REFORM OF STATE SALES TAXES : A SCHEME OF HARMONISED STATE VATs

7.1 Steps to Transform State Sales Taxes into State VATs

The review of the current system of domestic trade taxes presented in Chapter 2 shows that many of their ill effects are attributable to the structure of the sales tax systems and their operation in practice. They cause distortions damaging to the economy and inhibit free flow of trade in the country and impose costs on the economy in many ways. From the revenue point of view also, the system seems to have reached a dead end as States and Union Territories engage in fierce tax competition and tax exporting, and finding no other way to raise revenue are bringing about levies such as the turnover tax which are long discarded by progressive economies. While some of the evil effects of the present system could be alleviated through piecemeal reforms or harmonization of rates among the States, only a move towards VAT could help to get rid of the archaic and debilitating system of taxation that is prevailing today. Measures which the States can take to reform their present sales tax systems within the existing constitutional framework to move them towards a harmonized system of VAT are outlined below. If implemented, these measures would go a long way to impart neutrality, transparency and simplicity to the system while also strengthening the revenue base of the States by providing a stable source of revenue.

If the State sales taxes are to be reformed towards a simple, neutral and productive system of consumption taxation the essential steps would be to:

a. Convert sales taxes into VAT by moving over to a multistage system of sales taxation with rebate for tax on all purchases with only minimal exceptions.
b. Extend the tax base to include all goods sold or leased with minimal exceptions, and services which are integral to the sale of goods. The base should also include services which are predominantly of a consumption nature and can be taxed conveniently by the States.
c. Allow input tax credits for all raw materials and parts, consumables, goods for resale, and production machinery and equipments. (No rebate will be allowed in respect of overhead expenses like repairs, etc., office equipment, construction materials and fixtures and purchases in use for transportation and distribution of goods).
d. Replace the structure of tax rates with two or three rates within specified bands, applicable in all States and Union Territories.
e. Remove the exemptions except for a basic threshold limit and items like unprocessed food and also withdraw other concessions like tax holiday, etc.
f. Zero-rate exports out of the country and also inter-State sales and consignment transfers to registered traders with suitable safeguards against misuse.
g. Tax inter-State sales to non-registered persons as local sales.
h. Modernize tax administration, computerise operations and the information system and simplify forms and procedures.

The measures for harmonization of the rates will call for agreement among States and also the Centre. If the States signal their agreement on such a package, the Centre should permit the States to tax the three additional excise duty items, viz., textiles, tobacco and sugar under State VATs.

Further, under the CST Act at present, there is a ceiling on sales taxes that can be levied on certain commodities considered vital for inter-State trade and commerce (called declared goods) even when sold within a given State. The ceiling is equal to the tax on inter-State sale (i.e., 4 per cent). With the reforms outlined above these restrictions should go. This can be made effective through an amendment in the CST Act.

Because of its inherent neutrality, VAT can be applied in a comprehensive manner to most goods and services in a consumer basket without causing any unintended distortions. In fact, neutrality depends crucially on the coverage of the base. Levied on a comprehensive base it is especially suitable for bringing into the tax net those sectors where compliance under other forms of tax may not be very high. If applied at a uniform or at the most two or three rates, its operation can be simple.

Discussions with State government officials suggest that such a scheme may be acceptable. The rate bands proposed are: 4 to 5 per cent for essential goods and 12 to 14 per cent for all other goods. Basic, unprocessed food items may be exempted, while petroleum and diesel, tobacco, alcohol and narcotics subjected to a non-rebatable tax at a floor rate of 20 per cent. In principle, tax paid on fuels used ought to be rebated. On practical considerations and in the interest of conservation of energy, however, it is advisable not to allow any rebate for the tax on petrol. Consideration may be given to the feasibility of rebating the tax on other petroleum products like lubricants and diesel only when used in manufacturing.

Each of the elements of reform enumerated above is discussed in turn below. Statement 7.1 provides a summary of the likely benefits of the recommended reforms, as also the potential concerns.

7.1.1 Replacement of existing State indirect taxes by a VAT on all goods and selected services

The first step in reforming the State sales taxes would be to introduce VAT replacing all the sales and purchase taxes now being levied by them, including the general sales tax, purchase taxes, surcharges, additional sales tax, motor spirit taxes and the turnover tax. The new regime would be applicable in all of the States as well as Union Territories. In principle, the VAT should also replace the other indirect taxes levied at the States level like the electricity duties, entertainment tax and passenger and goods tax as well as octroi and entry taxes. However, in the first instance, the reforms may be directed towards replacing only the taxes on purchase and sale of goods.

The base of the tax should include all goods sold or leased with very few exceptions or exemptions. To maintain its integrity the VAT should be levied on services too. There are constitutional and practical problems in bringing all services under taxation along with goods at the State level. However, services which are normally rendered along with the sale of goods and also those which mainly go to final consumers and have good revenue potential should be subject to tax by the States. Which services could be brought within the tax net and at what level is examined separately (vide Section 7.2).

The tax would be a multi-stage levy, extending beyond the first point of sale and going as close as possible to the final point. All manufacturers and dealers with turnover exceeding a specified "small business" threshold would be liable for the tax. To avoid cascading, wholesalers and retailers reselling goods that have already borne tax at earlier stages would be allowed to claim a rebate for the tax paid by them at the time of purchase of the goods. As demonstrated in Chapter 5, this system of rebating would ensure that regardless of the number of times the goods change hands prior to the final sale to consumers, the tax would remain a constant percentage of the final selling price. Table 7.1 illustrates the calculation of State VAT at different stages of trade.

Table 7.1

Illustration of State VAT (All transactions within a State)

	Sales	State VAT @5%	Sales Incl. Tax
Manufacturer	100	5	105
Wholesaler	160	8-5=3	168
Retailer	200	10-8=2	210
Total Tax		10, that is, 5% of sale price (exclusive of tax)	

Statement 7.1

Benefits of Reform Measures and Potential Concerns

Tax reform Measures	Benefits	Concerns
Replacement of sales taxes by Value Added Tax	All round simplification. Check on undervaluation and evasion at the first point of sale. Removal of economic distortions created by first-point and cascading multi-point taxes and consequent costs to industry and trade. Inclusion of wholesale and retail margins in the tax base. Maximum retail prices may become more effective.	Cost of both compliance and administration may increase. Opposition from tax practitioners.
Inter-State harmonization and rationalization of rate structure	Reduction in complexity and fewer tax disputes. Improved compliance and simpler tax returns. Reduction in taxpayer harassment. More neutral application of tax and reduced distortion of business decisions. Reduction in revenue loss through inter-State tax competition.	Low tax States may have to raise their level of taxation.
Full rebating of tax on production inputs, including machine and equipment	Reduction in production and investment costs. Improvement in competitive position of domestic firms. Higher economic growth. Removal of bias in favour of vertically integrated firms and encouragement for economies of scale. Reduced pressure for selective industrial incentives. More predictable incidence of tax.	Revenue may suffer.

Contd.

Statement 7.1 (Contd.)

Tax reform Measures	Benefits	Concerns
Removal of exemptions and concessions except for a basic threshold and items like unprocessed food	Widening of the base. Removal of economic distortions and levelling of the playing field.	Possible adverse impact on prices and industrial growth.
Exemption of unregistered sectors	Facility of compliance and administration. Protection of revenue.	Some inequity and arbitrariness in incidence.
Zero-rating of inter-State sales and international exports	Preservation of the national common market. Reduced distortions in production and distribution of goods. Removal of hidden taxes on inter-State and international exports.	Revenue loss for States deriving substantial revenue from CST. Greater risks of evasion.
Extension of State VATs to declared goods and sugar, textiles, and tobacco	Broader tax base. More neutral application of VAT. Simpler tax design. Substantial revenue gain.	
Modernization of administration, including computerization, simpler forms and procedures, and improved staff training	Revenue gain through improved compliance and enforcement. Greater fairness and uniformity in the application of tax.	This will require initial investment.
Overall	Transparency, efficiency and simplicity. Greater control over incidence. Stable revenue source.	Administration and compliance burden.

The proposal to introduce multi-stage sales tax upto the retail point might give rise to apprehensions of administrative problems and compliance hassles for taxpayers. These apprehensions could be greatly allayed if (i) the threshold is fixed at a reasonable level; and (ii) simplified systems are devised for small dealers who still could not come within the tax net. It needs to be emphasised that the fear that taxpayer numbers would multiply to unmanageable level and evasion would be tremendous is not very well founded because under the proposed system of State VATs, the bulk of the tax revenues will continue to be collected from a relatively small number of manufacturers and dealers at the first point of sale. Even though wholesalers and retailers would also be brought into the tax net, the net revenue contribution of small dealers would remain small. Data on the distribution of dealers currently paying sales tax according to size of turnover show that 83 per cent of the total amount of tax is paid by only 24 per cent of the registered dealers (vide Table 7.2). The main reason for extending the tax to the retail level is that it would minimize the incentives for dealers at the first point to under-invoice sales, or to employ other tax avoidance devices. Any reduction in tax at the first point would result in a corresponding diminution in the rebate allowed at the next stage, with no net loss to the government. The tax system would also be simplified as there would be no need to define the first point of sale. What would be an appropriate threshold level is discussed in sub-section 7.1.4.

Table 7.2

Distribution of Dealers under Sales Tax According to Turnover*

Dealers	Number of dealers	Revenue (Rs. lakh)
Small Dealers (0 to 5 lakh)	1001057 (67.92)	83238 (8.16)
Medium Dealers (5 to 10 lakh)	121671 (8.25)	87940 (8.63)
Large Dealers (10 lakh and above)	351184 (23.83)	848331 (83.21)
Total	1473912 (100.00)	1019510 (100.00)

Source: Office of Commissioners of Sales/ Commercial Taxes of the States.

Notes :
1.* Based on data from Andhra Pradesh, Himachal Pradesh, Karnataka, Maharashtra, Orissa, Punjab, Rajasthan and Uttar Pradesh.
2. Figures relate to 1992.
3. Figures in brackets show the percentages of total.

It may be noted further that even under first point (or for that matter, any single point) taxation, intermediate dealers have to file returns even if they are not liable to tax and, where turnover taxes are in operation, those above the prescribed exemption limit are required to pay some tax. If the administration is streamlined and the structure simplified, there is no reason why the new system should mean additional hassles. No doubt, scope for manipulation would get reduced. But so would the scope for harassment.

7.1.2 Rebating of tax on production inputs, including machinery and equipment

To avoid tax cascading, and the resulting loss in economic efficiency and output, it is essential that the VAT collected on raw materials, parts, consumables, and production machinery and equipment be fully rebated to manufacturers. In addition, registered wholesalers and retailers should be eligible to claim rebates for tax paid on goods acquired for resale. No rebates would be allowed for construction materials, office supplies and equipment, and inputs for use in the distribution of goods (e.g., transportation equipment, and advertising inputs). Non-registered persons would not be eligible for any rebates. They would include all consumers, non-commercial institutions, small traders, service sector organizations.

As suggested below (sub-section 7.1.5), inter-State sales will be zero-rated so that goods may be imported by a dealer in one State from another State without payment of tax leviable on domestic sales by the exporting State. The tax on the full resale price of the goods will be charged by the importing State. In the presence of exemptions and zero-rating provisions, it is the tax credit method that is suitable for imposition of VAT at a sub-national level (see Section 5.2).

In a given period when a dealer is building up inventory, the tax paid by him on purchases could exceeed the tax collected on sales. In such cases, the excess would be allowed to be carried forward, to be offset against any future tax collections. In other words, the excess would not be refundable (except in the case of registrants with export sales that are not subject to any tax).

The proposed rebating system would have two important advantages. First, it would obviate the necessity of a purchase tax which is currently imposed by many States to make the tax burden on exempt inputs acquired from unregistered dealers equal to the non-rebatable tax paid on inputs acquired from registered dealers. Second, the rebate for production machinery and equipment would be a suitable replacement for selective industrial incentives. The new system would lower the cost of all new manufacturing investments. Its benefits would be available to all in a neutral manner. At present, producers and manufacturers have an incentive to buy their taxable production machinery and equipment outside the State. Such purchases attract CST in the exporting State at the maximum rate of 4 per cent, which is usually lower than the tax that would apply on intra-State local purchases.

To facilitate compliance, until the States are empowered to levy the tax on services like works contracts, construction contractors could be treated as exempt traders. They would pay tax on their purchases of construction materials from registered dealers, with no right of rebate. If they were to be treated as vendors of goods, they would need to be registered, and required to charge tax on the contract price exclusive of the service component. If, as suggested elsewhere (vide Section 7.2), the States are empowered to impose tax on works contracts, consideration should be given to accord them similar powers for the taxation of services of repair, maintenance, installation and such other services that are ancillary to sale of goods.

Lessors of goods would charge tax on their rental receipts, and claim a rebate for the tax paid on the purchase of goods to be leased.

7.1.3 Inter-state harmonization and rationalization of tax rates

One of the basic maladies of the present sales tax systems is the multiplicity of rates. If the system is to acquire transparency and simplicity the rates must be rationalized. For simplicity as also certainty, a uniform rate is the best. The case often put forward for differentiating the rates to distinguish between necessities and luxuries on grounds of equity is not well founded. It is now well recognised that rate variation is a very blunt and ineffectual instrument for mitigating regressivity, creates complexities in the law and generates disputes. In absolute terms, the rich benefit much more than the poor (in some countries twice as much). Also, it is not easy to distinguish higher quality essentials like food (e.g., Basmati rice) from products consumed by the poor (coarse rice) for tax purposes. As a result, lower rates are not very helpful in moderating the regressivity of VAT. Surveys conducted among some of the EU countries show it makes little difference to the incidence of VAT whether the necessities are zero-rated or taxed at a lower rate or the standard rate. While the consumption patterns of the rich and the poor are not the same, there are significant areas in common.

Administration and compliance costs too multiply enormously when the rates are differentiated as it requires classification of commodities which is rarely easy to delineate unambiguously. Compliance costs also go up tremendously especially for small firms. Evidence shows that the incidence of costs fall more heavily on the smaller firms with lower incomes. Further, lower rates for some commodities obviously necessitate higher rates for others than would otherwise be required to raise a given amount of revenue, with all their distortionary and evasion inducing effects. Usually, the higher the tax rates, the more acute are the distortions to producer and consumer choices. High ad valorem rates also tend to affect product quality adversely. For all these reasons, experts favour keeping the structure of VAT rates uniform and helping the poor through other means (expenditure programmes or income transfer). This is, however, not to argue against the levy of excises at higher rates for expenditures on drinking, smoking or motoring.

Despite strong arguments against rate variation, many countries that have adopted VAT provide for concessional treatment of necessities through lower rates or exemption or zero-rating. Appendix Table A3.4 shows the structure of VAT and excises in over 60 countries across the world as of January 1992. It appears that in the EU, variation in rates is common among countries which had a multiplicity of rates to start with. The trend for countries which joined the EU later is to have a uniform rate.

For the proposed State VATs too, a single uniform rate would be helpful in many ways. A major benefit would be that such a rate would be much more moderate than the level at which the standard rate would have to be fixed otherwise. However, considering the sharp disparities in the consumption pattern of the rich and the poor in India, the limited coverage of poverty alleviation programmes and the compulsions of policy makers, it seems that provision has to be made for concessional treatment of necessities as distinguished from others, in the form of exemption or a lower rate than what might be designated as the 'standard rate'. To accommodate these considerations, while minimising revenue loss and economic distortions from inter-state competition, and for facilitating compliance, it is proposed that the basic structure of the VAT be so designed as to permit only three rates at the most, and tax rates be kept within specified bands in all States. For rate purposes all commodities should be divided into the following four categories:

- Basic unprocessed food items sold in their original or "natural" state, exempt from tax;
- Other basic necessities, taxable at the lower rate of 4-5 per cent;
- All other goods, taxable at the standard rate of 12-14 per cent; and
- Tobacco, alcohol, petroleum and aviation fuels, and narcotics, subject to a non-rebatable floor rate of 20 per cent.

Statement 7.2 lists specific items in each of these categories. Tax on high-rated goods as listed against (d) would not be rebatable although the tax paid on their inputs would be creditable against the VAT leviable on them (like in the case of office equipment as indicated in Section 7.1.2). However, care would have to be taken to see that resellers of these commodities get credit for the tax paid on their purchases.

The States/Union Territories would be free to choose any rate within a given rate band. However, all goods within a chosen rate-band category would have to be subjected to tax at the same rate in that State. For example, for the third category of goods, one State could choose to impose tax at 12 per cent, and another at 13 per cent, but a given State will not use 12 per cent rate for some goods and 13 per cent rate for other goods. Essentials like basic unprocessed food will be exempt.

All States and Union Territories should fix their VAT rates within these bands. The Union Territories have a special responsibility in this regard and their compliance would be critical to the success of harmonization as it is often the attempts at tax competition on the part of Union Territories that have queered the pitch.

Exemption as contrasted with zero-rating does not provide full relief from tax because, unlike in zero-rating, no refund (or credit) is given for taxes paid at earlier stages. Hence, at first sight, there seems to be a persuasive case to zero-rate the necessities for providing complete relief to the poor. In UK and Ireland, food except when served in hotels and restaurants is zero-rated. However, operation of zero-rating of the commodities produced in unorganised sectors is cumbersome. Therefore, exemption of food products may be preferable to zero-rating. An exemption for farmers implies that they need not have any interaction with the tax department. If food is zero-rated there would be need for the farmers to keep proper accounts to substantiate their input tax credit claims and file returns periodically.

With the rationalisation of the rates into three bands as proposed above, classification of commodities based on fine distinctions would no longer be needed.

The rates suggested for the middle two categories are illustrative. They should be set so as to yield the same revenues as under the

Statement 7.2

Proposed Commodity Grouping for State VAT Rates

Exemptions

1. Unprocessed cereals including rice, rice flour, wheat, atta, maida, and suji.
2. Pulses.
3. Fresh vegetables and fruits.
4. Fresh meat, fish, and livestock excluding race horses.
5. Unprocessed salt.
6. Fresh milk
7. All types of eggs
8. Plain water not including mineral water, aerated water, tonic water, distilled water, scented water or water sold in sealed containers/sockets, etc.

Rate of Tax (4 TO 5%)

1. Oilseeds, edible oils and oil cake
2. Processed salt
3. Dried fish, vegetables and meat
4. Pasturised milk
5. Chillies, turmeric, tamarind, cumin seed, dried ginger, etc.
6. Kerosene
7. Sugar

High Rate of Tax (Minimum 20%)

1. Diesel, petrol and aviation fuel.
2. Opium, ganja, bhang, narcotics, etc.
3. Liquor
4. Tobacco and tobacco products.

All Other Commodities

Standard Rate (12 to 14%)

current system. In our judgment, the standard rate of 12-14% is rather high, especially when combined with the burden of the central excises. A tax at this rate is bound to encounter resistance from dealers as well as consumers. These rates could be lowered if the introduction of the VAT were accompanied by a tangible improvement in tax enforcement and administration. It would also call for some restraint on the part of the Centre in fixing the rate of MODVAT.

With the rationalisation of rates and rebate for all inputs including capital goods, the exemptions and tax concessions including tax holidays given in sales taxes should go. One of the most potent factors undermining the revenue potential of sales tax systems and causing distortions in the treatment of businesses has been the operation of these concessions. They weaken the States' capacity to strengthen their infrastructure, which is crucial for economic development. It is relevant to note that even business organisations like the Confederation of Indian Industries (CII) have urged the government to provide infrastructure rather than tax concessions. A recent paper by the CII, Gujarat has even described the tax holidays in sales tax as a destructive strategy of industrial development.[31]

7.1.4 Treatment of small businesses and unorganized sector

For administrative reasons and also in order not to burden the small traders and producers, VAT systems usually exclude traders and producers having turnover below a specified level. Dealers falling below this level are not required to register or furnish return to pay the tax or maintain the prescribed records. What would be the appropriate threshold level for State VATs should be left mainly to the judgement of the tax authorities in the respective States. However, by and large, a level of Rs 300,000 of annual turnover would seem to be a reasonable level that would take account of the concerns of both administration and small businesses. In a harmonized system, States would be free to fix their threshold level but preferably within the specified limit.

It should be understood that exemption from paying tax does not relieve the small dealers of the tax completely in that, not being registered, they cannot claim credit for the tax paid by them on their purchases. They have no compliance or other obligations under the tax and are treated the same as households or consumers. They are not required even to register for the tax. Full

31. See Confederation of Indian Industries (1993).

relief is possible only when sales are "zero-rated", for then the vendor is allowed to claim a credit for the tax paid on its purchases, even though no tax is charged on the sales.

The exemption system is beneficial to only those firms that deal mainly with final consumers. If they make sales to other registered dealers, then an exemption system can result in a net increase in tax. This is shown in Table 7.3 for the tax-credit or invoice system. In the example, when it is assumed that a wholesaler is exempted from the tax, the total tax collected by the government increases from Rs. 30 to Rs 50. This occurs because when the wholesaler is exempted, the loss of tax collections from the wholesalers is more than made up by the additional tax collected from the retailer, the next person in the production and distribution chain. The retailer would have remitted only Rs 5 in tax had there been no exemption, but with the wholesaler exempt, the additional tax paid by the retailer is Rs. 25. The difference in the two amounts represents the tax of Rs. 20 paid by the wholesaler on his inputs which is blocked by the exemption mechanism. It is for this reason that most intermediate dealers prefer to be registered and liable for tax under a tax-credit or invoice method of VAT. For the same reason, in principle, an option should be allowed to dealers falling below the threshold also to register and pay tax. However, with a threshold of Rs 3 lakh, it may not be necessary to grant such an option as that might provide scope for spurious firms to spring up and ask for registration.

While exemption will serve to spare small traders from the obligation to register for and pay VAT, there will be a good number of producers and traders, who would be above the threshold yet not large enough to be able to cope with all the formalities and requirements. To take care of taxpayers of the country, many countries operating VAT provide simplified methods for computing their liability or reduce their liability substantially. Some of the practices to this end followed in VAT countries are:

- Small traders exempted from VAT but subjected to an equalization tax (i.e., a higher than normal rate of VAT on their purchases). This presupposes correct reporting of purchases which is not easy to ensure.
- Very small traders exempted, others coming under the category of "small" granted a reduction of VAT liability by a specified fraction of the turnover or the tax. This method requires computation of the normal tax before granting relief.
- Exemption for certain categories of trade (e.g., pedlars, hawkers, etc.).
- Presumptive assessment ("forfait") based on certain external indicators (size of business premises, location, etc.).
- Simplified assessment based on a specified percentage of sales turnover or purchases.

Table 7.4 shows the treatment of small firms under VAT in selected countries. As will be seen, all the methods indicated above have their drawbacks. The simplest seems to be the last method whereby the VAT liability is computed by applying a specified percentage to the purchases or sales of the dealers although even that presupposes faithful recording of purchases and sales. Simplified assessment procedures are not unknown in present sales tax systems and may be adopted for VAT too. In any case, it would be advisable to avoid complicated schemes as they involve drain on administrative resources with little gain in revenue. Besides, under VAT, exclusion of small businesses does not entail great revenue loss because tax on inputs is collected anyway.

7.1.4.1 Treatment of small farmers

Farmers and other primary producers engaged in animal husbandry, horticulture and fishing are also accorded special treatment in recognition of their vital role in the economy. Special attention is called for also in view of the fact that small farmers rarely maintain accounts in the conventional way and, in India, it would be too much to expect them to comply with the obligations that registration for VAT would imply, even with drastic simplification. Exempting them from the tax fold would, of course, relieve them of any tax liability on their value added. Taxes paid on their inputs

Table 7.3

VAT With and Without Exemption of Wholesalers

	Primary	Manufacturer	Wholesaler producer	Retailer	Total
A. VAT with Exemption of Wholesalers					
Sales	100	200	250	300	
VAT on sales @ 10%	10	20	0	30	
Less: VAT paid on purchases	0	10	0	0	
VAT payable to government	10	10	0	30	50
B. VAT without Exemption of Wholesalers					
VAT due on sales	10	20	25	30	
Less: VAT paid on purchases	0	10	20	25	
VAT payable to government	10	10	5	5	30

would, however, remain. Several countries provide compensation for this in various ways.

For instance, Belgium, Ireland, The Netherlands and Spain allow a presumptive tax credit for the tax paid on inputs of agricultural products. Some countries tax primary producers at a rate fixed in such a way that they equal the tax based on their inputs while others compensate the farmers directly for their input tax. In some countries, farmers are exempted without compensation but a lower rate is charged on the main agricultural inputs like feed, seed and fertilizers. All such provisions create complications for the system. The suggested threshold for the liability to register for VAT should be adequate to take care of the problems of small farmers and producers of primary products whose marketable surplus does not exceed Rs 3 lakh.

7.1.5 Zero-rating of inter-state sales

As noted in sub-section 6.1.2, consumption type VAT is levied in virtually all jurisdictions, whether at the national or sub-national levels, on the basis of the destination principle. Under this principle, goods going out of a State/country are relieved of domestic trade taxes while imports are taxed in the same way as domestic products. There are basically two alternative ways of operating the destination rule - the deferred payment or zero-rating and the credit clearing method. Presumably for practical reasons, the EU has adopted the zero-rating route for the present.

Table 7.4

Treatment of Small Firms Under VAT*

	Complete Exemption	Simplified Schemes	Forfait
Hungary	(1) Ft 1 million (US$15,900) (retailers); and (2) Ft 250,000 (US$3,975) (others)		
Indonesia	Rp 60 million (US$33,408).		
Japan	Y 30 million (US$210,000).	Y 30-60 million (US$210,000-220,000) Y 500 million (US$3,500,000) or less, rate is 0.6 per cent of sales, except for wholesalers the rate is 0.3 per cent. Also, if interim tax liability is under Y 300,000, tax payment can be delayed until year-end.	
Korea		W 24 million (US$35,346). W 6 million (US$8,834) (agents, contractors, proxies).	2 per cent of turnover tax (and allowed to deduct 5 per cent of reported input tax).
Mexico		(1) Income must not exceed 32 times the minimum wage; (2) no more than three employers; and (3) business space no more than 50 square meters.	Applied on a presumptive basis if (1) to (3) are met.
Nigeria		Turnover below: CFAF 30 million (US$588,950) (goods); and CFAF 10 million (US$29,650) (services).	
Philippines	P200,000 (US$9,250).		2 per cent turnover tax
Portugal	(1) Esc 7.5 million (US$27,300) (retailers); (2) Esc 800,000 (US$4,850) (entrepreneurs); and (3) Esc 500,000 (US$3,030) (professionals).	Small retailers pay quarterly per cent of tax on purchases.	
Spain	Individual retailers not required to register.	Withholding "markup" VAT applied by suppliers to retailers.	
Taiwan Province of China		NT$2.4 million (US$91,954).	1 per cent of turnover tax (and allowed to deduct 10 per cent of reported input tax).
Trinidad and Tobago	TT$75,000 (US$17,650).		
European Community	ECU 150,000-300,000 (US$144,000-287,000) (suggested).		

Source: Tait, (1991).
Note : * As of 1990.

For the preservation of the national common market, to remove all hidden taxes on exports, and to minimize distortions in business location choices, it is imperative to remove the taxation of inter-State sales and for this purpose zero-rating seems to be the preferable alternative. This means that the CST rate for inter-State sale to a registered dealer should be reduced from 4 per cent to zero. Table 7.5 illustrates the calculation of VAT under the zero-rating system, where the wholesaler selling goods in one State acquires his stocks from a manufacturer located in another State.

Inter-state sales to non-registered persons and consumers would be taxable in the same manner as intra-state sales to local consumers. There could be special provisions for the taxation of inter-state purchases by large institutional buyers, e.g. government departments, that are not registered for the tax. Instead of paying tax to the exporting State, such institutions could be required to get themselves registered and self-assess the tax in the importing State. This would safeguard the revenue of States where the goods are consumed.

Table 7.5

Illustration of State VAT, imposed @ 5% with Inter-State sale by a Manufacturer

State	Dealer	Sales	State VAT	Sales Incl. Tax
X	Manufacturer	100	0	100
Y	Wholesaler	160	8	168
Y	Retailer	200	10-8=2	210
Total			**10** (To State Y only)	

The zero-rating of inter-state sales to registered persons would be limited to only those goods which would have been eligible for tax rebate, had the tax applied to them. This would include raw materials, parts, consumables, production machinery and equipment, and goods for resale. Without this restriction, registered traders would have an incentive to buy non-rebatable goods (e.g., office equipment) from another State on a zero-rated basis, rather than on a tax-paid basis within the State.

Abolition of tax on inter-State sales may adversely affect the States deriving large amounts of revenue from this source. In the case of States like Maharashtra, the loss will in all probability be made up with the extension of the base to include consumption items like textiles and the capture of trade margins beyond the first point under the multi-stage system that VAT implies. For States like Bihar and Madhya Pradesh, where CST on minerals yield substantial revenue, appropriate pricing of their natural resources and a wider base for their VAT should take care of the revenue loss, if any. Estimates presented in Chapter 8 show that with the widening of the base and withdrawal of exemptions and some improvement in administration, it should be possible to protect the revenue of even the exporting States with tax rates within the suggested bands.

Several exporting States have major apprehensions about zero-rating because they feel that it would not only lead to heavy loss of revenue but also lend itself very easily to evasion. In general, it is easier administratively to record and capture the inter-State sale of a good at the point of origin (say, a factory or wholesaler) than to record and capture the same transaction at destination (which may involve a large number of small retailers). The evasion possibilities of a destination-based system, especially in the Indian context where the retail sector is outside the tax net, cannot be dismissed lightly. The perceived advantages of destination-based taxation may be outweighed by severe evasion risks, unless adequate safeguards are built into the system against leakage.

An alternative model for avoiding the problems of cascading and tax exporting *without* the evasion risks of a destination base, could be:

i. All inter-State sales and consignments taxed at origin;
ii. Credit given in the importing State for the tax paid at origin; and
iii. Importing States to be compensated for the net amount of rebate allowed by them vis-a-vis the exporting States and inter-State accounts settled through a clearing mechanism.

A version of this - the tax credit clearing system - was seriously contemplated in the EU as mentioned in sub-section 6.1.2.1 but has been put aside at least for the present.

If the clearing mechanism is considered too complex, one alternative could be to pool the revenues and arrange for their sharing. In fact, the critical issue to be resolved in this model is the distribution of the revenue from tax on inter-State sales. Exporting States feel the revenue can be retained by the State of origin (as is now the case with CST) or at best a part of it could be pooled and shared. Importing States would, on the other hand, prefer such revenue to be transferred entirely to the destination State.

It may be argued that the issue of *sharing* of revenue is quite separate from the principle of origin based taxation and should be resolved independently. However, in reality, the two cannot be viewed totally in isolation. The accentuation in the distribution of revenues that may occur if origin based taxation persists and, what is more, consignment transfers are allowed to be taxed on origin basis, cannot be brushed aside in the context of reforms of the present tax system. It must be recognised that origin based taxation will not be compatible with the destination principle unless the importing States grant rebate on the tax collected by the States of origin. They are unlikely to do so unless the revenues are finally shared fairly. If tax on inter-State movement of goods is to be removed - as is eminently desirable - levy of tax by the State of origin should not be permitted except as a device to minimise revenue loss with full rebating by the importing State. Importing States cannot possibly be expected to give such rebate unless assured of a reimbursement through some mechanism such as credit clearing or pooling of revenue. If the revenues are pooled then the State of origin would have little interest in collecting them. Also, granting rebates for taxes paid in other States would not be very simple or free from risks of abuse. For all these reasons, zero-rating by the exporting States seems to be the best course. Possible safeguards to check evasion under zero-rating are discussed below.

7.1.6 Verification of zero-rated inter-State sales

Zero-rating of inter-State sales would call for special procedures to verify that the zero-rated sales are truly made to registered dealers who would account for tax in the importing State. Under the present system, inter-State sales to registered dealers are relieved of the local sales tax if the buyer produces a "C" form issued by the State of the importing dealer. This system does not seem to be working too well. Inquiries by the exporting States to check the validity of the forms issued by importing dealers are either ignored or given low priority by the importing States. It is understood that often long delays occur even in the issuance of the forms or their verification holding up assessments of the exporting dealers.

In the absence of an effective mechanism for inter-State verification of the registration status of dealers, there is a risk that zero-rating of inter-State sales could become a source of large scale revenue leakage. To guard against this possibility, consideration should be given to the adoption of a special system of pre-payment of tax on zero-rated inter-State purchases.

Under the pre-payment system a registered dealer making an inter-State purchase would make a payment of tax on the total purchase price of the goods to the sales tax department of the importing State. The tax payment receipt (stating the value of purchases, a brief description of goods to be purchased, and the amount of tax pre-paid) issued by the importing State would authorize the export dealer to make the inter-State sale on a zero-rated basis, up to the total value of the goods stated in the tax payment receipt.

The sale would be treated as a local sale, and attract the tax of the exporting State, if the importing dealer fails to provide such a tax pre-payment receipt to the export dealer at the time of sale (or at least before filing the return). Any tax prepaid by the importing dealer would become creditable under normal value-added tax rules, as if the tax was paid to another registered manufacturer or dealer on an intra-State purchase of the goods. The importing State would issue three copies of the receipt, one to be submitted to the export vendor, the second to be attached to the tax return of the importing dealer to support the credit claim, and the third to be retained by the importing dealer. The export vendor would, in turn, attach the prepayment receipt to its tax return to support its claim for zero rated sales. The three copies should be of different colours, or otherwise distinguishable from one another, to prevent their use for multiple zero-rated inter-State sales. This system would have the following merits.

First, it would ensure an unbroken chain of tax collections and input tax credits on all domestic sales, as goods move from manufacturers to wholesalers to retailers, regardless of whether the sale is intra-State or inter-State. The only difference between intra-State and inter-State sales is that in the case of the latter the tax is paid directly to the importing State, as opposed to the vendor.

Second, both importing and exporting States would have a stake in prompt monitoring of inter-State sales. For the importing State it would mean additional revenue inflow to the State. Any tax prepaid to the State would be creditable by the importing dealers against the tax that they charge on their sales. The importing State would thus also have an incentive to verify the validity of tax payment receipts submitted by the importing dealers with their returns. From time to time, the exporting State would send a random selection of prepayment receipts to the issuing State to check their validity. Unlike under the present "C" form mechanism, both importing and exporting States would have a mutual interest in the verification of the receipts.

Third, while the system proposed would require advance financing of tax by the importing dealers, any additional cash flow requirements for the dealers would conceptually be the same as those associated with local purchases. When the goods are bought locally, the tax has to be paid to the vendor at the time of purchase. The timing of tax payments would differ for the intra-State and inter-State purchases only to the extent that the tax charged by the local vendor during a tax reporting period may not be remitted to the government until the end of the reporting period. This timing difference also arises under the MODVAT in the treatment of international imports and domestic purchases. The prepayment of tax to the importing State would work in a manner similar to the countervail duty on imports. Registered dealers under a VAT generally enjoy a cash flow enhancement. They collect tax throughout the tax reporting period as they make taxable sales, but remit it to the government only at the end of the tax period. The prepayment of tax would reduce this cash flow advantage, but not eliminate it. Even this diminution in the cash flow may not take place if the receipt for local tax payment by the importer is timed with the filing of the return by the exporting dealer, as is the practice now for the production of "C" forms.

Fourth, if the State sales tax rates are harmonized, it would be easy for the exporter to verify that the tax pre-paid was correct. Even if there was an error and the tax pre-paid was less than the required amount, the risk of revenue loss to the governments is minimal because any tax shortfall would be offset by a matching reduction in the input tax credit claim of the importing dealer.

The application of the pre-payment system should be extended to movement of goods on consignment or branch transfers. Though such movement of goods does not constitute sale, on considerations of risk to revenue, the prepayment rule has to embrace consignments too. Since any tax paid in advance under this process by a registered dealer in respect of stocks or material transferred to his branches will eventually be rebated against his sales, there should be no distortionary impact.

The prepayment system might come in for criticism on the ground that it would result in blocking of funds in businesses doing inter-State trade. No doubt this would imply some interest cost but the fears on this score should not be exaggerated. The interval between the payment of tax by exporter and getting it credited on payment of advance tax paid by the importer would depend very much on how soon the certificate of advance payment is furnished by the importer. Since the offset would be automatic and operate through the accounts of the exporter, there should be no apprehension of "hold up" by tax departments. To guard against fraud, assessments should, however, be completed speedily within six months of furnishing of return.

An alternative to the prepayment system would be to allow the exporting States to levy the tax at a low rate (2 per cent) with corresponding rebate by the importing State and the revenue collected shared through a pooling arrangement (see Section 6.1.2.1). This, however, would not neutralise the gain from camouflaging intra-State sales as inter-State but could be given consideration as an interim arrangement until the prepayment system is put in place.

7.1.7 Extension of the State VAT to declared goods, and sugar, tobacco, and textiles

Currently, States are not allowed to impose tax on certain goods (commonly referred to as declared goods), which are viewed to be of importance in inter-state commerce and trade, beyond the rate laid down for CST. Under the new regime the neutral design of the VAT makes such restrictions redundant. If inter-state sales are zero-rated, and the tax on production inputs rebated, then the imposition of tax on the declared goods does not in any way hamper inter-state commerce. However the Central legislation to fix the maximum rate of tax on declared goods may be retained to ensure that the States accept and adhere to the harmonized rate structure envisaged here.

The special regime for tobacco, sugar, and textiles also becomes unnecessary under the proposed VAT structure. There are no technical reasons for the continuation of the additional central excise on these goods in lieu of the State sales tax. They can be easily made taxable within the structure of the State VAT.

7.2 Taxation of Services

Under the Constitution as it stands at present the States do not have the power to tax services except those specifically assigned to them, viz., taxes on passengers and goods carried by road and inland waterways, taxes on luxuries including amusements, betting and gambling, and taxes on advertisement other than in newspapers, radio and television. The power to tax services in general (in addition to advertisement in newspapers, radio and television) rests with the Centre by virtue of the residuary entry in the Union List though the Centre has not used the power effectively so far.[32]

As argued earlier, in principle, the base of a comprehensive consumption tax should comprise both goods and services. Exclusion of services from the base creates economic distortions and aggravates the regressivity associated with taxes on consumption. Moreover, services constitute a large and growing sector of the economy and the distinction between goods and services is no longer sustainable. There is, therefore, a strong case for bringing services under the tax base and VAT facilitates a comprehensive approach to the taxation of goods and services. Some exceptions may, however, have to be made for social policy or administrative reasons. Thus, while taxing services comprehensively under their VAT system, the EU and OECD countries exempt certain public interest activities like health,

32. The tax on foreign and inland travel levied by the Centre constitutes an exception. A tax is also imposed by the Centre on amounts charged for accommodation in certain classes of hotels and for food and drink in such hotels under the "Expenditure Tax Act" legislated by Parliament. However, its constitutionality has been upheld by the Supreme Court, as a tax on "expenditure" and not on services as such (Federation of Hotels vs. Union of India, AIR 1990 SC 1637).

education and social services. Financial transactions and life insurance are also usually kept out because of problems in measuring value added in these services. Such problems are inherent also in the taxation of housing services and services provided by government. Excluding these hard-to-measure categories, all other services should be brought within the VAT base. The taxation of services on this way seems to have worked well in Europe. Many countries in Asia also tax services on a comprehensive basis. In New Zealand even services provided by government are taxed.

For several reasons, however, it may not be feasible or even desirable to go in for the taxation of the generality of services at the State level right now.

First, for reasons noted above in bringing services under taxation, exemption has to be provided for several categories of the same service. The line between exempt and taxable services is not always easy to draw (e.g., between health and educational services provided by government and those provided by the private sector). Often arbitrary rules are required.

Second, the bulk of consumer services are provided at the retail level and that too by small firms in the unorganised sector. With a reasonably high threshold few of them would come under the tax net anyway, and so the revenue gain may not be worth the hassles that any attempt to tax them will entail.

Third, there are a range of services, such as transportation, telecommunication, advertising and professional/management consultancy, for which the place of origin or destination cannot be defined without the help of complex rules. For instance, consumption of inter-State transportation services could be defined to occur entirely in the State where the transportation commences, the State where it terminates, or both of the States in proportion to the distance travelled. The gains from advertising in a national newspaper may accrue from all parts of the country, or only from those areas where the advertiser markets his goods or services. There is thus good rationale for the provision in the Constitution whereby powers of taxing advertisements in newspapers, radio and television are assigned to the Centre while that of taxing advertisements through other media is conferred on the States. If the States were to extend their VATs to all services, they would need to agree upon a set of rules for a proper allocation of the tax base for services having inter-State spread. That would add to the enormity of the task of tax reform in India.

For all these reasons, it would seem to be advisable to extend the base of State taxes on consumption to services only selectively, at least to start with. In order that the selection does not proceed arbitrarily and so does not give rise to unintended distortions, some rational criteria should be laid down as a guiding rule. A simple and non-discriminating way of going about this task would be to concentrate on services which are integral or ancillary/incidental to the supply of goods, e.g., installation, works contracts and delivery. In other words, services should be brought under the State tax base only where it is necessary to ensure proper application of the tax to goods. By the same token, services integral or ancillary to the production or manufacture of goods should come within the base of the Central VAT on manufacturers.

The definition of services which are integral, ancillary or incidental to the production or supply of goods would, no doubt, need careful consideration. But once the principle gains acceptance, services integral, ancillary or incidental to the production or manufacture of goods should get taxed at the level of the Centre and all such services related to the sale of goods such as supply and delivery should be taxed by the States. With explicit stipulation in the law in this regard, there would be no scope for disputes over imposition of manufacturers' VAT in cases where the production is done on site or the manufacturing includes installation. Similarly taxability of products of branding, printing, blending or packaging would no longer be in doubt.

This rule would, however, leave out services which are delivered and consumed qua service. The significance of such services is growing fast and several of them figure prominently in the consumption basket of the rich (e.g., the service of photoproduct developing and printing, video filming, xeroxing and telecommunications, decorators, etc.). Keeping them out of the base obviously creates distortions and inequities and undermines the revenue potential of the consumption tax. However, the problem in bringing them under taxation is that identifying them individually would be arbitrary and so open to the charge of discrimination. Moreover, such selective taxation also generates pressures and lobbying for exemption or concession. Hence, as argued at the outset in this sub-section, the ideal course would be to bring all services in general under the tax base (with a few exceptions for social or practical reasons). But for reasons already mentioned, taxation of services on a comprehensive footing might throw up tremendous administrative and compliance problems without commensurate gain. Then there are problems of inter-State allocation of the base in the case of certain services. On these considerations it is desirable to make a beginning by taking up only services which are ancillary or incidental to the production or supply of goods.

In addition, pending the introduction of a generalized scheme, services which are predominantly in the nature of consumption and form a significant component of consumption (that is, those which are not directly related to business) such as photoprocessing or cable TV and video filming services may be brought under taxation with provision for rebating the taxes paid on materials. VAT paid for such services however need not be rebatable even though they are sometimes used in business also (like in the case of office equipment). Powers to tax such services may be given to the States. Only those among such services which have inter-State ramifications may be taxed by the Centre.

Based on the principles advanced above, proposals are put forward in Appendix 1 for the levy of tax on a few services by the Centre. The States should be empowered initially to tax services ancillary or incidental to the supply of goods and those which are essentially for consumption and can be identified as having a good revenue potential. VAT on services which are predominantly consumption in nature need not be rebatable. Eventually, the States should be vested with powers to tax services generally along with goods down to the retail level. Allocation of services with inter-State ramifications should not pose any inseparable problem. It appears fairly satisfactory rules in this regard have been evolved in the EU. However, that is a vision for the future.

For the present, since under the Constitution the Centre alone can legislate for the taxation of services, it would be expedient if legislation for the purpose was made by Parliament and powers in suitable cases delegated to the States as under the CST Act for the sales tax on inter-State sales. Such an arrangement should, however, be only transitional and if the experience is not unfavourable, the State VAT bases may be widened to include services in general except those specifically excluded.

As noted, some services (like entertainments) are at present taxed by the States under the powers conferred by the Constitution. Ideally all taxes on goods and services should be integrated into a single tax. However, given the limited scope of the scheme of State taxes on services proposed for immediate implementation, the continuation of a few taxes on services as separate levies could be justified as a transitional measure, pending a successful conversion of the sales taxes on goods into VAT. Where such integration is possible, e.g., in works contracts, the base should be integrated straightaway.

The revenue impact of the reform scheme proposed above and the likely economic effects are considered in Chapter 8. The legal, administrative and institutional requirements are briefly enumerated in Chapter 9.