broadbased tax as it

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also covers the value added to each commodity by a firm during all the stages of production and distribution. It is a modern tax system which has been introduced to improve the collection of taxes, to increase efficiency and to lessen tax evasion.

VAT is a modern and scientific tax system. It is not similar to customs, excise duty or sales tax that have borne the traditions or historical heritage. It is not a tax that has been improved and amended, and accordingly inserted and deleted. It is a tax of the 21st century since it is highly developed and refined. It is a tax that suits the present speed of knowledge, development and skill. Moreover, it confirms with the present context of liberalization, privatization and globalization. It is easily adaptable with the open economy system and matches with the private sector and the market economy of the present day. It is a tax that is transparent and has an in-built system of self-control. There can be no difference of opinion on the above facts.

The value added tax system is designed to address various problems associated with the conventional sales tax system. It is a tax that has developed as an alternative for the traditional sales tax. That’s why it is also called improvised version of sales tax. In sales tax, there is no provision for input tax credit, which means that the end consumer may pay tax on an input that has already been taxed previously. This is known as cascading and leads to increase consumer tax and price levels, which increases the rate of evasion and can be detrimental to economic growth. In contrast, the VAT that has been levied in the previous level can be deducted while paying taxes on the later levels. It has a
special system where a person trying to deceive tax will be caught on either one of the subsequent levels. Therefore, the trend of tax evasion is highly discouraged.

**Types of VAT**

Value added tax can be classified into the following three types:

1. **Gross Product Type Variant**
2. **Income Type Variant**
3. **Consumption Type Variant**

The essential distinction between these three variants is their treatment of capital goods, that is, items such as machinery, buildings, equipment, furniture and vehicles or any asset that will not be used up entirely within the tax year of purchase.

1. **Gross Product Variant**: Under this variant, deductions are allowed for raw material and components purchases, however, no deduction/set off is allowed for purchase of Capital goods. Tax paid on Capital Input such as purchase of Plant, Machinery and equipments, etc. are not eligible for set off, and hence, not deductible from the tax collected on sales.

The economic base of gross product variant conforms most closely to the gross national product account in the national income statistics. Under this approach, the business is not permitted to deduct the cost or the depreciation on capital goods purchased from other firms in calculating its tax liability. Purchases of goods and services from other firms that are entirely used up in the current year, that is, purchases on
current account can be deducted. The gross product value added tax base, can be illustrated with the help of this example. Let us assume that a firm has only the following three transactions in the course of its taxable year:

a) Gross receipts (Sales) of Business Rs. 1,25,000/-
b) Purchase of a machine (Capital Goods) Rs. 10,000/-
c) Purchase of materials and supplies (Non-Capital Goods) Rs. 25,000/-

For this firm, the gross product value-added tax base will be Rs. 1,00,000/- (Rs. 1,25,000/- in gross receipts less Rs. 25,000/- in purchases on current account).

No deduction is permitted for the Rs. 10,000/- machine since this is a purchase of a capital asset.

2. **Income Type Variant:** Under this type of variant, the cost of a capital asset again is not deducted when it is purchased. However, the firm is permitted to deduct the amount of depreciation that occurs in a given year on its capital assets. Under the usual definition of income type value added tax base, depreciation is allowed on all capital assets, whether old or new. Depreciation could, however, be limited only to capital assets purchased after the adoption of the tax. If, to the previous three transactions of the firm, an item for depreciation of its purchased machine is added, say Rs. 2000/- (Depreciation rate is assumed to be 12%) for the year then the income type value added tax base would be Rs. 98,000/-
(Rs. 1,25,000/- gross receipts from sales less Rs. 25,000/- for purchases of materials and supplies, less Rs. 2,000/- for depreciation of the machine during the year).

This type of tax is complicated by the fact that it involves the depreciation of capital equipment. Computation of depreciation is just as complex under this variant of the value added tax as it is under the income tax system. Because the income variant requires separating purchases and sales of both capital and current goods.

3. **Consumption Type Variant**: This type of tax corresponds closely to the personal consumption account in national income statistics.

It provides closely the neutral treatment of capital assets. Under this tax base, a firm that purchases a capital asset may deduct, in the year of purchase, the full value of this purchase. In contrast to the income-type value added tax base, where depreciation is deducted year by year, the consumption value-added approach permits no adjustment for depreciation since to do so-after allowing deduction of full value in the year of purchase-would amount to deducting the price of the capital goods twice.

The name consumption-type value-added tax is appropriate because the value-added represented by the capital equipment is not subject to tax until later years, as the equipment is being consumed in the process of production.

In effect, the immediate tax rebate granted to users of capital equipment imposes the tax only once on gross proceeds of the sales of the goods and services produced by the capital
equipment. Funds are not tied up for tax purposes as under the income variant of this tax.

The consumption variant, then, is equivalent to instantaneous depreciation of these capital acquisitions.

Using the same illustration, the tax base for the firm in question under the consumption type value-added tax would be Rs. 90,000/-. This is arrived at by taking Rs. 1,25,000/- in gross receipts from sales and subtracting purchases on both current account (Rs. 25,000 for materials and supplies) and capital account (Rs. 10,000 for the machine).

In this way, the variants of VAT differ in their treatment of capital goods. Among these three types of VAT, the consumption variant is the most superior form of VAT and is universally practiced. The reasons for its popularity are as follows:

(i) This variant doesn’t affect decision regarding investment and growth since it relieves investment from any tax burden.

(ii) Likewise, the consumption variant is attractive from tax administration point of view as there is no need to distinguish between the purchase of intermediate goods and capital goods under this variant which is necessary under the other two variants. Unlike the consumption variant, the other two variants stimulate firms to classify their purchases of capital goods as intermediate goods leading to complication for the administration.

(iii) Furthermore, the consumption variant is more attractive than the income variants from the consideration of foreign trade, because the consumption variants are compatible
with the destination principle of taxation, which has been used by many countries. Under the destination principle, the tax base is consumption and hence export is relieved completely from VAT.

The consumption variant, thus, possesses several advantages over the other two variants. This is why, the consumption type variant has been widely used in several European countries and elsewhere in recent years.

**Methods of Computation of VAT**

There are three basic methods by which VAT can be calculated. These are: (a) Addition Method, (b) Subtraction Method, and (c) Tax credit method.

(a) **Addition Method** : This method is based on the identification of value added which can be estimated by summation of all the elements of value added (i.e. wages, profits, rent and interest). This method is also known as income approach method.

(b) **Subtraction Method** : The subtraction method estimates value added by means of the difference between the value of the outputs and inputs (i.e., \( T = t (output - input) \)). This is also known as product approach and has further variants in the way subtraction is attempted, namely, (i) direct subtraction method, (ii) intermediate subtraction method, and (iii) indirect subtraction method. Direct subtraction method is equivalent to a business transfer tax whereby tax is levied on the difference between the aggregate tax-exclusive value of sales and aggregate tax-
exclusive value of purchases. Intermediate subtraction method is based on deduction of the aggregate tax-inclusive values of purchases from the aggregate tax-inclusive value of sales and taxing the difference between them.

(c) **Tax Credit Method:** The indirect subtraction method entails deducting of tax on inputs from tax on sales for each tax period, i.e., t (output) − t (input). This method is also known as tax credit method or invoice method. In practice, most countries use this method and employ net-consumption VAT.

Since business is required to state the tax on invoices under the tax credit method, it facilitates border tax adjustments. This implies that the amount of tax that levied on export can be refunded to exporters. Similarly, this method is effective under the destination principle where exports are zero-rated and the tax credit chain is not broken. It also provides the facility of cross checking.

This method is particularly useful if it is desired to reduce the rate of value added tax at a certain stage in the process of production and distribution. Since this mechanism puts an equal burden of taxation on both imports and domestic products, it is further preferred. The tax credit method, thus, is desirable for several reasons and has been adopted by many countries of the world.

Punjab and Haryana states have adopted the tax credit method.
Principles of VAT

VAT can be implemented either under the origin principle or the destination principle.

(A) Origin Principle
Under this method, the tax base is obtained by adding the incomes produced by the firm. This implies that all exports are taxable and all imports are non-taxable. Where there is a border and cross-country trade, this principle gets important to imported goods or services over domestic production. Countries with international boundaries do not prefer to have this principle. But in European community (EC) where there is a common border this principle of taxation is essential. The main reason behind not following this principle is of revenue loss. It also discourages exports, either directly or indirectly.

(B) Destination Principle
This principle is quite popular and followed by a large number of countries. Under this principle, goods or services are taxed on at the place where they are produced and not at the place where they are consumed. This means all imports are taxed, while all kinds of goods and services are free to taxation. The main advantage of this principle is non-discrimination between import and internal production. This principle is favourable for promoting export. Many countries follow this principle because they are eager to boost their exports.

History and Development of VAT
Tax is collected by the government to meet the need of budget. Among the various types of tax, the sales tax is one of the major sources. VAT is the most scientific system of sales tax.
In the early days, the tax from the consumption and production was collected as sales tax. But now, it is almost completely replaced by the concept of VAT. This concept was introduced in 1919 by Dr. Wilhelm Von Sieman in Germany. It replaced the multi stage sales tax due to its undesirable effects, particularly cascading and vertical integration of the latter tax (MST) for the first time. Germany knew the administrative complications of the VAT system. So, it has the fear to implement. Therefore, the rate of multi stage sales tax is reduced instead of the implementation of VAT. In 1921, America was implementing the corporate income tax. Prof. Thomas S. Adams suggested the tax for the United State of America to replace the existing tax system. Until early '50s the development of VAT remained limited to the theory only.

France was the first to implement VAT in 1954 covering only the industrial sector. The VAT was limited only up to the whole level. But these countries limited the VAT only on import and manufacturing stage.

In late '60s, VAT started to become popular. Countries like Denmark and Brazil adopted this system of tax in 1967. France, the first implementer of VAT, extended it to the retail level for the first time. And Germany also adopted VAT in the same year. In 1969, the countries like Netherlands and Sweden also adopted VAT in their countries. In 1970, 1971 and 1973, Luxembourg, Belgium and Ireland introduced VAT respectively.

In Asia, Vietnam was the first country to introduce this most scientific tax system. The country adopted VAT in 1973. With the passage of time, VAT gained popularity all over the

In SAARC region, Pakistan was the first adaptor of VAT. It implemented VAT in 1990. India introduced VAT first as modified value added tax (MOD VAT) in 1996. But in real terms, VAT replaced sales tax on 1 April, 2005 in the country. Haryana was the first state to introduce VAT on 1 April, 2003. The Empowered Committee, constituted by Government of India, provided the basic framework for uniform VAT laws in the states but due to the federal nature of Indian constitution, States do have a liberty to set their own valuations for the VAT levied in their own territory. India introduced the full VAT in some prescribed regions of the country on April 1, 2005. Around 130 countries have introduced VAT system across the world. The list given below in Table 1.1 presents the implementation of VAT by different countries in a chronological order.

Table 1.1

Implementation of VAT by Different Countries

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<td>Belgium</td>
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<tr>
<td>1972</td>
<td>Ireland</td>
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<tr>
<td>1973</td>
<td>Austria, Bolivia, Italy, United Kingdom, Vietnam</td>
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<td>1974</td>
<td>Argentina, Chile, Colombia, Costa Rica, Nicaragua</td>
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<td>1976</td>
<td>Honduras, Israel, Peru</td>
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<td>1977</td>
<td>South Korea, Panama</td>
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<td>1980</td>
<td>Mexico</td>
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<td>1982</td>
<td>Haiti</td>
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<td>1983</td>
<td>Dominican Republic, Guatemala</td>
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<td>1984</td>
<td>Peoples Republic of China</td>
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<tr>
<td>1985</td>
<td>Indonesia, Turkey</td>
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<td>1986</td>
<td>Morocco, New Zealand, Nigeria, Portugal, Spain, Taiwan</td>
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<td>1987</td>
<td>Grenada, Greece</td>
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<td>1988</td>
<td>Hungary, The Philippines, Tunisia</td>
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<tr>
<td>1989</td>
<td>Japan, Malawi</td>
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<td>1990</td>
<td>Iceland, Kenya, Pakistan, Trinidad and Tobago</td>
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<td>1991</td>
<td>Bangladesh, Benin, Canada, Jamaica, Mali, Algeria, South Africa, Armenia, Azerbaijan, Cyprus, EL Salvador, Estonia, Fiji, Kazakhstan</td>
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<td>1992</td>
<td>Tajikistan, Belorussia, Kyrgyzstan, Russia, Thailand, Turkmenistan, Ukraine, Uzbekistan, Moldova</td>
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<td>1993</td>
<td>Burkina Faso, Czech Republic, Paraguay, Poland, Romania, Georgia, Slovak Republic, Venezuela</td>
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<tr>
<td>1994</td>
<td>Bulgaria, Finland, Lithuania, Singapore, Western Samoa, Madagascar, Niger</td>
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<tr>
<td>1995</td>
<td>Gabon, Ghana, Switzerland, Zambia, Malta, Latvia, Liechtenstein, Mauritania</td>
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<tr>
<td>1996</td>
<td>Albania, Belize, Guinea, Uganda</td>
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Table 1.1 (Contd.)

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<thead>
<tr>
<th>Year</th>
<th>Countries</th>
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<tr>
<td>1997</td>
<td>Barbados, Congo, Nepal</td>
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<tr>
<td>1998</td>
<td>Croatia, Mongolia, Sri Lanka, Tanzania, Vanuatu, Surinam, French Polynesia</td>
</tr>
<tr>
<td>1999</td>
<td>Cambodia, Cameroon, Mozambique, Netherlands, Papua New Guinea, Slovenia, New Jersey</td>
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<tr>
<td>2000</td>
<td>Australia, Chad, Macedonia, Namibia, Sudan</td>
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<td>2001</td>
<td>Botswana, Rwanda</td>
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<tr>
<td>2002</td>
<td>Lebanon</td>
</tr>
<tr>
<td>2005</td>
<td>India*</td>
</tr>
</tbody>
</table>

**Source:** The VAT Project Office (Revenue Administration Support), IRD, IRD/DANIDA, 2001:3-4)

*India has implemented Modified VAT since 1986. This system is not exactly a VAT system. The system was introduced to refund excise duty paid on inputs.

**Reasons for the Increasing Popularity of VAT**

VAT is definitely a new and modern tax as compared with other traditional tax systems. Actually, VAT is considered the most important tax reform in the 21st century. Of all the indirect taxes that evolved in the past, VAT is by far the best tax system. By contrast, other tax systems had never risen into prominence in such a short span of period.

Ever since its introduction in France around 1954, VAT has gradually and promisingly won the heart of people and is currently implemented in about one hundred and thirty countries.

Several other countries, which so far have not adopted VAT are trying to make necessary changes in their fiscal policies and laws to assimilate and accommodate this scientific tax system into their economic set-up.
Although VAT is out and out a new system as compared to other traditional tax systems, its popularity is growing fast. It is a precondition that any European country which wants to become a member of EEC must have already adopted VAT. This precondition has played a vital role in the popularization of VAT. In addition to these, there are some other factors that are attributed to its growing popularity:

1. VAT is neutral with respect to the choice of method of production and distribution. As the tax is levied only on the value, it is quite effective and efficient. An efficient tax system is one that does not cause any distortions in production and consumption. In other words, such a tax system does not bring any unintended and undesirable effects in the methods of production and distribution or in consumption. Added at each stage in the system, tax liability remains the same regardless of the system of production and distribution. Total tax paid on a given commodity depends on the rate of tax and on the total value added (i.e. the final price) of the commodity but not on the number of states through which it has passed. Since VAT does not interfere with the optimal allocation of means of production, it is considered neutral. All other forms of sales tax are distorted since they bring unnecessary and intended changes in the methods of production and distribution. VAT is, thus, superior to other forms of sales tax on the ground of efficiency since this tax is neutral with respect to method of production and distribution.

Likewise, VAT is neutral with respect to consumer’s choice too. VAT does not affect the relative price. Consequently, there is
no need for the consumer to shift from one commodity to the other as responsive to tax.

Thus, VAT does not affect the preference of the consumer. It also avoids probable distortions of the optimum allocation of resources. All other forms of sales tax are not neutral in respect to consumer’s choice.

2. Another feature of an ideal tax system is equity. VAT is more equitable in the sense that it falls equally on all goods that gather a different proportion of value added at various stages.

VAT is also attractive from the point of view of foreign trade considerations. Exports are commonly relieved from taxation in order to maintain the competitive power of domestic manufacturers in the international market. This promotes exports and increases global competitiveness. That is why, the tax levied on exports is refunded to exporters. It is possible to refund the exact amount of tax levied on exports under VAT. It is difficult to refund the exact amount of tax levied on exports under other forms of sales tax system except the retail tax.

Another reason for the growing popularity of VAT is that this tax avoids the problem of cascading. Under VAT system especially when the invoice method is adopted, the exact amount of tax can be shifted forward to the consumer.

3. One of the desirable features of a good tax system is the revenue productivity. VAT is popular from the revenue point of view. VAT is well known in the world for its effective revenue generation. It is important instrument for the mobilization of resources. There is tremendous scope for increasing the revenue
from VAT. It offers greater revenue potentiality as compared to other forms of sales tax. VAT is an improved version of sales tax, which has the virtue of mobilizing substantial amount of revenue. Hence, VAT has become an important source of revenue on many developing as well as developed countries. It yields more than 20 per cent of tax revenue.

4. Furthermore, VAT is favourable from the administrative point of view also. It is favoured on the ground that as the base of this tax is broad, a relatively low rate can produce the required revenue. Low rate reduces the possibility of tax evasion. Since the tax burden is distributed among a large number of taxpayers under the VAT system, it does not put a heavy burden on a taxpayer, and hence, avoids the chance of considerable tax evasion. The built-in control nature of VAT makes tax evasion more difficult. VAT is, thus, better in this respect than other forms of sales tax.

In a nutshell, VAT is a modern and transparent tax. It is less distorted and more revenue productive. That is why this tax has become a popular topic for tax reform and has been spreading all over the world since the late 1960s. The attractiveness for VAT across the nation has proved that it is preferred not merely for raising revenue but also its avoiding multiple distortions as created by other forms of sales tax. In the process of economic liberalization and globalization, VAT makes the tax system more flexible and effective.
**Objectives of the Study**

1. To trace the historical development of VAT as a means of state tax revenue.
2. To study the tax structure of Punjab and Haryana.
3. Comparison of revenue from VAT in Punjab and Haryana.
4. To identify the factors responsible for an increase in revenue from VAT in Punjab and Haryana.
5. To identify problems faced by traders and other stakeholders after implementation of VAT in Punjab and Haryana.
6. To solicit the views of consumers regarding VAT.

**Database and Methodology**

The study is based on both primary and secondary data. The secondary data was taken from various publications of Government of India, Reserve Bank of India, Centre for Monitoring Indian Economy, State Budgets of the Punjab and Haryana Governments, Statistical Abstracts of Punjab and Haryana, Excise and Taxation Departments of Punjab and Haryana and NSS Consumer Expenditure Survey 60th Round, 2004. The primary data was collected from 100 VAT-paying units each located in Patiala and Panchkula districts of Punjab and Haryana respectively selected. The dealers were classified into different categories, i.e., production, trading and others. A stratified random sampling technique was used for the purpose of selecting units from each category. Thus, 8 units located in Rajpura, 5 in Patiala and 2 in Nabha were selected for the survey under the production category in Patiala district of Punjab. Further, 27 units situated in Rajpura, 41 in Patiala and 16 in
Nabha were selected for the survey under the trading category. Similarly, 9 units located in Panchkula, 6 in Barwala and 1 in Kalka were selected for the survey under the production category in Panchkula district of Haryana. Further, 42 units situated in Panchkula, 24 in Barwala and 15 in Kalka were selected for the survey under the trading category. The data was collected through two sets of well-structured and pre-tested questionnaires. One set was used for the respondent traders\(^3\) and the other for the customers\(^4\). The sample of the study consisted of 200 respondents each from both the categories.

Apart from the simple tabular analysis, an attempt was made to study the relative importance of different taxes by computing their compound growth rates; and the results were interpreted accordingly.

The compound growth rates for the revenue from different taxes were calculated by using the formula:

\[ Y = ab^t \]

where \( Y \) is the revenue from a particular tax and \( t \) the time period. The growth rate is equal to \((b-1)\).

In order to examine the structure of VAT/sales tax in Punjab and Haryana, i.e., to work out whether it is levied more on low elasticity goods or on high elasticity goods, we classified VAT/sales tax item into different groups. The basis of classification was the elasticity coefficient of an individual item which was calculated using the formula

\[ Y = aX^b \]

i.e. \[ \log Y = \log a + b \log X \]

\(^3\) Appendix -I
\(^4\) Appendix -II
where $Y$ is the expenditure on a particular commodity, $X$ the total expenditure and $b$ the elasticity. Using the elasticities, goods were categorized into 4 groups, viz. commodities with elasticity <1, >1 & <2, 2 and unclassified. Further these elasticities were worked out from the data contained in the NSS Consumer Expenditure Survey 60th Round, 2004.

**Organization of the Study**

The study has been organized into six chapters. The present chapter is introductory in nature and provides a detailed information about the topic under study. It also highlights the objectives formulated for the study. Second chapter provides an overview of various aspects and issues of this study through the review of existing literature. Third chapter concentrates on the tax structure of Punjab and Haryana states. Fourth chapter analyses the revenue collection from VAT in the states of Punjab and Haryana. A comparative study as to growth of revenue from VAT in both the states has been undertaken. Fifth chapter demonstrates the results of sample survey. Sixth chapter provides the summary, conclusions and suggestions emerging from the study.