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How to bring unincorporated enterprises under VAT net?

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The introduction of Value Added Tax (VAT) is often based on the premise that it will encourage better compliance by providing taxpayers the facility of claiming credit for any taxes paid on their purchases. This is often presented as one of the important arguments in favour of replacing a cascading tax with a VAT. In the context of the proposed introduction of a comprehensive VAT in the country spanning all goods and services (Goods and Services Tax, GST), it is useful to ask whether the first step towards good compliance, in the form of comprehensive registration of all potential taxpayers is achieved. Since this new tax regime is expected to work through more integrated and redefined supply chains, for units to benefit from this new tax regime and for the success of the new regime, it is important that more and more enterprises find it useful to be a part of the GST regime.

In a recent paper (Mukherjee and Rao, 2015), we investigate **the factors influencing unincorporated enterprises to register with State Tax Authority in the VAT regime**. The focus of the paper is not on the amount of taxes paid but on whether the enterprise is registered with the tax department or not.

The paper is based on unit level data of the 67th round survey of National Sample Survey Office (NSSO) for the year 2010-11 (NSSO 2012). A preliminary scrutiny of the data indicates that 31.2 percent of partnership firms and 12.9 percent of proprietary firms are registered for VAT. Even taking into account the fact that small firms do not need to register for VAT in states, there is considerable difference in the number of firms that exist and that register for VAT and are reported. Even with turnover between Rs. 1 crore and Rs. 5 crore, only 80 percent of the firms are registered for VAT. Following these observations, an attempt is made to identify differences between registered and unregistered firms and then use probit models to identify significant factors contributing to this difference.

1. Impact of cost of borrowing from informal sources of credit on VAT registration.

Lower access to formal sources of credit and higher cost of informal sources of credit could indicate that economic viability of the enterprise is lower and hence the entrepreneur would have less interest in being registered for tax purposes. We found that unregistered firms face higher cost of credit from informal sources of credit. Alternatively, firms that face higher cost of credit choose to remain unregistered. One of the reasons could be that interest payments on such borrowing might have to be paid in cash, requiring the need to keep transactions out of the books of accounts.

2. Does size and organizational structure influence VAT registration?

The probit analysis throws up some fairly intuitive results as well as a few counter-intuitive ones. For instance, larger and older firms are more likely to register. And similarly, those receiving some form of government assistance are more likely to register. In terms of the number of individuals involved in decision making, it is to be expected that if there are more individuals involved in working or in decision making, the functioning of the firm would perhaps be more structured – registration for taxes being one element of such an effort. This is reflected in the fact that a partnership firm is more likely to register when compared to a proprietary firm and similarly a firm which uses a hired worker is more likely to register.

3. VAT registration: Does manufacturing firm behave differently from trading firm?

One would expect that firms engaging in manufacturing would have more likely to register since the threshold above which the state tax laws make it mandatory for units to register is significantly lower for manufacturers when compared to traders. The results however suggest that manufacturers are less likely to register when compared to traders. In trying to find explanation for this counterintuitive result, there are two possible explanations – one, manufacturers are small units not part of supply chain and having their own marketing systems. Since they are not integrated with the rest of the economy, they may not perceive any merit in registering for VAT. Second, small units are less keenly monitored by the tax departments and these units perceive this as well.

4. Does VAT registration vary across States?

Units in some states are more likely to register as compared to others. Using Bihar as the benchmark, in some states, registration is consistently higher in states like Uttar Pradesh, Gujarat, Rajasthan, Haryana, Punjab and Delhi. On the other hand, registration is consistently lower in states - Maharashtra, Andhra Pradesh, Kerala, Tamil Nadu and West Bengal.

5. Does lower availability of input tax credit influence VAT registration?

Another interesting result from the analysis is that firms with a higher ratio of gross value added (GVA) to value of output are less likely to register. This result suggests that with a high ratio, the extent of benefit available to the unit from the VAT regime in the form of input tax credit would be lower and hence the incentive to be part of the regime too is reduced.

Policy options:

- With enhanced support in the form of assistance from the government or through easier access to formal sources of credit, it might be possible to bring in more firms within the ambit of the VAT.
- With a sizeable segment of the unincorporated enterprises choosing not to register for VAT, the success of GST in changing the economy and business environment for these enterprises may be rather limited.
- It is often argued that tax laws tend to be complex and impose high compliance cost on the enterprises which then seek to remain out of the tax regimes to avoid such costs. Perhaps the corrective for this behaviour could be explored in finding ways of reducing compliance cost.

References

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