Chapter 6

OPTIONS FOR VAT IN THE INDIAN CONTEXT

6.1 The Basic Choices

As will be seen from the discussion in Chapter 5, the value added tax basically is a multi-stage tax that seeks to tax consumption of goods and services while avoiding the taxation of inputs. However, its introduction in any country calls for a number of decisions regarding design features. The choices that have a bearing on the character of the levy, its incidence and economic effects relate to the following questions:

1. What type to adopt: consumption, income or gross product?
2. Should it be levied according to origin or on the principle of destination?

In a federal country a crucial choice centres around the question, at which level or levels of government should the tax be levied and administered, and what should be the rule of operation, consistent with the objectives in view?

6.1.1 Consumption, income or gross product type?

As noted in Section 5.1, VAT can be levied in three forms, viz., consumption type, income type, and gross product type. Most countries that have gone in for VAT have chosen the consumption type. Argentina, Peru and Turkey had originally opted for the income type but have now gone in for the consumption type. Because it lacks rationality, the gross product VAT is not in vogue in any major country.

The main advantage with the consumption type is that it is simple to compute; only purchases have to be subtracted from the sales (or tax paid on purchases from that due on sales) and the troublesome distinction between capital goods and others is avoided. There is no need to compute depreciation either. As already pointed out, the consumption type achieves neutrality better than the income type of VAT and enhances competitiveness in international trade. It avoids the double taxation of savings caused by income tax, being neutral between present and future consumption. It is also neutral to the use of capital vs. labour in production.

6.1.2 Origin or destination based?

In principle, a VAT can be levied either according to origin, that is, where the goods and services are produced or on the basis of destination, that is, where they are consumed.

Under the origin principle to which a reference has been made earlier, the tax is levied on all value added domestically, that is, the total value of domestic production, including exports while imports are excluded. Under the destination principle, all value added in goods sold within the country whether produced domestically or imported are taxed. Exports do not bear taxation while imports are taxed in the same manner as domestically produced goods.[17]

A consumption type VAT has necessarily to be destination based. Neutrality, whether external or internal cannot be achieved unless the system follows the destination rule. As already noted, the main reason for making the adoption of VAT as a condition for the membership of the EU is that in this form it is more amenable to the operation of the destination principle.

6.1.2.1 Mechanism for operation of destination rule

Where the tax is levied only by the national government of a country, operation of the destination principle poses no acute

17. Under certain conditions, the origin and destination based VATs can be shown to be equivalent in their economic effects. The equivalence theorem is, however, of little practical relevance since it holds "only if, in the equilibrium position before a change from one of the principles to the other, (a) exports from one country to the other equal imports, and (b) there are no capital flows or transfer payments between the two countries". (See Gillis, Shoup and Sicat, 1990).

problem. For then, rebating for taxes paid at the intermediate stages of the product that is, upto the final point of sale within the country, can be provided for irrespective of the location of the production or sale. Exports out of the country can be relieved of all taxes and imports, taxed like domestic products wherever used or consumed in the country. Problems arise when the tax is levied by sub-national governments in a federation (or by governments of member countries of a block or union like the EU joining together to promote trade and competition without any tax induced distortion). This is because the destination principle cannot operate unless sales between VAT registered dealers across inter-jurisdictional borders within the country (or block) are treated as essentially intermediate sale and relieved of all taxes suffered at the earlier stages of production or trade. Operation of this rule is not simple and calls for a high degree of coordination and harmonization when sub-national governments in a federation or member countries of a large group or trade block exercise their autonomous or sovereign powers of taxation and appropriate the revenues realised for themselves.[18]

In the EU, until recently, the destination principle was operated through border controls administered by customs authorities. No tax was levied on goods crossing country borders but remaining within the community and taxes suffered at the earlier stages were rebated to the exporter on the basis of declarations furnished at the borders. The importing dealer was liable to pay tax at the rate applicable to local products to the government of his country. Since January 1, 1993 border controls have been abolished and the destination principle now operates on the basis of a computerized information system. Under the new system, a registered dealer in one country (say France) selling goods to a registered dealer in another country within the EU (say Germany) can zero-rate his sales (now called "despatches") by checking the identity of the buyer through the computers. The imports ("acquisition") are then taxed in Germany when the goods are sold by the importing dealer. This system - sometimes described as Deferred Payment or Payment Accounting System (PAS) - has in effect shifted the border tax adjustments from the borders to the books of account of the exporting dealer and the first taxable dealer in the importing country. Intra-community sales to unregistered dealers (such as cross-border sales) are taxed in the exporting State.

A possible alternative to this system is the tax credit clearing mechanism. Under the clearing method, intra-community exports would be taxed in the first instance in the exporting country; but importers would get a credit for the tax invoiced by exporters of other member States and the importing country governments could claim the amount of the tax credit so allowed from the government of the exporting country under a mutual clearing system whereby only the balances of the net exporting country would be settled. The usual border tax adjustments would operate for trade with countries outside the EU. This system, however, did not find favour with member-countries and the EU has now adopted the PAS at least for now.

Yet another alternative could be, as suggested by the TRC, to permit the exporting State to levy a tax on inter-State sales for which credit will be given by the importing State against the tax payable on it by the importer, with the stipulation that the exporting State will credit the tax on inter-State sales (and consignments, if these were also brought under taxation) to a pool. The revenue so pooled could be shared among the States according to an agreed formula.[19]

The question of tax assignment - which level of government should have the powers of levying the tax, if a VAT is introduced in India (discussed in Section 6.2 below), has to be considered in the light of the problems of implementing the destination principle in a

18. The problem is much simpler where the Constitution of a federal country vests the power of taxing transactions between dealers across States or provinces with the federal government. In India, although such powers rest with the Centre and the law regulating taxation of inter-State sales has been enacted by Parliament, its implementation has been delegated to the States who also retain the revenue from the tax.

19. See TRC, Final Report - Part I, para 2.16.

multi-level tax system. The experience of EU is of relevance in this context. It may also be noted that a retail sales tax when levied by the States in a federation is by its very nature destination based since no tax is payable until the article in question is sold to the consumer. This is one of the main reasons why the operation of the States sales taxes has not caused the problems in USA and Canada that a tax at the State level on origin basis gives rise to. The origin principle is followed for VAT levied by the States in Brazil though not for international trade. However, Brazil's experience with the origin-based State VATs has not been very smooth and the entire system is currently under review.

6.2 VAT Options for India

By and large, it is the destination-based, invoice-operated consumption type VAT that is prevalent in countries imposing VAT. If the trade taxes are not to interfere with the decisions of producers and consumers for India too this seems to be the preferable form in which the VAT should be levied, if it is decided to reform the excise and sales taxes and replace them with a system of VAT.

In India's context, a crucial question that needs to be addressed before the reforms can be launched relates to the issue of assignment, that is, which level or levels of government should levy the VAT if introduced and how, granting that it should be destination based, consumption type. The question has ramifications going beyond the arena of taxation and needs to be considered from several angles. The considerations that must be kept constantly in view are:

i. the need to remove economic distortions caused by the present system in the matter of business decisions, resource allocation within and between States;
ii. the issue of jurisdiction - inter-jurisdictional conflicts and the need to harmonize relations between States and between all States and the Centre; and
iii. the burden of administration for all levels of government.

Given the federal structure, the options in the matter of assignment of powers for levying a VAT in India broadly are:

1. **A Central VAT** - VAT as a National levy implemented through a Parliamentary legislation and administered by the Centre (or the States on behalf of the Centre) replacing both Central excises and State sales taxes, covering all goods and services, with arrangements for revenue sharing.

2. **State VATs** - Centre withdrawing from domestic trade taxation and leaving it to the States to levy the tax on domestic trade in the form of VATs, replacing both the Central excises and the State sales taxes.

3. **Dual or Joint System** - Both the Centre and the States levying VAT, converting their excises and sales taxes into VAT.

There are several variants of these options, as the discussion below would show.

6.2.1 A National VAT

A unified system of taxing domestic trade in the form of a national VAT imposed and administered by the Centre would appear to be most attractive from many angles. It would, at one stroke, bring about harmonization and help remove the tax on inter-State trade.

In most federations the VAT is levied or controlled by the Centre. In Argentina, Austria, Germany and Mexico the VAT is controlled by the Central government, while the collection is made by the States and the revenue shared. A unified Central levy even if administered by the States would at one stroke achieve harmony and simplification and remove the complaints of trade and industry regarding harassment caused by multi-level taxation. Rough computations show that if applied on a comprehensive base (that is, removing the exemptions but excluding services, with a threshold of Rs 30 lakh and about 50 per. cent of agricultural output outside the base) a uniform rate of about 18 per cent could be revenue neutral (that is, would yield the same revenue as currently derived from Union excises and sales taxes combined). If services are included in the base, the revenue neutral rate works out to a little over 16 per cent (vide Table 8.1 in Chapter 8 below).

Though apparently attractive, an exclusively Central VAT would not be advisable for the following reasons:

It would require the States to surrender their powers of sales taxation which is their most important revenue source and compel them to depend on sharing arrangements for the bulk of their tax revenue. At present, the States derive about 68 per cent of their tax revenue from their own sources, the rest (32 per cent) comes from the Centre through devolution of income tax and Union excises. Under the Central VAT option, they would have to depend on the Centre for over 70 per cent of their tax revenue. Their dependence on the Centre for meeting current expenditure would go up from less than 40 per cent at present to about 65 per cent if the powers to levy sales tax were taken away from the States (vide Table 6.1).[20]

It would be objectionable on efficiency grounds as well since, with the tax powers of the States severely limited, fiscal decentralization which is advocated on efficiency grounds (that is, for permitting the citizens to determine the quantum and content of public services at the local levels according to their preference pattern) would be seriously undermined. By widening the divergence between revenue raising and expenditure decisions it would undermine fiscal accountability further.

The Centre will have to depend on the States for administering such a tax for the simple reason that it does not have the machinery to handle the number of dealers who would come within the VAT net even if the tax is levied with a fairly high threshold.[21] If, on the other hand, the revenue is collected by the States but pooled and distributed through a revenue sharing formula, there would be little incentive for the States to take the responsibility for administering it unless the distribution is made largely on the basis of collection.

Even if the aggregate revenues of the States are protected through the mechanism of transfers from the Centre, individual states may lose under this option. The transfers of excise revenues by the Finance Commissions have historically been tilted in favour of the lower-income States because of the significant weight assigned to population and factors like relative income levels and indices of backwardness in the distribution formula. The higher-income States would lose if the revenues from the Central VAT were also to be shared in the same manner. To overcome the likely opposition of the States, one can think of a suitable modification of the sharing formula to keep their losses to a minimum. However, even that would not meet their misgivings regarding loss of fiscal autonomy. They would be reluctant to acquiesce in the arrangement for the fear that it would remain subject to unpredictable political influences. Discussions and interactions with representatives of the States in the course of the present study indicate that most States are unlikely to agree to part with their powers of sales taxation while without a political consensus it will not be possible to carry out the amendment of the Constitution that would be required to introduce a unified national VAT.

6.2.2 State VATs

A polar opposite to a Central VAT, as put forward above, would be a VAT levied and administered by the States, with the Centre withdrawing completely from taxation of domestic production or trade. From the angle of linking spending decisions with revenue raising powers and thereby promoting fiscal responsibility, widening the sales tax base of the States by getting the Centre to vacate the domestic tax field has much to commend itself. In the public finance literature, there is a strong body of opinion that favours assignment of income and capital taxes to the federal government and taxes on

20. This assumes that the States will not be willing or able to raise the yield of the other taxes at their disposal, such as agricultural income tax and land revenue, significantly.
21. At present the Central excise department handles only about 150,000 assessees. A nationwide VAT would involve dealing with at least a million taxpayers even with a relatively high threshold.

Table 6.1

States' Total Current Expenditure, Revenue, Contribution of Devolution and Sales Taxes

(Rs. crore)

	All States	1990-91	1991-92
1.	Total current expenditure	67860	82496
2.	i. Total revenue	62754	77191
	Of which:		
	ii. Tax revenue	44185	52011
3.	Out of 2		
	i. Share of income tax	3983	4959
	ii. Share of Union excises	10056	11876
	iii. Grants from Centre	12384	16153
	iv. Revenue from sales taxes	17548	20928
4.	Total 3(i) to (iv)	43971	53916
5.	Share of Central Taxes [3(i) plus (ii)] as per cent of tax revenue [2(ii)].	31.8	32.4
6.	Share of Income Tax, Union Excise and revenue from Sales Tax [3(i)+(ii)+(iv)] as per cent of tax revenue [2(ii)]	71.5	72.6
7.	Share of Central Taxes and grants [3(i)+(ii)+(iii)] as per cent of current expenditure (1)	38.9	40.0
8.	Share of Central taxes, grants and revenue from sales tax as per cent of current expenditure (4 as per cent of 1)	64.8	65.4

Source: *Indian Public Finance Statistics*, Government of India, Ministry of Finance, 1992.

consumption to the sub-national levels (although the contrary view is also held by some). The diminution in the Centre's revenues that such a scheme would entail could be taken care of by (a) permitting the Centre to levy special (non-rebatable, non-sharable) excises on a few sumptuary items, and (b) bringing down the level of flow of federal funds to the States (devolution of taxes, or grants or both).

Reference may be made in this context to the existing VAT system of Brazil - the only federal country having a system of VAT both at the federal and at the State levels. The VAT at the federal level (IPI) is a tax on industrial production and VAT at the State level (ICMS) is a tax on the circulation of goods within the State. Both these taxes are characterized by multiplicity of rates, complexity of tax structure, large exemptions, double taxation of the same bases, higher effective tax rates and lack of transparency. In addition, there is a cascading tax on the services at the local level. All these taxes cause serious distortions and administrative problems. With a view to rationalizing the existing IPI and the ICMS, proposals are under consideration for having a new State-VAT (IVA) which would replace the existing VATs. If the proposals go through, the new VAT would be levied only by the States. The federal government would withdraw from the field of internal commodity taxes. It is also proposed that the inter-State transactions would be settled through a clearing mechanism and the tax would be based on destination principle. The entire structure of federal financial relations are currently under review in that country.

A regime of exclusively State VATs on the pattern of Brazil or the EU, to replace both Central excises and sales taxes, however commendable in principle, does not seem to be feasible in India in the foreseeable future. The reasons are advanced below.

First and foremost, a pure State VAT would involve such a fundamental rethinking of the tax and financial relationship between the Centre and the States that, even if desirable in the long run, it is not a viable or relevant option at this point of time. It will impair the Centre's revenues grievously and the Centre will not be able to balance its budget unless there is a sharp increase in its revenue from the non-sharable sources or the quantum of devolution of Centre's revenues to the States is reduced drastically or there is a major shift in the distribution of powers and functions between the Centre and the States. Most variants of this scheme envisage that even after vacating the excise field in general, the Centre would levy special (non-rebatable and non-sharable) excises on a few commodities like petroleum, tobacco, and some luxury consumer products like automobiles and aerated waters. Rough calculations indicate that even with special levies like these the Centre will not be able to make up for the loss of revenue likely to result if it gives up the excises.

Revised estimates for 1992-93 show that the Centre derives almost one-third of its tax revenues (net of devolution to the States) from Central excises.[22] Special excises on selected commodities simply cannot make up for the loss if the Centre is to withdraw from the domestic trade tax field altogether. At the most, they can yield Rs 5,000 to Rs 6,000 crore out of an excise revenue of Rs 18,000 crore or so. There would thus be a drop of around Rs 12,000 to Rs 13,000 crore in the Centre's revenue even if special excises are allowed to be levied. There is no way the Centre can make it up especially when customs revenues have to come down to facilitate tariff reduction which is imperative in the process of liberalisation. Improvement in the yield of the direct taxes that would be needed to offset the drop also seems unlikely to come about soon. If services are taxed by the Centre and the revenues retained without sharing, the additional revenue will in all probability not be more than Rs 1,500 crore. The Centre will not be able to balance its budget or reduce its fiscal deficit in such a situation, unless the share of the States in the Centre's revenues is sharply reduced and/or unless there is a drastic reallocation of functions and responsibilities between the

22. Total tax revenue — Rs 58,179 crore
Of which, from Union excises (net) — Rs 18,035 crore

Centre and the States.[23]

Such a shift in revenue accrual to the Centre will also impair its capacity to provide grants to the States. In 1992-93, the total amount of Centre's grants to the States came to about Rs 18,400 crore. Even if the States' share in income tax (Rs 6060 crore in 1992-93) and grants for Centrally Sponsored Schemes were cut down by half, with a drop in revenue to the tune of Rs 12,000 crore, the Centre would not be in a position to make the grants which have a perceptible equalizing effect in the distribution of government revenues (and thereby level of public services) in the country. It is relevant to note that of the total grants budgeted for 1992-93, over Rs 11,000 crore (out of Rs 18,400 crore) was meant for the low income and special category States.

A recent paper on the subject, while proposing the assignment of VAT powers to the States as a long-term solution,[24] recognises the problems mentioned above and concludes that with a system of State VATs and Centre vacating excises, the present practice of tax-sharing and grants from the share would have to end. That, the authors also note, would mean that the five poorest large States would lose upto 40 per cent of their budget and the nine richest major States gain, also upto 40 per cent. They agree that such a redistribution of resources would "not only be next to impossible to achieve politically, it would also be undesirable".

To mitigate these redistributional effects, the paper proposes a system of cross-State transfers whereby each State would remit a certain percentage of its tax to a Central pool which would then be available for redistribution. Their calculations show that as much as 40 per cent of the indirect tax revenue of each State would have to be transferred to the Centre to maintain the pre-reform distribution of revenue among States. Ruling out transfer of such magnitude to the Centre as impracticable, the authors next suggest a tax to be levied on the States at the rate of 2.5 per cent of their GDP.

Given the realities of the Indian political scene, these proposals do not seem to be practicable. If the powers of taxing consumption are to vest primarily in the States, the only viable solution would be to reduce the proportion of revenue shared by the Centre in the form of tax devolution and to use the grants mechanism primarily to help the poor States. Whether or not such a drastic change in the system of devolution and grants that has come to prevail in India since Independence is advisable is for the Finance Commission to consider. Another possibility is to reduce the responsibilities of the Centre and confine its functions strictly to what a federal authority can perform better than the States. Such a radical shift in the role of the Centre in the Indian Union would call for a national consensus. Consideration of the merits of this alternative is beyond the scope of this study.

Second, while it is possible in principle to achieve, under State VATs, some degree of harmonization and reduce tax competition or tax exporting, given the disparities in endowment and levels of development among the States, it would be unrealistic to assume that without Centre's involvement in domestic trade taxation and a Central law to regulate taxation of inter-State trade, States deriving large amounts of revenue from the CST will move away from origin-based taxation. In fact, the chances are that the distortions in location of industries and flow of trade in the country would get more acute. Thus this option is unlikely to remove the ills of the present system arising from origin-based taxation. On the contrary, it may accentuate the disparities by aggravating the concentration of revenue among the relatively advanced States. The Centre would be ill advised to vacate the domestic trade tax field unless the States come forward to accept the logic of destination based consumption taxation and necessary administrative and institutional infrastructure is created for its efficient operation.

23. In 1992-93 (RE) transfers to States from the Centre were of the order of Rs 18,400 crore comprising:

i.	Non-plan grants	Rs. 3262 crore
ii.	Plan grants	Rs. 8332 crore
iii.	Assistance for Central and Centrally Sponsored Scheme	Rs. 6824 crore

24. See Burgess, Howes and Stern (1993).

The proposal for a State VAT regime has also to contend with the fact that not all States are administratively strong enough to take over the task of implementing VAT entirely on their own immediately without the Centre's involvement. For the Centre to withdraw from domestic indirect tax field almost entirely in the present condition would be too risky for the revenue of both the Centre and the States.

Partly in recognition of this reality, one variant of the State VAT schemes envisages the levy of VAT by the Centre at the manufacturing stage (as under MODVAT) with the States levying VAT in place of their sales taxes thereafter, but allowing rebate for MODVAT against their VAT.[25] Under this variant, the Centre would compensate the States for the revenue loss on account of MODVAT rebate. In effect, the Centre would transfer the MODVAT it collects to the States where the goods are subsequently sold. For all practical purposes, MODVAT becomes a tax collected by the Centre on behalf of the States. As can be easily seen, this variant suffers from most of the major problems mentioned earlier (viz., weakening of Centre's finances and accentuation of disparities in the distribution of revenue among States). In addition, it will give rise to problems of cross-system verification and open up opportunities for fraud and evasion. Moreover, if the Centre has to compensate the States for the rebate for MODVAT to be given by the States, it will have little incentive to administer the MODVAT well.

From the viewpoint of trade and industry also the system of State VATs is unlikely to be acceptable unless the States agree first to harmonize their systems as it will mean operation of disparate regimes across the country at different levels of administrative efficiency. For all these reasons, in introducing VAT in India, leaving it entirely to the States in the first instance does not seem to be a feasible proposition even though it might be given serious consideration as a long-term option when the States are able to overhaul their tax administration and also agree to abide by the rules of a destination-based consumption tax.

25. See Purohit (1993).

The foregoing discussion suggests that in exploring the possibility of reforming the domestic trade taxes in India with a system of VAT, one has to think of a dual system in which both the Centre and the States share the consumption tax base in a mutually acceptable arrangement, in other words, a system of VAT levied at the two levels of government independently but preferably with some coordination.

6.2.3 Dual VAT Systems

A dual system essentially connotes parallel exercise of tax powers relating to a given base, by two levels of government. In the context of taxation of domestic trade in India, one can think of at least three variants of a dual VAT :

1. A system of concurrent VATs where both the Centre and the States levy the tax with common base, but allowing the States to determine the rates within specified bands.[26]
2. The Centre levies VAT upto the wholesale stage but the tax at the wholesale level is administered and retained by the States, and the State sales taxes are converted into VAT. This seems to be the pattern suggested by the TRC.
3. The Centre levies the tax only on manufacturing as under MODVAT, but covering all commodities and at least some services and the State sales taxes are converted into VAT, but both operating independently, with or without coordination.

6.2.3.1 Concurrent VAT

A theoretically appealing variant of the dual system is one in which both the Centre and the States have concurrent jurisdiction in taxing goods as well as services going up to the retail or final-point sale. Under such a system both Centre and the States would levy a VAT under a unified law on a common base. To achieve neutrality the base has to be as broad as possible. The States would have

26. The case for a joint federal-State VAT is put forward cogently in Poddar (1990).

the powers to fix the rates but within a harmonized system. Inter-State sales will carry a rebatable Central VAT but will be zero-rated for the State VAT levied by an exporting State and taxed by the importing State. For revenue and other reasons (e.g., externalities) the Centre would have the powers to levy non-sharable special excises on a few sumptuary items.

The Central VAT would apply to all sales throughout the country at the given uniform Central rate. The State VAT would apply to only local sales, not including inter-state sales to registered dealers. Because of difficulties in verification of the final destination of goods sold to non-registered persons, inter-state sales to them would be treated as local sales.

Main elements and imperatives of a possible Concurrent VAT scheme are summarised below:

Concurrent VAT: Main Elements

A: *Constitutional Amendment* to confer concurrent powers to the Centre and the States to tax goods and services traded within the country.

B: *Design of Concurrent VAT*

1: **Base** as comprehensive as politically and **technically** feasible.

2: Common base for the Centre and the State VATs.

3: Uniform central rate(s) on sales throughout the country.

4: State rates set by each State, variable within narrow bands.

5: Inter-State sales to registered dealers subject to Central VAT only and zero-rated for State VATs.

6: Inter-state sales to unregistered persons subject to Central and State VATs as local sales.

7: Collection by the Centre of State countervail duties on imports by unregistered persons.

C: *Tax Administration*

1: Common registration for Central and States VATs.

2: Common VAT return, with separate columns for the two taxes.

3: Taxes remitted to Centre and States directly.

4: Full autonomy of Centre and States in other administrative and enforcement matters.

5: Free exchange of information between Centre and States.

D: *Special Excises*

1: Limited to selected final consumer, and demerit goods only.

2: Imposed at the manufacturing level.

Registered dealers would be allowed to claim a rebate or tax credit for the tax paid on their purchases. The Central input tax would be creditable against the Central VAT collected by them on their sales, and the State input tax would be creditable against the State VAT. They would remit the net amounts due under each to the respective governments. Since the tax would be computed for, and remitted to, the two governments separately, there would be no need for a clearing house or such other mechanism to transfer the funds to the governments to which they belong. This would also resolve the problem created by consignment transfers under the CST. When inter-State sales are zero rated, there would be no tax on inter-State movement of goods, regardless of whether it is pursuant to a sale or consignment transfer.

In this scheme, inter-State sales to registered dealers[27] would be treated under the State VAT in the same way as international export sales under the Central VAT, i.e. they both would be zero-rated. This means that dealers would not collect any State tax on inter-State sales, but would be eligible to claim a tax credit for the State tax paid on their purchases. Where the credits exceed the tax collected on sales, the excess may be carried forward. Firms perpetually with excess credits, because they make most of their sales outside the State, should be eligible for cash refunds.

The example in Table 6.2 illustrates the operation of a concurrent VAT as outlined above.

A concurrent VAT extended upto the

27. And similarly, consignment transfers by registered dealers.

Table 6.2

Illustration of a Concurrent VAT

State VAT Levied on Price Including Central VAT

A. All Transactions Within a State : Central VAT @ 10%, State VAT @ 5%

State	Dealer	Sales	Central VAT	State VAT	Sales incl. tax
X	Manufacturer	100	10	5.5	115.5
X	Wholesaler	160	16-10=6	8.8-5.5=3.3	184.8
X	Retailer	200	20-16=4	11-8.8=2.2	231
	Total tax		20	11	

Revenue to Centre: 20
Revenue to States:
State X: 11

B. Inter-State Sale by the Manufacturer : Central VAT @ 10%, State VAT @ 5%

State	Dealer	Sales	Central VAT	State VAT	Sales incl. tax
X	Manufacturer	100	10	0	110.0
Y	Wholesaler	160	16-10=6	8.8	184.8
Y	Retailer	200	20-16=4	11-8.8=2.2	231
	Total tax		20	11	

Revenue to Centre: 20
Revenue to States:
State X: 0
State Y: 11

retail stage would get over many of the problems in administering the taxes at the manufacturing level encountered under the present excise system and first-point sales taxes. The evils of tax exporting and hindrance to inter-State movement of goods would also go. The system would be economically efficient and neutral, remove cascading of tax, strengthen the revenue bases tangible simplification of administration and compliance. Also, it would maintain the fiscal autonomy of the two levels of government.

However attractive for its rationality and simplicity, for reasons specified below, a concurrent VAT does not seem to be practicable in India.

Drawbacks of Concurrent VAT

First, effective administration of a concurrent system would call for a degree of coordination between the Centre and the States that is absent at present and would be difficult to achieve in the near future. There could also be administrative conflicts between the tax authorities at the two levels over assessment of the base that would not be easy to resolve. For instance, what should be done if a State amends a VAT return or liability declared by a taxpayer on the basis of some examination but the Centre does not follow? One tax administered by two jurisdictions will invariably evolve into two taxes. Designing the invoice for operating a concurrent VAT would also not be simple and taxpayers may have problems in accounting for the two VATs on the same form unless the base is identical.

Apart from the conflicts which it might generate, a concurrent VAT will be seen by the States as an invasion into their tax powers. It will call for a major constitutional amendment to confer powers on the Centre to levy a multi-stage tax on domestic trade which it does not possess now. That would give the Centre an even more dominant role than it has at present in the tax field and any chance of its ceding the consumption base to the States would be lost for ever.

Reference may be made in support of the concurrent scheme to the system of consumption tax operating in Canada where both the Centre and the States have concurrent powers of domestic commodity taxation. One however, may wonder whether the Canadian experience is of much relevance for India in the present state of the Centre-State relations. In Canada (or for that matter in USA) the constitutional delineation of powers between Ottawa and the provinces are so firmly established that governments can perhaps agree more readily on the joint imposition of VAT. In India, the "power" position of the States and the Centre is yet to settle down. In this context, the increased "technical" involvement of the Centre in the tax domain of the States will be viewed as a shift in the balance of power in favour of the Centre.

While designing a model of dual VAT, it is thus advisable to explore ways in which both the Centre and the States can move their respective excises and sales tax systems towards a system of VAT within the framework of the Constitution and improve their implementation through better legal and administrative structures. Two variants of dual VAT based on these parameters are considered next.

6.2.3.2 MODVAT extended to wholesale stage along with State VATs

One of the drawbacks of the concurrent VAT option discussed above is that it does not take account of the limitations of the Centre in administering a tax beyond the manufacturer level. The Central Excise Department which administers the Union excises and MODVAT is simply not equipped to handle the number of dealers who would come within the tax net even if the threshold was fixed at a relatively high level. Taking note of this problem and also to circumvent the need for constitutional amendment, the TRC had proposed the extension of MODVAT to the wholesale stage but with the proviso that the tax at the wholesale stage would be administered by the States who would also retain the revenue.

The proposal to extend the MODVAT to the wholesale stage is designed mainly to overcome the problems of taxation at the manufacturer level. Any reduction in tax at the manufacturing level through shifting of marketing or other ancillary activities to a subsequent trade level or through sales to a sister company at low value would be recaptured in the form of an offsetting tax increase at the wholesale stage. It would thus minimize valuation disputes and reduce incentives for manufacturers to understate the value of their shipments for purposes of the ad valorem excise levies. This would, in turn, facilitate conversion of specific excise duties to ad valorem duties that could be applied to the invoice value of manufacturers' despatches/sales.

The TRC has proposed that, for this purpose, wholesalers be defined to include dealers (whether wholesalers or retailers) in excisable goods with annual turnover in excess of, say, Rs.50 lakh or Rs.1 crore. They would pay tax on their value added, i.e. the difference between their selling and buying prices.

While the TRC proposal would resolve some of the valuation problems that currently arise under the MODVAT, there are certain features of the proposal that make its consequences somewhat arbitrary and unpredictable.

For instance, the proposal to allow the States to keep the taxes that they collect from the wholesalers, while necessary to buy their cooperation, would create a conflict of interest between the Centre and the States. The division of tax revenue between the two levels of government would depend upon the value declared by manufacturers for their clearances or sales. This could lead to a situation where the manufacturers are subjected to conflicting valuation instructions from the two levels of government. Such conflicts would scarcely be healthy for the administration of the tax.

Another source of arbitrariness would be the problem of identifying the location of wholesale trade. Under the scheme envisaged by the TRC, the revenues from the tax at wholesale stage would accrue to the States obviously on the basis of origin, i.e., the tax would be retained by the State where the wholesale value-added originated, regardless of the final destination of the goods in question. Thus, the tax on inter-State sales by traders would accrue to the exporting State. This system would suffer from a degree of arbitrariness because the place of origin is not easy to define. Unlike the place of manufacturing or the place of final consumption, the location of an intermediate sale can be altered with relative ease, while every such alternative would have significant consequences for inter-State distribution of revenue. States might also offer inducements to manufacturers to make supplies of raw materials, parts, etc. to other manufacturers through intermediate dealers rather than directly.

The possibility of shifts in the distribution of revenue and accentuation of distortions caused by origin-based taxation can be minimised with a modification of the original TRC proposal whereby the revenue from the tax at the wholesale stage will be pooled for distribution among the States with a large weight assigned to origin.[28] While this might mitigate some of the distributional ill effects of the original proposal, the problems of dual or triple administration of VATs (two for MODVAT and one for State VATs) would remain. Also, unless there is a high degree of coordination between the Central and State tax departments and exchange of information, there would be the possibility of fraud on a large scale, e.g. manufacturers claiming inflated credits under the MODVAT for the tax paid to wholesalers (and collected by the States).

For all these reasons, this model of VAT would not seem to be a workable or desirable option.

One can envisage another alternative system of concurrent dual VAT in which the States exercise their powers of taxing domestic trade by levying the tax at the retail level and the Centre has the authority to extend its VAT to the wholesale level but withdraws partially from the field by limiting the level of its rates. This would give the States more authority and could provide the basis for dual system in which the Centre and States share the consumption tax base in a

28. A modification of the TRC proposals on these lines was suggested by Prof Chelliah in a public address in 1993.

harmonised basis. It would not cause the type of disruption to the pattern of Central transfers which would be implied in a regime of State VATs. Much of the conflict of jurisdiction and distortions arising from the system of sales taxation prevailing in India now would be avoided under such a system. As noted, this, in essence, is how the commodity tax base has come to be shared in Canada. The scheme of domestic indirect taxation suggested by the Indirect Taxation Inquiry Committee (Jha Committee) also ran on similar lines.

Although, in principle, it provides a neat way to rationalise and harmonise the system of consumption tax in a federal country, this pattern is not likely to be acceptable to the States because of their unhappy experience with the retail sales tax and also because it would necessarily imply an extension of the Centre's powers to tax domestic trade. However, this could be considered as a long-term option when Centre-State relations are well settled and harmonious and the States feel confident enough to apply their sales taxes at the retail level only.

6.2.3.3 Independent dual VAT system

Given this background, the only feasible option seems to be a dual system in which the VAT is levied by the two levels of government independently within the existing constitutional framework. This would be possible if the MODVAT now operating through the excise tax system is made into a full-fledged manufacturers' VAT and the States also adopt a destination-based harmonized system of VAT in place of the chaotic sales taxes operating now. Although it would not be the perfect or first best solution to the problems of the present system since the difficulties inherent in the taxation of manufacturing would remain, reform on these lines would go a long way to remove many of its ill effects and lay the foundation for an even more rational regime in the future. Considering everything this seems to be the course along which reform can take off and avoid getting bagged down in controversies and Centre-State wrangles.

On the excise side, the scheme of reforms contemplated under the independent dual VAT system is a logical extension of the present MODVAT system towards what was envisaged as the MANVAT by the Jha Committee to which a reference has been made earlier. The changes that would be needed in the current excise structure to bring this about principally are:

a. Widening of the base to include all goods produced, manufactured or imported and a few selected services;
b. Provision for full and immediate credit of input duty to registered manufacturers and producers for
   - all raw materials and parts used in manufacturing;
   - production machinery and equipment for use exclusively in taxable manufacturing; and
c. Rationalisation of the rates to introduce a structure of not more than three rates at the most and eventually a uniform rate. However, excises would also be levied on selected luxury items and commodities with negative externalities.

As and when VATs replace the States sales taxes, the tax rental agreement with the States whereby additional excise duties are levied on three major commodities, viz., textiles, tobacco and sugar should cease. The Centre should be free to apply the MODVAT to them like other commodities, as at present.

Since the MODVAT would be confined to the manufacturer level and extension of the Central VAT beyond manufacturing is ruled out because of considerations spelt out in the preceding paragraphs it would be necessary to take steps to strengthen the manufacturing base and minimise the ambiguities and scope for abuse and disputes. Despite its limitations, it should be possible to achieve significant improvement through technical amendments in the Central excise laws and procedures.

Exercises carried out with available data show that with excises converted to VAT and the rates reduced to three (10, 15 and 20 per cent) along with (non-rebatable, non-sharable) excises on a few commodities and tax on selected services, it should be possible to carry out these reforms without any loss of revenue. There could, in fact, be a gain of about Rs 1,000 crore to provide a cushion for the change. Details of the reforms of Central excises proposed in the scheme are set out in an appendix to this report (Appendix 1).[29]

Under an independent dual VAT, the State VATs will be based on ex-factory price of products including the Central VAT and no rebate will be allowed for the Central VAT on manufacturers against the State VATs. This, it might be thought, would run counter to the goal of removing cascading. This presumption is not correct. There would be no cascading by way of tax on inputs so long as the Central VAT is a truly single point tax and the State VATs operate on VAT principles. For then there will be only a one-time tax on tax (State VAT on Central VAT) effect equal to the rate of State VAT times the Central VAT, but cumulation should not occur. The additional tax incidence that will occur because of the State VATs being levied on the base including Central VAT would get rebated through the system until at the last taxable sale point. Thus the distortions associated with input taxation because of cumulation or cascading will not occur.[30] An element of extra burden on the final consumer may still remain because of the mark-up on the Central VAT ("pyramiding" as it is sometimes called).

To keep the burden of taxation by both levels of government within reasonable limits, over a period of time, the rate of Central VAT should be brought down to a uniform rate of 10 per cent, so that the cumulative incidence of all indirect taxes - Central and State - is generally not more than 20 per cent. The strategy should be to allow more room for the States to levy their VAT down to the retail level. Such a reform can be attempted only after the indirect tax system in the country as a whole has been rationalised on the lines proposed in this report. This will have to be coupled with an assessment by the Finance Commission of the devolution of finances between the Centre and the States under the proposed structure. A modification in the existing formulae for devolution of individual taxes will be necessary. An ideal arrangement will be sharing of a specified percentage of the Centre's gross tax revenues with the States, as recommended by the TRC.

As the value added principle is already operating in the excise system, changes on the excise should not pose any serious problem in implementation though it must be emphasised that the operation of VAT in its true spirit would call for a radical change in the approach and methods of administration. Introduction of the VAT at the State level would imply a more fundamental change than on the excise side. The focus of the reforms of the domestic trade taxes would therefore have to be on the transformation of the States sales tax systems into State VATs. The main elements of the reform of the State sales taxes are set out and elaborated in the chapter that follows.

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29. These proposals were drawn up before the Union Budget for 1994-95 was presented in Parliament.

30. The following example illustrates the point. Suppose the ex-factory price of an article is Rs 80 and the excise duty is Rs 20 (assuming that no taxable inputs are used). With a State VAT of say 10 per cent, the manufacturer's (net) VAT liability would be Rs 10 (Rs 8 on his own value added plus Rs 2 on the Central excise). The manufacturer's invoice to the wholesaler will thus show a selling price of Rs 100 plus the VAT of Rs 10 adding up to a total amount of Rs 110. Now, if the wholesaler resells the product to a retailer for say Rs 150, exclusive of VAT, his gross VAT liability would be Rs 15, and net liability, Rs 5. If the retailer sells it for Rs 250, then (net) VAT payable by him would be Rs 10 (Rs 25 on the selling price minus a tax credit of Rs 15). The total VAT payable by the consumer would thus be Rs 25, consisting of Rs 23, that is, the aggregate of the VAT on the values added by the manufacturer (Rs 80), the wholesaler (Rs 50) and the retailer (Rs 100), plus Rs 2 on the Central excise of Rs 20. Clearly, there are no general tax-on-tax effects, only a one-time VAT-on-excise effect which can be exactly replicated by an adjustment in the rates. If, in the present example, no Central excises were levied, the total VAT base would be Rs 230. To obtain the same amount of revenue, viz., Rs 25, the VAT rate would have to be increased to 10.87 per cent.