CHAPTER - III
VAT – AN OVERVIEW

3.1 INTRODUCTION

Value Added Tax (VAT) is a type of indirect tax that is imposed on goods and services. Around 136 countries in Asia have recognized the importance of value added tax. In one of the most large-scale reforms of the country’s public finances in over the past 50 years, India has finally agreed the launch of its much delayed value added tax from 1st April, 2005 at a rate of 12.5%. VAT was introduced in almost all the States in India after 2002 by replacing the single point sales tax system. Considering the fact that VAT has been successful in most of the States which has implemented the VAT, the States like Gujarat, Chhattisgarh, Jharkhand, Madhya Pradesh and Rajasthan with a view to integrate with the rest of country implemented VAT in their respective States. VAT is levied not only on products but also on services, which forms the source of revenue for the government to plan for development activities in the country. Since VAT/Sales tax is a State subject, the Central Government has been playing the role of a facilitator for successful implementation of VAT.

This chapter gives an overview about the Structure of sale tax in India, origin of VAT, VAT in Tamilnadu, Objectives of VAT, Methods of Computation of VAT and Benefits of VAT.
3.2 Structure of Sales Taxes in India

There is total uniformity among the states for the continuous levy of sales tax, since it is a resourceful source of revenue. However, the structure of sales tax among Indian States is neither homogeneous nor uniform. The reason behind this situation is that the union government didn’t take any step to maintain uniformity in sales tax structure among the states during the early stages of its adoption. A close scrutiny of the introduction of the system of sales taxation and the rate structure among Indian States will testify this issue.¹

Though the system of sales taxation followed by the Indian States is divergent in nature, they can be classified on the basis of certain commonalities. These commonalities are scope or coverage of sales tax regime, legal characteristics and turn-over.

i) Sales Taxation On The Basis Of Scope

On the basis of scope or coverage, sales tax in India can be classified into General Sales Tax (GST) and Selective Sales Tax (SST). General Sales Tax can again be classified into single point; double point and multi point sales tax.

The single point sales tax (the first stage or the last stage) is a tax which is collected from only one of the dealers who are inter-connected in the process of exchange of goods. In this case, the impact of sales tax may take place either at a point where an importer or manufacturer makes the first sale of goods (Single Point First Stage Sales Tax (SPFSST)) or at a point where a retailer sells (if he is a dealer) his goods to the consumer (Single Point – Last Stage Sales Tax (SPLSST)). In single point (first stage/last

¹ M.C. Purohit, Sales Taxation in India, S. Chand & Co. Pvt. Ltd., New Delhi, 1975, p. 5.
stage) sales tax system, the liability of the tax is restricted to one single occasion, irrespective of the multiplicity of sales in succession and the law is so framed as to prevent double taxation\(^2\).

The double point sales tax provides for the taxation of commodities at both the points (i.e.) when they enter the segment of registered dealers and when they go out of it. The volume of tax which the government intends to levy on particular goods is split up between two points, the first point and the last point in the chain of sales. A specified proportion of tax is collected at the point of entry and the balance at the point of exit.

The multi-point sales tax system has a provision for taxation at each stage of a sale. The goods are sold by an importer or manufacturer to his sole-selling agent, who sells them to a wholesaler and the wholesaler to a semi-wholesaler or retailer by whom they are finally sold to the consumers. Sales tax is imposed at each of these transactions. The prices of goods are thus necessarily inflated at each stage in this chain of sales.

### ii) The Legal Basis Of Sales Tax

Legally, sales tax is levied on dealers, either on those who sell the commodities or on who purchase them. Therefore, sales tax is known as sales tax or purchase tax.

Actually, the nature of the commodity decides whether it is subject to sales tax or purchase tax. Certain commodities have been isolated for the levy of purchase tax. For example, in Rajasthan, cumin seeds are subject to first point purchase tax, in Tamil Nadu, rubber is liable for last point purchase tax, in Assam, paddy is subject to first point purchase tax and in some other states sugarcane is liable to first point purchase tax.

3.2.a Exemptions Granted Under Sales Tax Act

Exemption from sales tax means, freeing the commodities from the clutches of tax. The equity principle of Fiscal Economics demands that people with income to contain the bare necessities of life should not be indiscriminately taxed. This policy can be achieved by exempting certain commodities of consumption from the purview of sales tax. This exemption also makes the sales tax system less regressive. Exemptions are being granted on the basis of any one or all aspects of the following norms.

a) Necessities
b) Goods for production
c) Goods sold to or by social or economic institutions
d) Goods taxed under separate law
e) Administrative exemptions

Granting exemptions to a group of commodities from sales tax also has justification on the basis of Engel’s law of consumption. It states that, a poor man’s family budget is a budget of such consumption goods as are of basic necessity over which a major portion of his income is expended.

3.2.b Demand For Abolition Of Sales Tax

Sales tax is the only major source of revenue for states, but there is diversity in rate structure, base of taxable goods and taxable turn-over limit.

In spite of the fact that there are diversities in sales tax system, its enforcement in some states put up maximum difficulties and harassment to traders and businessmen who in turn demand the abolition of sales tax. Lack of uniformity in sales tax among
states, and deficiency in the administration of the system can be rectified through a central enactment. But, the demand for the abolition of sales tax will not solve the problem rather it deprives the states fiscal autonomy and make them totally surrender to the Union government for revenue requirements.\(^3\)

3.2.c Recent reforms in sales tax structure: approach towards value added tax in India

The sales tax system operating in India is very old and it needs complete overhaul. Periodical review of sales tax system not only makes the system dynamic but also brings handsome revenue to the exchequer. The existing sales tax system in states is marked by several deficiencies such as lack of uniformity, multiplicity of rates, cascading of taxes, pyramiding effects and revenue loss due to incentives. As time passes, and the system of sales taxation grows, inherent deficiencies noted above should be routed out.

Instead, the system becomes more complicated. To overcome these deficiencies, experts prescribed a hybrid variety of taxation called Value Added Tax (VAT). Value Added Tax is a multi-stage sales tax levied as a proportion of the value added. (i.e., sales minus purchases which is equivalent to wages plus profit).

A full-fledged VAT was first introduced in Brazil in 1960’s, then in European countries in 1970’s and subsequently introduced in about 130 countries. In Asia, it has been introduced in countries including China and Sri Lanka. In India, there has been a VAT in respect of Central Excise Duties. At the state level, the VAT system has been introduced in terms of Entry 54 of the State List of the Constitution. VAT came into

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operation in India at state level from 1 April 2005. Majority of the states in Indian Federation opted to it, barring a few states, including Tamil Nadu on non-economic reasons. These states also joined with the mainstream subsequently and today Value Added Tax is being implemented in India at state level\(^4\).

### 3.2.d Sales Taxation In Tamil Nadu

Tamil Nadu state which accounts for 4 per cent of the land area and 7 percent of the population in India was the first state in the country to introduce a general sales tax in its present form way back in 1939 and used to account for 62 per cent of sales tax collected in India in the early sixties. Tamil Nadu General Sales Tax being the first of its kind in India was a multi-point turn-over tax primarily to make up for the loss in revenue arising as a result of the introduction of prohibition. It was a multi-point tax levied at a very low rate of 0.5 per cent on all dealers with a turn-over in excess of Rs. 20000 were made liable to this tax. But there was also a provision for levying a slab rate of Rs. 5 per month on the dealers having turn-over between Rs.10000 and Rs.20000 per annum. This tax covered almost all the commodities, except agricultural and horticultural commodities sold by the producers. Other commodities exempted from the purview of the sales tax were, bullion and spices, cotton, cotton yarn and cloth woven on handlooms.

Exemption given earlier to commodities such as cotton yarn, bullion and spices and handloom cloth were withdrawn and they were taxed at the rate of 0.25 to 0.50 per cent single point. The law was amended to permit taxation of works contract.\(^5\) But this was not maintainable till the enactment was included in the Constitution in 1982. The 46th


Amendment to the Constitution enlarged the definition of the word “tax on sale or purchase of goods” under Article 366 (29A) (b) to include “a tax on transfer of property in goods (whether as goods or in some other form) involved in the execution of a works contract”

As the turnover of hotels exceeded Rs. 25000, a tax of 2.34 per cent was levied in 1949. Similarly, 1949, was marked by the withdrawal of tax on cotton and it was subjected to a single point tax. The period between 1949 and 1953 didn’t have much change in the sales tax structure. In 1954, an additional tax at 7.8 per cent was levied on the first sale of superfine and fine varieties of cloth in the state. Similarly an additional first point tax at the rate of 3.125 per cent on precious stones was levied. In 1956, first sale of sugar was liable for an additional tax of 6.25 per cent and an additional tax of 7.81 per cent was levied on medium cloth also.

**3.3 STRUCTURE OF SALES TAX IN TAMILNADU – A GLANCE**

“Tax structure refers to the mix and types of taxation used by governing bodies. It is a measure of the relative importance of various kinds and methods of taxation used. The tax structure observed at any point of time reflects a political equilibrium resulting from the historical evolution of institutions and the distribution of political power. Tax structure changes over time as political and economic conditions change.6 Existing structure of sales taxes in the state is governed by the Tamil Nadu General Sales Tax Act 1959 (TNGST). Basically, it was a multi-point tax. Later, it has undergone several changes, and the number of commodities under multi-point receding and the

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number of commodities covered by single point fastly increasing. Some commodities are
taxed at the first point whereas some other commodities are taxed at the last point. Those
commodities, which were not classified so far, are subject to multi-point taxation. The
share of revenue from multi-point commodities declined from 60 per cent in 1959-60 to
24 per cent in 1972-73 and 12 per cent in 1979-80.

In addition to the General Sales Tax, the TNGST (1959) provides for the levy of
Additional Sales Tax (AST) under Tamil Nadu Additional Sales Tax Act (1970). AST is levied on the basis of turn-over as decided by the TNGST Act, 1959. The special feature of AST is that, it doesn’t permit the traders to shift the burden of AST on consumers. Despite, the AST, a surcharge is also leviable as per Tamil Nadu Sales Tax (Surcharge) Act, 1971⁷.

The rate of surcharge in Madras City and its suburban is 15 percent and 5 percent in Madurai, Salem, Coimbatore and Tiruchirapalli. An analysis of the trend of revenue from AST and surcharge with respect to GST shows that, the share of surcharge with GST is more or less constant (3 per cent); whereas the revenue from AST is gradually increasing over the years. The share of AST with GST was 3.9 per cent in 1972-73, 10.15 percent in 1979-80 and 14.5 percent in 1995-96.

3.4 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.
3.4 a 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

<table>
<thead>
<tr>
<th>General Welfare Theory (GWT)</th>
<th>Social Expendiency Theory (SET)</th>
<th>General Benefit Theory (GBT)</th>
</tr>
</thead>
<tbody>
<tr>
<td>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.</td>
<td>SET represents that a general business tax is more expedient and advantageous to be imposed than other taxes.</td>
<td>GBT postulates that the Government acts as a factor of production for the business community. Taxes are the cost of services recovered by the State from the citizens.</td>
</tr>
</tbody>
</table>

### Assumptions

<table>
<thead>
<tr>
<th>GWT</th>
<th>SET</th>
<th>GBT</th>
</tr>
</thead>
<tbody>
<tr>
<td>a) Benefits of general welfare services can be allocated among citizens.</td>
<td>a) Business taxes are the appropriate sources of revenue</td>
<td>The cost of services of the State is utilized by the enterprise in relation to the size and value of operations. Thus the costs can be allocated on the basis of value added.</td>
</tr>
<tr>
<td>b) Recipients of benefits should be made to pay for them, and</td>
<td>b) Administration of these taxes is comparatively easy.</td>
<td></td>
</tr>
<tr>
<td>c) Tax is equivalent to the price for the general welfare services.</td>
<td>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.</td>
<td></td>
</tr>
</tbody>
</table>
3.4.b 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. The list given below in Table 3.1 presents the implementation of VAT by different countries in a chronological order.

**Table 3.1 Implementation of VAT by Different Countries**

<table>
<thead>
<tr>
<th>Year</th>
<th>Countries</th>
<th>Standard rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1954</td>
<td>France</td>
<td>25%</td>
</tr>
<tr>
<td>1967</td>
<td>Brazil, Denmark</td>
<td>25%</td>
</tr>
<tr>
<td>1969</td>
<td>Netherlands, Sweden</td>
<td>25%</td>
</tr>
<tr>
<td>1970</td>
<td>Ecuador, Luxemburg, Norway</td>
<td>25%</td>
</tr>
<tr>
<td>1973</td>
<td>Austria, Bolivia, Italy, United Kingdom, Vietnam</td>
<td>12%</td>
</tr>
<tr>
<td>1980</td>
<td>Mexico</td>
<td>16%</td>
</tr>
<tr>
<td>1986</td>
<td>Morocco, New Zealand, Nigeria, Portugal, Spain, Taiwan</td>
<td>12.5%</td>
</tr>
<tr>
<td>1988</td>
<td>Hungary, The Philippines, Tunisia</td>
<td>12%</td>
</tr>
<tr>
<td>1990</td>
<td>Iceland, Kenya, Pakistan, Trinidad and Tobago</td>
<td>24.5%</td>
</tr>
<tr>
<td>1991</td>
<td>Bangladesh, Benin, Canada, Mali, Algeria, South Africa, Turkmenistan, Ukraine, Uzbekistan, Moldova</td>
<td>5%</td>
</tr>
<tr>
<td>1992</td>
<td>Tajikistan, Belorussia, Kyrgyzstan, Russia, Thailand,</td>
<td>7%</td>
</tr>
<tr>
<td></td>
<td>Myanmar, Vietnam, China,</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Korea, Japan, Malaysia, Singapore,</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Australia, New Zealand,</td>
<td></td>
</tr>
<tr>
<td></td>
<td>India, Bangladesh,</td>
<td></td>
</tr>
<tr>
<td>1993</td>
<td>Burkina Faso, Czech Republic, Paraguay, Poland, Romania, Georgia, Slovak Republic, Venezuela</td>
<td>22%</td>
</tr>
<tr>
<td>1999</td>
<td>Cambodia, Mozambique, Netherlands, Papua New Guinea, Slovenia, New Jersey</td>
<td>10%</td>
</tr>
<tr>
<td>2000</td>
<td>Australia, Chad, Macedonia, Namibia, Sudan</td>
<td>10%</td>
</tr>
<tr>
<td>2005</td>
<td>India</td>
<td>12.5%</td>
</tr>
</tbody>
</table>

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

3.4.d 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.

3.4.e 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.

3.4.f 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 implementation of VAT in the states and gives a brief background of the work done by the Empowered Committee on the state level VAT implementation.

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 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.

3.4.g 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.

3.5 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 Percent VAT Rate

Under this category, there are largest numbers 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”. As of 1st January 2011, the general 4% VAT rate has increased to 5%.

2. **12.5 Percent General VAT Rate**

   The remaining commodities in all the States will fall under the general rate of 12.5% (residuary category). As on 1st January 2011, the 12.5% VAT rate has increased to 14.5%.

3. **1 Percent Special VAT Rate**

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

3.5.a **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.

   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 method 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. 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. So That 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.

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. 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. Having seen the origin, significance, Principles of VAT and benefits of VAT, a detailed analysis about the VAT revenue pattern in Tamilnadu is given in the next chapter.