CHAPTER-5
SALES TAX v/s STATE VAT

"The Indian Sales tax are scarcely models for other countries to follow, they are perhaps better characterized as having features to avoid. But the manner in which the states have adopted these taxes to the circumstances of the country and to meet new problems is of substantial interest (John.F.Due) (Purohit, 1995)."

5.1 INTRODUCTION

Sales tax is a most important fiscal measure in India. Sales tax has occupied the important revenue generating instruments to states. Sales tax is an advalorem levy imposed on the seller with reference to the transaction of sale. Sales taxes are levied by the states in various forms under its own legislation conferred by the constitution. They vary in structure, point of levy and the rates as well as administrative procedures. In any state, neither the structure nor the procedures are simple. Sales tax in a state may in the form of a single point, double point or multipoint levy. The rate structure of sales tax is also complicated in view of exemptions, numerous nominal categories in each of the states. Since independence, sales tax has grown considerably in depth and coverage and also it forms the mainstay of states own tax revenue.

5.1.1 PRE-CONSTITUTIONAL DEVELOPMENT

Entry 48 of List II in the Seventh schedule of the Government of India Act 1935, vested powers to the province to levy taxes on sale of goods and advertisement. Maharashtra was the first state to impose a selective tax on the sale of tobacco in 1938. Second in list was Madhya Pradesh that imposed a tax on the retail sale of Petrol and Lubricants in January 1939. But the first state to impose general sales tax was Tamil Nadu, which levied a multi point sales tax in 1939. Bengal, Punjab, Bihar quickly followed and by 1948 all provinces, barring Jammu and Kashmir, introduced sales tax in their provinces.

5.1.2 POST-CONSTITUTIONAL DEVELOPMENT

Under Entry 54 of List II in the Seventh schedule of the Constitution, states have been given power to levy a tax on sale or purchase of goods other than newspapers. The taxes on the sales or purchase of goods in the course of inter-state
trades were brought expressly within the purview of the legislative jurisdiction of the Parliament. In 1956, Central Sales Tax (CST) Act was passed. The important objective of the CST Act was:

- To formulate principles for determining when a sale or purchase of goods takes place in the course of inter-state trade or in the course of import into or export from India.
- To provide for the levy, collection, and distribution of taxes on sale of goods in the course of inter-state trade or commerce.
- To declare certain goods to be of special importance in inter-state trade and specify the restrictions to which state laws imposing taxes on the sales and purchase of such goods of special importance shall be subject.

CST Act of 1956, authorized the states to impose and collect taxes on inter-state trade and commerce under the provisions. A maximum rate of tax has been fixed. While the CST was levied by the Centre, the rate would be fixed by the exporting state which was also authorized to collect and retain the revenue. CST, which was levied at the time of its introduction in 1956, has been raised in stages to the present rate of 4 percent.

Apart from the introduction part, this chapter has been divided into nine sections. Section 5.2 discusses nature of existing sales tax system in India and 5.3 explain classification of sales tax. Section 5.4 studies present features of Indian sales tax system. Section 5.5 analyses shortcomings of the sales tax system and 5.6 discusses need for sales tax reforms. Section 5.7 discusses need for VAT. Superiority of VAT and fears about VAT is discussed in the section 5.8 and 5.9 respectively. Last section draws conclusion based on above discussion.

5.2 NATURE OF SALES TAX SYSTEM IN INDIA

Before turning to the VAT, it will be useful to set the stage, by describing the characteristics of an ideal sales tax, defects of existing sales tax, how a VAT achieves the characteristics of an ideal sales tax.

Being an important tool for revenue generation in the State List, all state governments have adopted sales tax. Each state has adopted different variants of the sales tax due to a number of reasons including administrative convenience, ad hoc measures to increase tax revenue etc. Exercising the powers conferred by the constitution of India, every state has enacted its own legislation on sales tax and
framed sales tax Acts and related rules. Sales tax in a state may take the form of a single point, double point or multi point levy. However, sales tax system in India can be broadly classified into two types:

- Federal sales tax
- States sales tax

The central sales tax can be considered as the federal sales tax, as the central government has the choice to levy the tax and define the rules to govern its administration, though states collect and retain the proceeds. The General Sales Tax (GST) levied by states on the transactions within the boundaries of a state comprises the states sales tax. While CST is levied on inter-state sales, GST is levied on the intra-state sales.

A series of transactions take place in the production of goods, beginning from the vendors who sell inputs to the manufacturers, wholesale traders, retail traders, till it reaches the hands of the consumers. We can depict it as below:

```
Vendors
  ↓
Manufacturer
  ↓
Wholesaler
  ↓
Retailer
  ↓
Consumers
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Some times, there are more than one wholesaler and more than one retailer in the chain, before the goods ultimately reach consumers.

**5.3 Classification Of Sales Tax**

On the basis of collection, sales tax can be broadly classified into:

- Single - Point Sales Tax
- Double - Point Sales Tax
- Multi - Point Sales Tax
5.3.1 **Single-Point Sales Tax**

When the sales tax is levied at only one point of sale, it is called as single point taxation system. It may be either at the first point or at the last point. The tax is said to be collected at the first point of sale, when the tax is levied only on the manufacturer when he sells his goods to the wholesaler or on the wholesaler when he sells the goods, which he has imported from outside the state or country to a retailer. All subsequent sales of the wholesaler to the retailer and to the consumers are exempted from taxation and these exempted sales are called as "Tax Paid Sale". Under Tax Paid Sale system, enforcement of this tax requires the first dealers’ pay the tax and verifying that the subsequent dealers have documents to prove that the tax paid goods have been purchased.

The advantage of the "Tax Paid Sale" method is that, it is administratively more convenient since tax is collected from relatively a small number of assesses who are manufacturers or whole sale dealers. Most state governments rely on this method of taxation for generating revenue. The disadvantage of the system is that all subsequent stages of production and distribution chain escape taxation. Value added in the subsequent stages of production and distribution is not captured and leads to loss of revenue to the state government. It encourages producers to shift value additions to subsequent stages in order to minimize the burden of the tax. Moreover, it is not easy to determine the effective incidence of tax by different consumption and income group, making it difficult for the state government to design a progressive tax system.

The single point taxation eliminates the cascading effects of taxation and makes it easy for state governments to consider and determine the kind of burden that should be imposed on consumers of different products. Sales tax at the retail stage can be shown separately from the price of the goods. But on the other hand tax administration becomes difficult due to the large number of taxpayers ranging between small shopkeepers and scattered retail outlets.

Sales tax at manufacturing or wholesale stage is administratively preferable, because the number of taxpayers is small and readily identifiable. However, the problem of ‘cascading’ will reappear.
5.3.2 **DOUBLE - POINT SALES TAX**

When sales tax is levied at two points, usually at the first point and the last point of sale, then the system is called as double point taxation system. This system is comparatively simpler to the multi point taxation and reduces scope for evasion. But the main disadvantage of this system is that the discontinuous stages of production and distribution chain escape taxation.

5.3.3 **MULTI - POINT SALES TAX**

When sales tax is levied at two or more stages of production and distribution chain, then this system is called as multi point taxation system. This system can generate a given amount of revenue at a lower rate of taxation. Multi point sales tax reduces the temptation for tax evasion. But it encourages vertical integration of production and distribution process, in excess of the technological requirements. Administratively also this system becomes a difficult task for the tax collectors to track and collect tax at each and every stage of production and distribution chain. As this involves more work it becomes unattractive to tax administers.

5.4 **PRESENT FEATURES OF INDIAN SALES TAX SYSTEM**

We can identify the following features of the sales tax which has been summarized below:

5.4.1 **FIRST POINT TAXATION**

Most of the states were following the system of Single Point taxation and tax was levied at first point of sale, for majority of the goods. Bulk of sales tax revenue was generated from such a levy. However, states did collect tax for some commodities at the last point of sale, double point and at multiple points.

5.4.2 **RATE STRUCTURE**

The rates of sales tax have been designed in such a way that a large number of commodities used by poor people have been exempted. Rate structure differs from states to state and within a state has a wide range. Commodities are taxed differently according to their nature viz., necessities, comforts and luxuries. Generally, necessities are taxed at a very low rate of 1 to 4 percent, or even exempted. Comforts are taxed at an average rate of 10 to 12 percent. However, in the case of luxury items
like motorcars, refrigerators etc, and the rate may vary from 15 to 20 percent in some states.

Commodities treated for differential treatment are classified in ‘Rate Schedule’ annexed either to sales tax Acts, or to the rules and procedures of the Act. Residuary entry in the rate schedule covering all commodities not classified elsewhere is referred to as a ‘General Rate’. The numbers of rates in most states is at least six or seven and in some as many as twelve or more varying from zero and one percent to 150 percent.

5.4.3 EXEMPTIONS

Exemption for commodities varies from state to state, either to reduce the regressivity of the tax or as ‘incentives’ to the industry. This provides:

✓ Concessional tax on sale of output.
✓ Provide for deferment of tax
✓ Makes provisions for interest free sales tax loans. In most of the states, specification is provided for the area of location of industry and for the specific commodities produced in the states.

Exemptions can be broadly classified into:

i. Exemptions for necessities:

Those commodities that fall under the mass consumption of poor strata of the society and which are crucial in the budget of the lower income groups are exempted on the consideration of the principle of equity. Examples of such exemptions would include tax exemptions provided by most of the states for basic food products sold in unprocessed form, student’s exercise books, maps and bicycles. This also helps the states to design a progressive tax structure.

Nevertheless, states must exercise rational judgment while exempting such necessities. However, there are significant inter – state variations in the list of exempt food items. For instance, Haryana, Punjab, Rajasthan, Uttar Pradesh and Orissa apply tax to cereals and pulses, while many other states exempt them. Tamil Nadu exempts cereals but not pulses. Andhra Pradesh exempts pulses but not wheat or rice.
Apart from the exemption, the tax rates can be at very high rates so as to prevent the citizens from consuming those, which will be harmful. For instance, Karnataka had fixed the sales tax rate for liquor at 115% while Tamil Nadu has fixed a rate of 70% on sale of foreign liquor. Similarly, Maharashtra has fixed a rate of 60% on sale of lottery tickets.

ii. Exemptions For Specific Institutions:

Under this, exemptions are granted for goods sold to or by particular social or economic institutions, with the intention to encourage certain types of production in preference to other. For instance, co-operative societies, khadi, village and small-scale industries in preference to others. Another category of exemption is related to end-use like military canteens, public hospitals and so on.

Exemption is also in the form of industrial incentives which take various forms such as deferment of sales tax, sales tax holidays, repayment of term loans from sales tax collected etc. These are generally limited to new industrial enterprises, small-scale enterprises, and units locating in specific areas.

iii. Other Exemptions:

On the other hand, sales tax exemption is also granted to most of the perishable agricultural and dairy products on the basis of administrative expediency. Some exemptions are granted because a different statute exists for taxing these commodities. For instance, additional excise duties in lieu of sales tax are levied by central government on textiles, sugar and tobacco under a 'tax rental agreement' between central government and state.

The exemptions led to unproductive inter-state competition and unhealthy rate wars amongst states also existed. This caused diversion of trades to neighbour state where the rate was comparatively lesser. Diversion of trade resulted in revenue loss to the state form which trade was diverted.

5.4.4 Treatment of Inputs

Sales tax is generally levied on the sale or purchase of commodities including raw materials, inputs and capital goods, except for commodities specifically exempted. To alleviate the cascading effect of taxation, total exemption or taxation at concessional rates for inputs were provided by some states. Only few states allowed
rebates to manufacturer on the inputs like raw materials, parts and consumables used in manufacturing process.

In Haryana, Himachal Pradesh and Punjab manufacturers can buy inputs free of tax while some states reduced the tax to approximately 4%. Some states reduce the input tax rebate in respect of goods that do not subsequently attract the state sales tax. No rebate was allowed in respect of machinery and equipment or for inputs used in the distribution of goods.

**5.4.5 Taxation of Inter-State Sales**

Tax is collected in respect of inter-state sale of goods by the government of the state from where the movement of goods commenced under the Central Sales Tax Act of 1959. CST is legislated by the centre but collected and retained by states. There is a ceiling on the rate of tax which can be levied. Initially fixed at 1% but the current rate stands at 4%. If the rate of tax within the state is less than 4 percent, CST permits sale of such goods in the course of inter-state transaction without the use of 'C' form. While the exporting state does not lose in the process, the importing state could lose some revenues, since such transactions would often go unrecorded in the importing state in the absence of any documentation.

Administration and compliance of CST becomes complex requiring the sales tax department to monitor the sale to unregistered dealers of another state and the requirement to procure ‘C’ forms from the sales tax department or from the importer, as the case may be. Since CST are not set off in subsequent transactions, this leads to cascading effect as sales tax is levied on the sale price on the goods after landing in the importing state, which has the CST embedded in it.

**5.4.6 Surcharge and Additional Sales Tax**

Some states levy surcharge on the basic liability and some states levy additional sales tax, but there are other states which levy both. These were done purely for revenue considerations.

**5.4.7 Tax on Resellers**

Since most of the states levy sales tax at the point of first sale, dealers other than the first dealer, though, being within the overall tax administration, do not have to pay tax and are treated to be outside the system. In order to generate more revenue
some states started levying a resale tax on these dealers. While in some states, it takes the form of a turnover tax, where dealers above a threshold limit of gross turnover are levied a tax on their annual turnover, some states levy a resale tax.

5.5 SHORTCOMINGS OF THE SALES TAX SYSTEM

India is a federal country with clear-cut demarcation of functions and resources between the centre and the states. This has led to interminable problems in separating out the service component in sale of goods taking place in several instances. Pressure for revenue has impelled many states to go in for supplementary levies in the form of surcharges, additional sales tax and in many cases, a turnover tax applicable at different stages of sales resulting in lack of transparency and uncertainty and for several sectors unduly heavy burden of tax. That in turn generated pressure for further concessions for selected sectors and sections with the result that, rates vary widely across commodities depending on their classification in the rate schedule, which is based on distinctions.

According to the Report of a Study Team, NIPFP (1994), the manner in which sales tax was structured and administered caused:

- Loss of output
- Inefficiency and high cost
- Handicap for exports
- Impediments for free flow of trade within the country and growth of common market that the Indian union offers, and
- High cost of compliance and enforcement

Some of the shortcomings of the prevailing tax system at the state level in India are outlined below.

5.5.1 COMPLEX STRUCTURE

Provisions in the sales tax acts of states, right from criteria to become eligible to pay sales tax to penalties and punishments for offences committed under the acts vary from state to state. It would be difficult for some one to compare various provisions of the acts across the states. Complexity makes the system unfair by imposing a disproportionate compliance cost burden on small business. It also creates inequalities by providing unequal opportunities for evasion and avoidance depending on the nature of the commodity and operation of trade channels.
5.5.2 Treatment of Tax on Inputs

A closely related problem is the taxation of inputs by the central and the state governments through excise duties and sales tax respectively. Treatment of tax on inputs varies from state to state. While some states do not allow any set-off for the tax paid on inputs or raw materials against the tax to be collected on sale of manufactured goods where such inputs or raw materials were used, some states allow such a set-off only when manufactured goods are sold within the state. Some states offer concessional rates. Apart from generating cascading effect, sales taxation of inputs benefits the comparatively richer state at the cost of poorer states.

To quote "The taxation of inputs also means that its burden falls on consumers outside the state. While procedures exist for refund of excise duties on a product when it is exported outside the country, the sales tax paid on inputs is not rebated. In consequence, the more developed states which have attained high levels of agricultural or industrial production are able to derive additional resources, by taxing consumers in other states, while the resource mobilization capacity of the less developed states, which have to depend on most of their needs being met by imports from other states is weakened". This reverse flow of funds is further strengthened by the frequent in the rate of central sales tax.

5.5.3 High and Multiple Rates

Not only there are a number of rates of sales tax in states, but also these rates are revised frequently, mainly for revenue consideration of the concerned state governments. This often results in the business community losing confidence on the government. The tax structure was mostly concentrated towards higher side.

For example, the import duties had the nominal tariff rates mostly in the range of 75 to 100 percent with average duty estimated to be over 100 percent. Thus, the higher rates had caused increase in effective rate of protection making the products non-competitive. However, the high costs limit the size of domestic market causing constraint on the ultimate growth. High tax rates aggravate the distortions inherent in manufacturer's tax. They also provide incentives for evasion and avoidance, and generate pressures for exemptions and concessions.
In order to attract trade and industry to their respective areas, some states have been indulging in a kind of 'rate war'. Differential rates of sales tax on the same set of commodities in different states often lead to uneconomic diversion of trade as well as production centers. Similarly, rate differentials may cause flight of capital and enterprise from high to low tax rate states thereby distorting natural selection of production centers based on geographical advantages, leading to unnecessary transportation of raw materials and finished goods and hence cost escalations.

5.5.4 Multiplicity of Levies

The present sales tax system is characterized by multiplicity of levies on the same base. The existing system allows levy of different taxes on the same base. The multiplicity of levies like additional sales tax, surcharge, resale tax and turnover tax creates further confusion in the minds of the taxpayers and encourages tax evasion. The tax department also finds it difficult to administer such a wide range of rates and multiple levies. The area of disputes widens, which make compliance more expensive. The levies imposed as supplements to sales tax are also often structured to serve the objective of progressivity while raising additional revenue. Multiplicity of levies results in lack of transparency and creates economic distortions.

5.5.5 Vertical Integration

The first point and the multi point tax system induce vertical integration in the business in excess of technological requirements, causing economic distortions. In order to attain specialization, a firm should direct its concentration on its core area, rather than engaging itself in different activities. Instead of outright purchasing of certain parts required in the production process the firms starts manufacturing these as well, there by directing its concentration on the non-core activities also. The reduction in the number of sales transaction helps the firm to minimize the payment of tax. Though this helps in tax saving, it serves as an incentives for the firms to integrate vertically wherever possible.

To discourage this trend, the Modified VAT (MODVAT) was introduced in the year 1986 in respect of goods covered by 37 specific chapters of the Central Excise Tariff. This scheme was extended to cover practically all chapters except those relating to petroleum products, textile products, tobacco products, cinematography films and matches. However, the coverage of MODVAT was not complete. Also at state level, the sales tax system does not provide any such mechanism.
5.5.6 BACKLOG OF UNRESOLVED DISPUTES

The complex and irrational sales tax system has created huge backlog of unresolved disputes. The approach has been to use section and chapter notes to provide classifications. Conflicts arise not only over whether or not certain sales should be subject to the tax, but also over which tax rate should be applied. The judicial rulings generate notes to the law, which constitute changes, without necessarily addressing the origin of the disputes.

5.5.7 PITFALLS OF THE FIRST POINT SALES TAXATION

An important problem in the sales tax structure relates to the point of levy. There has been a tendency of the states over the years to switch over the point of levy to the origin. Most of the states rise between 70 to 90 percent of the revenue from the first point tax. So that the states levy sales tax at the first point of sales resulting in narrowing down of the tax base due to the exclusion of the value added in the subsequent stages.

Moreover, it is not easy to determine the effective incidence of tax by different consumption or income group, making it difficult for the state government to design a progressive tax system if it desires so. Primarily for reasons of administrative convenience, the states have tended to apply the tax more and more at the first point of sale, falling either on manufacturers or on importers from other states or from abroad.

First point taxation also leads to discrimination amongst goods, depending on the number of stages they go through in the course of production and trade, and also the relative proportion of value added at the subsequent stages of sale. It is also not possible to discriminate between purchaser for intermediate use and those for final consumption. This may result cascading, excess burden and distortions in economic decisions.

5.5.8 CASCADING EFFECTS OF TAXATION

Cascading Effects of Taxation occurs when inputs of a business are taxed and no set-off is given when computing the tax due on the output sold. Non-availability of such a set-off inflates the input cost of the business both directly as well as through inflated interest costs for financing the business activity.
Table 5.1: Impact of cascading on prices

<table>
<thead>
<tr>
<th>Manufacturer</th>
<th>Value of inputs</th>
<th>Value of inputs inclusive of taxes</th>
<th>Value added</th>
<th>Value of output</th>
<th>Multi point tax I</th>
<th>Multi point tax II</th>
<th>Retail sales tax</th>
<th>Total tax collected</th>
<th>Value of good at final point of sale</th>
<th>Contribution of cascading to tax revenue</th>
<th>Additional impact on prices due to cascading (excluding tax cascading)</th>
<th>Total impact on prices of cascading as a percentage of the value of output excluding taxes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Value of inputs</td>
<td>100</td>
<td>100</td>
<td>160</td>
<td>211.2</td>
<td>211.2</td>
<td>211.2</td>
<td>211.2</td>
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<td>211.2</td>
<td>211.2</td>
<td>211.2</td>
<td>211.2</td>
</tr>
<tr>
<td>Value of inputs inclusive of taxes</td>
<td>110</td>
<td>107.7</td>
<td>50</td>
<td>160</td>
<td>160</td>
<td>160</td>
<td>160</td>
<td>160</td>
<td>160</td>
<td>160</td>
<td>160</td>
<td>160</td>
</tr>
<tr>
<td>Value added</td>
<td>50</td>
<td>50</td>
<td>50</td>
<td>50</td>
<td>50</td>
<td>50</td>
<td>50</td>
<td>50</td>
<td>50</td>
<td>50</td>
<td>50</td>
<td>50</td>
</tr>
<tr>
<td>Value of output</td>
<td>160</td>
<td>157.7</td>
<td>12.1</td>
<td>12.1</td>
<td>12.1</td>
<td>12.1</td>
<td>12.1</td>
<td>12.1</td>
<td>12.1</td>
<td>12.1</td>
<td>12.1</td>
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</tr>
</tbody>
</table>

Source: Source: Primer Of Value added Tax, Dr.Raja Chelliah (ed), NIPFP, 2001
The increases in the price of inputs in only on account increases in its cost of production, but also on account a tax on tax. The cost of production increases. Domestic industries are therefore, put to disadvantageous position as their products become expensive when compared to the import and export markets.

An example of how existing sales tax leads to cascading effect and how VAT avoids the ‘cascade effect’ is presented in the table 5.1. The table shows that the price of the good without a tax would be Rs.198 at the retail stage. A retail sales tax of 10% would raise the price to Rs.217.8, giving the government revenue of Rs.19.8. In a regime of first point taxation, the increase in price at the retail level is significantly higher at Rs.224.10. The tax rate in this case only 7.68%. For the same tax rate, a retail sales tax yields lower revenue than a first point or a multi point tax.

5.5.9 Vicious Circle

The first stage tax results in a narrow tax base to the state government. State governments are forced to increase the rates of taxes and also to resort to multiple taxes. This leads to higher cost of production, tax avoidance and inter-state competition. Higher cost of production ignites the pressure for industrial incentives. Industrial incentives along with tax avoidance and inter-state competition lead to loss in revenue to state governments. Loss in revenue once again requires state governments to increase the tax rates and go in for multiple rates, requiring complex legislation. Complex legislation results in poor compliance and weak enforcement, forcing the state governments go in for first stage tax, in which the revenue base once again becomes narrow.

In the diagram, the starting point is the poor compliance by taxpayers and weak enforcement of tax laws by administrators. The reason for weak enforcement may be inefficient administration. This leads to impose tax at the first point of sale. The narrow tax base necessitates higher tax rates and it results cascading, which increases tax avoidance and inter – state competition and creates pressures for industrial incentives. These forces further undermine revenue potential of the tax system and elicit policy response. The result is a more and more complex structure, which can worsen compliance and enforcement. So, thorough reforms are needed if the problems as to be removed.
5.5.10 INTER – STATE SALES TAXATION

Another important problem in the sales tax structure relates to taxation of out–of–state sales. The CST Act which is based on the recommendations made by Taxation Enquiry Commission (TEC) of 1953-1954, no doubt helped to restore some order in the tax system of inter–state sales, the operation of CST has impeded growth and diminished welfare by acting as barriers to free trade. It has also given rise to problems like,

1. Cascading
2. Valuation of inter-state sales
3. Tax exporting
4. Inter-state tax competition
5. Tax evasion
6. Problem of consignment

1. Cascading

The tax on inter-state sales levied on all commodities which also includes inputs when sold in an inter-state transactions. No relief is available to users in the importing state even when these are used as industrial input while some relief is
commonly extended for taxes paid on locally purchased inputs. As a result, the effective rate of tax on goods produced and consumed.

Since the CST is leviable on each inter-state sale of goods, regardless of the tax at prior stages, when the goods go through a chain of purchase and resale in several states, the tax cascades in a manner similar to a multistage turnover tax.

For example, if a dealer in Karnataka imports paper from Maharashtra and then resells it to a dealer in Tamil Nadu, the CST would apply twice, for a total burden of 8%. This becomes a handicap for the Karnataka dealer, compared with one who can arrange a sale directly from Maharashtra to Tamil Nadu.

2. Valuation of Inter-State Sales

A sales tax based on the origin principle in an unharmonised regime gives rise to the problems of valuation of inter-state sales among sister companies. It is similar to the problem of transfer pricing under the income-tax system. When the tax on inter-state sale is not rebatable against the tax on the resale of the goods in the importing State, both the exporting and the importing dealers have an incentive to undervalue the inter-state sale.

3. Tax Exporting

The sales tax system prevailing in India is a form of restricted cascading type origin tax. The exporting state levies the CST, and the importing state applies its local rate on the resale value of the goods imported including the CST paid to the exporting state. This system hinders the smooth flow of inter-state trade and growth of a common market with its benefits that a country of India’s dimension could offer. It raises issues of inter-jurisdictional equity which need to be resolved in the interests of unity and political stability of the country.

4. Inter-State Competition

The lack of harmony in the tax structure has promoted tax competition. In the bid to attract trade and industry some states reduced the rates of tax on sales compared to those prevailing in the neighboring areas. Union Territories, in particular, Pondichery, Dadra and Nagar Haveli have reduced sales tax rates to attract shoppers from neighboring states. Many states had lowered their sales tax rates on consumer durables to stop revenue loss from such inter-state shopping.
5. Tax Evasion

The lack of harmony in the tax structure has promoted tax competition. To attract trade and industry some states reduced the rates of tax on sales in their territories compared to those of neighbor states. Many states have had to lower their sales tax rates on consumer durable to stop revenue loss from inter-state shopping. Some states reduced the sales tax rates on motor vehicles, TVs and other electronic goods and raised the rate on certain basic food items from zero percent to 4 percent to compensate for the revenue loss from the rate cuts.

6. Problem of Consignment

The operation of inter-state sales tax has led business to find ways of avoidance and evasion. A simple and widely practiced way is to conceal inter-state sale of goods is transfer on consignment or branch transfers. Sale consequent to a "consignment" implies transfer by the manufacturer/dealer himself or his agent out of own premises in a state other than the state of origin (Final Report of Tax Reform Commission, 2001). This adds to costs since it implies transport of goods by the exporter to the importing state. It also encourages uneconomic location of production units for components used in an industry.

5.5.11 Narrow Base

The existing tax base is confined to commodities only. Services are exempt from taxation due to the constitution limitations. A few selected services are separately taxed under specific provisions of the constitution. Excluding services from the tax net arrows the revenue base of states. It also leaves plenty of scope for loopholes for avoidance of sales tax in some peculiar ways as in the case of works contract, where in sales as part of works contracts cannot be taxed.

The state can levy tax only on specified services like luxuries, entertainment, and amusements, betting and gambling and on goods and passengers carried by road and inland waterways. However, the general power to tax services does not lie with states. This has been a source of acute problems in taxing even the sale of goods where the sale takes place as an integral part of providing a service.

Since, services constitute a fast growing sector in the Indian economy; exclusion of services deprives the government of a profitable source of revenue. In fact, in most countries under VAT, the tax base does include services.
Besides the above, the whole tax system is very complicate. It is therefore, well recognized that internal trade transactions have been a source of inequity as well as distortion and inefficiency in economic decisions. It entails high cost of compliance and of administration. In the context of the prevailing situation the reform of sales tax has become an overriding priority.

5.6 NEED FOR SALES TAX REFORMS

One of the basic tasks of sales tax reform is to reconcile the revenue objectives that would sub serve the ends of equity growth and efficiency.

In this context, the reform of the sales tax has to concentrate on the following:

✓ Total removal of cascading
✓ Zero rating of inter-state sales
✓ Reduction in the number of rates
✓ Reducing the number if exemptions to a few goods
✓ Extending the tax to resellers on a value added basis

5.6.1 OBJECTIVES OF THE SALES TAX REFORM

The basic objectives of tax reform have to be to instruct neutrality and transparency to the tax system. The tax system should not cause distortions of producer choices and of consumer choices for one good over another. The following are the main objectives of the sales tax reforms in India.

1) Neutrality:

In the context of consumption taxes, the taxes should apply equally to as broad a base as possible including all goods and services. The important requirement for the neutral application of tax is removal of tax on production inputs including plant and equipments. This could be achieved either through suspensions of tax on production inputs or through a system of credits for the tax already collected on purchase of production inputs by registered manufacturers.

2) Equity:

Equity is a desirable objective. The international experience suggests that consumption taxes with multiple tax rates and exemptions cannot be applied in a fair manner. Equity is served better if the tax is applied at few rates taking into account both social policy and administration considerations.
3) Fiscal Autonomy of the Centre and the States:

Given this significance of consumption taxes in the finance of the centre and state, it is desirable that they continue to enjoy fiscal autonomy with respect to the broad design features and overall revenue contribution of these taxes.

4) Augmentation of Tax Revenue:

Reform initiatives should not affect the overall revenues of the centre and the states. State governments have a wide range of expenditure needs. Governments need revenue to provide public services, to redirect resources to areas of social and economic priorities, and to reduce inequalities in the distribution of income and wealth. Therefore, tax reforms in the sales tax system should aim at augmenting the tax revenue of the state government to meet its ever-growing expenditure needs. Revenue generation thus becomes the prime concern of states to undertake tax reforms.

As the income levels of citizens increase, the tax system is able to automatically gather revenues to the government, without the need for altering the tax rates. To achieve this objective, tax reforms should aim at a progressive tax regime and broadening the base of the sales tax. Even lower tax rates in this situation will be able to generate and revenue to the state.

5) Efficient Tax Administration:

Another important objective of reform is the improvement of tax administration. The replacement of the current structure by a simple and rational system would be an important step. Full benefits of tax redesign cannot be realized without complimentary reforms of administration system. When tax administration is weak, tax compliance is poor through tax evasion and avoidance. This results in revenue loss to the government. Complex tax laws and procedures, lack of trained staff, inadequate infrastructure makes the tax system weak. Complex tax laws coupled with enormous discretionary powers to tax officials, lead to corruption. Thus, tax reforms should aim at efficient tax administration.

6) Minimizing the Efficiency Cost of Taxation:

Efficiency cost refers to the difference between the resources that the government gains and sacrifices that is made by the taxpayers while the tax regime
should aim at a progressive structure. It should also take care that the sacrifice made by the businessmen does not provoke them to alter their decision on production and consumption. When the efficiency cost of taxation is huge, businessmen gets disgusted and tend to alter his production decision. Therefore, reforms should aim at a tax regime where the efficiency cost of taxation is minimum.

7) Rationalization and Minimization of Tax Incentives:

A large number of incentives have been introduced in the sales tax system to encourage savings and investments, increases production of certain goods in social interest, regional dispersal of industries etc. These incentives take the form of tax rebates, tax holidays, investment credits, depreciation allowance etc.

If these incentives are not properly employed they do not serve the objective of ensuring more effective allocation of resource in conformity with the social goods. Tax reforms should aim to rationalize and minimize such tax incentive, to justify the continuance of the incentives and phasing out the ones that have outlived its utility.

8) Simplicity of Tax System:

Tax reforms should aim at making the tax system as simple as possible. A simple system with least number of tax rates, exemption and deduction will give to the least possible discretionary power to the tax officials for interpreting the law.

5.7 WHY A VALUE ADDED TAX IS NEEDED?

An important component of structural adjustment initiated in 1991 had been the reform of the indirect tax system. In the first phase of reforms, the emphasis had been to simplify central taxes. The attempts had been made to broaden the tax base, lower and simplify the rate structure, and make more efficient the administration. The focus has been shifted to the reform of state taxes particularly sales taxes. It was necessary to rationalize the sales tax systems prevailing indifferently states so as to minimize the price distortions. The main emphasis on simplifying the rate structure and this would reduce the compliance cost to some extent.

The recent discussions on the direction of reforms in sales have pointed towards the need to transform the prevailing sales tax system in to a VAT. The major factor inducing large number of countries to go for VAT is to avoid the problems intrinsic in manufacturer’s sales or cascading turnover taxes. The introduction of VAT
recognized world wide as the best way for taxing indirect taxation. The main reason for its popularity is as follows:

✓ A set – off will be given for input tax as well as tax paid on previous purchases.
✓ Other taxes, such as turnover tax, surcharge, additional surcharge etc will be abolished.
✓ Overall tax burden will be rationalized.
✓ There will be self – assessment by dealers.
✓ Transparency will increase.
✓ There will be higher revenue.

In its purest form, VAT is a tax that is levied on the value added along different stages of production and distribution of a commodity or service. Therefore, it is a tax on the sum total of value added which is equal to the value of a commodity or service. In this sense, it should be equivalent to a retail sales tax that is collected only at the retail stage. But the retail sales tax is difficult to collect because there are too many retailers of various sizes. The VAT instead can be collected earlier stages of production in fragments and can end at the retail stage. But the total collected from the VAT should be exactly the same as if collected only from the retailers of the commodity concerned.

5.8 SUPERIORITY OF VAT

The VAT system is superior to the previous sales tax system and addresses the weakness of the system in the following ways:

1. In the sales tax system, there are problems of double taxation of commodities and multiplicity of taxes, resulting in cascading tax burden. In VAT system a set – off is given for input tax as well as tax paid on previous purchases. VAT liability is calculated by deducting input tax credit from tax collected on sale during payment period. Input tax credit is given manufacturers, traders for purchase of inputs, supplier meant for sale within sales as well as other states. Therefore, VAT does away with cascading effects. Having done so, it avoids distorting business decisions and the need for vertical integration is dedicated only by the market forces or technical considerations and not by the tax structures.

2. VAT improves accounting standards of traders as all stages of production and distribution are subject to tax. It encourages a better-administered system and the taxpayers are encouraged to keep proper records of their sales and purchases to
optimize the benefits that accrue to them. Moreover, incentives for undervaluing
the sales are lower.

3. VAT helps in buoyant tax revenues to the states as it is linked closely to
consumption. Value is created or added not only in the production process but
until the commodity reaches the hands of the final consumer. VAT therefore,
COVERS value added at all transactions and will fall on the value of the commodity
in the hands of the consumers. Since VAT permits a relatively larger coverage as
much as it is possible to extend it to value addition at all stages in the production –
distribution chain, the potential for raising resources efficiently is generally
higher.

4. It is desirable to replace the system of inspection existing in the erstwhile system
by a ‘friendly’ built – in self-assessment by traders and manufacturers, in the VAT
system.

5. VAT is susceptible to less lobbying, as the system becomes more diffuse.
Successful lobbying can get a tax removed or altered for the benefit of the entire
industry. Overall tax burden to be rationalized and prices would generally fall,
there by leading to a more efficient, equal competition and fairness in the taxation
system.

6. There is no other tax that can be as transparent and simple like VAT. At every
stage of transaction, VAT indicates the quantum of tax payable after adjusting tax
credits. The tax payer, the ultimate consumer, and the administration are all fully
aware of all the details of tax payment. This transparency improves compliance as
it becomes difficult to evade taxes successfully at every transaction stage.

7. The most important merit of VAT is its neutrality, which is the benchmark of an
efficient tax system. With uniform rates, VAT is neutral to producers’ preferences
and consumers’ choice. It treats all inputs uniformly to avoid any tax-induced
distortion. VAT also keeps total neutrality between capital and labor. If the
exemptions are kept at the minimum level, the impact of neutrality will be more
visible.

8. Since the cumulative effective of input taxation is absent under VAT system, the
cost of production increases by the amount of tax itself. Thus, by preventing
unnecessary cost escalation, VAT promotes competitiveness of domestic
industries in the world market and there by generates favorable effects on exports.
9. VAT has been successfully implemented in more than 120 countries of the world. It is a major source of revenue in many countries to the federal and or to the provincial governments, including Brazil, Canada and the member countries of EU, among other countries. It has also been an efficient and buoyant source of revenue wherever designed and administered properly.

The Value Added Tax has been seen as a way of:

- Modernizing the tax structure by substituting it for selective excise and imperfect single stage sales taxes, there by raising the revenue more efficiently and at lower economic cost.
- Encouraging trade based development by reduced reliance on tariff revenue
- Providing an abundant and elastic source of tax revenue.

Some major conclusions, which arise from both economic theory and practical experience, might be summarized as follows:

- Advantage in economic efficiency requires the tax to be consumption based with the destination principle, and to apply as little rate differentiation and a few exemptions as possible. The experience has been that the higher the degree of economic development, the more successfully can comprehensive VAT be applied.
- The major advantage of the VAT is its wide tax potential and neutrality with respect to domestic resource allocation.
- Any gains to trade are likely to arise from the more complete border tax adjustments, which the VAT permits as compared with early stage sales taxes and excise which get to enter into inputs in export industries.
- There are administrative advantages that largely arise from the improvement in auditing capability. However, this may require computerized system of record keeping cross checking.
- The more comprehensive the tax base, the more tax payers have to be dealt with and the more costly it becomes to collect the revenue.

5.9 FEARS ABOUT VAT

More than 140 countries have switched over to VAT. However a number of countries have not yet gone for VAT. Australia did not adopt VAT. In Greece, there was undue delay in switching over to VAT. The U.S has opted to be out of VAT.
The main reason is that the U.S does not merely appear to be satisfied with its existing states’ retail sales taxes. But the possibility of the federal government usurping the states’ powers of sales taxation has been keeping away from the VAT at a respectable distance. Therefore, very often the question arises – why the countries has not gone for VAT?

The most frequent objection to a Value Added Tax is that, it would be unfair to lower income individuals. It is often assumed that “A straight forward single rate of VAT with zero rates and a few exemptions must mean that the VAT payment by low income households will be in higher proportion of their income than payments by the higher income households. That is VAT will be regressive”. Regressivity of VAT increases if some of the items consumed as household income rise remain untaxed. Since consumption as a share of income falls as income rises, a VAT levied at a uniform rate falls more heavily on the poor.

The introduction of VAT has some times been opposed on the following grounds:

- VAT is more complicated than a simple cascading first point sales tax. Because the taxpayers has to keep accounts not only of sale but also purchases and taxes paid on those purchase. So, it is argued that for both taxpayers and administrators VAT is a more difficult tax to operate.

- It has been argued that the introduction of VAT would cause some inflation. Based on the above, following can be listed as reasons for not favoring VAT:

1. **FEAR ABOUT REGRESSIVITY**

   The most pointed criticism of a VAT is that, its burden is distributed regressively with respect to income. Since consumption as a share of income falls as income rises, a VAT levied at a uniform rate falls more heavily on the poor than the rich.

2. **ANTICIPATED HIGH ADMINISTRATION COST**

   Experience has shown that the introduction of several rates complicates the administration of VAT considerably. The complication arises from the fact that the tax-payer has to maintain separate records in order to match inputs and outputs that may be taxed at different rates.
3. Effects on prices

Another issue that is usually raised in discussions on VAT is the likely impact on prices. VAT, it is often said, is inflationary. The effect, however, depends upon whether VAT is a new levy, which is, intended to mobilize additional resources or simply replacement for existing tax to recover the lost revenue from other taxes reduced or replaced by VAT.

4. Compliance cost

Differentiated rates involve a significant increase in compliance cost, particularly of small firms. Usually it is not possible for them to keep separate accounts for the sales of differentially taxed products. The tax liability must then be determined by applying presumptive methods, an approach that increases the difficulty of monitoring the tax payer’s compliance. Smaller firms with lower income bear proportionately more of the burden than do larger firms.

The fear expressed above is overstated. The negative aspects are far less in magnitude than the positive aspects of VAT. There are alternative measures to tackle the problems of regressivity and so on. Tait puts it, “It is a great pity to sacrifice the good qualities of the VAT (Uniformity, Simplicity and Revenue Potential) to try to make it do what it is not intended to do (be progressive). Instead, transfers should be used to target households (low income, unemployed) or special benefits to get help to the really poor (Tait, 1991)”.

5.10 Conclusion

Thus, looking at the advantages of the VAT system, it can be concluded that since the advantages are more than disadvantages any country can adopt VAT. However, there are problems in any alternative. The country can adopt a VAT system, which is least distortionary and is a better substitute for the prevailing system. It should also be remembered that no country can evolve a foolproof system at one stroke. The current phase of the tax reforms is an important step forward. It is linked to the ongoing structural reforms. All these attempts are important and are likely to have far reaching implications for the reforms of the overall structure of the commodity taxes in the country.

In the Indian context, the attraction of VAT lies in the promise it holds for providing a solution to many of the ills of the present system. A move towards VAT is predicated strongly as the only way to cut through the laws and procedures that govern the system of commodity taxation in the country at present.
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