CHAPTER - II

REVIEW OF LITERATURE

Tax reforms have drawn the attention of researchers both in India and abroad. The implementation of VAT of comprehensive nature, or at central and state levels both, may also involve some elements of tax design. Most of the countries have introduced VAT in the last about 25 years. In India also indirect tax reforms have drawn attention only after introduction of economic reforms in the country. Therefore, the literature on VAT is of recent origin. The Value Added Tax does not have a long history admittedly, there is not as much literature available on this topic as other forms of tax system. So, in other words, only a limited number of studies have been undertaken on VAT and those too with different perspectives. An attempt thereby, has been made to review the literature on VAT.

Purohit (1982), examined the fiscal importance of sale tax in the state finances in India. Overall, the share of sales tax in own revenue of the states increased from about 31 per cent in 1960-61 to 57 per cent in 1978-79. He presented economic analysis of sales tax structure in India and pointed out that wide variations prevailed among different states in the rates of sales tax. There was multiplicity of rates and in certain states there were as many as 17 different rate categories, which had no justification. He pointed out that states should follow Orissa pattern, where there were only four rates. While examining the taxation of inputs, he suggested elimination of the tax on inputs or full set-off of the tax paid on raw materials. Examining the arguments for and against first and last-point tax, he suggested
a mixture of different systems. He opined that either the states should go in for value added tax or two-point tax with set-off. As surcharge and additional sales tax increased effective rate of sales tax, the sales tax structure should be rationalized so that effective rate is comparable with the neighbouring states. He also pointed out the limitations of Central Sales Tax (CST) and discussed the need for revamping CST rates. He also highlighted the need to tax the services. Further, examining the impact and incidence of sales tax, he concluded that sales tax might not always be regressive because progression could be introduced through rate variations, exemptions and adoption of physical-ingredient rule. He concluded that as sales tax had a significant role in fiscal structure of the states, the tax structure should be reformed to make it economically rational and administratively expedient.

Purohit (1993), examined the system of commodity taxation in India and discussed the problems which could arise in introducing VAT in view of the federal structure of the country. He pointed out that the prevailing system of commodity taxation in India was unintegrated and gave rise to many problems like multiplicity of levies, complexity of structure, high tax rates, cascading effect, lack of transparency, vertical integration and narrow base, etc. He emphasized the need for immediate tax reforms like reducing the number of rates, reducing tax incidence, sales tax reforms, adoption of VAT and broadening the tax base by bringing services under tax net. He brought out the documentary and accounting obligations under MODVAT. While examining the existing sales tax administration,
he brought out the problem areas for introducing VAT, which included need for more staff, training of tax personnel, suitable computational technology, Tax Identification Number (TIN) and auditing.

Purohit (1995), in his another study, examined the structure and administration of sales taxation in India. He expressed the opinion that failure to administer the sales tax properly could defeat its purpose and threaten the canon of equity. It could create parallel economy due to increased tax evasion. He brought out the features of sales tax administration, examined its operational requirements, which included management information system (MIS) and suggested certain improvements in the operation and administration of sales tax. He opined that tax administration has important role in achieving the objectives of tax policy. He emphasized the need for strengthening sales tax administration to pave way for adoption of VAT in place of sales tax.

Burgess, Howes and Stern (1995), in their study on value added tax options for India analyzed that the pressure of aggregate revenue, the requirement of a reduced role for customs duties for the liberalization of the economy, and the complexity and strains of the current system together point clearly towards the desirability of tax reform in India. Since domestic indirect taxes provide the major source of revenue, they deserve special attention. They argued that India would benefit from moving toward a system of value added taxation (VAT) and focused on the way in which a VAT (or VATs) can be best introduced into India given the country’s federal structure. Three different
options are distinguished: a central VAT, dual VAT, and states' VAT. They argued that the first is politically infeasible, that the second represents the best way forward in the short-term, and that the third deserves consideration as a long run option. Special attention is paid to the problems that would arise under either a state's or a dual VAT with regard to taxing inter-state trade.

Murti (1995), stated that a comprehensive VAT covers value added at all the three levels of business activities, i.e., manufacturing, wholesaling and retailing. He distinguished between three types of VAT, i.e., consumption VAT, net income VAT and gross income VAT; and opined that a comprehensive VAT with consumption base, the tax credit method, following destination principle to determine VAT on international and inter-state trade flows could be an ideal commodity tax structure for India. There could be ideally two types of tax regimes in India with central and state VATs. There could be parallel central and state VATs on the same base from manufacturing to retailing or central VAT up to manufacturing stage and the state VAT at wholesaling and retailing stages. He further pointed out that VAT system with one or two rates might have to be supplemented by special excise and subsidies to take care of the problems of equity, environment and social bads like tobacco and alcohol.

Bagchi (1995), termed the operating sales tax system as unworkable. Different problems in the system including multiple cascading levies, numerous rates, drawing hair-splitting distinction among commodities, large number of exemptions which narrowed the tax base, ‘tax wars’ among the states which
led to bizarre results, cumbersome laws and procedures resulting in thousands of cases pending before courts, etc. did not reflect comfortable picture about commodity taxation in India. He opined that simplifying sales tax and removing the drawbacks, was not the solution and stated that superiority of sales tax lay in taxing consumption of goods and services in the economy without needless interference with market forces and freeing of exports from domestic trade taxes in a way which was not otherwise possible. VAT also offered a buoyant but non-distortionary source of revenue for governments by virtue of wide base and structure. He cautioned that VAT should apply to all goods and services with minimum exclusions and should also strictly adhere to the principle of destination, following preferably tax credit method.

Purohit (1997), reported that most of the federations did not adopt VAT. Brazil was the only country with independent VAT both at federal and state levels, and as such the researcher tried to examine the salient features of VAT implementation in Brazil. The share of VAT in total domestic taxes on goods and services increased in Brazil, indicating increased fiscal role of the tax. The federal VAT in Brazil was levied on delivery of industrial products at producer’s level. The tax rates were based on degree of processing of commodities and nature of commodities. As such more revenue came from cars, tobacco products, beverages, chemical products and machinery industries. The state VAT was imposed by states on sale of goods, while services were covered under a separate tax. There were five rate categories in state VAT, depending upon the nature of the
products. In the inter-state sales, origin principle was followed and tax was imposed by exporting state. However, to neutralize the impact of level of development, the tax rate on inter-regional transactions varied according to destination, the rate being lower for exporting to less developed and higher for exporting to more developed region. Municipal governments were also authorized to impose tax on services which was not included in state VAT. It was reported that Brazil was further contemplating to reform the VAT system. The researcher suggested that India could also follow Brazilian model of VAT.

Michael (2000), in his paper titled, “VIVAT, CVAT and All That : New Forms of Value Added Tax for Federal Systems in 2000” stated that conventional wisdom has it that the value added tax is not a suitable instrument for lower-level jurisdictions (‘provinces’) in a federal system. The problems that arise when it is so used have become a serious constraint on the development of the VAT — and closer economic integration — in Brazil, the EU, India and elsewhere. In his study, he describes and compares two recent proposals for forms of VAT intended to alleviate these difficulties: the VIVAT and CVAT. Both enable the VAT chain to be preserved on inter-provincial trade without compromising the destination principle (allowing provinces to tax consumption at different rates) or introducing new scope for game-playing by the provinces. The key difference between them is that the CVAT requires sellers to discriminate between buyers located in different provinces of the federation, whereas VIVAT requires them to discriminate between registered and non-registered buyers.
D.OSei (2000), in his article on political liberalization and the implementation of Value Added Tax in Ghana, examined an aspect of Ghana’s political economy in the 1990s, covering its transition to democracy from military dictatorship and how this change process impacted in its attempt to implement a VAT. It assesses the claim that political transition from autocracy to democracy improves policy-making and policy outcomes. Ghana’s experience of implementing VAT typifies an inherent problem in African governance, that of lack of adequate capacity for improved policy-making and for the institutionalization of inclusive politics and public accountability. The VAT case served in the end to impose a previously absent level of public accountability on the Ghanaian growth.

Purohit (2001a) examined roadmap for national and sub-national VAT in India and stated that in the unique indirect tax system in India, central government had the power to impose broad spectrum of excise duties on manufacturing; and states had power to impose sales tax and other taxes like entry tax, octroi, motor vehicle tax, and passenger and road tax. Although tax reform committees recommended adoption of comprehensive VAT, covering all commodities and services but the dichotomy of tax power created obstacles in adopting European style VAT in India. He brought out the problems and prospects of introducing VAT in India in view of the experience of states which experimented in adopting VAT in one form or the other. Andhra Pradesh introduced VAT on selected items with effect from April 1, 1995 for resellers only. Kerala also introduced VAT on resellers in the case of select items but did not grant set-off on
taxes paid on inputs. Maharashtra moved towards real VAT with effect from October 1, 1995. Existing tax structure prior to introduction of VAT was simplified and ‘additional tax’ and ‘turnover tax’ were abolished. It also provided set-off on input tax paid by manufacturers. Efforts were made to make VAT system neutral and transparent. Thus, the experience of the states showed that except Maharashtra, no other state attempted to introduce VAT in its proper form, as the first and foremost prerequisite of VAT was to give input tax credit. Further, he pointed out that there was no requisite preparedness of tax department for introduction of VAT.

Purohit (2001b) examined the evolution of sales tax in India and the efforts at introducing VAT. He discussed different categories of sales tax according to coverage, legal basis and total turnover. Discussing the fiscal role of sales tax, he reported that in most of the states, sales tax constituted more than 50 per cent of the states’ own tax revenue. The buoyancy coefficients of sales tax revenue were estimated to be greater than one in most of the states. The analysis of structure of sales tax indicated large variations in rates and multiplicity of rates. Exemptions were granted to large number of commodities and services. The treatment of inputs varied from state to state. Levy of surcharges, additional sales tax and tax on resellers aggravated the complexities in the structure of sales tax. He suggested short-term and medium-term measures to reform the sales tax, and the major medium-term measure was to introduce state-VAT. Further, when the states adopted VAT, he suggested important changes in CST and existing system of taxation. He
pointed out that certain reforms were to be carried out in sales tax for introduction of VAT, which included registration of dealers, raising exemption limit, smooth processing of returns, simplified payment procedures, and prompt and proper assessment. He also suggested some reforms in the governance of state–VAT, which included mechanism to oversee its operation, separation of duties of different functionaries of VAT department, integrated management information system, procedure for risk management and reducing interaction of dealers with the department.

Mukhopadhyay (2002) examined the issue of implementation of VAT going wrong in India. Providing details of revenue from CST to the states in India during the period 1990 to 2002, he reported that Maharashtra, Tamil Nadu, Andhra Pradesh, Haryana, Uttar Pradesh and West Bengal were to lose a lot of revenue if CST was abolished. As there was no consensus and no attempt to reach compromise in the interests of the states, VAT was introduced in an imperfect manner in the states. No enough thought had gone into drafting of the Acts in this context. He concluded that if it was pointed where exactly the efforts went wrong, it would not be difficult to improve matters.

Yasmin (2004) examined sales taxation in Jammu & Kashmir with respect to its structure, fiscal significance, feasibility of replacement by VAT; and suggested some policy prescriptions. She found sales tax to be highly elastic and buoyant in the State. The tax base had been widened considerably, but there was still scope to widen the base and coverage of sales tax as there was a long list of exempted goods,
which could attract at least 4 per cent tax. There was prominence of first-point single stage sales tax. Though first-point sales tax had administrative advantage but the tax base became narrower. She opined that VAT appeared to be better alternative for extending tax base but suggested gradual introduction, starting with select items. She stated that VAT could cover some of the deficiencies of first-point sales tax. It would reduce tax evasion considerably. She also cautioned about the problems which would arise when VAT was introduced.

Rao (2004) tried to examine the extent of gain or loss to the states from the introduction of value added tax, having features of uniform design, tax credit for inputs, extension of tax base to transactions beyond the first-point sale and zero-rating of inter-state trade and international exports. She stated that exclusion of services from the base would not eliminate the problem of cascading from the tax system. As manufacturing sector output was the major basis of sales tax, the estimation of impact of VAT was limited to registered manufacturing sector only. If the entire cost of tax was passed on as higher prices of output, then the result would be reduction in value of output. The effects of introduction of VAT were classified into four parts, i.e., loss from providing input tax credit, loss from reduced value of output, loss from removal of CST, and gains from taxing second and subsequent sales within the state. With certain assumptions, she estimated the losses, gains and net impact on different states for the year 1997-98. With 15 per cent rate of VAT, the impact (loss) varied from Rs. 932 crore for U.P. to Rs. 1054 crore for Maharashtra. However, she reported that this exercise did
not take certain features of the economy into account which included zero-rating of exports, turnover taxes on second and subsequent sales by some states, impact of introduction of VAT and withdrawal of CST on structure and locational choice of business/industry. The author further argued that homogeneity in VAT rates and structure was required to reduce the scope of tax competition among the states and neutrality of tax system to economic activity. However, homogeneity in rates might not ensure that all states retain their existing level of revenue. As tax-GSDP ratio varied, this indicated that different states had different interests, therefore, at later stage, the states might change the VAT rates and structure. The author concluded that on the basis of assumptions, some states seemed to gain consistently from introduction of VAT, while the others were expected to lose. The losses could be avoided by changing the VAT rates and structure but this could be a hindrance in the formation of a common internal market. She cautioned that Central Government’s assurance for compensation in case of losses in revenue from introduction of VAT could invite negative response from states in terms of slackness of efforts in collection of VAT.

Empowered Committee (2005) laid down the roadmap of state-level VAT in India in the White Paper, which consisted of three parts. In Part-I, justification of VAT and background were discussed. Problems of double taxation and multiplicity of taxes were cited as the major drawbacks of sales tax structure. The merits of VAT were reported to be input tax credit, abolition of other than VAT taxes, rationalization of overall tax burden, self-
assessment by dealers, transparency and higher growth in revenue. To harmonize the VAT design in the states, common points of convergence with certain flexibility were reported to be the basis, which were elaborated in Part-II. These points included: input tax credit, its coverage and carrying over; treatment of opening stock; compulsory issue of tax invoice, cash memo or bill; registration; small dealers and composition scheme; tax payer’s identification number; return; procedure of self-assessment of VAT liability; audit; declaration form; incentives; other taxes; penal provisions; coverage of goods under VAT; VAT rates and classification of commodities. In Part-III of the paper, related issues were discussed, which included provision of compensation to states in case of losses, resulting from implementation of VAT to the extent of 100 per cent of loss in the first year, 75 per cent in the second year and 50 per cent of the loss in the third year of introduction of VAT. Other related issues discussed were: phasing out of Central Sales Tax (CST), need for including imports under VAT chain, decision on collection and appropriation of service tax, need for close interaction with trade and industry, and comprehensive campaign at state level to communicate the benefits of VAT to common people, traders and industrialists in simple and transparent manner. Co-operation of all sections of people in the country was sought for introduction of state level VAT.

Nour and Pramanik (2005) stated that VAT is a multi-point turnover tax imposed at each stage of production and distribution on sales minus cost incurred. They discussed different variants of VAT, i.e., gross product type, income type,
consumption type and the wages type. They also discussed the three methods of computing VAT, i.e., addition method, subtraction method and credit (invoice) method. From the methods of computing, they brought out that VAT helped in reducing tax evasion, whereas sales tax had considerable scope for evasion. They suggested that for better administration of VAT, each taxpayer be allotted a master file and Tax Identification Number (TIN). They concluded that VAT would help in improving allocative efficiency, growth and balance of payments; avoiding cascading effect; providing less scope for vertical integration; and facilitating accuracy of tax refunds on exports.

Bezborah and Singh (2005) pointed out the weaknesses of sales tax structure which included lack of uniformity in tax rates, multiplicity of rates, cascading nature, pyramiding effect and revenue loss due to incentives. While reporting essentials of good sales tax structure, they opined that VAT was a good alternative for sales tax. However, VAT also has some black spots. Further, they brought out implementation problems of VAT in India. They also discussed the issues of uniformity of rates, removal of CST, making service tax VATable, unification of taxes, threshold limit and refund mechanism; and concluded that implementation of VAT in India should not be delayed further.

Misra (2005) opined that Value Added Tax was a measure to broad-base the tax net and countries all over the world have adopted this miracle tax. He pointed out that the superiority of VAT lay in the fact that it prevented cascading effect of taxation
and reduced tax evasion. Cross verification of accounts of all the enterprises has been made possible with the help of computers under VAT and as such accounts could not be manipulated. VAT could lead to capital formation in the country when depreciation is made deductible from tax base and tax on capital goods is offset against VAT liability. VAT could also improve balance of payments of the country as exports are zero-rated. However, VAT might not be suitable for a large country with a strong federal system. The author stated that for introduction of VAT, existing tax rates be rationalized, tax credit system be introduced in place of incentives and steps be taken to abolish CST.

Sthanumoorthy (2005) reported that states in India carried out a path-breaking tax reform by replacing defective sales tax with Value Added Tax (VAT). The author pointed out that sales tax system suffered from many structural weaknesses, including multiplicity of sales tax rates and commodity categories in each state; wide differences in rates within and between states; cascading effect due to its imposition on a large number of inputs; tax competition among states; tax exportation; large number of exemptions; application of surcharge and additional levies; additional sales tax and turnover tax; entry tax and octroi; complicated and wide variety of tax rules and widespread tax evasion. Even when policy-makers were advocating replacement of sales tax with VAT, the attempts were initiated in early 1990s. The process was delayed due to several implementation problems and finally Central Government persuaded majority of the states to switch over to VAT with effect from 1.4.2005. The author discussed important issues and
challenges in implementation of VAT and in this context experience of some of the Indian states and countries operating VAT system was reported.

Sharma (2005) opined that VAT emerged as one of the most fundamental component of ambitious process of implementation of VAT in India since 1991 but the process of implementation faced constraints in a federal country like India as the experience of Brazil suggested. The major constraint in implementation of dual VAT in India was that mutual cooperation between centre and states was quite low. The fear of revenue loss as a result of introduction of VAT and phasing out of Central Sales Tax (CST) was the major difficulty in implementing dual VAT. The author opined that ‘no tax credit’ in case of inter-state trade, as laid down in White Paper of the Empowered Committee (2005) undermined the basic benefit of enforcing VAT system, i.e., removing the distortion in movement of goods across the states. The integration of national VAT and state VAT into GST was also stated to be a distant dream. The author highlighted the need to develop a ‘federal friendly model’ of VAT that could be implemented in India without compromising federal principles.

Mukhopadhyay (2005) brought out the global experiences of VAT and practical difficulties in introducing it in India. He presented VAT design along with central excise and sale tax structure. While bringing out the evolution of VAT, the author brought out the variations in definitions, procedures and statutes in Indian states despite Empowered Committee’s efforts to provide common platform. He also brought out the major
constraints in adopting VAT in India. In the origin and destination principles, inter-state trade posed a major problem. He advocated removal of CST with introduction of VAT. The author also explained administrative and procedural requirements for introducing VAT.

Bird (2007), in the preliminary document, argued that in Canada, state value added tax was more likely to be the right way to tax state level sales. He gave three major reasons for introduction of VAT in place of retail sales tax (RST) which included taxing sales, taxing business and replacing other taxes. Discussing the economics of choice between VAT versus RST, he established the superiority of VAT because RST has cascading effect and subject to abuse. He advocated inclusion of services under VAT net. Further, he discussed the issues relating to revenue, eroding of revenue by exemptions, self-enforcing nature of VAT and reducing of tax evasion to establish the superiority of VAT. He pointed out that even when VAT has to deal with much larger number of tax payers, its administration is still easier because the onus is on the taxpayer to keep the record to claim input tax credit to be presented to the authorities, if they doubt the legitimacy of the credit. Discussing the broader issues of states and exports, he stated that inter-state sales would not create more problems under VAT than under RST. He concluded that VAT is the best form of consumption tax both economically as well as administratively. He suggested that government should check unwarranted price increases, protecting the interests of low-income consumers and taxing services at discounted rate. He
suggested that remaining states of Canada should also more seriously explore the possibility of adopting state VAT.

Bansal (2008) opined that as some states did not join the VAT system, the fractured implementation of VAT could cause some problems. She stated that CST and VAT were not compatible as CST was not VAT able and credit could not be claimed for CST. The producing states got considerable revenue from CST while consuming states did not get much revenue and some states hesitated in joining VAT system. Examining the Delhi experience of VAT, she reported that VAT needed honest and efficient government machinery for cross checking and linking production activities with tax liabilities of the firms but such machinery was lacking. VAT put additional burden on tax authorities, producers and shopkeepers to keep the records. There was no uniformity in rates in the states. The Empowered Committee covered only 550 commodities under VAT rates and left others to states to decide. As a result there were variations in rates even in neighbouring states. Further, she stated that co-operation of taxpayers was needed in self-assessment and keeping correct accounts but this co-operation was not forthcoming. As the government machinery was not able to do cross checking, there was lot of tax evasion. She termed the VAT procedure as complicated.

From the review of available literature, it clearly emerges that the topics undertaken in these limited research studies mainly focus on the drawbacks of sales tax and make justification for the introduction of VAT. Similarly, problems which could arise in introducing VAT have also been explored in
some studies. There are only few studies which explore the effects of VAT after its introduction. Significance of this study lies in the fact that it empirically examines the introduction of VAT after the replacement of sales tax in the states. The study undertakes an in-depth analysis of Punjab and Haryana states and recommends measures needed to improve revenue collection from VAT. It takes into consideration the secondary data as well as primary data collected from the traders and consumers. Thus, the present study is much more comprehensive as compared to the earlier studies.
REFERENCES


