CHAPTER -8
SUMMARY OF FINDINGS AND CONCLUSION

8.1 INTRODUCTION

The basic idea of the VAT appears with a German businessman, Von Siemens, writing in the 1920s. Early proposals to introduce the tax were made in France in the 1920s definition used in this report, the first VAT appeared in France in 1948 which initially applied up to the manufacturing stage and gave no credit for tax on capital goods. It was converted to a consumption type VAT by 1954. Manufacturing level VATs were adopted by Coted’Ivore in 1960 and Senegal later in the 1960s. Michigan introduced the single business tax in 1953.

Brazil introduced the tax to South America in 1967. In the same year the adoption by Denmark began its widespread introduction in Europe. The pace of VAT implementation remains rapid until the late 1970s and again the latter part of the 1980s and well into the 1990s. The early phase was dominated by adoption of the VAT in:

1. Western Europe, following the decision of the European communities.
2. Latin America, following the initiative in Brazil.

Of the 24 member countries of the Organization for Economic Co-operation and Development (OECD), 21 have accepted the VAT as their main consumption tax. Switzerland and Australia are the only OECD area, which have not yet done so.

In India, there have been a number of attempts at improving the tax system since independence. The main objective of these attempts has been to enhance revenue productivity to finance large development plans. The various tax reform committees considered economic efficiency as one of the objectives. The first comprehensive attempt at reforming the tax system was by the Mathai Commission (1953-1954). It examined the workings of the tax system as a whole and sought a progressive tax structure. Since then, there have been a number of attempts, most of them partial, to remedy various aspects of the tax system. On the Indirect taxes side, an attempt was made by the Indirect Taxes Enquiry Committee in 1972 under the Chairmanship of L.K.Jha. It presented the first part of its report in October 1977.
It desired to "pave the way for an integrated indirect tax system in the country which is more efficient, more equitable and better-oriented to further the objectives of planned development" (Burgess and Stern, 1992). To deal with the problem of cascading in excise duties the committee recommended an extension of the existing procedures for relief of input taxation, moving eventually to a VAT at the manufacturing stage (MANVAT). Further MODVAT was introduced in 1986.

Systematic and comprehensive attempts to reform the tax system at the central level started only after market based economic reforms were initiated in 1991. The Tax Reform Committee under the Chairmanship of Chelliah laid out a framework for reform of direct and indirect taxes as a part of the structural reform process, following the unprecedented economic crisis. The Committee focused its attention on central taxes and made some suggestions for state taxes particularly in the final report.

On Indirect taxes the Chelliah interim report recommended a move towards a VAT on a broad base to eventually replace central excise. It suggested reduction in the general level of import tariffs, reduced spread of rates. In Budget, presented in February 1992, the government started to move in the direction of the report's recommendations. In the final report of the Chelliah Committee presented in 1992, the themes of tax reform were given shape in the interim report were elaborated upon. Taken together the Chelliah Committee Report constitutes the finest treatment of tax policy and reform issues in India in the past 30 years. The report provided an excellent combination lucid, theoretical analysis, empirical supporting evidence and practical policy recommendations.

The first major breakthrough in the direction of tax reform came in the form of an agreement between Union Finance Ministers and State Chief Ministers on November 16, 1999. The main objectives are:

1. Implementation of floor rates within the existing sales tax regimes.
2. Elimination of the tax based industrial incentives for new and expanding industries.
3. Replacing the existing system of sales tax with a VAT at the state level VAT.

On the basis of the above objectives, Empowered Committee comprising of nine State Finance Ministers was constituted on 17th July 2000 to monitor the decisions taken in Chief Ministers Conference. Empowered Committee decided to rationalize the further rate structure under VAT to 5 rates.
In the budget 2002, the CST Act was amended and some of these amendments would help in implementation of VAT. Central government has agreed to compensate the states for loss due to implementation of VAT. The compensation package is 100% in the first year, 75% in second year and 50% in third year. The Committee recommended adoption of VAT from 1st April 2003. But, Haryana is the only state to introduce VAT from 1st April 2003. The target date for introduction of VAT has been rescheduled in the meeting of Empowered Committee on June 18, 2004 with the new target set for April 1, 2005. During this period, the Empowered Committee constituted to monitor the transition to the new tax regime through sustained deliberations, and at last 18 states have agreed to introduce VAT from 1st April 2005.

It may be noted that the postponement of introduction of VAT from 1st April, 2002 to 1st April 2005 was due to various reasons such as divergent views on treatment of existing sales tax incentives already granted by states, treatment of Central Sales Tax under VAT, lack of commitment by central government at that time on compensating the states for loss in revenue etc. The important reason for postponement was lack of preparedness by the states. After a lot of persuasion by central government, VAT was introduced from 1st April 2005.

State-level VAT implementation has almost achieved nation-wide coverage, with the five BJP ruled states with Meghalaya, a non-BJP ruled state switching over to the new tax regime from the existing sales tax system. The six states that have implemented VAT from 1st April 2006 are:

- Chattisgarh
- Gujarat
- Jharkhand
- Meghalaya
- Madhya Pradesh
- Rajasthan

Altogether, the commitment to implement VAT has been made by 18 states and 5 UTs from April 1, 2005. Haryana is the first state to implement VAT in April 1, 2003. While Manipur implemented VAT in June 1, 2005 and Assam in May 1, 2005. Uttarakhand and Tripura adopted VAT from October 1, 2005. Five BJP ruled states implemented VAT from 1st April 2006 with one non BJP ruled state Meghalaya. At last Tamil Nadu agreed to implement VAT from 1 January, 2007 and Uttar Pradesh on January 1, 2008.
With Uttar Pradesh finally joining the Value Added Tax regime, all goods manufactured and sold in the same state, anywhere in India, will pay a tax only on the value addition. All goods, which attract a central excise duty, too get a VAT refund. The only segment where VAT is not applicable is Central Sales Tax levied for interstate movement of goods. This is the reason why the current VAT format is called a State-Level VAT, and not a National-Level VAT. Since VAT is a state subject, the central government is playing the role of a facilitator. Technical and financial support is also being provided to the states for VAT compensation, publicity and awareness and other related aspects. Introduction of State-level VAT is the most significant tax reform measure at the State-level.

The reference period of the present study is chosen from 1990 to 2007. The main reason for this is that, systematic and comprehensive attempts to reform the tax system at the central level started only after market based economic reforms were initiated in 1991. The Tax Reform Committee under the Chairmanship of Chelliah laid out a frame work for reform of direct and indirect taxes as a part of structural reform process, following the unprecedented economic crisis. The Committee focused its attention on central taxes and made some suggestions for state taxes particularly in the final report. In order to study the state level Value Added Tax, all the states which adopted VAT from 1st April 2005 has been taken up and key features of these VAT Acts has been considered. The present study captures the developments that took place during the introduction of VAT in the current financial year (2005-06). However, the system sales tax that existed prior to 1.04.2005 has also been captured in the study. The study is based on published secondary data collected from various sources.

THE SPECIFIC OBJECTIVES OF THE PRESENT STUDY ARE AS FOLLOWS

1. To review of Sales Tax System Reforms existed in India, prior to the introduction of VAT (prior to 1.4.2005).
2. To ascertain the weakness and the need for reforms in the sales tax system.
3. To study Value Added Tax system in some federal countries.
4. To study the adoption of Value Added Tax in various states of India.
5. To study Haryana’s VAT experience.
6. To study whether the Value Added Tax increased the revenue of the states.
HYPOTHESIS

1. There is a positive relationship between the Value added tax and the revenue of the government.

8.2. SUMMARY OF VAT 2005

The salient features of the VAT levied in the states from April 1, 2005 are summarized as below:

1. The tax is levied at two rates namely, 4% and 12.5%. A special rate of 1% is levied on bullion and species and precious metals like gold and silver. Basic necessities are exempted. Most items of common consumption, inputs and capital goods are taxed at 4% and all the other items are taxed at 12.5%. Petrol and diesel are exempted from VAT regime and a floor rate of 20% VAT levied on Narcotics.

2. The facility of tax credit covers inputs / purchases as well as capital goods for manufacturers as well as dealers. As regards capital goods, credit for taxes paid can be availed against sales over three years.

3. The tax credit mechanism operator in full only in the case of intra-state sale. In inter-state sale transactions, the exporting state is supposed to give input tax credit for locally made purchases, against the collection of CST. The tax credit of CST in the importing state, or other mechanisms of zero-rating of inter state sales, will be extended after two years when the CST in its present form will be phased out.

4. The central government has agreed to compensate for any loss of revenue during the first three years of the introduction of tax on rates of 100%, 75% and 50% respectively. The loss will be calculated by estimating the difference between the projected revenue from sales tax on the 2004-2005 bases and the actual revenue collected. The projected revenue will be estimated by applying the average of the best three years’ growth rates during the last five years.

5. Tax incentives given to new industries by different states could be continued so long as they do not break the VAT chain. Many states proposed to convert tax holidays into deferment of the tax.
6. All dealers having turnover above Rs.5, 00,000/- would be required to register for VAT. However, the states may levy a simple turnover tax not exceeding 2% on those dealers having up to 5 million turn over. They need not keep detailed accounts of their transactions. But, these small dealers will not be a part of the VAT chain and no credit will be available for the taxes paid on purchases from these dealers. However, they may voluntarily register as regular VAT dealers.

8.3 FINDINGS

1. Reforming the tax system is necessary to achieve fiscal consolidation, minimize distortions in the economy. The way of tax reforms across the world began in the mid 1980s. Many developing countries used tax policy as the principal instrument to correct fiscal imbalances. The Indian tax system reforms are unique in some respects. Unlike most developing countries Indian reforms have borne the domestic brand largely in response to changes in the development strategy over time while keeping in the tune with institutional arrangements in the country (Rao M G, 2005). The Indian tax reform experience can provide useful lessons for many countries due to the largeness of the country with multi level fiscal frame work, uniqueness of the reform experience and difficulties in calibrating reforms due to institutional constraints.

2. The choice of VAT, the design, the rates and the type varies from country to country. Some countries use the value – added technique for sales taxes. These taxes are restricted to the manufacturing industries. Indonesia imposes a tax using the value added technique on manufacturers and importers; on firms that act as the main distributor. Sweden and Norway used the VAT to replace retail sales tax.

3. To tackle with the foregoing weakness of the sales tax system, experts have suggested introduction of VAT. Various states have studied the impact of present taxation system and have felt the need for a major reform to the existing system. It has been felt that introduction of VAT creates a level playing field to industries and a VAT scenario addresses the challenges of globalization for replacing the archaic system of sales tax in revenue generation. Countries which have introduced VAT have felt that the economic efficiency concern can be better addressed in a VAT regime. It has also been
experienced by governments, the world over, that VAT improves compliance levels and reduces evasion of tax by virtue of its self-policing effect.

4. The countries that have introduced the comprehensive VAT have shown a remarkable degree of unity in selecting among the possible combinations. Virtually all have opted for,
   1. Consumption type
   2. Destination principle
   3. Tax credit method
   4. Multiple rate (in addition to the zero rate)
   5. Tax exclusive VAT

5. Some major conclusions regarding the advantage of VAT 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.

6. 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.

7. 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.

**THE MAIN FINDINGS RELATED TO THE REVENUE IMPLICATIONS ARE:**

1. Regarding the tax revenue and non-tax revenue we may note that, in low, middle and high income states tax revenue plays significant role in states total revenue while in case of special category states the non-tax revenue plays very important role. Karnataka, Kerala and Tamil Nadu receive more than 80% of its total revenue from tax revenue but in case of Goa (46.04%) and Punjab (55.95%) it is less. If we consider non-tax revenue, Sikkim and Nagaland receives nearly 85% of its total revenue from non-tax revenue. In the VAT introduction year, most of the states show decrease in the share of tax revenue but in the subsequent years we may note improvement.

2. The share of own-tax revenue in total tax revenue is more in Gujarat, Karnataka, Maharastra and Tamil Nadu. These states receive more than 80% of total tax revenue from its own-tax. But in case of Arunachal Pradesh and Mizoram it is only 16%.

3. In case of the share of sales tax in own-tax revenue, most of the states like Andhra Pradesh, Bihar, Kerala, Madhya Pradesh, Maharashtra, Delhi, Punjab, Sikkim show decrease but in the next year they have registered a good performance.

4. In all India level, the growth rate of sales tax as well as own-tax has been increased from pre-VAT period to post-VAT period. Sikkim is the only state which show negative growth rate both in the sales tax and own-tax after the introduction of VAT.
5. If we considered the states which have adopted VAT from 2006, showed good performance in share of sales tax both in total revenue and own-tax revenue.

6. With regarding to the sales tax-NSDP ratio, the only case where there is a fall in the ratio is that of Bihar i.e. only 2.44 in 2005-06 where as Tamil Nadu shows higher ratio i.e. about 8% in 2005-06. High income states like Punjab, Haryana, Goa, Gujarat and Maharashtra could not exceed the level of 7 which has been achieved by some of the middle income states.

7. With regard to VAT revenue in the first year of introduction (2005-06), even though there was increase in the total VAT revenue, states like Andhra Pradesh, Himachal Pradesh, Karnataka, Orissa and West Bengal shows very less percentage increase. But in case of Arunachal Pradesh, Goa, Jammu & Kashmir, Maharashtra, Manipur, Mizoram, Nagaland, Punjab, Tamil Nadu and Uttarakhand shows greater increase in the VAT revenue. Bihar and Sikkim is the states which show decrease in the VAT revenue in the introduction year. In the next years, although we may note some decline in the percentage increase in VAT revenue we may expect greater improvement in the long run.

8. If we consider the states introducing VAT in 2006, except Gujarat all the states show increase in the VAT revenue.

Based on the above findings, it is concluded that the impact varies considerably across states, while some states seem to gain consistently from such a transition and in some other states seem to loss. During the initial years of the introduction of VAT the revenue collection may be less. This could be due to set off for inputs and changes in the rate categories. But in the subsequent years we may definitely see greater improvement in the revenues of the states.

8.4 POLICY RECOMMENDATIONS

1. The foregoing shows that VAT is desirable from several points of view. However, it is well known that VAT is a complicated tax. It requires much more preparation for both tax payers and tax administrators.

2. It is true that VAT is desirable but it requires effective enforcement. VAT in itself is not everything and can not be equally fruitful everywhere and in all circumstances. Experience shows that VAT is not applied in its pure form even in developed countries. Several exemptions have been adopted under the VAT system on administrative grounds. So, a careful consideration of
economic and administrative conditions and the state of record keeping is indispensable.

3. VAT requires more preparation than any other form of commodity tax. An extensive general information campaign to educate the public on VAT should be continued. The campaign should aim to give an idea of the working of the VAT system and its advantages over other forms of commodity tax. Information may be disseminated through media such as radio, TV, Newspapers, leaflets, booklets etc for the public and should be distributed widely seminars, workshops, training programmes, public talk programmes, forums and meetings should be organized. It would invite public participation in the formulation of VAT laws.

4. As VAT requires an extensive recording and accounting system, a simple accounting system should be developed, printed and circulated to potential tax payers.

5. An effective tax administration is an absolute prerequisite for a VAT system. A VAT unit should be created and well educated and energetic personnel should be recruited and given adequate training on VAT. A VAT manual should be prepared and distributed among other related government departments, the department of industry and the department of commerce whose co-operation is required for an effective implementation of VAT.

6. Although the administration cost is initially high, they would pay substantially within a short period. For example, a taxpayer education programme would remove the confusion and doubts of tax payers and they would be in a better position to comply with leading to lower compliance cost. When the VAT requirements are fulfilled properly by tax payers, tax administrators do not have to put much effort in to analyzing VAT accounts and there will be lower administrative costs.

7. The conversion of sales tax into the destination based consumption type VAT by the states initiated in April 2005, will have to be carried out with vigor. This would require complete phasing out the CST as soon as possible. Finalizing the mechanism to relieve taxes on inter-state transactions and building a proper information system for the purpose, is extremely important.

8. The treatment of inter state taxation by the constituent units of federal formations indicates that in all cases care is taken to ensure that there is no
effective taxation of inter-state sales. The government should also take care to see that there are no cascading and escalation costs. There are mainly three alternative solutions to the problem of inter-state taxation.

◊ Zero-rating of inter-state sale.
◊ Some kind of clearing house mechanism as envisaged by the European Union.
◊ Destination based central purchase tax.

9. A recent proposal in the Indian context relates to Destination Based Central Purchase Tax (DBCPT). This would replace the existing CST, which is levied by the exporting state on the basis of ‘Origin’. In this new system, there would be no tax on ‘Origin’. The goods would move from exporting state without any tax. Converting the existing CST into DBCPT would deprive the states of their revenue from this tax. It could be argued that in the long run, the states would be able to make necessary adjustment and that there need be no net loss of revenue to the state as a whole. In the short run, the states might feel difficult in adjusting the loss of revenue.

10. At last, it needs strong political will and real interest on the part of the central and state government and support from the people.