CHAPTER 2

Sales Taxation in India – An Outline
CHAPTER 2
SALES TAXATION IN INDIA – AN OUTLINE

2.1 Introduction

A tax is a compulsory extraction of money by public authority for public purposes which is enforceable by law and against which no services are guaranteed. Primarily the purpose of levying any tax is to raise fund to undertake developmental activities in the country. The policy of taxation primarily aims at raising revenue with the least sacrifice inflicted on the people and least injury caused to the economy as a whole.

Taxes are of two types: direct taxes and indirect taxes. When the impact and incidence of taxation fall on the same person, the tax is called a direct tax. On the contrary, in the case of an indirect tax, the impact is on one person while the incidence falls on another. Thus, shifting of burden of taxation is possible in case of indirect taxes. Commodity taxes come under the category of indirect tax.

Commodity taxation has assumed significant dimensions in the fast developing economy of a nation as it makes available substantial financial resources to the Government to go ahead with its plan of activities. Besides being a source of revenue, taxation also regulates and controls the use of certain goods and services in the desirable way. Commodity taxation has now become an integral part of State economy.

India has a government that combines the features of both a unitary and a federal system. There are three tiers of government- the union government, the State government, the local government; and all the three tiers are empowered to levy taxes. These taxes are enshrined in the Constitution of
India. The Indian Constitution assigns the powers of taxation more precisely and in greater detail than most federal countries. There are also provisions under which the legislature of a State may authorize the local governments (panchayat or municipality) to levy, collect and appropriate taxes, duties, tolls and fees in accordance with such procedure and subject to such limitations as may be specified by law. The tax jurisdiction of the Union and the State Governments are specified in the Seventh Schedule of the Constitution of India.

2.2 Tax Structure under the Constitution of India

India has a Federal constitution with two layers of Government viz., the Union and the State. The Constitution of India that came into force from 26 January 1950 has clearly classified the functions to be performed by the Union and the States and has also indicated their respective sources of revenue. As per the constitution, taxes within the jurisdiction of the Indian Union can be classified into four categories.

(a) Those taxes which are levied and collected by the Centre and the amount so collected is retained by the Centre. e.g. Custom-duties, Corporation taxes etc.

(b) Those taxes which are levied and collected by the Centre but the amount so collected is shared between the Centre and States e.g. Income Tax, Excise duties etc.

(c) Those taxes which are levied and collected by the Centre but the entire proceeds of which are assigned to the States e.g. Estate Duty.

(d) Those taxes which are levied by the Centre but are collected and retained by the States e.g. Stamp duties.
2.2.1 Tax-Revenue of the Central Government

Taxes within Union jurisdiction are enumerated in List I, Seventh Schedule of the Constitution of India as under:

1. Taxes on income other than agricultural income.
2. Duties of Customs including export duties.
3. Duties of excise on tobacco and other goods manufactured or produced in India.
5. Taxes on capital value of assets.
6. Estate Duty in respect of property other than agricultural land.
7. Terminal taxes on goods or passengers, carried by railway, sea, air, taxes on railway fares and freights.
8. Duties in respect of succession to property other than agricultural land.
9. Taxes other than stamp duties on transaction in stock exchange and future markets.
10. Rates of stamp duty in respect of bills of exchange, cheques, promissory notes, bills etc.
11. Taxes on the sale or purchase of newspapers and on advertisements published there in.

Out of these, excise duty is the prime revenue earner for the Union Government.

2.2.2 Tax Revenue of State Government

The main sources of tax revenue of the State Governments are the share of the States in the Union Excise Duties, Income tax etc. Taxes within the jurisdiction of the States are enumerated in List II Seventh Schedule of the Constitution of India as under:
1. Land Revenue, including assessment and collection of revenue.
2. Taxes on agricultural income.
3. Duties in respect of succession to agricultural land.
5. Taxes on land and building
6. Taxes on mineral rights
7. Excise duties on alcoholic liquors produced in the State
8. Taxes on entry of goods into local area for consumption, use or sale therein
9. Taxes on consumption or sale of electricity.
10. Taxes on sale or purchase of goods other than newspapers.
11. Taxes on goods and passengers carried by road or inland waterways.
12. Taxes on vehicles
13. Taxes on animals and boats
14. Tolls
15. Taxes on profession, trades, callings and employment
16. Capitation taxes
17. Taxes on luxuries including taxes on entertainment, amusements, betting and gambling.
18. Rates of stamp duty in respect of documents
19. Fee in respect of any of the matters in List II, but not including fees taken in any court.

Out of these, sales tax is the prime source of revenue for any State Government.

2.3 Sales Taxation - The Major Source of State Revenue

Sales tax is essentially a tax on business transactions and thus it differs from an excise duty in certain respects. Its significance in India is that it has provided a relatively elastic and productive independent source of revenue earning to the States. Sales tax can be general or selective. What is known as
the general sales tax in India is in fact, a selective sales tax; as many commodity transactions are not covered under it. From operational point of view, sales tax may be either single-point or multi-point. In India both single-point and multi-point sales taxes have been levied in different States. Sales tax is collected from all registered trading concerns who, in turn, invariably shift its burden to consumers. In India, the practice of charging the amount of sales tax from buyers is sufficient evidence of the fact that its incidence is wholly on consumers. The sales tax has been levied in this country practically on all tangible commodities, immovable property and services have not been covered under it. Tax rates are not uniform in all States. Steps are being taken to have uniformity of sales tax rates all over the country. Sales tax ordinarily means tax on sale of certain commodities made by a dealer.

Although we have come across many definition of sales tax, the one given by Prof. John F. Due (1957) may be described as the most comprehensive which says sales tax is 'a levy imposed upon the sales or elements incidental to the sales, such as receipts from them of all or a wide range of commodities, excluding taxes imposed at fractional rates upon gross receipts in the form of business occupation or license taxes'.

2.3.1 Evolution of Sales Taxation in India

Sales tax, which is an indirect tax, occupies a prominent position in the revenue structure of any State. This fiscal tool, of late, has been given adequate attention in order to mobilize resources to meet the ever-increasing expenditures in the States. Sales taxation is not of recent origin. It was also a source of revenue to the Government in ancient India. The Hindu theory of taxation is of immense importance from the constitutional point of view. Taxes were determined by Law and had been embodied in the sacred common law. The consequence was that whatever the form of Government, the matter of
taxation was not an object of the ruler's notion. No friction could, therefore, legally arise between the crown and the people on the question of taxation. The mainstay of revenue was the king's fixed bhaga or the share of produce of agriculture\(^1\). References indicating levy of sales tax during Mauryan Period (Circa 323-185 B.C.) are found in Kautilya's Arthasastra. According to Arthasastra, taxes were levied at 1/5 of the value of the goods imported. Taxes were levied on flowers, fruits, vegetables, roots, seeds and dried fish at the rate of 1/6 of the value of such goods\(^2\). Tax at the rate of 1/10 or 1/15 of the value of goods were levied on the items like iron, sandal wood, spices, hides & skins, silk cloth etc. Tax at the rate of 1/20 or 1/25 was levied on the items like cloth, animals, thread, cotton, scented item, timber, bamboo, earthen pots, food grains, sugar, salt etc. At the entrance of the town 1/5 of the value of food grains that come from villages were collected or sometimes keeping in view the benefit derived by the State from such commodity the rate were reduced. The superintendent of tolls were responsible for erecting office at the main entrance of the city and to place a flag there. The merchants passed beyond the flag were to furnish value and other details of the goods carried by them. Anybody who tried to cross the flag without paying taxes were to pay eight times of the tax as fine.

The medieval period of Indian history shows that sales tax was one of the important indirect taxes levied by the Mughal rulers. In India, the tax continued to be levied during the East India Company rule in the same way and form as it was passed on from the previous times.

Before the adoption of the Constitution of India, the State Governments levied tax under the provisions of section 100(3) of the Government of India Act, 1935. The Act introduced a large degree of autonomy in the provinces. Bombay was the first province in the country to levy selective tax on the sale of tobacco in the year 1938.\(^3\) Although the provinces derived power to levy tax,
there were certain restrictions on the imposition of tax on the newspaper and on sale and purchase in the course of inter-State trade or commerce, and on the sales outside the State and on the import and export of goods.

With the Constitution of India coming into force with effect from 26th of January, 1950 the States derived power to levy sales tax from entry 54 of List II of the Seventh Schedule to the Constitution of India. The State Governments have the sole jurisdiction to levy taxes on items included in the State List and the entire proceeds are credited to the consolidated fund of the States and are utilized for the purposes of the States. In India, erstwhile Madras (now Tamilnadu) was the first to introduce General Sales Tax as far back as in the year 1939. The tax was introduced by other States gradually. Because of the flexibility of this particular source of revenue and its contribution to the State exchequer, most of the States rely on this source as a major source of finance.

The sales tax enactment of Madhya Pradesh and Tamil Nadu were challenged in the courts of law by the Central Government on various grounds, particularly in respect of the authority of the States, to impose such taxes. The States, however, won the legal battle. Hence, the other States also started using the opportunity to impose sales tax.

Following Tamil Nadu, many States resorted to this form of taxation during and after the Second World War. Seven of the States adopted this form of levy in the 1940s. West Bengal and Punjab adopted it in 1941, Bihar in 1944, Maharashtra in 1946, Orissa in 1947 and Assam & Uttar Pradesh resorted to it in 1948. Many other States also imposed sales tax before 1950. As there has been no specific rationale behind a particular form of sales tax structure, models adopted earlier underwent many changes. As the States adopted a particular structure of the tax without giving thorough consideration to its economic rationale, difficulties were faced in the administration of the
tax. Also, it was overlooked that economic circumstances of different States were not homogeneous. Trade diversion, opposition from trade organizations, problems of inter-State trade and double taxation were experienced by many of the States. While some of the problems were sorted out in State Finance Ministers’ Conference held in 1948, some of them remained in the Constitution.

2.3.2 System of Sales Taxation

The present structure of sales tax in India consists of - State sales tax and Central sales tax. The former is levied on intra-State transactions and the latter on inter-State transactions. The general rate of tax in the States varies between 5 and 14 percent. In all the States, there are a large number of variations in the tax rates based on the type of commodities. The tax is levied at low rate on necessities and at high rate on luxuries. In addition, there are exemptions for necessities, specific institutions and for specification by the States. Most of the States levy tax on raw materials and other inputs as well. The tax treatment of these goods ranges from no exemption to concessional treatment varying between one to four percent, to complete exemption in some States. The tax-base is also affected by the grant of exemptions in finished goods by almost all the States. These exemptions have been provided as part of “incentive schemes”.

As per the original provisions of the Constitution, ‘services’ are exempted from levy of State sales tax. However, a new dimension has been added to the sales tax system through the Forty-sixth Amendment of the Constitution whereby sales tax can be levied by the States on works contracts, hire purchases and leases. Accordingly, many States have already imposed sales tax on such services.
The Central Sales Tax is collected on all inter-State transactions. The tax is levied, collected and retained by the States occasioning movement of goods from one State to another. The richer States earn larger resources from Central Sales Tax causing further inequality among States.

Taking all the States together, the yield from State sales taxes in 1950-51 was around Rs 600 million, accounting for 27.5 per cent of the aggregate State taxes. During 1991-92, the sales tax revenue represented around 54 per cent of the total yield from State taxes. In the structure of the State finances, the position of sales taxes is broadly similar to union excise duties in the case of the union finances, though the relative importance of the sales tax differs from State to State. Sales tax is the single largest source of revenue to almost every State in India, accounting for about 60 to 70 per cent of the States' own tax revenue in the case of several States. That the share of sales tax in the total revenue of the Centre and the States has increased from 12 per cent in 1960-61 to about 21 per cent in 1999-2000 bears eloquent testimony to the growing importance of this tax. As a percentage of the total tax revenue of the States including their share in central taxes, the share of sales tax increased from 26 per cent in 1960-61 to around 38.5 per cent in 1989-90. Most of the States levy tax on raw materials as well as other inputs. Sequel to the amendment to the Constitution in 1982, sales tax has become leviable on work contracts, hire purchases and leases. Among the various incentives offered by the State governments to encourage growth of industries, sales tax concessions either as deferrals or concessional rates are quite significant. Such concessional rates of sales tax or exemptions are available for small scale and tiny industries in nine States and medium and large industries in twelve States. In addition to the general sales tax, another peculiar feature of the Indian fiscal system is that inter-State sales are also liable to be taxed by the States of origin. Despite a ceiling of 4 per cent for the rate of Central Sales Tax (CST) laid down by Parliament, tea export on account of this tax is substantial. While, on an
average, nearly 18 per cent of the States' sales tax revenue is accounted for by the CST, the shares of certain individual States are quite high: West Bengal (35.2 per cent), Haryana (33.9 per cent), Maharashtra (28.3 per cent), Madhya Pradesh (23 per cent), Punjab (22.6 per cent), Karnataka (20 per cent) and Tamil Nadu (12.8 per cent).

An important feature of the Indian sales tax system is that sales taxes are applied extensively at the first stage of the sale in any State – a phenomenon which has contributed to the maximum amount of cascading as the first point sales tax is levied ad valorem on the price of a commodity that includes the excise duty paid into the central exchequer at the last point of its manufacture. Though this is somewhat similar to the practice in Canada, the element of cascading in Canada is not that large as the provincial sales tax in that country is imposed on retail sales only. Another peculiar feature of the Indian sales tax system is that while the sales tax is leviable on all commodities including of inputs and capital goods, services are excluded owing to the constitutional limitations. These characteristics have contributed to "complexity, lack of transparency, distortions in economic decisions and inequities in inter-jurisdictional division of tax bases. It is increasingly felt that these problems cannot be solved without harmonization [Bagchi 1997].

The disintegrated character of the existing tax system has given rise to the following problems relating to economic as well as administrative aspects.

- **Lack of uniformity**: One of the problems that the existing sales tax structure in India encounters relates to lack of uniformity in rates. The variations of rates cause diversion of trade as well as shifting of manufacturing activity from one State to another having low rate of tax or higher tax incentives. These variations of tax rates keep the sales tax department on its toes. Each time the sales tax department receives representation from traders or
manufacturers or whenever it notices diversion of trade, changes in the rate structure are attempted. This not only keeps the rates changing every now and then but also creates a ‘tug of war’ among different States.

- **Multiplicity of rates:** Another weakness of the existing sales tax system is the multiplicity of rates. This has arisen due to very fine gradation of tax rates for different commodities. The multiplicity of rates not only blunts the intended progressive effects but creates the need for additional calculations by the dealers causing an increase in the cost of compliance rather than increasing the revenue to the State coffer. More importantly, it creates many disputes relating to classification of commodities for the application of appropriate rates.

- **Cascading taxes:** The first point sales tax is a cascaded type of tax. As the tax is levied at the initial stage of production-distribution process, most of the inputs and raw materials as well as capital equipment are taxed without any set-off. All the taxes on these items become part and parcel of the price of the final product resulting in cascading.

- **Revenue loss due to incentives:** A weakness of the existing structure of the tax relates to the exemptions and incentives provided to industrial units. Although the exact loss of revenue as a result of these incentives is difficult to estimate, the available data indicate that due to these concessions the base has been eroded by approximately 20 percent. More importantly, the number of units availing these concessions has been increasing year after year, causing greater loss of revenue to the States.

- **Lack of transparency:** The existing system results in uncontrolled incidence of various taxes on the same commodity. The overall cumulative incidence lacks transparency for an economic analysis. As the cumulative incidence on commodities becomes fortuitous, it is rather difficult to grade different commodities progressively. The lack of transparency obviates exact calculations of tax incidence.

- **Encourages vertical integration:** The phenomenon of wider spread of taxation promotes vertical integration. That is, it mitigates against the
objectives of ancillary industries and encourages industries to produce more and more inputs needed by them rather than purchasing it from ancillary industries.

- Taxation on out-of-State sales: Taxation on out-of-State sales creates many formidable problems. Presently, inter-State sales are taxable under the Central Sales Tax Act. Such a tax causes the phenomenon of cascading. Also, a high rate of such tax increases the incidence of tax and forces the States to surrender their autonomy in deciding the State’s sales tax rate. Hence, taxation of all the transactions would be inflationary, iniquitous and distortionary.

### 2.3.3 Reforms in Sales Taxation in India

The shortcomings mentioned in the earlier section have given rise to tremendous problems. The Government of India, in consultation with the State Governments, has taken a number of steps to rationalize the sales tax system in India. The Central Government has been advising the States to formulate uniform tax structure with a view to avoiding competition. Most of the North Indian States impose lower tax rates to divert trades from neighboring States to their own, ignoring the 1997 agreement on floor rates. Haryana and Delhi have been engaged in a tax-war on several items. The Finance Minister of India exhorted the States aiming at luring private investment and industrial development. According to him, the unrealistic and unhealthy competition in providing more and more tax-concessions and subsidies will be harmful for the economy of the country in the long run. He suggested that the State Governments should arrive at a consensus to avoid tax war. The business houses are also hoping for a common market throughout the country to be achieved by way of withdrawing trade barriers among the States. They argue that while European continent can have a common market, why cannot there be a system in the Indian federation to withdraw all barriers in the intra-county transactions.
In the light of the above assessment of the commodity taxes, some strategies can be formulated for reforming the structure and administration of commodity taxation for the country as a whole. In this context, the recommendations of the Tax Reforms Committee (Final Report, Part I and II, 1992-93, Ministry of Finance, Government of India) are very useful. While suggesting any reform in this regard, the federal constraints applicable to Indian republic are to be considered. The division of tax powers between the Union and the States provides both the tiers of Government powers to levy taxes falling on the same base. The tax revenue from excises constitutes almost forty-five percent of the total tax revenue of the Centre while almost sixty percent of the States' own tax revenue comes from sales tax. Moreover, the dependence of the States on the Centre has been increasing over the years.

The Union and State Governments are sincerely trying hard to ratify the above problems present in the sales tax system of the country. As per the decision taken in the Chief and Finance Ministers' Conference convened by the Union Finance Minister, the State Governments were asked to implement uniform floor sales tax rates by January 1, 2000. The uniform floor rates of tax was recommended by the committee of Finance Ministers of Gujrat, Karnataka, Madhya Pradesh, Maharastra, Punjab, Uttar Pradesh and West Bengal under the aegis of the National Institute of Public Finance and Policy, New Delhi. The committee was set-up for the purpose of simplifying the rate structures by reducing the number of tax rates for enhancing transparency by eliminating or merging multiple levies under different Acts. On an average there are more than 500 commodities on which State Governments impose sales tax. The whole process becomes complex if a number of tax rates are applied for different commodities. As per the decision, ultimately there would be only six separate tax rates dividing the whole gamut of commodities into six main blocks. These tax rates are zero percent on basic necessities, four, eight and
twelve percent with two special rates viz. one percent for gold and twenty percent for petroleum products.

Besides the rationalization of State sales tax structure, the other basic aim of this decision of the Committee is to end the tax war among the States of the country. The floor rates of tax basically propose the rates below which the State Governments are not allowed to impose sales tax on specified commodities. It was also decided to phase out the sales tax based incentive schemes with effect from January 1, 2000. Some States are loosing revenue to the extent of Rs. 8,000 - Rs. 10,000 crore a year as a result of the competitive tax concessions being offered to attract industries. The big losers are Maharastra, Gujrat, Punjab and Haryana. Their tax revenue as a share of State’s income is on the decline. In the case of Gujrat, the tax-SDP ratio declined from 13.6 in 1992-93 to 10.5 in 1997-98. Maharastra, the most industrially advanced State, saw its tax-SDP ratio decline from 9.87 to 8.55 during the same period. It is the result of the fact that revenue loss on account of tax concession cannot be off-set by other benefits that might accrue as corporate route their projects to these States. Thus, an urgent need was faced by the country to end this unholy tax-war among the States and the decision of imposition of floor sales tax rates is an outcome of this necessity.

India has multiple indirect taxes at both State and federal level. Each operates largely independently, and the system lacks the essential qualities of coherence and transparency. Reform is controversial but the first steps is now being taken.

A modified VAT system of taxation is to be introduced by 1 April 2003 in 15 target States. It does not change the present division of taxation powers between the Central and State governments. It continues with separate taxes on goods and services and does not envisage credit for all taxes paid at an earlier
stage, against all taxes payable subsequently. Thus all the indirect taxes will continue to operate individually. Despite this, the proposals include some welcome reforms to the various sales tax regimes, including:

- Uniform sales tax rates. All States must collectively agree on the minimum rate of sales tax (the floor rate) for specific goods. Although the States can levy higher rates, it is hoped that this would prevent competitive tax rate wars between States, that distort local economies.
- Removal of incentives such as sales tax exemptions and deferrals, across all States.
- Alignment of sales tax rates with the Harmonized System of Nomenclature (HSN) as applies to customs and excise duty.

The essence of these reforms is to begin the process of ensuring uniformity and consistency in commodity taxation across India. A word of warning is, therefore, relevant as to the way these reforms are implemented. If each State goes ahead drafting its own legislation (as is believed to be happening) the inevitable result will be a lack of uniformity of basic principles. A strong case can be made for the need for Central Government to provide direction and focus in the form of umbrella legislation which States implement locally. This is possible as EC Directives establish the principles of VAT in the EU which Member States then implement and apply.

Overall, the proposed reforms have all the characteristics of compromise. However, if they prove successful, India may be encouraged towards more radical changes in future.
2.4 Value Added Tax

The origin of Value Added Tax (VAT) can be traced as far back as the writings of F Von Siemens, who proposed it in 1918 as a substitute for the then newly established German turnover tax. VAT was first introduced in France in 1954. Development of VAT in other countries has been gradual. Until the sixties many countries did not adopt it. As many as 50 countries have switched over to VAT during the last decade. This has brought the total number of countries who have adopted VAT as their major form of consumption tax to more than 110. Thus, the augmentation of interest in VAT has been the most remarkable event in the evolution of commodity taxation in the present century. VAT is common in most parts of the world with India remaining one of the few exceptions.

VAT is a multi-point tax system where taxes are paid at one stage of production and sales get set-off or rebated at the next stage. This clear up the problem of cascading taxes, where the same item is taxed several times through the production chain. VAT is a multi-point sales tax with set-off for tax paid on purchases.

- It is collected in installments at each transaction in the production distribution system.
- It does not have cascading effect due to the system of deduction or credit mechanism.
- It is a tax on consumption. The final and total burden of tax is fully and exclusively borne by the domestic consumer of goods and services.
- It being a tax on domestic consumption, no VAT is charged on goods exported.
- It is an alternative mechanism of collection of tax.
- It is, in many respects, equivalent to a last point retail sales tax.
2.4.1 Strides of VAT

As pointed out earlier, VAT is a multi-point tax. Tax is calculated on each point of value addition. Evasion of payment of tax is tried to be curbed in this system as all the points of value addition in a sale transaction are subject to sale. Fig 2.1 is an example that illustrates how VAT is calculated at different points of sale. For simplification, gross VAT at all stages have been taken as 10%. The product is sold for Rs. 400 to the ultimate consumer where tax rate is 10%, the consumer pays VAT as Rs. 40. However, this amount goes to the Government exchequer where all four viz. Raw material producer, manufacturer, wholesaler and retailer are involved in the payment of tax. Each one gets credit of tax paid by them.

Fig 2.1 Stages of Computation of VAT
2.4.2 Structure of VAT

Different types of VAT are prevalent in various parts of the world. The system and structure varies from country to country keeping the basic principle in tact.

2.4.2.1 Types of VAT

Value added tax is a tax on value added. There are different methods for calculation of value-added on a transaction. The following Chart explains the different variants commonly followed across the world.

<table>
<thead>
<tr>
<th>Gross Product Variant</th>
<th>Income Variant</th>
<th>Consumption Variant</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax levied on all sales with no deduction for business inputs</td>
<td>Tax levied on all sales with set-off for depreciation on capital goods</td>
<td>Tax levied on all sales with deduct for business inputs</td>
</tr>
</tbody>
</table>

**Addition method**
- Identification of value added by the summation of wages, profit rent and interest

**Subtraction method**
- Estimating value added by taking difference between output and input

**Direct subtraction method**
- Deducting aggregate tax exclusive value of purchase from the tax exclusive value of sales.

**Intermediate subtraction method**
- Deducting tax inclusive value of purchases from sales and taxing difference between them.

**Indirect subtraction method**
- Deducting tax on inputs from tax on sales for each tax paid.
2.4.2.2 Methods of Computation of VAT

VAT can be computed by adopting three different methods. These are (i) Addition method (ii) Subtraction method (iii) Tax credit method.

- **Addition Method**

  Identification of value-added can be done by summation of all the elements of value-added (i.e. wages, profits, rent and interest). This method is known as addition method or income approach.

- **Subtraction Method**

  The subtraction method estimates value-added by means of difference between outputs and inputs. This is also known as Product Approach and has further variants in the way subtraction is attempted among direct subtraction method, intermediate subtraction method or indirect subtraction method. Direct subtraction method is equivalent to a business transfer tax whereby tax is levied on the difference between the aggregate tax - exclusive value of sales and aggregate tax-exclusive value of purchases. Intermediate subtraction method is based on deduction of the aggregate tax -inclusive values of purchases from the aggregate tax-inclusive value of sales and taxing the differences between them.

- **Tax Credit Method**

  The indirect subtraction method entails deduction of tax on inputs from tax on sales for each tax period. This is also known as tax credit method or invoice method. In practice, most countries use this method and employ net-consumption VAT. A comparative picture of the three methods of calculating is presented in Table 2.1
Table 2.1
Different Methods of Calculating VAT Liability
A Comparative Study
(10% Tax Rate at all levels)

<table>
<thead>
<tr>
<th>Economy</th>
<th>Stage of Production</th>
<th>Value in Rs.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Manufacturer</td>
<td>Wholesaler</td>
</tr>
<tr>
<td>1.</td>
<td>Addition Method</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Wages</td>
<td>150</td>
</tr>
<tr>
<td></td>
<td>Rent</td>
<td>50</td>
</tr>
<tr>
<td></td>
<td>Interest</td>
<td>25</td>
</tr>
<tr>
<td></td>
<td>Profit</td>
<td>25</td>
</tr>
<tr>
<td></td>
<td>Value Added</td>
<td>250</td>
</tr>
<tr>
<td></td>
<td>(a+b+c+d)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>VAT</td>
<td>25</td>
</tr>
<tr>
<td>2.</td>
<td>Subtraction Method</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Sales</td>
<td>350</td>
</tr>
<tr>
<td></td>
<td>Purchases</td>
<td>100</td>
</tr>
<tr>
<td></td>
<td>Value Added</td>
<td>250</td>
</tr>
<tr>
<td></td>
<td>(a-b)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>VAT</td>
<td>25</td>
</tr>
<tr>
<td>3.</td>
<td>Invoice Method</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Sales</td>
<td>350</td>
</tr>
<tr>
<td></td>
<td>Tax on Sales</td>
<td>35</td>
</tr>
<tr>
<td></td>
<td>Purchases</td>
<td>100</td>
</tr>
<tr>
<td></td>
<td>Tax on Purchases</td>
<td>10</td>
</tr>
<tr>
<td></td>
<td>VAT (b - d)</td>
<td>25</td>
</tr>
</tbody>
</table>

Adopted from Purohit Mahesh C., Value Added Tax, Gayatri Publications, Delhi, 1999

Although all the methods are identical, these are not likely to yield the same revenue when tax rates vary according to commodities i.e. the rates are different for inputs and that for outputs. As depicted in Table 2.2, the yield from VAT to the total economy would be Rs. 30 under the subtraction method while it is Rs. 25 only under the invoice method when the tax rate is 15 per cent at wholesale stage, and 10 per cent at all other stages.
### Table 2.2

**Different Methods of Calculating VAT Liability**

**A Comparative Study**

*(Tax Rates at different levels are different)*

<table>
<thead>
<tr>
<th>Economy</th>
<th>Stage of Production</th>
<th>Value in Rs.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Manufacturer</td>
<td>Wholesaler</td>
</tr>
<tr>
<td>1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>a. Sale</td>
<td>100</td>
<td>200</td>
</tr>
<tr>
<td>b. Purchases</td>
<td>--</td>
<td>100</td>
</tr>
<tr>
<td>c. Value Added (a − b)</td>
<td>100</td>
<td>100</td>
</tr>
</tbody>
</table>

**Rate of VAT is 10% at all stages**

<table>
<thead>
<tr>
<th>Stage of Production</th>
<th>Value in Rs.</th>
</tr>
</thead>
<tbody>
<tr>
<td>VAT under Subtraction Method</td>
<td>10</td>
</tr>
<tr>
<td>Invoice Method</td>
<td>10 − 0 = 10</td>
</tr>
<tr>
<td>10</td>
<td></td>
</tr>
<tr>
<td>10</td>
<td></td>
</tr>
<tr>
<td>25 − 20 = 5</td>
<td></td>
</tr>
<tr>
<td>25 − 30 = 25</td>
<td></td>
</tr>
</tbody>
</table>

**Rate of VAT is 15% at Wholesale Level and 10% at all other stages**

<table>
<thead>
<tr>
<th>Stage of Production</th>
<th>Value in Rs.</th>
</tr>
</thead>
<tbody>
<tr>
<td>VAT under Subtraction Method</td>
<td>10</td>
</tr>
<tr>
<td>Invoice Method</td>
<td>10 − 0 = 10</td>
</tr>
<tr>
<td>15</td>
<td></td>
</tr>
<tr>
<td>25 − 30 =(-) 5</td>
<td></td>
</tr>
<tr>
<td>65 − 40 = 25</td>
<td></td>
</tr>
</tbody>
</table>

Adapted from Purohit Mahesh C., *Value Added Tax*, Gayatri Publications, Delhi, 1999

The invoice method is widely used in most VAT countries because of the inherent advantages in the credit method of calculating tax liability. First, it makes cross checking of tax paid at earlier stages more tractable, as dealers are required to State the amount of tax on invoices. Secondly, tax burden being dependent upon the tax rate at final stage, dealers at intermediate stages do not have any incentive to seek special treatment in tax rates. Finally, it facilitates broader tax adjustments.

### 2.4.2.3 Forms of VAT

VAT is normally levied on all items of final consumption including services. The overall coverage, however, depends upon the past experience of the country concerned. As shown in Fig 2.2 there are three forms of VAT which are adopted on the basis of coverage.
Manufacturer’s VAT could extend to all the manufacturers in the economy. As the number of dealers is limited here, this tax is the easiest to administer. Nevertheless, this form is not popular among the VAT nations and only a few countries have adopted it.

Wholesaler’s VAT covers all the transactions ranging from manufacturer to the wholesaler with the exclusion of retail dealers. This VAT is considered superior to Manufacturer’s VAT because it is closer to the consumer and takes care of the value added from manufacturer to wholesaler.

Retailer’s VAT encompasses all transactions in the economy. It is considered to be the most preferred solution because it does not create economic distortions. However, it comprises of a large number of small dealers who cannot keep adequate accounts. Hence, most countries have provisions through which small firms are fully or partly exempted from VAT.
2.4.3 Advantages of VAT

VAT is practised in many countries of the world because of its inherent advantages. VAT is very popular in these countries because of its following features:

- Simple tax structure
- Reduces evasion of tax.
- Neutrality of tax with respect to behaviour of consumer (relative prices are not affected) and behaviour of producer (production technique not affected).
- Efficient resource allocation.
- No tax on inputs.

Moreover, VAT is advantageous over other forms of sales taxation. This is because of the following facts.

- It has a flexible capacity to generate large and buoyant revenues.
- It could be designed to be neutral.
- Eliminates cascading and hence no tax-induced distortion in favour or against vertical integration.
- Tends to lessen incentive for evasion by not concentrating the impact of tax on any given level.
- Tax burden is transparent.
- Zero rating of tax on exports is easy.
- Large base. Low tax rates could have the same revenue.
2.4.4 VAT in India

The Finance Ministers of India's major States formed a committee in 1995 to reform sales tax in the line of VAT. The committee had set April 1, 2002 as the deadline for all States to switch over to VAT. In March 1999, Maharastra became another State to dumpster VAT. Earlier, Andhra Pradesh and Kerala withdrew VAT type of tax system and reverted to sales tax. Tamilnadu, though planned to introduce it in 1996, has not been able to do so till date because of resistance from the traders. Only in Madhya Pradesh does a carcass version of VAT survive. Maharastra and Madhya Pradesh came closer to implementing VAT correctly. Both reduced the number of tax slabs from twenty to seven and ten to four respectively. But Maharastra Government being faced with the problem to meet heavy public expenditure as well as traders resistance, had ultimately scrapped the system.

The Union Budget 2000-01 has proposed a CenVAT to replace MODVAT. This system has an essence for converting the whole system of commodity taxation in India into a VAT regime.

Implementing VAT had not been an easy job for most of the Indian States so far. It is said that most States did not do their homework properly. The State Governments worry about loosing revenue from Central Sales Tax- if Centre opts for VAT. The revenue from CST is retained by the States from which goods originate and accounts for 20-30% of the revenue of most States. The existing tax system is incompatible with VAT; yet it cannot be abolished unless the States are compensated for the revenue loss. Besides, there are some prerequisites which cannot be ignored. Tax offices have to be computerized since calculating VAT and maintaining the records required are, otherwise, complicated. Moreover, tax officials have to be trained and businesspersons and traders should be educated. Tax officials have to understand the system,
otherwise, there could be a lot of harassment to the tax payers. More importantly, VAT is to be introduced in the neighbouring States as well. Clearly, the aim of introducing VAT may not be achieved immediately.

The National Institute of Public Finance and Policy (NIPFP), New Delhi has come out with a model Value -Added Tax Act. By the end of September 2001, the State Governments of Delhi and West Bengal have already published their respective Draft Value-Added Tax Acts as a preparatory measure for its implementation tentatively with effect from April 1, 2003.

### 2.5 Conclusion

Revenue from tax collection contribute largely to the State exchequer. Both direct and indirect taxes are of great importance to generate such revenue. The Constitution of India provides the scope of collecting taxes by the Central Government as well as by the State Governments. Taking the advantage of the liberty to decide taxation policies in certain areas, the Governments of different States follow different tax policies. Wide variations in such policies among neighbouring States create disharmony and consequent problems in tax administration. Sales tax, which has been in force since the ancient days, is a type of taxation on which the State Governments rely most. Hence, it is necessary to have a proper structure and administration of sales tax in each State of India. In order to bring uniformity and to reduce complexities in administration, the system of Value-Added Tax (VAT) is being suggested for all the States of India. VAT has already been tried and has been found to be successful in many countries. In case of adoption of VAT system of sales taxation in Indian with effect from April 1, 2003, it would be necessary to see that the policies are formulated properly, the structure is made full-proof as possible, administration has to be easy, and it generates enthusiasm among all the stakeholders for its implementation.
References:

1  Jaiswal(Ed.1978), Hindu Polity, p 318

2  Deb Sarma R.K. and Sarma D (Ed. 1977), Kautilya's Arthasastra, (Assamese) p 79

3  Purohit M.C. (Ed.1975), Sales Taxation in India, p 52