Report on the Workshop on Value Added Tax

held during July 26-28, 1999
at the
National Institute of Public Finance & Policy,
New Delhi
(Supported by DFID, India & World Bank)

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Preface

An indirect tax system that mobilizes enough revenues for the governments to spend on basic necessities such as primary education, preventive health care, infrastructure and poverty alleviation is essential for the country's development. At the same time, we need a tax system that promotes efficiency in production, consumption, and the development of the Indian common market, and does not impair the competitiveness of the domestic producer *vis-à-vis* her foreign counterpart.

In this context, the National Institute of Public Finance and Policy (NIPFP) has been advocating the replacement of the existing system of sales taxes by a Value Added Tax (VAT). The Institute's report on *Reform of Domestic Trade Taxes In India: Issues and Options* was a major step in this direction. It initiated a debate on the implications of VAT for India. The Institute has also drafted a model statute for Value Added Tax and has carried out several training courses on VAT. It has been providing secretarial assistance to the Committee of State Finance Ministers in its deliberations on the introduction of VAT.

Recently, at a meeting of State Chief Ministers organized by the Union Finance Minister on November 16, 1999, the states have committed to the implementation of common floor rates of sales tax and cessation of sales tax incentives with effect from January 1, 2000, and for introduction of VAT by April 2001. This is a landmark decision, which is a source of great satisfaction to all of us at the Institute.

The workshop on Value Added Tax organized by the Institute during July 26-28, 1999, with support from DFID India and the World Bank, provided a forum for debate on the feasible design of VAT for the states in India. This report presents a brief summary of the deliberations at the workshop.

While attempts have been made to ensure faithful representation of the views expressed at the workshop, the responsibility for any omissions in the report lies mainly with the authors. The Governing Body of the Institute does not bear any responsibility for the contents and views expressed in this report.

New Delhi
December 20, 1999

Ashok Lahiri
Director, NIPFP

1. General

The workshop on Value Added Tax (VAT) was organized by the National Institute of Public Finance and Policy (NIPFP), with support from the U.K. Department for International Development (DFID) and the World Bank. The main objective of the workshop was to bring together the representatives of the Central and State governments, and the Indian and foreign experts on VAT to discuss issues relating to design of VAT for Indian States. The workshop was inaugurated by the Hon'ble Finance Minister Mr. Yashwant Sinha who in his well structured speech, set a high tone for the workshop by unraveling his plans for converting MODVAT at the Central level into a single rate VAT, in a phased manner,[1] with no discrimination and no discretion. The inaugural address was followed by the keynote address by Prof. R. J. Chelliah, professor of eminence, NIPFP. He outlined a framework for the reform of indirect taxes in India and emphasized the importance of production and consumption efficiency and the need to remove tax cascading[2]. In his welcome address, Dr. Ashok Lahiri, Director, NIPFP emphasized the importance of VAT in the context of globalization which calls for making the tax incidence transparent. The discussion spanning three days covered significant ground on issues relating to the rationale, structure and design of VAT for the Indian States[3]. Towards the end of the workshop, Mr. Satya Poddar (one of the foreign consultants on VAT) gave a brief review of the discussions held.[4] This was followed by concluding remarks by Prof. R. J. Chelliah.[5] The workshop ended with vote of thanks by Dr. Ashok Lahiri.

The workshop was well attended, with participation from a large segment of state officials, officials from the Ministry of Finance, Government of India, the Central Board for Excise and Customs (CBEC), representatives of trade and industry, and the VAT experts from India and abroad[6].

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[1] The transcription of his speech is at Annex 1.
[2] The text of his keynote address is at Annex 2.
[3] The schedule of sessions is at Annex 3.
[4] The transcription of his review is at Annex 4.
[5] The transcription of his concluding remarks is at Annex 5
[6] A list of officials who participated in the workshop is at Annex 6.

The workshop was structured into 10 discussion sessions spanning three days. Each session of 90 minutes duration began with a brief presentation by the lead speakers about the key issues and the available alternative solutions, laying down a framework for the discussions that followed. In order to facilitate a focused discussion, the participants were provided with a background paper, detailing the issues and alternatives, prepared by Mr. Satya Poddar in addition to other reading material and notes prepared by the lead speakers. The following is a thematic summary report of the discussions held at the workshop.

2. Why VAT?

The prevalent sales tax systems in Indian States are far from desirable. They are complex, non-transparent, apply to narrow tax bases (first point levy), pose barriers to the free movement of goods across state jurisdictions, and result in production inefficiency, tax exportation and high degree of tax evasion. Replacing the existing sales tax system by a retail sales tax (RST) or a destination based VAT with one or two rates can free the states from the above-mentioned deficiencies. Between the RST and VAT, the latter is advocated since it is collected all along the production and distribution chain, minimizing the possibility of evasion. The Indian states are well aware of the disadvantages of RST. Most of the states have experimented with the RST at one time or another before settling for the first point taxation. In fact, most of the participants were of the opinion that VAT is inevitable and the question that needs to be addressed is when and how to introduce VAT, and not 'why VAT'.

3. Issues relating to the design of VAT

The general issues discussed in the context of design of VAT for the Indian states included: choice of method of computation of VAT, choice of registration threshold, extent of exemptions, choice between single and multi-rate VAT, need for harmonization of VAT rates across the states, taxation of inter-state trade and role of special additional tax (SAT) on selected goods. A brief description of the discussions held on these issues follows.

- **Choice between input-tax credit and subtraction methods**

Between the input-credit and subtraction methods, the former has the following advantages over the latter:

- The incidence of tax is transparent. The rate applicable at the last stage (paid by the consumer or the final user) is the effective rate of tax on the commodity.
- It generates a trail of invoices, which permits better auditing and hence makes it a self–policing tax.
- It is easier to implement particularly in a tax regime with multiple tax rates.

- **Registration Threshold**

For fixing a threshold for registration, the following two approaches were discussed:

- One approach is to have a high threshold for compulsory registration for VAT and allow voluntary registration to those below the threshold if required for business reasons. In addition, any dealer with turnover in excess of a specified low threshold and not within the ambit of VAT may be subject to a low turnover tax.
- The second approach is to set a reasonably low threshold but do not allow voluntary registration to those below the threshold. In this case, if voluntary registration is allowed, voluntary registrants will be very small dealers, a difficult segment to administer.

Between these two alternatives, the latter is preferable to the former on grounds of economic neutrality. The former results in competitive tax disadvantage for those above the threshold vis-à-vis those below it. To that extent, it becomes a tax on profits rather than purely on consumption. Also, it is not conducive to voluntary compliance because, at the margin, the dealers would tend to undervalue sales leaving scope for shifting the increase in value to subsequent stages of sale, in the hands of persons below the high threshold.

The low threshold has also been recommended by various other studies such as the report of NIPFP (1994) on *Reform of Domestic Trade Taxes in India* and the *Model*

Statute for Value Added Sales Tax prepared by NIPFP (1998), besides the background paper circulated at the workshop. A threshold level of Rs. 3-5 lakh was generally agreed to.

- **Exemptions**

Exemptions cause erosion in tax revenue, and introduce gaps in the chain of tax credit resulting in cascading. Those who buy from the exempted sellers cannot claim tax credit for the tax paid by these sellers on their purchases, which remains embedded in the price of the good. They also pose difficulties in tax administration. Hence exemptions should be kept to the minimum.

- **Choice between single and multi-rate VAT**

A single rate VAT is ideal because it minimizes costs of compliance and administration and reduces the possibility of disputes in classification, whereas a multi-rate VAT gives rise to classification problems. It requires a more complex system of account keeping, issuing tax invoices, verifying tax returns and conducting audit. The more the number of rates the higher would be the costs of compliance and administration.

One of the factors that should be kept in mind in deciding about the VAT rate for a state is its revenue. The rate has to be at least revenue neutral, as no state can afford to lose revenue. A revenue neutral single rate may work out to be a high rate, which would inhibit voluntary compliance especially among the small dealers. Thus, there is a need to consider the feasibility of a two-rate VAT.

Under a two-rate VAT, possibilities for keeping low the cost of compliance and administration were considered. It was noted that a single manufacturer in general is likely to deal with commodities subjected to the same rate of tax. However, most of the resellers, particularly departmental stores and small dealers, are likely to deal with a combination of goods subject to different rates. One way of relieving these dealers from the associated compliance burden would be to prescribe a uniform rate for the resellers. This would require the application of the subtraction method at the level of resellers. This is so, because with the application of the credit method, this uniform rate would become the effective rate on the commodities passing through these resellers provided a refund of the excess credit is permitted. As a large proportion of sales for final use would pass through the resellers, an application of such a uniform rate with credit method would tantamount to a single rate VAT.

- **Harmonization of rates across states**

Whatever be the chosen design, it is crucial that it be harmonized across the states in India, so that the chapter of tax competition is not reopened. The existing agreement between the State Finance Ministers provides for a three-rate system with uniform pre-fixed floor rates. This framework may be used to evolve a consensus about a limited number of uniform rates or at least floor rates.

- **Taxation of inter-state trade**

Ideally, the tax should be operated on the destination principle implying that inter-state trade should be zero-rated. Accordingly, CST should be abolished. However, operation of zero rating is prone to tax evasion, and hence special steps need to be considered. Further, abolition of CST would result in loss of tax revenue that may at least partly be compensated for by raising the VAT rate to occupy the space created by abolition of CST.

Various alternatives were discussed for mitigating the possibility of tax evasion in the operation of zero rating. These are briefly described below:

- **Pre-payment system:** The importing state can issue a "C-form" against pre-payment of its tax on the goods to be imported and the exporting state zero-rates the goods against this form being produced.
- **Little boat model (System of dual VAT):** Let there be a complete dual VAT: central and state VATs extending right down to the retail level. In this case the exporting state zero-rates the inter-state transactions and the Center collects full tax on these transactions at the rate prevailing in the exporting state in addition to the Central VAT. In the importing state, the Center allows set off for both the Central and state VAT against the Central VAT on the sale of products purchased on inter-state trade and the importing state collects its full VAT. This mechanism, however, would be feasible only in the countries with dual VAT

extending to the retail level. In India, there is no scope of applying this mechanism, as its Central VAT does not extend to the retail level.

- **Co-ordination between the states:** In this system, the exporting state collects tax on inter-state trade and transfers revenue to the importing state which in turn, gives set off for the tax paid on all purchases including those purchased from other states. This mechanism is prone to delays in transfer of revenue by the exporting states to the importing states. Given the financial condition of the Indian states, this method is unlikely to work.

Between the three methods discussed above the pre-payment system seems to be the preferable mechanism for India. This avoids misuse of zero-rating provisions and hence avoids loss of revenue to the exporting states. This however may cause some hardship for the dealers in obtaining pre-payment certificates from the tax officials in the importing state.

Abolition of CST requires the support of the Central as well as State governments. Doubts were expressed regarding the plausibility of this outcome because some of the states deriving significant revenue from the CST are unlikely to agree for its immediate abolition. Until the time CST is abolished, it was considered necessary to minimize the resultant tax exportation. For this purpose, the following alternatives were discussed:

- The present organizational framework can be used to convert CST from a tax on exports to a tax on imports, with zero-rating of exports. This will facilitate a set off by the importing state for the CST paid on the purchases made from the other states. This procedure can be made operational either through the check posts or through a pre-payment system similar to the one discussed earlier.
- The second alternative is one where the exporting state refunds input taxes in respect of exports and collects CST that is transferred into a Central pool. The importing state gives a set off for the CST paid on purchases made from the other states against the taxes collected on the sale of these goods, and gets a refund from the Central pool. The advantage of this process is that the link of paper trade is maintained.
- The exporting state gives full set off for the taxes paid on inputs against the taxes collected through CST with the provision to refund the excess tax credit.

This would make the effective tax rate on exports equivalent to the CST rate that can be gradually brought down to nil (or one).

Under the first two alternatives, the existence of CST does not result in tax exportation. Adopting either of the alternatives would require some amendments to the CST Act. The third alternative requires minimal changes in the organizational structure of taxation but in this case, the reduction in tax exportation will be gradual. Under these schemes, the preference for consignment transfers over inter-state sale would be considerably reduced.

- **Special Additional Tax (SAT)**

With a view to keeping the revenue neutral VAT rate(s) as low as possible, the possibility of raising some revenue through a supplementary (non-rebatable) special additional tax (SAT) was explored. It is recognized that any such levy should be a first point levy and should apply only to a few demerit and luxury (final use) goods. These goods would therefore be subject to both VAT and SAT. This would facilitate setting in place a simple VAT with a few and low rates (say 2).

4. Special issues of importance

Certain conditions imposed on taxation of declared goods under the CST Act, the agreement between the Center and the States regarding taxation of textiles, tobacco and sugar, and exclusion of services from the tax jurisdiction of states pose special problems in designing a VAT for the Indian states. Ideally, all these goods and services should be within the purview of a VAT. However, the removal of these obstacles is likely to take some time. Therefore, some interim solutions were discussed. A brief overview of the discussions held and the interim solutions proposed is given below:

- **Treatment of Declared Goods**

Presently, as per the CST Act, declared goods cannot be taxed at a rate in excess of 4 per cent or at more than one point. As such, these goods cannot be integrated into a VAT and hence have to be exempted. This results in erosion of the tax base, and tax cascading. Also, the exemption could adversely affect investment in these sectors, as the manufacturers using these goods as inputs would not be eligible to get set off for the tax built-in into their prices. Therefore, the restrictions on declared goods, which are impediments in designing a suitable VAT, should be completely removed for the states adopting VAT. At the very minimum, the states that allow full set off for the tax paid at earlier stages should be permitted to tax these goods at multiple points at a rate not exceeding 4 per cent. The rate restriction should be removed with adoption of zero-rating of exports.

- **Treatment of textiles, tobacco and sugar**

As per the agreement between the Center and the states, the states have given up their right to levy sales tax on textiles, tobacco and sugar. On these goods, the Central government levies additional excises in lieu of sales tax, under the CST Act. The revenue from these additional excises is transferred to the states. These commodities cannot be covered under a state VAT unless the agreement is modified. Ideally, the Center should stop charging additional duties and the states should levy sales tax/VAT on these products. This however should be subject to a cap on the combined tax burden of Union excise duty and state VAT. But this would require consent of the Center and the states, and working out a consensus on this issue may take some time. In the interim, the Center could continue to levy additional excises (perhaps at reduced rates) on these goods and permit the states also to levy sales tax/VAT on these goods at a rate not exceeding 4 per cent, without sacrificing their shares in the additional excises collected by the center. This would also require an agreement between the center and the states. In the absence of this, these goods need to be exempted under VAT. This complicates the design of the tax. Also, the exemption could adversely affect investment in these sectors, as the manufacturers using these goods as inputs would not be eligible to get set-off for the taxes built-in into their prices.

- **Works contract and Services**

Ideally, VAT should cover both goods and services. However, the states in India do not have power to tax services. This restriction implies application of the tax to only the cost of goods used in the execution of the works contract. Accordingly, under a VAT, works contracts have to be treated as exempt. Exemption of works contracts and similar activities results in tax cascading to the extent these constitute inputs in the production processes. Also, the value added in the sale of goods (as part of works contract) remains untaxed. There are a number of such services intrinsically linked to the sale/provision of goods. In these activities, when only the goods are subject to VAT or sales tax, the seller has an incentive to undervalue the goods and overvalue the services so as to minimize the tax. Therefore, it would be desirable to permit the states to tax at least those services, which are intrinsically related to the sale of goods. Until this is allowed, works contracts have to be exempted under VAT. For facilitating a comprehensive coverage of the VAT it would be desirable to permit the states to tax services on adoption of VAT, starting with those that are of local character such as beauty saloons and vehicle repairs.

Taxation of services, in general, is a complex issue that requires special studies and agreement between the center and the states.

- **Entry Tax**

When a single state chooses to adopt the VAT with a single or a few rates, on some commodities the tax rate in the VAT-state may turn out to be higher as compared to that in some other states, introducing the possibility of trade diversion. Unregistered resellers in the VAT-state might prefer to import the goods from neighboring states rather than purchase them locally. An entry tax on such goods could provide a way out of this problem. This may however, require re-introduction of check-posts, which are usually found to be ineffective and inefficient.

5. Transitional problems

The main transitional issues include: (i) tax relief for the existing tax-paid inventories and (ii) treatment of capital goods installed prior to the date of implementation of VAT. For the former, it is important to determine stock of inventory, the amount of sales tax attributable to the inventories and the revenue costs of various alternatives of providing relief on these stocks. One option for determining the stock of inventory would be to take the closing balance reported for income tax purposes in the last fiscal year. If the dates do not coincide, the amount could be adjusted by net purchases in the intervening period. Tax attributable to the stocks would be the sum of actual tax paid on each of the items in the stock on a specified date[7]. It is ideal to allow full tax relief for the existing tax-paid inventories on a specified date, in the year of introduction of VAT. However, the practice varied across countries. Chile (1975) and Indonesia (1985) gave no tax credit for such inventories. In Belgium (1971) and France (1968), the credit due was spread over a given period to reduce its immediate revenue effect. It is important to note that the ideal method of allowing complete tax relief for the existing tax-paid inventories, immediately, is also simple as compared to the method of spreading the credit over a given period.

For the tax relief on capital goods installed prior to introduction of VAT, eligible value of these goods may be taken to be the written down book value of capital goods, on a specified date. Tax attributable to such a capital good would be the proportion of written down value to purchase value, multiplied by the actual tax paid. In this case also, it is ideal to allow full tax credit for the capital goods installed prior to the introduction of VAT. However, the practice has varied across countries. Some countries allowed full tax credit in the year of introduction of VAT while others allowed only partial tax credit. The latter category of countries includes Belgium (1971).

6. Issues relating to Administration of VAT

The participants expressed their concern regarding the misuse of MODVAT credit under the Central excise. The officials from the Directorate of Anti-evasion (excise) pointed out that the misuse of MODVAT credit should not be a cause for worry. The misuse is found to be in the range of 5-6 per cent of MODVAT credit due, and computerization can further reduce it. A substantial part of the misuse is attributable to the special provisions[8] in the design of MODVAT such as (i) the facility to the traders to issue MODVAT credit invoices although they are not in the ambit of the MODVAT system and (ii) exemption of small-scale industry (SSI). Since the MODVAT credit invoices are of no use to the exempt SSI units, the credit invoices

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[7] It, however, would not be feasible to compute input taxes built-in into the prices of inventories. A simple solution to that would be to ignore such input taxes, and focus on the actual tax paid on the purchase of inventories held.
[8] Such as the permission to issue tax invoices to those who are not in the MODVAT net.

relating to their purchases are misdirected to non-exempt units who in turn claim illegally the tax credit on the basis of these invoices. Thus the lesson that follows from the experience of operation of MODVAT in India is to have minimum exemptions and special provisions under a VAT. Besides this, the discussion focused mainly on the following three aspects: (i) voluntary compliance, (ii) identification of defaulters, and (iii) harmonization and the need for an institutional system to preserve the harmonized VAT system and reap the benefits of economies of scale in centralizing core functions of tax administration.

- **Voluntary Compliance**

Voluntary compliance is considered to be the backbone of a good tax system[9]. It lowers cost of administration, keeps up the morale of administrators, results in a fair distribution of tax burden, induces formulation of simple and transparent tax policies[10], avoids allocation of resources to economically unproductive activities (such as tax planning and tax litigation) and channels energies for economic growth. In fact, the degree of voluntary compliance can be used as a measure of success of a tax system. It was emphasized that the ladder to achieve success in tax administration is to promote voluntary compliance. Many small factors make a significant contribution towards voluntary compliance. These include the following:

- **Certain features of the VAT design:** These features include simplicity of the tax structure, reasonable level of taxation, well-tailored administrative procedures and minimum obligations of registered dealers. It was emphasized that viewing the dealers as tax collecting agents rather than as taxpayers in designing the VAT would go a long way in encouraging voluntary compliance.
- **Adequacy of taxpayer education programmes:** Imparting education regarding rights and obligations of taxpayers as also of tax officials through media, supply of booklets, workshops for representatives of trade and industry, and educational visits to potential new taxpayers are useful in promoting voluntary compliance.
- **Adequacy of taxpayer services:** Not only is it important that procedures for paying the tax and filing tax returns do not impose excessive compliance burden

[9] The discussion on voluntary compliance is applicable not only to VAT but also to other taxes.
[10] In fact voluntary compliance and simplicity and transparency in tax policies are mutually reinforcing.

on the taxpayers it is equally necessary that there exist an interface between the department and the taxpayers to address individual taxpayer queries and provide regular updates on the changes in the tax system, if any.

- **Credibility of tax administration:** The higher the credibility of tax administration, the higher would be voluntary compliance. The credibility of tax administration depends mainly on its ability to identify defaulters and bring them to book, and the perception of taxpayers about the ethics of tax officials. An image of honesty of tax officials enhances credibility of tax administration and hence voluntary compliance.
- **Efficiency in government spending:** The taxpayers will have strong resistance to paying taxes if they perceive government spending as wasteful. Efficient and transparent government spending encourages voluntary compliance.

- **Identification of defaulters:**

For the success of a tax system, a mechanism for identifying, penalizing and publishing defaulters is a must; otherwise there will be rampant evasion. A concerted effort would be necessary to identify unregistered potential taxable persons, stop-filers, tax evaders and persons indulging in tax fraud. A brief summary of the discussion held on the mechanisms for identifying different types of defaulters follows.

- **Unregistered taxable persons:** For identifying such persons, an access to various sources of information like income tax returns, business licenses issued, lists of importers and transactions through the banking system is crucial. This requires coordination and exchange of information among the different agencies in and /or outside the government.
- **Stop-filers:** Identifying stop-filers is a relatively easy job. The computer can match the list of tax return filers with the master file of taxpayers and identify stop-filers. In fact, the process of generating notices to be sent to the stop-filers can also be automated.
- **Tax evaders:** An important tool to identify tax evaders is audit. To be effective, the audits have to be detailed and hence should be focused and targeted well. Crucial to this process is the formulation of an appropriate audit strategy, which uses information not only from tax returns but from other sources as well, like income tax returns, and the pattern of industrial growth. All the tax returns

should be checked by the computer for any computational errors. In addition, a small percentage of the total number of taxpayers should be selected for audit depending on the capacity of tax administration. The cases selected for audit should include a specified number of the largest taxpayers (in terms of payment of tax) in addition to those selected on the basis of risk analysis.

- **Those indulging in tax fraud:** The process of identifying persons indulging in tax fraud is the same as for identifying tax evaders. Since tax fraud is a more serious crime as compared to tax evasion, it should be subject to heavier penalties.

- **Harmonization**

The scope and importance of harmonization between the center and the states and among the states was discussed. A brief summary of the same follows. The issues relating to harmonization can be classified into the following three broad groups:

(i) **Center-state harmonization:** This is necessary for keeping the combined burden of Union excise and sale taxes within reasonable limits. It requires that the center and the states arrive at a consensus on the maximum permissible rates of tax.

(ii) **Inter-state harmonization on policy matters:** This relates to harmonization in the design of the tax specially relating to the tax base (income or consumption type), absence of industrial incentives, zero-rating of exports, and the tax rates across the states.

(iii) **Inter-state harmonization on administrative matters:** This relates to harmonization of administrative procedures and mechanisms across the states, for checking evasion.

Cooperation on the latter should be easier to achieve because from this, all states stand to gain without any compromises on their autonomy. For instance, exchange of information on inter-state transactions would permit the states to check evasion. Also, harmonized tax administration would facilitate standardization of procedures and hence permit development of common software and training programmes, and sharing of information among the states. This will help in reaping the benefits of associated economies of scale. All these issues require dialogue among the states. Therefore, there is a need for putting in place an institutional mechanism for facilitating such a dialogue, and once some degree of harmonization is achieved, for preserving it.

7. Concluding Observations

On virtually every issue, there was a heated debate showing the maturity and understanding that is developing in the country on the issues that arise in designing and implementing VAT. The workshop gave an opportunity to discuss widely varied perceptions of the participants. A number of participants felt that VAT is inevitable. The key question is not, why VAT, but, what should be the design of VAT and what kind of preparation is necessary to implement it. As Mr. Satya Poddar puts it:

> "The discussions at the workshop have been, like anything else in life, full of ups and downs, love and fear. Some were extremely optimistic about VAT coming, others were pessimistic. Some wanted full VAT, others wanted partial VAT or no VAT at all. Some wanted high threshold: 1 crore or even higher, others wanted no threshold. Some wanted computerization, others say why wait for it, let us go for it right now. Now, these are really issues, which arise in any kind of a major change of this nature. And as long as there is an open mind and full willingness to explore these issues, it is a good sign" (See Annex 4).

It was emphasized that there is no need to fear political masters. The VAT design should be so chosen that it is saleable economically as well as politically and that is possible given the nice characteristics of VAT. What is needed is to draw attention of different agents in the economy to the advantages that would accrue to them under VAT. The change in the mindset should be brought about wherever necessary through an increased awareness of the merits of VAT over cascading types of sales taxes.

Planning for implementation of VAT is necessary for the success of such a major reform. It involves designing suitable VAT, educating tax officials as well as potential taxpayers about their rights and obligations, increasing awareness of dealers, exporters and consumers about the merits of VAT in general and specifically for them, and computerization. This requires full involvement of the tax officials.

While this workshop gave an opportunity to explore alternatives for addressing different VAT parameters, no consensus emerged on the design characteristics. Some more occasions for such discussions would pave the way for evolving a consensus. Further, given the revenue concerns of the officials, it might be useful to carry out a study to identify revenue neutral VAT rates for a few states to establish feasibility.

Inaugural Address by the Hon'ble Finance Minister Mr. Yashwant Sinha*

Thank you. Prof. Lahiri, Dr. Chelliah, Dr. Bagchi and friends, I am very happy that National Institute of Public Finance & Policy (NIPFP) has organized this seminar on Value Added Tax (VAT). It appears to me that from the point of view of time it could not have been more appropriate. I have been talking about VAT wherever I spoke about taxation. And I can only say that with so many experts gathered around this table from India and abroad, I shall be eagerly looking forward to the deliberations and recommendations of this conference, so that when the budget of the Central Government and State Governments are prepared for the first year of the next century or the millennium, some of the valuable suggestions that would emerge from here could be taken into account and implemented. I am not an expert on taxation and I admit before you that I feel completely at sea when technical issues about taxation are raised. But as a lay person, who has had some experience of looking at it, I would like to flag some issues for your consideration. I find that the list of issues that has been brought up for this seminar is quite comprehensive. The first issue is about the mindset of the taxpayer. I notice at least in this country, I don't know to what extent it is the same elsewhere, the mindset of the taxpayer is to avoid paying taxes if he can afford to do so. And whenever I had an interaction with a taxpayer the reason put forth is not the inability or unwillingness to pay taxes, but the hassle factor involved in paying taxes. I will never be able to forget easily the experience that I had last year when I presented the budget for 1998-99. As was the practice in the past, I also raised some duties and reduced some, both for customs and excise, and the mayhem that followed those changes was controversial. It was something, which I had not anticipated. The reason was that so long we have dealt with individual problems, and the taxes were used as a means of short-term accommodation. From the point of view of revenue or an emerging situation, taxes were not something which were at least of a semi permanent nature. They were not part of a trend. Even today, I am getting representations, besides the fact that the code of conduct for elections is in operation, that in order to meet a situation which has arisen in regard to a particular product or a product group, I should do something on the tax front to maintain their market shares. Therefore, the question that appears important to me is that, when we look at taxation in general, do we look at it in such a short-term perspective that we change it from quarter to quarter and from year to year? Or do we look at it in the long-term perspective and give an assurance to the producers and consumers that something that the government will do will stay for a while, so that they can plan their production and consumption accordingly? This year (1999-2000), I got out of it by consulting Dr. Lahiri. And we settled basically for three rates of excise and five rates of import tariff. And then I decided to build principles around it, in such a manner that if anyone put pressure regarding one commodity or another, then I would take shelter behind those principles and cite that as an argument for not accepting what they were pleading for. Therefore, the question I am raising is that, how will VAT enable us to deal with the problem of mindset of taxpayers and the demands raised by them to alter the tax structure in such a way that we accommodate their short-term interests? Is taxation meant to accommodate short-term interests? If the flow of imports into this country accelerates, do we alter the import tariff in order to meet that situation? Should we use it as an instrument or a weapon? Similarly, as far as excise is concerned, if competition from abroad becomes more intense, do we tamper with excise duty in order to give short-term relief and thereby change the system?

Dr. Lahiri was referring to a very important point and that is the integration with the world economy, and the integration with the regional economy in South Asia that is going to come around in the next three years. How are the Indian states going to cope with it? Is there even a study going on to find out the impact on the competitiveness of the Indian industry, if the State Governments continue to levy sales tax in the manner in which they are levying currently? That is an issue, which is very important and should certainly be gone into in great detail.

The second issue, which is on my mind as Finance Minister is that I would like to see a better tax to GDP ratio than at present. We have noticed over the last few years

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• It is the transcription of his speech.

and especially after introduction of MODVAT that the tax to GDP ratio and especially the excise tax to GDP ratio has declined. And if I am not mistaken about the figure, it has come down from over 11 per cent to a little over 9 per cent in about 8 years. Now for any Finance Minister this would be a matter of concern. If the tax to GDP ratio continues to decline in this manner, then we will be hard put for resources.

Now whatever reform in taxation we might conceive here, it is very important that we keep also the revenue concern in mind. And I would like to share with you that ever since MODVAT has been made more extensive, a lot of malpractices have crept in and have had an adverse effect on revenue. I have instructed my revenue officials to take very special care of MODVAT refunds. There are units, which are not eligible for the advantage of MODVAT. But they are in the business of sale and purchase of goods, and we have information that in many cases those purchase vouchers which are of no use to them, are being passed on to others who can misuse them to claim MODVAT refunds. Unfortunately, computerization and connectivity has not spread so far in the excise department as to permit verification: whether a producer in Coimbator has actually bought what he claims to have bought in Amritsar, Ludhiana or somewhere else. The result is misuse of the MODVAT facility. Now in the short run as long as this system continues and even in the long run while we move to a single rate VAT, how are we going to tackle this problem? And how are we going to prevent this misuse? This is something, which tax administrators have to apply their mind to, because if a large leakage of revenue takes place for this reason, then obviously it will not serve the purpose that we have in mind.

The third issue, which I thought is very important and the central government is concerned about it, is that, if we are thinking of a single-rate VAT then what is the ideal rate? In this year's budget, I have settled for three rates: 8,16 and 24 per cent. Now where exactly do we fix that? And, what will be the kind of response of trade and industry to such a change. I for one am firmly of the view that India must move towards a single-rate VAT. And here, in conferences like this we must be able to evolve a solution to the problem, which will arise as a result of this transformation or migration to a single-rate VAT. Single-rate VAT is preferable for various reasons. Firstly, it will be absolutely transparent. I do not have to go into the details. Secondly, all the problems of classifications will be done away with, at one stroke. When we had

11 rates of excise, there were classification wars going on between the producers and the excise officials, which are still continuing even with three rates. All this will be eliminated if we were to move to a single-rate VAT. The question to which I would like to draw your attention here is that, will the single-rate VAT and the refund of duties paid at every level lead to an increasing contact between the tax administrators and taxpayers than at present? And if it does increase the points of contact, the levels of contact, then how is this going to impact on the minds of taxpayers? Because they are really scared and they do not want to deal with the tax officials.

The fourth issue connected with this in my mind is what kind of paper work do you expect in this? Because not only small scale units but even medium scale units have come to me and represented that they are prepared to pay taxes but not to do paper work. Now, how can this miracle be achieved that you don't do paper work and still end up paying the taxes? I am not able to envisage such a system and that is the reason why many of the people who come and represent their problems have said that we should move away from VAT to capacity based taxes, without need for maintaining books of account. A taxpayer is the favorite prey of a tax collector. The tax collector visits him, he is bound to find something or the other wrong and haul him up. Now when we are thinking of a single-rate VAT, what is the kind of paper work that we expect these units to do and maintain? What is the role of self-assessment? What is the role of self-clearance? What should be the periodicity of inspections or even collection of taxes? How do we change the duty rates? But there are a number of products where today capacity is the consideration and not the value. I am also guilty of changing *ad valorem* duty rates into specific duties on some products. How do we bring them once again into this kind of a net? What are the special circumstances surrounding these products?

Then we have the problem of the small-scale units. I am referring to it, because small-scale sector will continue to play a very important role in our national economic life. The small-scale sector, over a period of time, has got used to various kinds of concessions including tax concessions. Up to first 50 lakh rupees, as we know, there is no excise duty on them. And then the rates are much lower than the rates on similar products produced in medium and large sectors. Now when we think in terms of a single-rate VAT, how do we integrate small-scale sector into it? How do we take care of the resistance from the small-scale sector? This will be a major problem in any shift to a single-rate VAT. It is not merely, as I said the paper work, it is also the tendency not to give up certain concessions, which they have been enjoying and suddenly being exposed to a disadvantage of parity. How do we tackle the problem of the small-scale sector? I have said at other forums that small-scale sector will have to quickly look at itself in order to brace itself for the kind of competition which is lying in wait in the next two years. Dr. Lahiri was referring to the fact that if goods produced in Bangladesh, Sri Lanka, Pakistan or Bhutan can come into this country, duty free, then we will have a common market but then this will militate against the local products. India will then become only a dumping ground. It will not be the production base because we would be preventing units from coming up, because of their size, in 840 products, which are today reserved for the small-scale sector. This is one area, which is so full of anomalies even today. Half of those products, which are reserved for small-scale sector, I am told, are on OGL. Many of those products have been produced in large units with a stipulation that 50 per cent of the goods be exported. And the balance 50 per cent might be much larger than the production of a small-scale unit. Our vigilance machinery to ensure that 50 per cent is being exported is somewhat weak. We are not sure that 50 per cent is being exported or most of it is being sold in the domestic market. So it is a myth. The reservation for small-scale sector has been reduced to a myth in this country. But we are carrying on with this myth and the myth will become stronger with the passage of time. Such reservations would not make sense as we open up the economy, wherein W.T.O binding rates become applicable to more number of items and non-tariff barriers to imports are reduced or removed. We have obligations to open up more and more products and go for the SAARC common market. So, how do we integrate the small-scale sector? How do we solve their problems? These are the issues, which will have to be debated.

Then there is a very complicated issue of center-state and inter-state relationships to which attention was drawn by Dr. Lahiri. This issue has been studied extensively by Professor Chelliah. We have been wrestling now for almost 5-6 years, without having arrived at the destination that we have set for ourselves. When I took over as Finance Minister, I called a meeting of the chief ministers to discuss the ongoing reforms program, and I found in that meeting there was a consensus. Every one was in agreement that the rate wars should stop, the taxes should be simplified and the states must be somewhat progressive etc. But how and in what time frame it has to be done, was something, which was still eluding us and was not possible to arrive at, at that conference. So we decided to set-up a small committee of chief ministers under the chairmanship of the chief minister of West-Bengal. That committee met in January this year and gave its plan of action. And I, on that basis, wrote a letter to all the Chief Ministers, and said "Please implement this plan of action in your budget for 1999-2000". And I had some response, but the response is far from satisfactory. Now this is an area where we have to tread very carefully and cautiously, but progress we must make. According to our constitution, this part is entirely within the jurisdiction of state governments. We can only act as friends, philosophers and guides and that is exactly what Prof. Chelliah has been doing. But, as I said the desire was there to arrive at a consensus but the desire to implement that consensus has been somewhat lacking. The result is that while some states have moved forward, the others have held back and even those states, which moved forward, have now retraced their steps. So this requires a plan of action which will make all the states move simultaneously, in this direction, so that nobody is at a disadvantage.

Then we have the Central Sales Tax, an issue, which calls for a very close look. Then there are centrally administered areas: the Union territories, where the Home Ministry and the Government of India is responsible. In many places they are the biggest impediments, I use a mild word, in moving towards a more rationale tax system. Now these inter-state and center-state problems have to be gone into in some detail. They might even impinge on the jurisdiction of the Finance Commission but if there are recommendations from this seminar, I am sure Prof. Khusro and his colleagues will be benefited. But this is an aspect, which needs to be looked at very, very seriously. We have to in fact look at the tax to GDP ratio that I was referring to, not only from the point of view of the Center, but nationally. How are the state ratios of tax to state domestic product working? The 10th Finance Commission recommended that 29 per cent of the taxes should be devolved to the states: there is a constitutional amendments legislation that is pending before the parliament. Hopefully, when the next Lok Sabha is elected this legislation will go through. But, if I am not mistaken, I think the 10th Finance Commission recommended that this 29 per cent should hold good for 15 years. The ink has not yet dried on the 10th Finance Commission report and there are already demands from the states that it should be raised to 33 per cent. Now, that raises issues of devolution of taxes, relationship between the center and the states, the needs of the states, the needs of the central government and how best should the system be so ordered that the states' needs as well as the center's needs are met. What kind of co-ordination must necessarily exist between the central and state taxes, on the one hand, and among the state taxation systems, on the other.

These are issues, which have impeded the path of the tax reforms in this country so far. It appears to me that unless we move towards very reasonable rates of taxes, utter simplification of taxes and simplification of procedure and forms, and change the mindset of tax administrators as well as taxpayers, the tax reform will continue to elude us and remain a distant dream. We will continue to tamper with the system by making changes here and there, but we will not be able to come to grips with the fundamentals of the problem. I can tell you from experience of the last two months that I have been able to sleep peacefully because I did one thing and that thing was that I abolished power of the government to grant exemptions. I said, I will just not exercise this power. So nobody is coming to me now with the request to exempt him from customs duty. Nobody is coming to me and saying why didn't you exempt my products from excise duty. This has been a big relief. Now this is the kind of simplification that one has to look forward to, a non-discriminatory, non-discretionary and transparent tax system. That is the challenge still before us and I am very confident that this group of experts will be able not only to come to grips with the problems which face us but also come out with well thought of and practical solutions, which can then be implemented by the administration of the states.

Thank you very much.

VAT AS A COMPONENT OF A DESIRED TAX SYSTEM

A Keynote Address delivered by

Raja. J. Chelliah

I am glad that NIPFP and DFID have jointly organized this workshop on value added tax in the context of attempts being made to introduce a state level VAT in India. I am given to understand that senior officers from the State governments connected with finance and taxation have been invited to attend the workshop. It is extremely important that senior officials get fully acquainted with all aspects of value added taxation as well as discuss among themselves the problems of making a transition from the existing system of sales taxation to a full-fledged state level VAT. Your inputs into the discussions and conclusions on what problems will be encountered in making the transition and the methods of overcoming the difficulties in administering VAT would be of great value and must be taken into account in outlining an action plan.

As a kind of an introduction to the technical discussions that would be held in the next three days, I would like to outline before you the characteristics or design of a desirable tax system and then indicate how the value added tax will fit into such a system. Of course, a tax system is needed to bring in revenues to the government; but tax revenues can be raised in many different ways. The theory of taxation deals mainly with a question of what would be the best and proper way of raising taxes for the government. In other words, what are the criteria of a good tax system?

Many of you might be familiar with the criteria. To mention only the major criteria,

- The tax system should be fair or equitable
- It should cause the least possible harmful effects to the economy and to the extent possible promote its growth, should be simple both for administration and compliance and last but not least should be income elastic.

The most important criteria are those of equity and economic rationality (least harm to the economy). However, the extent to which these criteria can be fulfilled will be limited by the requirement of simplicity and revenue elasticity. Every one would agree that a system that is put forward should be administrable. Indeed the VAT system is objected to by State level officials and others on administrative grounds. One has to pay a good deal of attention to the question of administration. The characteristic of income elasticity is also important because we really need a system which will automatically produce more revenues when the economy grows so that it would not be necessary for the government to keep raising tax rates or introducing new taxes from time to time to get more revenues as the economy grows.

It is generally agreed that since taxes are unilateral payments for which there is no direct *quid pro quo*, citizens should be required to pay taxes on the basis of a rule of equity; and that may be according to ability to pay (Musgrave, 1959).[11] Intuitively, the criterion of ability to pay appears to be the proper rule. An individual's ability to pay can be measured on the basis of his income (which will indicate the level of economic welfare he can enjoy during a period, say, a year) or his consumption (which will measure the level of economic welfare he actually enjoys). The person's wealth also makes a contribution to his welfare, apart from the income it yields and hence some would argue that wealth should be taken as a supplementary test of ability. But income and consumption are generally accepted as the main tests of ability.

There are many problems in defining correctly, for tax purposes, a person's income or total consumption. I will not go into them in this address. Some theorists have argued that a direct tax on the total annual consumption of an individual would be a superior alternative to a direct tax based on income. This is because it could be shown that if life time consumption is equal to life time income, a direct tax on annual consumption would be a more equitable alternative and also that a proportional consumption tax will be neutral between consumption and saving whereas a proportional income tax will discriminate against saving (Atkinson, 1990). However, because of the extreme difficulty in measuring the total annual consumption of an individual in practice, a direct personal consumption tax is not being levied in any country now. Furthermore, in a country such as India where the majority of the population have fairly low incomes and consumption, we can rely only on indirect

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11 By and large, taxes cannot be required to be paid according to the value of services or benefits received because the benefits from public goods are indivisible and cannot be apportioned.

taxes for taxing that section of the population. Hence, we need to have a combination of an income tax to be levied on the better off individuals and a tax on consumption on all citizens to be measured indirectly through the expenditure on goods and services.

The main task of the tax economist is to devise a system of taxation that would enable us to reach the income and consumption of individuals without causing any, or more than the minimum possible, adverse effect on the economy. At the same time, the system should be made equitable in the sense that equals will pay equal sums of tax and unequals will pay unequal sums with the better off paying more and the worse off paying less.

Since taxes are compulsory payments for which there is no quid pro quo, the obligation to pay taxes tends to alter the affected individuals' economic behavior. Effects on economic decisions arise from the desire to minimize tax payments and from the impact on incentives. All economic agents (producers of goods or services) have to make certain major decisions, namely, what to produce or what employment to seek, where to produce and how to produce (what factors of production to use and in what proportions to combine them). The combination of factors of production is partly determined by technological considerations but they are also made on economic considerations. Given the technological factors, economic decisions should be made on economic considerations, namely, producing goods and services at the lowest possible cost so that productivity is high and consumer welfare can be maximized. The argument of the tax theorists is that unless a very important social purpose is to be served, taxes should not be levied in such a way or the tax system should not be structured in such a way that economic decisions will be altered for tax considerations. That is to say, taxes should not alter the allocation of resources in terms of location of industry, the kinds of goods produced and the methods of production. There may be cases where in the social interest, some alterations may be considered necessary and taxes may be devised in such a way as to bring about such alterations. These will be very few; in practice, unintended alterations through taxes are quite common. Such unintended alterations are referred to as distortions in resource allocation. The aim should be to minimize such distortions while devising taxes on income and consumption.

As is well known, taxes also tend to affect economic incentives: willingness to work and earn, willingness to save, willingness to take risk, etc. Very high rates of personal income tax, for example, can alter the choice between leisure and work, between savings and consumption or between risky and safe occupations/investments.

As regards indirect taxes, taxation of consumer goods and exemption of capital goods would tend to promote investment. This may be considered desirable in the social interest. So, one could introduce an intended alteration of this kind. It may be best to leave the pattern of consumption unaltered except for the discouragement of consumption of harmful goods such as alcohol and tobacco[12].

Let us assume that there is a properly structured personal income tax, which does not seriously weaken incentives. The question then is what kind of a system of taxes on commodities and services should we design so that there is the minimum of unintended alterations (distortions) in resource allocation. Such a system would minimize the cost of production, which would maximize consumer welfare and give competitive advantage for domestic products as against imports as well as in export markets.

Taxes on commodities are intended to be taxes on consumption, because the ultimate aim is to reach the consumption of individuals. Commodity taxes can be divided into taxes on domestically produced goods and services and those on imports.

Import taxes or duties are to be levied for giving protection to domestic producers. Strictly speaking, they should not be any higher than the minimum needed to give protection. That is to say, they should not be used to raise revenues.

Taxes on domestically produced or traded goods and services, otherwise called domestic trade taxes, can be classified into categories on different bases:

a. Excises and sales taxes: An excise is defined as a tax on goods produced domestically whereas a sales tax is a tax on the sale of goods wherever goods might have been produced.

Though the excise is a tax on production, the tax becomes payable when the producer sells it, though the tax may not be based on the actual value of the sale or the sale price. It can therefore be considered a sales tax at the manufacturing stage. A sales tax proper on the other hand may be levied at any stage in the chain of transactions - from production to the retail sale.

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12 There could be disagreement on this point. Some would argue that goods which could be classified as luxuries should be taxed at higher rates in order to impose a higher burden on the better off sections of the population, even though the higher rates could alter the pattern of consumption.

b. Origin based vs. destination based taxes: This distinction arises when trade takes place across more than one jurisdiction as in the case of international trade and inter-state trade within a federation. In these cases, production takes place in one country (the exporting) or state and consumption or use takes place in the importing country or state. An origin-based tax is one, which is levied/ collected and retained by the jurisdiction of production; a destination-based tax is one, which is levied/collected and retained by the importing jurisdiction. The rule of destination-based tax ensures that the tax yield accrues to the jurisdiction where consumption takes place so that the consumers pay tax to the respective jurisdictions in which they live.

c. Cascading vs. non-cascading taxes: A cascading tax is one, which effectively falls on inputs and thereby increases the cost of production. Such a tax tends also to create distortions through altering the degree of vertical integration. Also, unless all the inputs are taxed at the same rate, a cascading tax will alter the methods of production in terms of combination of factors of production. In a multi-jurisdictional context, a cascading tax becomes in effect an origin based tax, if goods subjected to that tax are exported out of the jurisdiction. Finally, the incidence of a cascading tax is not transparent: the rate of tax which the consumer pays does not indicate the total tax burden on the commodity because the taxes on the inputs in the various stages of production are included (partly or wholly) in the price of the product.

Choice between Categories of Taxes

We know that value is created or added not only at the stage of manufacturing but also at all subsequent stages of activities/transactions (transport, insurance, trade, etc.,) until the commodity concerned reaches the hands of the final consumer or user. This being so, a tax which covers value added at all transactions is to be preferred to that which covers value added only at the stage of manufacture and sale by an importer. The former will fall on the full value of the commodity in the hands of the consumer. Therefore, it will be a tax on the value of his consumption. Therefore, as a general tax, sales tax is to be preferred to excise.

I had earlier pointed out that taxes should be required to be paid according to an individual's income and/or consumption. But in trying to reach a taxpayer's consumption or income, the least possible distortions should be caused in the economy. It follows that the domestic commodity taxes levied should be of the non-cascading type. That is to say, either no tax should be levied on inputs[13] or any tax levied on inputs should be rebated so that the producer does not count it as part of his cost. Under a retail sales tax no tax falls on inputs; if sales tax is levied at earlier stages (i.e., any stage prior to the sale to the consumer or a small non-registered dealer) the taxes paid at those stages would have to be rebated. That is what is done under a value added tax (VAT) (Cnosson, 1992). The technical details will be discussed in the course of the workshop.

If there is only one level of government or if the power to levy commodity taxes is vested in the Central government only, the indirect taxes levied automatically become destination-based taxes. If in a federation, the constituent states are given the power to levy domestic trade taxes, it must be ensured that they can levy only destination-based taxes. A retail sales tax is by definition a destination-based tax. If any other type of sales tax is levied (first point or multi-point) there must be a mechanism to ensure that it will in effect be a destination-based tax[14]. VAT is a multi-point tax system under which rebate is given to tax paid on inputs at earlier stages. It is for the purpose of ensuring that the states levy a non-cascading, destination-based tax that VAT is being recommended. The States will have to be restricted to levying a VAT with inter-State transaction being subjected to a zero rate so that the taxes on inputs earlier paid will be refunded to the exporter and the commodity concerned will go free of tax to the importing State. With VAT in existence, exports out of the country can be made free of tax by zero-rating the sale by the exporter. An alternative is retail sales tax (as in USA), but that is not easy to administer.

We may conclude that under a federal set up, the objectives of minimizing adverse effects on the costs of production, allocation of resources and the degree of integration and ensuring that the tax is destination-based can be fulfilled only if (a) the States levy a retail sales tax or (b) adopt a VAT with zero-rating of exports and inter-State trade.

In either case, almost the entire value added will be covered giving the States a wide base. If only a few exemptions are granted and if there is only one rate, the tax will be very easy to administer and that VAT will act as a proportional tax on consumption.

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13 In the present context, all purchases for use in business (including capital goods) are defined as inputs.

14 See for the details of the existing sales tax system in India, Purohit (1995).

If the Central government in a federation also levies a domestic trade tax, it must also be of the VAT type, but zero-rating of inter-State transactions will not be needed.

I had earlier referred to the effect of taxation on economic incentives. If only a moderately progressive personal income tax is introduced along with a moderate corporate profits tax to reach undistributed profits, the adverse effects on incentives to work and earn, save and take risks will not be significant. In order to ensure equity and to avoid creating distortions, income for personal tax purposes should be fairly comprehensively defined, i.e., all net accruals that add to economic power (in the sense of power to consume or save) should be included in the definition of income.

A combination of such a personal income tax and a VAT falling on consumption will constitute a moderately progressive equitable tax system[15] with broad bases which will give to the government(s) the bulk of the revenue needed and we would have "reached" income and consumption with the least adverse effects on the economy.

It may be necessary to have a few other taxes for certain specific purposes. But it is preferable to keep down the number of taxes to only a few to make administration simple, to avoid harassment and inconvenience to the taxpayers and to minimize adverse effects that may flow from the interaction of all the taxes.

At present the following taxes on commodities and services are being levied by the state governments:

1. taxes on the sale and purchase of goods other than newspapers
2. excise on alcoholic liquor for human consumption, Indian hemp and other narcotic drugs
3. taxes on the entry of goods into local areas for consumption, use or sale therein (octroi levied and collected by local authorities through delegated power)
4. tax on the consumption or sale of electricity
5. tax on goods and passengers carried by road or inland waterways
6. tax on vehicles suitable for use on roads
7. tax on animals and boats

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15 It is assumed that with an adequately high exemption level, the income tax will not fall on the lower income groups.

8. tolls
9. tax on luxuries including tax on entertainment, amusements, betting and gambling.

If the sales tax (No.1) is converted into a state VAT, in course of time, the tax on electricity (called electricity duty), the tax on entertainment, amusements and the luxury tax on hotels could be integrated with the state VAT. In principle, the tax on goods carried by road should also be integrated with VAT. However, the states have found it difficult to administer an accounts based goods tax and several of them have compounded the levy and even merged it with the motor vehicles tax (No.6). A tax on the transport of goods should be a rebatable tax. A compounded levy cannot be rebated in the hands of the business users of transport services because it cannot be apportioned among the large number of users. Hence, until the goods transport sector gets better organized, the tax on goods should not be levied. A fee for state and national permits can however be collected as now.

The octroi and the equivalent state-level entry tax should be abolished as they are cascading taxes. In their place, a small surcharge on VAT can be collected and handed over to the local bodies. The tax on animals and boats is a nuisance tax and should be abolished. Since the hotel tax will be integrated with the VAT, there need be no tax on luxuries. Tolls should be levied only in respect of new bridges for the duration necessary to recoup the capital cost.

The motor vehicles tax (No.6) is, really speaking, a fee for registration of motor vehicles. It is necessary to have the registration and the fee for administrative reasons. It should be a moderate levy.

After the above restructuring, the structure of indirect taxes levied by the state will be as follows:

a. a comprehensive VAT on the sale of goods, electricity, the price of tickets for entertainment and the sale of food and accommodation by hotels
b. excise on alcoholic liquor, etc.
c. a toll tax on new bridges
d. a tax on bus passengers collected through a tax on the sale of tickets

e. a tax on gambling if horse-races and lotteries are allowed in the state
f. a registration fee for motor vehicles (this is really not a tax)

Of these, the comprehensive VAT, the excise on liquor and the passenger tax will bring in the bulk of the revenue. The other two taxes are minor ones and will not cause any inconvenience. The taxes, taken together, will form an economically rational structure and the limited number of taxes will be a matter of great convenience for the taxpayers.

If there is agreement between the Center and the States on the levy of some service taxes by State governments, then those taxes will also be integrated with the state VAT.

The Central indirect tax structure too has to be restructured and simplified. The Central indirect tax system should consist of only the following taxes:

a. purely protective import duties; and
b a tax on the basis of value added at the manufacturing stage (which could be extended to the wholesale level with the consent of the states).
c. special excise on a few commodities in addition to VAT

The import duties should be used only for granting a legitimate degree of protection. As the degree of efficiency of the Indian economy improves, the import duties should be lowered to the levels prevailing in most other countries. Imports will of course be subjected to central VAT (now called countervailing duty).

The tax on air-travel or fare must also be integrated with the Central VAT. A low rate tax on railway freight and fares should be levied as part of Central VAT. The Railways will then be able to claim set-off for Central input taxes paid. The net collections from railways can be handed over to the States as per Constitutional provisions.

The expenditure tax on hotels should be abolished. It is not worth collecting (yield about Rs. 300 crore). Further, the States would be levying a tax on hotels as part of state VAT.

With the reforms of the Central and State indirect taxes indicated in the foregoing paragraphs, India would have a broad-based economically rational and equitable system of indirect taxes. Both the levels of government would have productive sources of revenue. Each structure would fulfil the criterion of economic efficiency. However, the task of harmonization between the two systems will still remain.

I would like to end by drawing attention to the important promotional, facilitational/interventional and co-ordinating role that the Central government has to play if any sizeable progress is to be made in the reform of domestic trade taxes in India. This is borne out by the experience of some other federal countries. Without the Center taking the lead, the States will not be able to work out the reforms by themselves.

The Center has indeed promoted considerable discussion among the States through the appointment of Committees of State Finance Ministers and convening conferences of Finance Ministers of all the States. However, it has not initiated action in any relevant area. An action plan has to be evolved and quickly implemented.

This workshop can be looked upon as part of the necessary preparatory work.

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3. Atkinson, A.B., and J.E. Stigtitz (1999), Lectures on Public Economics, Mc Graw Hill, New York.
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Schedule of Sessions at the Workshop

July 26, 1999: 9:30 am to 11:00 am

1. a. Welcome address : Dr. A. K. Lahiri, Director, NIPFP
   b. Inaugural address :Shri Yashwant Sinha, Hon'ble Finance Minister
   c. Keynote address :Dr. R. J. Chelliah, Professor of Eminence, NIPFP

July 26, 1999: 11:30 am to 1:00 pm

2. Economic Rationale for VAT: Pulin Nayak

July 26, 1999: 2:00 pm to 3:30 pm

3. Alternative options for VAT: M. C. Purohit, M. G. Rao
   a. Assess the International Experience: Canada, Brazil, EU, China
   b. Why Dual VAT may be the preferred option for India now

July 26, 1999: 4:00 pm to 5:30 pm; and July 27, 1999: 9:30 am to 11:00 am

4&5. VAT Structure and Design: Satya Poddar, Andrew Marsland, Michael Cowan

a. Why a VAT
   - Revenue
   - Simplicity
   - Voluntary Compliance
   - Economic Efficiency

b. How not to do a VAT
   - Subtraction method not desirable
   - Combination of First point tax and VAT
   - Multi-rate VAT, Less than full rebate for tax on inputs: not desirable
   - Adequate planning/ Computerization
   - Large Taxpayers VAT : Not desirable

c. Broad Outline of a VAT
   - Without harmonization
   - With harmonization

d. Registration Threshold

e. Rates

f. VAT+ SAT Combination

g. Declared Goods

July 27, 1999: 11:30 am to 1:00 pm

6. Experiments in Indian States:

   Presentations by State officials, R. Kavita Rao, Moderator: R. J. Chelliah
   a. Approximations to VAT in Indian States: Experiences of Delhi, Punjab and Haryana
   b. Experiments with VAT in Indian States: Experiences of Andhra Pradesh, Madhya Pradesh and Maharashtra.

July 27, 1999: 2:00 pm to 3:30 pm

7. Administration – I : Michael Cowan, Andrew Marsland and P. K. Aggarwal

   a. Identification and registration of taxpayers, requirements regarding invoicing and book-keeping
   b. System of tax collection: documents and mode: use of banking system, etc.
   c. system of identifying defaulters
   d. Structure of penalties
   e. Self-assessment and audit (scrutiny assessment)
   f. A comparison of administration: VAT versus cascading type sales tax.
   g. Large tax payer Unit
   h. Causes for Evasion/ Poor compliance and how to deal with them

July 27, 1999: 4:00 pm to 5:30 pm

8. Administration – II: J.V.M. Sarma and Y. Reddy (Commercial Taxes Dept., A.P.)

   a. Computerization for VAT: Need, Design of a model system, technical requirements
   b. Design of Andhra Pradesh Model

July 28, 1999: 9:30 am to 11:00 am

9. Tax harmonization in Federations: World Trends and The Indian Scenario: A. Bagchi

   a. Between Center and states: Reasonable combined tax burden
   b. Between states
      - Issues concerning CST
      - Multiple rates or single rate
      - Floor levels or narrow bands
      - Dispute settlement mechanism
   c. Taxation of Services

July 28, 1999: 11:30 am to 1:00 pm

10. Transitional problems: M. C. Purohit

    a. Treatment of declared goods
    b. How to deal with phasing out of existing incentives
    c. Phasing out CST: zero-rating of inter-state sales, treatment of consignment transfers
    d. Treatment of stocks & inventories
    e. Treatment of capital goods
    f. Other transitional problems: Continuous supplies, effect on contract prices, supplies: treatment of installment payments, etc.

July 28, 1999: 2:00 pm to 3:30 pm

11. Wrap-up session

July 28, 1999: 4:00 pm to 5:30 pm

12. Valedictory session

A Brief Review of the Discussions at the Workshop by Satya Poddar*

I should start by saying that I came to this workshop with some misunderstanding/apprehension about how it will go, and I am going back with a feeling of absolute surprise and amazement. I really say that not to exaggerate or please the organizers but, because I participated in a number of workshops and this is the first workshop where there has been true discussion and challenging of positions taken. Previously it has been some sort of a monologue from the podium by somebody or the other, others have listened, applauded, gone back home. But, this is the one context where, on virtually every issue, there was a heated debate, if only time had allowed it. And that really shows the maturity and understanding that is developing in the country on the issues that arise in implementing VAT, which is a very refreshing thing, because prior to any major change that debate is necessary. The discussions at the workshop have been, like anything else in life, full of ups and downs, love and fear. Some were extremely optimistic about VAT coming, others were pessimistic. Some wanted full VAT, others wanted partial VAT or no VAT at all. Some wanted high threshold: 1 crore or even higher, others wanted no threshold. Some wanted computerization, others say why wait for it, lets go for it right now. Now, these are really issues, which arise in any kind of a major change of this nature. And as long as there is an open mind and full willingness to explore these issues, it is a good sign.

The conference started on a very high note. All the three talks or speeches or sermons given in the inaugural session (the Welcome Address by Dr. Lahiri, the Inaugural Address by Hon'ble Minister Yashwant Sinha and the Keynote Address by Dr. Chelliah) were music to my ears. They emphasize that VAT is inevitable; it is not if, but when, and when is likely to be sooner rather than later. Dr. Lahiri emphasized the importance of VAT in the context of globalization, removing cascading, making tax incidence very clear. Dr. Chelliah mentioned importance of cascading. The Minister was absolutely amazing. I could not believe that a politician can speak without notes for 45 minutes without making one mistake. He set such a high goal that you cannot go

*This is the transcription of his speech.

higher: a single rate VAT. Even Dr. Chelliah is talking about two rates and three rates. A single rate VAT, a system with no discrimination and no discretion. Amazing words coming from a Minister of Finance. This reminds me of a story about discretion. Another Canadian was involved in Kenya in drafting the so-called VAT law in the country. The Commissioner said – very good VAT law; only minor problem, Mr. Mike Cowan. You see we are developing poor country and the penalty provisions are not right for us. Can you think about it and modify them? He had a penalty provision of 20 per cent extra tax plus interest and so on. He thought it is a developing country, an African country, so 20 per cent is not good enough. So he went back and made it 60 per cent of tax due plus interest. Again he went back. The reaction was: very good draft, Mike Cowan, but still you know we are developing country, poor country, penalty provisions are still not good. He came back, scratched his head and amended it: okay, one month in jail and 100 per cent penalty for the tax due. Again he goes back, and now the response is "Yeah Mr. Cowan, it is better, but you see we are poor country, developing country, this is still not right for us". He went back again saying "What the hell do you want?" He talked to some of the colleagues, and they say, "Ah! Put a death penalty but give the commissioner the right to waive it." He went back, and the response: "Yes, Mr. Cowan. This is a fantastic system, this is ideally suited for Kenya." That's what discretion does: commissioners love it, taxpayers know how to get away from it. Therefore, to listen to those words from the Minister that he can sleep in peace if you remove the discretion of granting tax relief was amusing. I think we have the reality: if you want to sleep in peace, have no discretion and no discrimination.

Pulin Nayak, took us to even greater heights: Ramsey's law of neutral tax. As Dr. Lahiri put it, in India, everything starts with a high note, "alap" as they say, that high note was indeed very high. It was very difficult for us to live up to those high notes and thank god, we came back to lower notes. Important thing was as Dr. Chelliah mentioned, there are two aspects of efficiency: production efficiency and consumption efficiency. Production efficiency, there is absolutely no dispute about this, requires no taxation of inputs. And for consumption efficiency, the world has come to recognize that the most efficient tax from consumption point of view is a uniform tax: at least you know what you are doing, as opposed to changing the tax every minute as tastes change and the elasticities change.

Dr. Purohit and Dr. Rao gave a very good description of the VAT system in those three countries, namely, Brazil, China and Canada: all of which are federations. Important message from that was that it is not easy to design a proper VAT for a federation. Most are struggling. Perhaps, Canada is the most successful model. If you call Europe a federation, it is reasonably successful. In fact they are making a lot of money from VAT. Second important point is that whether it is a federation of states or a federation of nations, origin based taxes don't work. Their days are numbered, in fact, they died long time ago. India is trying to put oxygen pump into their bodies. I think it is time to remove the life-support and let them rest in peace.

On the VAT structure and design, there was reasonable amount of discussion. Important point I want to emphasize is, it is not good enough to design a good product. You have to have full commitment from politicians and you must have good management and good administration. It is a three-legged stool, just working on one leg or two won't function. You won't have proper benefits of the VAT law without working on all three legs of the stool. If I look at the experience in India of the VAT experimentation, the problem has really been the lopsided approach, working on one leg of the stool at a time and hoping that it would stand. It will balance for a few minutes if the wind blows in the right way and the moment the wind changes, it will fall. This is what happened in Maharashtra. The wind may be political wind or it could be any thing else. In designing the tax system, one should challenge oneself. If all you could do are the things that were easy to do, life won't be much fun. Any reform that does not require a lot of sweating is not a reform at all. So reform necessarily implies compromises, pushing the frontier, and the goals that the Minister set are very apt. I will try to quantify those goals

- Tax return no longer than one page; it can be a postcard if you can make it.
- Tax compliance burden no more than 2 hours in a month per dealer,
- Improve tax compliance on inter-state sales by at least 100 per cent; you will not have full benefits of VAT if you do not set that as a goal. I know based on my limited survey of the dealers, that on inter-state trade, for whatever reason, compliance is not more than 20 per cent. The 20 per cent should be moved up, to at least 50 per cent. And even if you do not want to count that as positive revenue in your projections, in setting a revenue neutral rate, that should be the

goal internally. If you cannot design the system that can move compliance from 20 per cent to 50 per cent, you have not done enough sweating to design a proper system.

- Rate Structure: Aim for a one-rate model. Even though it may be difficult politically to go to one rate model, I would say that if there is possibility of waiting for six months, I would rather wait for that as opposed to coming with a compromise that does not meet the Minister's idea of changing the mindset.

There was a fascinating presentation by Mr. Rastogi, Mr. Prasad and Mr. Chakravarty on experience of MODVAT. One thing I found heartening from Mr. Rastogi's presentation was the realization that they introduced MODVAT in bits and pieces without a plan, which was not a good approach. Very refreshing thought, a good realization. Think about it, have a picture of the destination before you start travelling. That picture is very critical. At the moment, there is a tendency to put the car into gear and move, and along the way, we will find where we want to go. But as they say, if you don't have a destination, any road will take you there. Have a destination, a well-defined picture, so that you can travel in a systematic manner.

Problem of bogus invoices, Mr. Prasad mentioned that a part of the problem of bogus invoices is from the large exempt segment: dealers below 50 lakhs rupees and also the exempt sectors. If every body was in the loop, the problem of bogus invoices won't disappear but at least according to Mr. Prasad it would be much less than what it is today.

Fascinating presentation about experience of the states, which were represented here. Mr. Chari's explanation and views about what happened in Maharashtra was absolutely refreshing. And in a way politics is full of "U-turns" and you can't avoid them, as a policy matter you have to live with them. But, you should be ready to make another "U-turn" when the circumstances arrive. In some ways, if I can give my own personal views, if you rush into a VAT without absolute conviction, preparation, getting the dealers ready, putting in infrastructure, then easy come, easy go. If the Government of Maharashtra had spent 30, 40 or 50 crore of rupees in training the dealers, computerizing, putting infrastructure, creating the ideal system, perhaps the wind that blew the opposite way, would not have been so effective in toppling the building that was created. I can't comment on the power of politics but I think if you build your building on a sound foundation, perhaps, you can spend the precious little, a little better than otherwise.

Last evening we saw a very good presentation on computerization of tax administration in Andhra Pradesh and the benefits they are deriving from it. I think the sentiments participants expressed spoke for themselves.

On this morning, Dr. Bagchi's presentation on harmonization and comments by Dr. Chelliah made the message very clear- the CST has to go. The most disturbing part of CST is its cascading feature. It is an additional tax, which is not rebated. So if we can't abolish it completely we cut it, reduce it, whatever else we can do. About how you can do it: obviously one view is that, and this is also view about Canada, whenever there is tax reform there are always few nutty issues that require little bit of grease and that's Federal Money. In Canada we could not have harmonized the VAT system in the three provinces without the center putting some money in the pot. This is one area where the center may have to grease the wheels by putting some money into the pot to facilitate elimination and cutting of the CST.

Pawan Aggarwal and Andrew Marsland have given lot of inputs on administration and enforcement. Again the message was the same, simplicity has to be respected. If it is respected, compliance will improve. Need for cooperation among the states is emphasized again and again. Beggar-thy-neighbor policies, competing with each other, is a race to the bottom. And if we can put a stop to that, so much the better.

Interesting thing that came out of Andrew's presentation was that harmonization has many dimensions. There is center-state harmonization and inter-state harmonization. Within inter-state harmonization, there are policy issues where people may have some feeling and may not be able to cooperate, but there are inter-state harmonization issues regarding administration where every body can win, with no loss of ego or politicians autonomy, and that dimension is perhaps worth emphasizing. In the last presentation by Dr. Purohit he mentioned creation of two inter-state consultation bodies: a VAT Council of States and the continuing Committee of Commissioners. These were very refreshing thoughts, because in many ways the success is a journey, not a destination. The process of getting there is as critical as the destination and to have a forum or a body where you can maintain the momentum is very critical.

Interesting thoughts by Pawan Aggarwal on compliance issues and how you can improve compliance. I think it should be a must for everybody to read. It may look like a simplistic approach, but in fact, the reality is, you don't need high-power solutions to improve compliance. To improve compliance, lots of little things need to be done. Actions have to be taken swiftly without any discretion, if you want to improve compliance.

Let me give you some (2 or 3) parting thoughts as to where we go from here. One thing that came up throughout the conference was conflict in politics and economics. Will politicians support you, will dealers support you, or not. There is an interesting story I can tell you. I was in the Ministry of Finance 10 years ago and we were pushing the Minister very hard, to buy a particular policy and the discussion went on for 2-3 hours. Minister was there and there was me and Professor Jenkins of Harvard, who was the senior official in Ministry of Finance and they were going back and forth and Minister said "No! No! No! I can't sell it politically" and Glen Jenkin said "Minister! Please". Minister said "I can't do it because politically it is not good. And so anything which is not good politics is not good economics". Glen's retort was "Good economics is also the good politics". In a way, that is indeed the conflict. People look at politics and economics as two isolated camps. But it is the time, we look at the two in a unified fashion. I put myself as an economist I say, "The Minister is trying to maximize utility as much as I am: as a bureaucrat or as an advisor. And if you can design a package, which is good for the people, it is good for him to get re-elected. Why do you want to design a tax system that people would hate and how do you expect politician to sell that package". And that is the challenge we face. I know, no body wants to pay taxes. But, I think if you confront them they say if we have to pay the taxes, please be fair, be reasonable. So I don't look at those two as mutually exclusive options. You can design a package, you can work hard, so it is good economics as well as politics.

The other part I would emphasize is particularly for administration. I would look at taxation business as any other business. You are in the business of collecting tax revenues and that is really not different from what a businessman does. A few days ago, I came across a very good description of what runs a good business. Any business is based on 5 Ms:

- One is *Men,* who are your employees - Employees must be properly trained and motivated to do a good job for you in business. You can not do business without employees.
- Second "M" is *Materials,* it is raw material - in this case, it could be data. We need good data, a collection system and paper and stationery supplies.
- Third "M" is *Machines*- You can call them computers in this context.
- Fourth "M" is *Methods*- Forms and Procedures.
- Fifth "M" is *Market*- In order to penetrate market, you must have quality product, lowest possible price, service compliance and advertising.

If you want to implement VAT, remember the following things you need.

- You must have a good rational clean product.
- You must have a low tax rate.
- Your whole administration must be turned around, as opposed to service to yourself and the politician, to service your clients who are the taxpayers and dealers who are the trustees.
- Advertising: You must popularize your concept. You must be so confident of the product you have, that you should be able to put it out on the road-side: come to my VAT and pay. Indeed if you are embarrassed of what you have designed then you have no right to sell, even if you sell it nobody would buy it. If you have a good product at low price, the mindset would change automatically. Good product commands respect of the taxpayer. And I think in all the presentations we have participated in India, if you give them a good product, they go for it. Manish Gupta was saying that they went to several dealers in Delhi, even small dealers with turnover below Rs.25 lakh, when they presented them with a simple product, they said they will go for it.

Going forward, I think destination may not be well defined at this stage. But it was one of the purposes of this workshop, that there should a very clear crystal view of what the destination should be. But, at least discussion has started, the brains are churning and hopefully some compromise and some understanding could be reached as to what it should be. But you need a process, where those dialogues can continue and conclusions can be reached. I think in that context the country is looking forward to NIPFP and the leadership of Dr. Chelliah, Lahiri and others here in maintaining the process. That process is needed in center-state coordination. That requires review of issues of declared goods, tobacco, textiles, sugar, services ancillary to the sale of goods, issues of that nature. The second part is inter-state harmonization. The two committees that Dr. Purohit mentioned can be very good forums and they require policy coordination and also administrative coordination. The ideas that we have mentioned are very fundamental. There is lot that can be achieved in administration. Some mentioned problems of check posts: if you have data sharing among the states that itself is a very powerful tool.

Last part is implementation planning. Because my own personal view is you have experimented enough over the past two-four years with piecemeal changes: VAT for 19 commodities in AP, large dealer VAT of Maharashtra and some other VAT in MP. I think it is about time you put a stop to piecemeal changes. Benefits of any VAT reform will be proportional to the effort that goes into it. If you do it over two years it would last for two decades.

Thank you Very Much.

Concluding remarks by Dr. R. J. Chelliah

Now gentleman, I must first of all thank Dr. Satya Poddar for coming and being the main moving spirit of this workshop. He prepared a very detailed paper - I don't agree with every thing he said, but it is a very good paper. It deals with all of the important aspects, and is very painstakingly thorough, looking at all the problems in the Indian context. He has been with us throughout and with his oral presentation, he has made a significant contribution to the success of this workshop. Well, I don't go to the extent of saying that he is the one who brought about the changes. But he has made a contribution to bringing about a perceptible change in the way in which the officials of the state governments are approaching the problem this time as opposed to earlier occasions. Gradually things move. There is a proverb in Tamil that "if you keep on hitting a stone, even the stone will gradually start moving". But this time there has been a very refreshing change and I feel optimistic of the reforms that might follow later. But I want to make one point clear in this context. I don't know how it is in other countries but here, the political bosses have to change their mindset. Otherwise, nothing will happen. All sort of suggestions that we made in the latter half of the eighties, did not make any significant dent. At the political level they said they will not make the change. But once at the time of the elections in 1990, and subsequently during the campaign when Rajiv Gandhi was assassinated, you see the manifesto of the Congress Party, you would find large number of changes already postulated there. Once they made the changes, everybody had to change.

Now the history of reform of indirect taxes in India will be a very interesting story. It started in 1976 with the recommendations of the Jha Committee. When I was young, I was a member of that. I still remember that the recommendation that we should move towards a value-added tax was put in the shelf and forgotten for years. After 10 years, it was taken up by Shankaracharya and Bimal Jalan when they were in the Ministry of Finance. They took it up and introduced MODVAT to start with. Again they appointed a committee which said it cannot be extended. The committee was composed of mainly the excise people. Possibly, Dr. Bagchi was also there. But the change came when they said, "now we are going to open up, we have to reform our tax system", and it was done. But if you can bring about changes in the mindset of political leaders at the state level, who of course will be influenced by the thinking of the central leadership, then the reform would go faster. I think we should try to engage the leaders in conversation. And we should perhaps produce material to be distributed not only to the traders and general public but also to the political leaders. That is very, very important.

As far as this particular group is concerned, I think all of us, at least most of us, are agreed that there have to be reforms, broadly along the lines that have been suggested in the various presentations. And we should move towards VAT. The inter-state tax harmonization has been quite well emphasized but, I think the sticking point really is the CST, but we don't have to wait until that is solved. We should at least move towards the reform of local sales tax in each state. As far as, rates are concerned, I think we have agreed on rate harmonization. I must say, no matter what your views are, we must insist on harmonization. If it is a choice between one rate in one state and 2 or 3 rates in another state and so on, I am not in favor of that. I must insist, and I would like to tell you, this is my view. Please consider this seriously. Do not say that I would have one rate, no matter what the others have. Do not break the agreement. If everybody comes to one rate, fine. If all of you are agreed on two rates, have two rates. If all are agreed on three rates, have three rates. I am not so pessimistic as Mr. Satya Poddar is, that if you start with three, you will never go to one. We started with 350 import duty rates. Now the number of rates has been brought down to 11. We have an idea that we will have 3 import duty rates, three excise duty rates, three income tax rates and three VAT rates i. e., a 3-rate world, not an uni-rate world. I think that would be a good system. We have a three-rate income tax system. Excise duty started with 56 rates, and the number of rates has been brought down to eight, under our recommendation. The reason why I would not insist on one rate is that, India being a poor country, one rate that would give us enough revenue would be too high for the poorer classes and you have to raise all the rates above four per cent. Then I think of CST also. I would like to have more emphasis on phasing out CST and on harmonization than on one rate. That's all. Moving to a two or three rate VAT can be treated as first step and it does not prevent us from moving to an uni-rate VAT in the future. We are an ingenious people - when we want to do something we do it and when we don't want to do it we can find hundreds of reasons why we can't do it and nobody can change us. But don't underestimate our capacity to do it. I would therefore say that one of the lessons that I have learnt from listening to all of you is that we must go ahead faster in moving towards VAT. Let us not be stopped by the CST question. That has to be taken care of but even with it, it is better we move quickly towards VAT in the states. And there, in my view two essential things are: have limited number of rates and give complete set-off for input taxes for the manufacturing sector, including capital goods. That will help India in the current situation, because that would minimize the cost of production. Next of course, is the phasing out of CST. That would mean that we would be ready to meet competition from the SAARC countries any time they adopt a free trade policy.

Then one of the political difficulties in introducing VAT is the opposition by the traders. Because we taught them that first point levy is good, just as we taught them that they should tax inter-state trade, very wrongly. It is not their fault: it is our fault, the fault of economists. We have been telling these people for the last 25-30 years that the first-point tax is good. Now we reverse and say all of you should pay tax and that is the paradise for taxation. So they don't agree. The politicians find it very difficult. In my state Tamil Nadu, the state to which I originally belong, you will find the Chief Minister saying, "bad economics is good politics". He has been doing all wrong things in the last three years, preparing for the election. If you go to him, he will tell you, he told me, "I told these people that the first point tax is good. Now you come and tell me, I should reverse it. How can I reverse it?" Do you think, I want to ask you (Satya Poddar) a question, supposing I succeed in getting these two reforms: the complete set off for inputs for the manufacturing sector and phasing out of CST, would that not be a substantial reform? (Satya Poddar – Good enough for a Nobel Prize!)

Then we can tackle the resellers. I want to make a comment on the Maharashtra experiment. I think the Maharashtra experiment was very balanced one. They removed some distortionary taxes, introduced a tax on resellers and they reduced the burden of input taxation. Very good, balanced steps. I was not here for the full presentation of Mr. Chari, but I think it is purely a political decision to abandon it. It has done a great harm to the country. Maharashtra is a state that we all look up to. It is the best administered state, they take very good initiative, I don't think that the steps that they took were wrong, they were good steps. I would also like to comment on the fact that Punjab has an approximation to VAT. Do you know, Punjab gives full set-off on all inputs including capital goods? (So does Haryana.) Punjab has a last point tax. Which means it is a substitute for VAT. So, internally they have cleaned up the system. However, they are not raising revenue, their administration is very bad. That shows that even if we have good tax system we must have very good administration. I would like to underscore what Satya Poddar said: we must pay lot of attention to administration. That burden rests on your shoulders. Administration should be very good, and we are happy to note that many of you are taking important steps towards improving administration and computerization.

Lastly, I would like to fully support the points made here that the center should be fully involved and that the center should be willing to help. The center is not to count these things in terms of what money it gets, and how much it has to spend. I am sure, you are right, wherever it is needed they should also grease to move the reforms. In fact, we made a recommendation to the present Finance Minister that he should reduce the CST by 1 per cent and give to each state 25 per cent of whatever it is getting, for five years. Meanwhile we can take number of other steps. I would like to appeal to all of you to work on these packages.

Then there is the yield from the service tax. That would automatically be shared if the new formula of sharing 29 per cent of the central tax revenues with the states comes into force. This is an interim measure. I would agree that ultimately the states have to have power to tax some localized services. And for services, which are intimately connected to the sale of goods, such as works contracts, the center should be positive and permit the states to tax. And wherever needed, they should also give money out of the central budget to compensate states, which are going to lose in the bargain. At the same time, the states should take steps to improve administration, to phase out industrial incentives and rate competition through which they are losing revenue. I think all of this is within our power; we can achieve all this within the next 5 years. It is not too long a time. We were able to give much less preparation time for the rationalization of central taxes. I fully agree with you, we should prepare well, but in these matters very often we don't prepare. We are forced into something due to some event or the other. So without much preparation, we went into the transformation of the import duty structure. Do you know, a tremendous exercise was undertaken to merge auxiliary duty and basic duty? I was amazed at the way in which the officers (Mr. Sivaraman was then the revenue secretary) worked. Fantastic! They were given the motivation and the order by Manmohan Singh who was the Finance Minister, who said go ahead and do it. With no preparation they were able to do it. Similarly they were able to extend MODVAT. I think, the proper administrative preparation has not been made even today. That's why they are losing revenue. But the reforms have been carried out. Now, as far as the states are concerned, we are much better prepared. We are more aware of the issues, and I am extremely happy that NIPFP was given the opportunity to host this workshop and I would like to congratulate the Director and the staff who are involved in this, for an excellent job they have done. On your behalf I would like to thank NIPFP and thank our Canadian experts who have made very good presentations. They have been helping us in other ways also.

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