CHAPTER - 4

VAT IN SOME FEDERAL COUNTRIES

"Difference in tax systems did not come about at random but rather reflect social and political preferences that should not be ignored......efficiency losses..... may be an acceptable price to pay for retaining national diversity and autonomy (Sijbern Cnossen) (Tait, 1988)".

4.1 INTRODUCTION

Value Added Tax, first introduced more than 50 years ago remained confined to a handful of countries until the 1960s. Today it is a key source of government revenue in more than 120 countries. The spread of VAT throughout the world is largely based on the fact that VAT has raised more revenue than the sales tax. Several federal countries have adopted VAT. In examining a federal tax structure, one has to concern the rates and bases, sharing of revenue and organization of tax administration.

If there are separate Central and State powers to choose bases and rates for related taxes, we must know how those decisions are coordinated. If tax rates are chosen separately by states, there arises question of the treatment of goods crossing internal borders. There also needs to be analysis of what institutional bodies carried out the collection of taxes and how revenue is shared between different levels of government. This will help to understand the political arrangements, administrative complexities associated with any given system.

Apart from introduction this chapter examines the experience of selected federal economies with VAT introduction. Section 4.2, 4.3, 4.4, 4.5, 4.6 and 4.7 presents an overview of the VAT system in Argentina, Brazil, Canada, Germany, Mexico and European Union respectively. In each section we looked at-the type of VAT introduced, the structure it replaced, rate setting, revenue sharing arrangements, particular problems encountered and the steps taken to meet these. The last section presents conclusion based on the above discussion.

In the context of a federal VAT, Poddar (1990) sets out the following options. "The various options for the imposition of a general sales tax at the state level fall in to the following broad categories":

1. Central government imposes tax on all inherently taxable items, state governments then collect tax from the dealers.
2. State government imposes tax on all inherently taxable items, central government then collects tax from the dealers.
3. Central government imposes tax on taxable items within its area of jurisdiction and state government imposes tax on the remainder of the taxable items.
4. State governments impose tax on taxable items within their area of jurisdiction and central government imposes tax on the remainder of the taxable items.
5. Central and state governments impose tax on all inherently taxable items.
6. A single sales tax is imposed by either the central or state government on both centrally and locally taxable items.
1. A National tax with revenue sharing arrangements

2. Origin based taxes
   VAT with Uniform Rates
   Vat with Variable Rates

3. Destination based taxes
   Retail sales tax
   VAT with uniform rates
   VAT with variable rates

4. A joint- federal state VAT

As regards operating and collecting a national tax with revenue-sharing arrangements, problem arises with the sacrifice of fiscal independence by the states. States may have different revenue needs, which are not adequately reflected. They also may have different preferences and some states may decide, they would want a larger role in the economy than the others. Thus, the objections to this form of a state – federal Value Added Tax are not to do with efficiency or administrative feasibility but do with political acceptability.

The second group is Origin-Based taxes. It was thought that Origin-Based taxes where there were no formal internal borders between states. But this is not valid and Origin-Based taxes generate their own problems of distortions and cross border movements.

If an Origin-Based tax were at the same rate in every state then it would have the same economic effects as the more familiar destination-taxation. For this reason, it is likely that rates will vary across states, as there is competition both to raise revenue and attract investment.

As Poddar (1990) points out, Destination-Based state taxes meet the objectives of autonomy and economic neutrality. There are important problems regarding the procedures for inter state flows and also the problem of cross-border purchasing. But where states are large this problem may not be serious.

The final option described by Poddar has a number of attractions. It provides the system of revenue-sharing, tax operated at the national level and at the same time
allowing the states some fiscal autonomy. Essentially the tax base would be identical across states and there would be a basic federal rate common to all states. It could vary across commodities and activities. The states would then be free to levy additional rates on the same base.

Besides the above, as Satya Poddar puts it, it is important that a tax reform requiring the introduction of a VAT in a federation should have the following objectives:

1. The tax reform should be revenue neutral between the governments. It should not cause gain in revenue to government at one level at the cost of government at other level, or gain to one state, loss to the other states. However, owing to inter-state disparities in the level of development and taxable capacities, a uniform VAT across the states find it difficult to accomplish this objective.

2. The VAT also requires the tax base to be uniform across the nation. It is not so in practice in a federation.

3. The federating states should have the autonomy to set the tax rates to reflect their own social and economic priorities and fiscal needs.

Since India is a large federal country, in this chapter we tried to examine the experience of some federal economies with the introduction of VAT. The countries selected for our study are Argentina, Brazil, Canada, Germany, and Mexico, which tried different methods of reforming their system of indirect taxation. These countries encountered very different problems and have achieved their reforms with varying degrees of success. This experience provides a useful backdrop to India.

For each of these selected countries, we are interested to know about the rates, revenue sharing and tax administration. This also analyses the various institutional bodies, which carry out the collection of taxes and of how revenue is shared between different levels of government. An examination of the system of sales taxation, which the VAT system replaced, provides insights into the motivation for VAT introduction. The study also examines the problems that have arisen with different VAT specifications in these federal contexts. For an overview see table 4.1.
Table 4.1: VAT in some federal countries

<table>
<thead>
<tr>
<th>country</th>
<th>When introduced and type of VAT</th>
<th>Taxes replaced and effect on revenue</th>
<th>Base setting</th>
<th>Rate setting</th>
<th>Collection of tax</th>
<th>Revenue sharing</th>
<th>Problems</th>
<th>Reform of system</th>
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</thead>
<tbody>
<tr>
<td>Brazil</td>
<td>Jan 1967 Origin</td>
<td>Federal VAT replaced federal wholesale tax and state VAT replaced state turnover tax. Decrease</td>
<td>IPI: industrial production. ICM: sales goods at all stages of production.</td>
<td>IPI: 0-30% ZFM, exports are zero rated. Alcohol and tobacco are taxed at 300%. ICM: 17% Basics: 12% Luxury: 25% A complex set of rules on border trade apply since states have different rates.</td>
<td>Responsibility shared by the federal, state and municipal government</td>
<td>Sharing is always downward. The state participation fund is made up of 21.5% each of federal income tax and VAT. Distribution by the council of states. Formula takes in to account Population and Per Capita Income.</td>
<td>1. Complexity of administration due to the two-tier system. 2. Federal and state, local and state tax bases overlap. 3. States have little autonomy in setting rates and bases.</td>
<td>1. 1988: the new constitution led to a decentralization drive. 2. 1989: introduction of new rates: 12% basics 25% luxuries</td>
</tr>
<tr>
<td>Mexico</td>
<td>Jan 1980 Destination</td>
<td>30 federal and 400 state and municipal taxes. Increase</td>
<td>Acts and activities related to sales of goods, provisions of services, imports. Exemptions: housing, education, medical, transport.</td>
<td>General: 15% Luxuries: 20% Food: 6% Agricultural and exports are zero rated.</td>
<td>States and the federal district collects the federal tax.</td>
<td>The General Revenue Sharing Fund is made up of 17.5% of all federal revenue. Formula takes into account previous state share and effort. States are allowed to keep 30% of the VAT revenue that they collect.</td>
<td>1. Problem of disincentives for states to collect VAT as they cannot affect the rate structure and as there is a lag between collection and awards. 2. Richer and poorer states both unhappy with formula.</td>
<td>1. 1983: general rate became 15% 2. 1989-1991: period of fiscal reform 3. 1991: general rate back to 10% 4. Jan 1992: VAT rates in border regions changed to a single 10% rate.</td>
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<tr>
<td></td>
<td>Jan 1968</td>
<td>Cumulative all stage turnover tax</td>
<td>Wide range of goods and services and imports.</td>
<td>General: 14% Food, books and some raw materials at 7% Exports are zero rated.</td>
<td>States collect federal VAT. Common rates and on a common base.</td>
<td>Revenue split between federal and state governments varies between 70:30 and 68:32, and there is some redistribution for weaker state.</td>
<td>System of rate and base setting and revenue sharing is rigid.</td>
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<td>Germany</td>
<td>Jan 1981</td>
<td>Destination</td>
<td></td>
<td>General: 14% Food, books and some raw materials at 7% Exports are zero rated.</td>
<td>States collect federal VAT. Common rates and on a common base.</td>
<td>Revenue split between federal and state governments varies between 70:30 and 68:32, and there is some redistribution for weaker state.</td>
<td>System of rate and base setting and revenue sharing is rigid.</td>
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<td></td>
<td>Jan 1991</td>
<td>Destination</td>
<td>All suppliers of goods and services and imports.</td>
<td>General: 7% Agriculture, Fishing, exports and some medical and financial services are zero rated.</td>
<td>The federal government collects the federal VAT.</td>
<td>Some downward transfers. Federal transfers to provinces are almost 20% of provincial expenditures. Provincial transfers to the municipalities are about 45% of local government expenditure.</td>
<td>1. Provinces are reluctant to give up retail sales tax and hence their revenue generating autonomy. 2. There is poor harmonization of federal and provincial tax bases. 3. Problem of reaching a single rate and tax universality due to decentralized nature of the Canadian government.</td>
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<td>Canada</td>
<td>Jan 1968</td>
<td>Destination</td>
<td>Constant</td>
<td>General: 14% Food, books and some raw materials at 7% Exports are zero rated.</td>
<td>States collect federal VAT. Common rates and on a common base.</td>
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<td></td>
<td>Jan 1991</td>
<td>Destination</td>
<td>Hybrid federal wholesale tax. Most provinces still have a retail sales tax</td>
<td>General: 7% Agriculture, Fishing, exports and some medical and financial services are zero rated.</td>
<td>The federal government collects the federal VAT.</td>
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4.2 ARGENTINA

The Value Added Tax in Argentina is an income type VAT. The tax extends through the retail level. VAT in Argentina is based on Destination principle and it was adopted in 1974. In certain respects it began like the Indian MODVAT. It replaced sales tax, which had been adopted in the mid thirties at a rate of 1.25 percent. There were higher rates on durable goods up to 20 percent and as well as lower rates of 3 percent for certain goods of mass consumption. The sales tax levied on manufacturers only, while agriculture wholesale and retail trades were exempted.

Till 1970, no allowance was given for VAT on capital goods but from 1970 onwards a deduction of 25 % of capital invested allowed. This was increased to 50% in 1971. In 1968, the Argentinean government sent a team of experts to Europe to collect practical experience on the implementation of the VAT. This team found diverse opinions on the desirability of adopting the VAT. The main recommendation was the adoption of VAT as a substitute for the sales tax. The report of this team suggested more urgent measures to be taken to improve the overall tax system.

After the introduction of VAT, the revenue as a percentage of total tax revenue rose from 7.7 in 1975 to 10.3 in 1976, 12.5 in 1980, 21.7 in 1981 and 23.7 in 1982. But it was declined to 14.9 percent in 1983 and 13.3 percent in 1984 and again rose to 15.3 percent in 1985. One of the reasons for the stronger revenue performance of the VAT was the inclusion of a significantly larger number of firms in the indirect tax base under the VAT. In 1975, the coverage was widened and it included,

- Mining
- Electricity, gas and potable water
- Communication, Transport and Storage.

At its introduction in 1974, the rate of VAT was set at a uniform rate of 16 percent. This had gone up to 20% but declined to 13% in January 1993. Foodstuffs and Pharmaceuticals have been subjected to lower rates. Exports are zero-rated. Until 1983 agricultural sector was exempted. Fiscal experts and economists are of the view that the exclusion of agriculture and certain other sectors from resulted a hidden incidence of tax on the purchase made by the exempted sectors because credit for VAT already paid was not available.
According to Schenone (1987) there are following adverse consequences:

- It raised the relative prices of agricultural goods.
- The terms of trade moved against the agricultural sector.
- It distorted resource allocation and price fixation mechanism between industrial and agricultural sectors.

To get over from these problems agricultural sector was included in the VAT system from May 1983.

In Argentina, federal transfer system is called as “Co participation” scheme which is responsible for over two third of all federal – provincial transfers. The VAT along with income taxes and excise taxes are subject to revenue sharing under the co participation scheme.

According to some experts, the system of VAT in Argentina has not been a successful source of revenue. Except for 1980 to 1982, VAT revenue did not rise above 3 percent. Although the available evidence is not enough to pin the blame on exemptions. They are likely to explain at least partially the poor revenue performance of VAT in Argentina.

From the above description, a change towards a consumption type VAT with a perfectly general coverage would promote efficiency from the view point of both capital accumulation and the composition of current consumption in Argentina. Other changes needed to improve the VAT in Argentina consist of (Ahuja, 2004):

- Abstaining from using it as an instrument for sectoral or regional promotions.
- Making the legislation more stable by preventing frequent and unpredictable changes in the base or the rate of tax.

4.3 BRAZIL

Although more than 100 countries have gone in for a system of Value Added Tax, Brazil is one of the oldest federation having a comprehensive division between different tiers of government. Brazil is perhaps the only country with a federal set up to have both a federal VAT and state VAT. It has a very complicated formula for sharing VAT revenue.
4.3.1 Taxation at the National Level

Until the mid 1930s, there were virtually no significant taxes in Brazil (Longo, 1990). The bulk of their revenue collected by the federal and state governments from a variety of limited taxes and tariffs on trade and business. The tax provisions of the 1934 constitution broaden the scope of taxation. As a result, a personal income tax began to be collected by federal government, a turnover tax by the states, and an urban property tax by local governments. But these taxes did not become relevant source of revenue and the federal government collected much of its revenue from import tariffs and excises on liquor and tobacco.

In the mean time, states depended heavily on export and import taxes. The new tax regime was implemented in 1966. Income taxes and various single – stage wholesale taxes (cigarette, liquor and luxury items) accounted for about 75% of total revenue at the federal level. At the state level, the turnover sales tax was the most important source of income and accounted for 80% of total state revenue.

The states had control over their own tax base and rates and their tax rates differed according to local conditions and needs. The 1965 tax reform, grouped existing taxes in to four categories according to their economic base – external trade, income and wealth, production and special taxes. This reform abolished numerous taxes on specific activities which were similar to the cascade turnover tax. Even though Brazilian state VAT is fairly comprehensive and was meant not as a fundamentally new tax but as an improvement over its predecessor, the turnover tax, it immediately gave rise to conceptual and practical difficulties. Disputes continue among state representatives and between them and the central government concerning the proper composition of the tax base (Longo, 1982).

1967 was the year of VAT introduction with the federal VAT (Imposto Sobre Produtos Industrializados – IPI) replacing the federal wholesale taxes and the state VAT (Imposto Sobre Circulacao De Mercadorias – ICM) replacing the state turnover tax, local taxes on specific business and traders were transformed in to general municipal service taxes. Exports as well as imports became exclusive bases of federal taxation. With small changes, the 1965 reform distributed 20 percent of the revenue from federal income and value added taxes to states and municipalities. Soon after the reforms, this share was reduced to 10 percent and it gradually returned to 20% in 1975.
Federal excise collected on energy and mineral continued to be shared with lower levels of government various sharing schemes apply and weights depend on factors such as revenue source, population and the per capita income performance.

4.3.2 **FEDERAL VAT**

The federal VAT levied in Brazil is known as IPI (Imposto Sobre Produtos Industrializados). At the federal level the VAT is a selective tax which subjects a list of manufactured goods to various rates from a low of 4 percent to the highest of 365 percent on cigarettes. In general the rates are,

- 4 to 6 percent on Metal
- 4 to 10 percent on electrical machinery and equipment as well as non-metal minerals
- 8 to 10 percent on chemical inputs
- 20 percent on wine
- 40 to 50 percent on automobiles
- 77 percent on beer and
- 365 percent on cigarettes

Revenue collection is highly concentrated on cigarettes, beverages and automobiles and altogether make up for about 60% of the total federal VAT revenue in the mid 1980s. In 1968, federal VAT accounts for slightly over 51% of the federal tax revenue but by 1985 this share had dropped down to approximately 21%. During the same period the share of income tax went up from 22% to 50%. One of the reason is introduction of new forms of indirect taxation like tax on gross revenue and wage contributions earmarked to social security and public investment and expenditure towards the poor.

4.3.3 **STATE VAT**

The system of VAT at the state level is known as ICMS (Imposto Sobre Circulacao De Mercadorias E Servicos), replaced the then sales turnover taxes in 1960s. The state VAT encompasses most stages of production and distribution, including retail sales. It is applied according to the credit method of tax collection, cash rebates are not granted except for exports. Sales of many types of capital equipment were exempt, but credits were not allowed in the purchase of permanent assets. Thus office machines, furnishing, transport equipments and similar items were included in the tax base, since they were not explicitly exempt.
The state VAT coverage falls short of a comprehensive base in many respects. The service sector is excluded from its scope along with a number of activities such as fuel, electricity and mining taxed as excise at the federal level. A few exemptions are granted by interstate covenants which are subject to tight financial controls. Other exemptions have been granted by the constitution: books, newspapers, printing papers as well as manufactured goods. Some agricultural products are also exempted.

Under ICMS there are five rates categories, viz.;
- 7 percent on rice, beans, bread, salt, meat and food items
- 8.8 percent on capital goods
- 12 percent on the supply of electricity
- 18 percent standard rate (applicable to most other items)
- 25 percent for luxury consumption items, such as liquor, cigarettes, tobacco, electronic goods, video games, sports, communications, gas, alcohol.

At the state level, VAT exemptions and exclusions including the system of zero-rating follow no uniform practice. The state VAT base does not include fuels but simple foodstuffs like beans and rice are taxed. The reason being that a poorer state depends on this source of revenue. The financial government currently taxes the sale of energy, minerals and transport and communication transactions.

Exemptions become effective, foods are zero rated when granted in the last stage of the productive process and taxpayers are allowed full credit for taxes paid on purchases. Generally there are few cases of zero rated good except for exports. The sale of some agricultural goods like vegetables, fruits and dairy products are exempt if sold unprocessed. How ever most of the agricultural products are taxed.

As pointed out by Affonso Sud Silva (1995), the ICMS has traditionally suffered from a number of shortcomings, some of which were eliminated in 1996 through a major reform. Particularly (Gurumurthi, 2002):

- The ICMS is levied at different rates on different categories of goods: reduced rates on “essential necessities”, 17% on most goods, and 25% on luxury goods. These rates are levied on tax-inclusive base. All interstate transactions are taxed on origin basis. The difference in rates on interstate and intrastate transactions complicates administration and provides an incentive to misclassify transactions to reduce the tax liability.
Until the 1996 reform, exports of non-manufactured goods were not zero rated, and credit was not allowed for the purchase of capital goods.

The base of ICMS has not been necessarily uniform across the country.

The super imposition of the ICMS with the selective federal and municipal taxes has given rise to cascading and distortions in the tax burden across sectors and localities.

As regards interstate trade, a complex system applies where revenue allocation is contingent on the difference between importer and exporter state VAT rates (World Bank, 1990). The council of states having finance ministers from all states as its members administers state VAT. Any changes in tax rates or base must be presented by the individual states to the council for approval. Another implication is that there has been little autonomy for individual states to set bases and rates in line with their perceived expenditure needs (Shah, 1991).

We can conclude with the reasons why VAT performance in Brazil has been poor, with the joint share of federal and state VAT in total revenue between 1970 and 1988.

The first problem is difficulty in administration. A new and complex system introduced where administration is weak. Without additional safeguards, checks can lead to revenue falls. There is little coordination between the different levels of administration of the VAT.

The second reason, with the federal and state VAT bases which overlap in Brazil and the fact that the two systems are under separate jurisdiction complicates tax administration.

The third reason is that, states feel their tax base is too narrow and too inflexible to meet adequately their expenditure needs. Decentralization of taxes has weakened the ability of the central government to carry out macro economic stabilization through fiscal instruments.

The fourth reason is with the Origin based principle of the state VAT. Under this system net exporting states obtain a larger share of revenue while importing states obtain a smaller share (Poddar, 1990).
4.4 CANADA

India and Canada are two large countries of the world. Canada is one of the richest countries of the world, while India is among the poor. But both are the federal democracies. Canada has a much longer experience in federal governance and its system of federal – provincial arrangements. Like in India, domestic trade is taxed in Canada at two levels that is federal and provincial.

For many years since 1920 until the introduction of VAT in 1991, the federal government levied a manufacturer’s sales tax while the provinces levied sales tax at the retail level. Here the question is, is it possible to co ordinate a federal Value Added Tax with state retail sales tax? Canada’s experience over the last 15 years demonstrates that it is. Canadian experience suggests that the adoption of a sensible federal sales tax may provide a more promising avenue.

Canada struggled along for 70 years with a poorly functioning single stage federal manufacturer’s tax (MST) that applied to a limited number of businesses. Canada’s federal sales tax has been criticized as an inefficient and inequitable. These taxes result in uneven effective tax rates on goods and services with the cascading of taxes as products move through the production chain.

Despite the MST was an important source of revenue some of the defects are identified:

- The MST had a narrow base, covering only one – third of total consumer expenditure.
- The structure was complex and distinctions drawn between commodities and services which resulted in frequent disputes.
- The application of the tax to many business inputs led to cascading of the tax.
- There were competitive distortions caused by the exclusion of retail sales from its practice of splitting advertising and marketing functions.
- Problems were faced in dealing with value of proprietary right goods, branded goods, sole distributorships and sale by manufacturers to related marketing agencies.
By the mid 1980s, Canada's federal government, which was recording increasing fiscal deficits. To sustain sales tax revenues tax rate was gradually raised from 9% to 10% in 1984, 11% in 1986 and to 13.5% in 1989. In 1987, the federal government proposed substantial reforms in both the sales and income taxes. The sales tax reform was to replace the Manufacturers Sales Tax by VAT either in the form of a Business Transfer Tax or a Credit – invoice VAT, which is more typical among countries around the world.

However, because of all these problems, federal government decided to replace the MST with a Value Added Tax named Goods and Services Tax (GST). The GST was brought into operation from January 1, 1991. A provincial VAT which would replace provincial retail sales taxes and harmonize with the federal VAT has also been proposed. Only Quebec has adopted a provincial type VAT as of 1, January 1992.

The GST which replaced the MST in Canada in 1991 is a multi-stage sales tax operated on invoice – credit method and collected at each stage of trade. It is a Destination Based tax. A standard rate of 7 percent on the consumption of domestically produced goods and some services. Exports are zero rated and also transportation services, financial services, certain medical categories, agriculture and fishing also zero-rated. Health, education and legal aid services and some financial services are exempt.

In addition to the levy of GST by the federal government all provinces except Alberta (it has considerable revenue from gasoline) levy a provincial sales tax (PST) on the sale of tangible personal property. PST is levied on the final purchase price of a product sold by registered retailers. Since retailers’ acts as tax collectors, all the provinces except Quebec provide for reduction of a small percentage of taxes remuneration. Each province exempts some specified goods from levy of the tax. The exemptions vary from province to province.

Exemptions to producer goods also vary from one province to another. In general, all provinces exempt farm machinery and equipment, farm products, seeds and crops, livestock, feeds and fertilizers.

In spite of the replacement of MST to GST the public response to the new system was anything but aggressive. In 1993, The Liberal Party came to power and
made promise to abolish the GST. The Liberal Party requested the standing Finance Committee of Canada's House of Commons to suggest other alternatives. The Committee gave its report in 1994.

The Committee identified the following defects in the design of the GST:

✓ The GST suffered from a narrow base and because of exclusion of a number of goods and services from the base, only two-thirds of the consumers expenditure fell within this tax net.

✓ Exclusions based on commercial differences among commodities were responsible for several complexities in the system.

✓ There was no proper coordination between the federal and provincial tax systems.

✓ There was also general perception that the GST has led to the proliferation of the economy.

The committee after considering 20 different alternatives took the view that only a National VAT integrating all Canadian sales tax, both GST and the provincial sales tax was the answer to the problem raised by the GST and simultaneous operation of the provincial sales tax.

Based on the recommendations of the House of Commons Committee the federal government proposed in October 1994, a 12 percent integrated VAT with the objective of:

✓ Fairness for consumers
✓ Simplicity for business
✓ Federal provincial tax co-ordination
✓ Reduced overlap and duplication

Key features of the proposals are:

✓ A single lower rate of tax, that is, 12 %, 5 % federal and 7 % provincial.

✓ A wide common base with exclusion of only basic groceries, prescription drugs and medical devices.
The idea of having National VAT administered at the subnational level does not seem to have many takers among experts. But those who favor decentralized administration of VAT cited harmonization of GST and PST. A combined federal and provincial VAT has been invented by the federal government. In 1996, the federal government entered into an agreement with three provinces, namely, Newfoundland, Nova Scotia and New Brunswick to introduce a Harmonized Sales Tax (HST) to replace GST and PST.

Effective from 1, April 1997, a Harmonized Sales Tax (HST) was levied by the federal government at 15%. It is consisting of two parts – federal tax component at 7 percent and the provincial component at 8 percent. HST is administered by the federal government. The provincial share is remitted to the respective provinces based on collection. In addition, the federal government compensates the provinces by offering them a grant of 361 million as adjustment assistance. This is payable over a period of 4 years.

From the above description of the Canadian system of VAT and sales tax, it can be seen that the Canadian VAT has three interesting features (Purohit, 2002):

- Separate federal and provincial VATs administered provincially (QST)
- Joint federal and provincial VATs administered federally (HST); and
- Federal GST and provincial retail sales taxes (PSTs) administered separately.

What the Canadian experience clearly confirms that exports have long averred viz. no country has yet been able to work out a satisfactory way of operating sales taxes independently at two levels of government (Bird, 1994). Integration in some form is essential. Ultimately a joint VAT administered by the federal government allowing flexibility to the provinces in the matter of rates may find a solution for Canada. What comes out from the Canadian experience is that domestic taxation of commodities at two levels can not be carried on entirely independent. Ultimately there has to be integration in some form.

4.5 GERMANY

On January 1, 1968, Germany replaced its multi-points sales tax which had been in effect for nearly fifty years. The VAT in Germany is based on the destination
principle. It is levied on all taxable transactions carried out within the boundaries of Germany at all stages of consumption and production. Imports into Germany are included in the tax base and are taxed on the same basis as domestic goods. VAT was revenue neutral and the share of total revenue has been constant averaging between 12 and 13 percent throughout the 1980s. At introduction the general VAT rate was 10 percent and a reduced rate of 5 percent on foodstuffs and agricultural products like raw wool, raw hides and timber. The general VAT rate was subsequently revised upwards to 14 percent in 1980 to confirm with EC directives.

Financial and insurance activities, real estate transactions and services of physicians and dentists are exempt. A system of exemption and zero-rating applies to the expert of goods and to a number of transactions relating to cross-border transportation. A rate of 7% applies to certain foodstuffs, raw materials, books, dental technician services and cultural activities. Thus, the base of VAT in Germany is very wide.

German VAT system has a strong administration and a Centre/State harmony on revenue sharing. The VAT system is controlled and legislated by the federal government so that common rates apply on a common base. This arrangement simplifies administration and minimizes inefficiencies. The states however are responsible for the day-to-day running of the system and collection of VAT revenue. As the VAT based on destination principle and rates are common there are no more problems with interstate trade.

VAT in the German federation is characterized by inflexibility both as regards base and rate setting and revenue sharing. For such a system federal and state legislature must agree on a common base, revenue sharing formula, tax structure and administration and rates. This agreement is greatly facilitated where the federal government has ultimate power over such proceedings. However, the VAT system is ideal from point of view of the federal government as it can maintain careful control over its fiscal position and macro economic policy. The total VAT revenue is currently shared between the federal government and states roughly in the ratio of 70/30 percent.

The German VAT, as a model for other countries, according to Tait, exemplifier the need for an agreed federal and state legislation on base, structure and
rates. At the same time it should be mentioned that even the formula of sharing of VAT revenue between the federal and state governments could be achieved without considerable disagreements.

4.6 MEXICO

Tax structure in the Mexican federation was largely undeveloped until 1950. The main emphasis was on a range of specific taxes levied on three easy to tax bases:

- Natural resources
- Industrial production
- International trade

At the end of the 1940s, a national turnover tax introduced which replaced a large number of production and sales tax and represented the first stage of indirect tax reform. The deficiencies of the financial turnover tax as regional cascading, calculation of the tax content of exports, vertical integration and the favoring of large firms and the taxation of investment led policy makers to consider a VAT. Because of its potential to streamline and simplicity which comprised many sales and excise taxes with multiple rates, VAT become more attractive. These considerations led to the adoption of a VAT in 1980.

The main characteristics of the 1980 VAT law are:

A single general rate at an adequate level (10 %)
- Few exemptions
- Use of the zero rate almost exclusively of exports
- A special regime devised for tax payers for ease of administration and
- Exemption of agricultural products, to eliminate the need for administrative controls in a sector where they would be difficult to apply.

The Mexican VAT replaced 30 financial excise taxes and 400 municipal and stage taxes which simplified tax administration and improved compliance with indirect taxes. VAT introduction was a central feature of the 1978 – 1981 tax reforms. The latest episode of the tax reform took place between 1989 – 1991 focused on base broadening, strengthening administration and enforcements as well as on the simplification and reduction of VAT rates.
The Mexican VAT is levied on activities connected with the sale of goods, the provision of independent services, the granting of the temporary use of property and the importing of goods and services. Exports were zero rated since VAT introduction. Agricultural products and machinery, medicines were also zero rated. Housing construction and rentals, passenger transport, education, most medical services and public administration are exempt. As a result, though large fractions of value added in mining (90%), manufacturing (80%) and commerce (70%) fall within the taxable base, the taxable proportion of value added in construction (30%) and agriculture (10%) is low. There are also administrative problems connected with the inclusion of the self-employed and small business in the VAT net (World Bank, 1989).

When first introduced, VAT was levied at a single rate of 10%. This general rate was increased to 15% as part of response to rising fiscal deficits in 1983. To improve the progressivity of the system an additional rate of 20% on luxury goods was subsequently introduced. A 6% rate on food was also included at a later date. In 1991 the general rate lowered from 15% back to 10% rate implying that the bulk of transactions are now taxed on the same basis in all parts of the country (Aspe, 1992).

In Mexico, the financial government has control over the VAT through administration and collection is carried out by both the states and financial districts. For this type of system to work it is necessary that two conditions should meet:

✓ There are sufficient incentives for state and local governments to collect the tax.

✓ State and local taxes which tax the same base as VAT but which gives states either exclusive or more favorable revenue claims are not allowed or are at least contained.

The present system of Mexican VAT is designed to be rigid to simplify administration, promote national tax harmonization and to prevent the introduction of distortions. Mexican VAT is on the basis of the destination principle and interstate trade is not taxed. VAT rates and bases are constant across the different states. There are problem with zero rating and exemptions and also with the taxation of particular sectors like agriculture, self-employed, small business etc. However, from the perspective of administration and efficiency the system is attractive. The main difficulties have related to the issues of collection and revenue sharing.
A General Revenue Sharing Fund (GRF) was set up as an incentive for VAT adoption, where the GRF for a particular year is determined by:

$$GRF = 0.30 \text{ VAT} + 0.13 \text{ FA} - \text{DEV} = 0.175 \text{ IF},$$

Where

- VAT = Value Added Tax
- FA = Adjusted Fund
- DEV = Tax Rebates
- IF = Total federal receipts (World Bank, 1989).

This shows comprised of 30% of VAT plus a complementary fund which equals 13% of the total federal revenue pool less the jurisdictional VAT rebates (World Bank, 1989).

Distribution of the GRF to the 31 states and federal district is done in accordance with above formula. The main problem relates to the fact that because states have given up their ability to levy taxes in exchange for revenues sharing there is less of an incentive for collection. But a recent reform which allows a state to retain 30% of the VAT assigned to it has increased collection effort.

The system does, however, have very strong advantages as regards having a coherent base and rate structure and a coordinated administration which greatly reduces the scope for inefficiencies. Also partly because fiscal policy is largely under the control of the powerful government, macro economic stabilization through fiscal correction has proved to be very successful and is identified as being one of the main factors underlying Mexico's recent turnaround (Aspe, 1992).

### 4.7 EUROPEAN UNION

The Value Added Tax which was also adopted by the every member countries of the European Union (EU) as the ideal means to promote neutrality and uniformity. Though the EU Fiscal and Financial Committee had recommended the adoption of VAT in 1962 for all Member States, the change for original members was completed only in 1973 when Italy switched over to the VAT. The original invoice based method of the EU is the most popular VAT system among several countries in the world.

Coverage of VAT in the EU includes both goods and services. Since each member states has its own VAT law and, given that the EU has only mandated that the standard minimum VAT must be 15% rate vary among Member States and among certain types of products. There are one or two reduced rates on a few
specified items with a minimum of 5% following the removal of border controls. The standard rate varies from 15% to 25%.

As of January 1, 1993, the “Single Market” became reality, national borders ceased to exist within the EU. A “transitional arrangement” was put in place that combined both origin and destination based taxation, making it possible to abolish controls at tax frontiers. For individuals, VAT liability was incurred by transactions. This meant that individuals could purchase goods and pay VAT on the goods in a Member State other than their own (i.e. at origin). They could then return to their home Member State (destination) with their purchases without paying any more VAT.

While private individuals have benefited from origin based VAT, companies have been subject to various destination based methods. Non-EU companies that export to the EU are taxed at import; exported goods are zero-rated and not subject to the VAT.

According to the Sixth Council Directive of the European Community, a “farmer” is being taxable within the frame work of a list of agricultural production. This provides a common flat rate scheme for farmers to use. Under the flat rate scheme, the farmer gets compensated for the VAT he pays on his inputs and he is exempt from both registering for the VAT and issuing an invoice. But there are certain problems with respect to the flat rate compensation in EU.

✓ Depending on the particular type of farming, the VAT paid on final production could vary. As the flat rate is not in a position to compensate all the farmers equally, a flat rate VAT allowance appears necessary.

✓ Tait also points out that Member States differ in their treatment of the disposal of capital goods. So they suggested the ratio for calculating the flat rate should be:

$$\frac{\text{Total input tax for the sector}}{\text{Final production + resale price of used capital goods}}$$

Except all these problems, by the time of the submission of Sixth Draft Directive to the Council, all the nine member - countries, Denmark and United Kingdom, do not have a special regime to farmers. In other member countries, there is flat rate compensation system.
4.8 CONCLUSION

The above study of leading federation brings forth that the implementation of VAT is not difficult in a federal country. But it is meaningful to have dual VAT in a federation. It is considerably easier to resolve the problems of cross-border trade when there is a dual VAT system. It is very important to know why adoption of VAT is difficult in a federal country. The tax system of a federation needs to satisfy several criteria other than the usual canons of equity, efficiency and minimal collection costs. Some of the aspects are:

✓ The primary reason for the absence of VAT at the state level appears to be the lack of Inter-State harmony in the tax structure. Without such harmony state VATs would need to be based on origin principle for interstate sales. An origin based VAT distort the location of economic activity unless the tax was imposed at a uniform rate in all other states.

✓ The states forming a union or a federation need to co-operate with the national government in the process of tax reform. Introduction of VAT requires tax harmonization, with very little variation in the tax rates across the federating states. A uniform VAT may not meet the differential requirements of the constituent states. There is a conflict between fiscal autonomy of states. Therefore, VAT in a federal country has been a subject of debate.

✓ In a federation there is Inter-State tax competition. As explained by Keen (1999), "The exercise of their tax setting powers may trigger external effects across jurisdictions – international or otherwise with consequent potential for the provinces to do themselves mutual harm. The destination principle in itself goes a long way in this respect: origin taxation, in contrast, creates scope for either exporting taxes onto foreigners or stealing tax base by under – cutting rates charged elsewhere".

Inspite of all these problems, the experiences of various countries with VAT brings forth that it can work in a federal system also. However, it is very important that the states have, to have an interest in making the collective system work and perceive that the formula for revenue distribution is fair (Tait, 1988).
REFERENCE


Tait Alan, 1988, "Value Added Tax: International Practice and Problems", International Monetary Fund, Washington D C.