

SUMMARY

1. Introduction

Domestic trade taxes in India are in urgent need of reform. The system that is operating at present is archaic, irrational and complex - according to knowledgeable experts, the most complex in the world. It interferes with the free play of market forces and competition, causes economic distortions, and entails high costs of compliance and administration. The rapid economic growth that is occurring in many Asian countries will bypass India, if, among others, its antiquated system of domestic trade taxes is not reformed.

2. Costs of the Present System

The manner in which the taxes on domestic production and trade are currently levied and administered causes:

- . Loss of output growth and welfare;
- . Inefficiency and high cost in industry and trade;
- . Impediments to the free flow of trade within the country and growth of the common market that the Indian Union offers;
- . Inter-jurisdictional conflicts;
- . Handicap for exports; and
- . High costs of compliance and enforcement.

2.1 Basic problems

The costs enumerated above stem essentially from the following features of the present system:

- . Levy of taxes at the manufacturer level/first sale point;
- . Exclusion of services from the tax base;
- . Taxation of inputs and capital goods;
- . High level and multiplicity of rates;
- . Taxation of inter-State sale and lack of harmony in States' sales tax systems; and
- . Complex laws and archaic administration.

2.1.1 Taxation at manufacturer level/ first sale point

Under the Constitution, the bases of excise duties and sales taxes, the two principal components of the domestic trade taxes, are distinctly defined - production of goods in the case of excise, and sale or purchase for the sales taxes. In practice, the two bases have come to overlap. Because of problems in administering taxes at the retail level, most States have moved the point of levy of their sales taxes to the first point of sale, that is, on manufacturers and importers of goods in their respective jurisdictions.

Taxation at the manufacturer level or at the first point of sale encounters intractable problems as the term "manufacturing" is not easy to define. Goods may undergo a change of form due to a variety of processing activities performed after their initial production or manufacturing (e.g., grinding, packaging, blending). There are many processes which constitute only "marginal manufacturing". Attempts to bring them all under "manufacturing" for excise taxation have given rise to disputes and uncertainty. Clarifications have been provided in the law in the form of section/chapter notes to contain the areas of dispute but the uncertainty persists.

Determination of manufacturing value also is equally troublesome. Manufacturers often sell their products through their own distributors or through wholesalers and sometimes directly to the consumers. In determining the assessable value at the manufacturer level adjustments have to be made for legitimate trade margins at different trade levels. Sales between related entities also need careful examination. These problems are aggravated by the exclusion of services from the base.

Taxation of sales at the first point, besides encountering all these problems, increases the risk to revenue in that the entire tax burden is concentrated at one stage. The rates of tax also have to be higher to raise a

given amount of revenue than if the base was wider. Higher rates induce evasion and thus call for stringent anti-evasion measures which are not very easy to enforce.

2.1.2 Exclusion of services

The definition of the powers of excise taxation as well as sales tax refers only to "goods" without any mention of services. As a result, neither Central excise nor sales tax can be applied to services. The distinction implicitly drawn in the Constitution between goods and services is not in accord with the realities of modern economies. Services are often an integral part of manufacturing and trade, and the line between goods and services is getting increasingly blurred (e.g., in the manufacture of computer software, desk-top publishing, developing and printing of photographs, photocopying, etc.). Manufacturers may provide a wide variety of services for the goods manufactured by them such as training, advertising, installation and maintenance. Taking advantage of the definitional ambiguities and the exclusion of services, manufacturers have tried to minimise the assessable value of their products by making sales at artificially low values to a related distributor/wholesaler and by claiming discounts for the so-called "post-manufacturing services" (e.g., transportation, installation and warranty services).

Similar problems are encountered in first-point levy of sales taxes too. Apart from technical problems, taxation of goods only at manufacturer/first-point level, that is, on a base that does not include distribution margins and associated services, tends to distort producer and consumer choices. Items which carry large trade margins (as is usually the case with luxury products) are favoured over essential consumer goods. It also provides an incentive for producers to push as many trading functions forward as possible to keep down the assessable value of their products. Exclusion of services from the base also creates a bias against goods and in favour of services (which are usually consumed more by the rich).

2.1.3 Taxation of inputs and capital goods

Left with a base constrained by exclusion of trade margins and services and faced with mounting pressures for revenue, both the Centre and the States have gone on to extend the coverage of their excises and sales taxes to include inputs and capital goods. This leads to cascading and constitutes another major source of economic distortion. Cascading inhibits specialisation and thus efficiency in industrial production. While attempts have been made to alleviate the ill-effects of input taxation through MODVAT in Central excise and concessional treatment or exemption in sales taxation, the distortions persist as the reliefs are inadequate or ineffective. Moreover, no relief is available for taxes paid on plant and equipment. In many States there is now a turnover tax which falls on all commodities including inputs at more than one point of sale but does not get relieved. This causes cascading and induces vertical integration with all its attendant evils.

2.1.4 High and multiple rates

With a narrow base the rates have to be high to raise the same amount of revenue. Where the trade margins are high (in the case of certain consumer durables, the margins can be more than 100 per cent of the ex-factory price) the rate of tax at first point has to be higher than if the margins were taxed. Finding it difficult to raise the level of sales taxes at the first point any further, the States are now resorting to additional levies like turnover tax, additional sales tax, surcharges and so on, making the system totally non-transparent and the tax incidence arbitrary and unpredictable.

All this further aggravates the distortions inherent in a manufacturer's tax. It also provides incentives for evasion and avoidance and generates pressures for exemptions and concessions. One thus witnesses multiplicity of rates based on classification (sometimes hair-splitting) of commodities and sectors with bizarre results. Not surprisingly, the system has proved to be a breeding ground for disputes. Over 30,000 excise cases are

pending before the Appellate Tribunal alone (over 12,000 before the High Courts). In some States (e.g., West Bengal) the number of sales tax cases awaiting decision before the appellate authorities is more than 50,000.

2.1.5 Taxation of inter-State sales

Another major source of distortion is the system of taxing inter-State sales under the Central Sales Tax (CST) Act. Though legislated by Parliament, it is administered by the States who also retain the revenue. Operation of the inter-State sales tax implies taxation according to "origin", that is, where the goods are produced, no matter where they are consumed ("destination"). This constitutes a serious impediment to the free flow of trade within the country and is inimical to competition and efficiency. It also conflicts with principles of inter-jurisdictional equity because the producing States can export their taxes to others, constraining the domestic tax base of the poorer consuming States (like U.P., Bihar and M.P.). Four "high income" States with less than 20 per cent of the country's population account for 45 per cent of the total revenue from CST, while the low income States with 44 per cent of the population get 18 per cent of the CST revenue.

The States have been trying to "export" taxes via the CST and at the same time undercutting each other in sales tax rates to attract trade and industry. This has created a situation in which all States are finding it difficult to rationalise their tax structures, and in some States, products like automobiles are currently being taxed at the same low rate as cereals.

Taxation of inter-State sale combined with the tax on inputs encumbers exports since under such a system the incidence of tax on export production cannot be reliably quantified, much less relieved.

Since transfers between the branches of a firm do not constitute "sale", one way of avoiding the CST is to transport goods across State borders as transfer on consignment. With a large part of the inter-State trade now flourishing in several States in the form of consignment transfers, the States have been

clamouring for a tax on consignments too. If introduced, this will exacerbate the hindrance caused by inter-State sales tax to the flow of trade within the country and the growth of the common market, and accentuate the disparities in the revenue levels among the States. While the trend all over the world is towards unification of markets to promote competition and efficiency, India is almost the only country going in the opposite direction.

2.1.6 Complex laws and administration

The distortions are compounded by the complexity of the laws and administration. In order to counter avoidance and evasion, the laws have been tightened to help enforcement and elaborate procedures and forms have been laid down. These have, however, not been very effective in the absence of a modern system of information and administration. On the contrary, they have added to the complexities.

The damage caused by the distortions discussed above remains to be quantified. There can be little doubt, however, that the resulting losses to the economy are enormous. It cannot be gainsaid that if trade and industry is to grow, the tax system must be neutral, that is, it should not interfere arbitrarily with producer and consumer decisions. If competition and efficiency are to be promoted, there has to be a level playing field. Neutrality in the domestic market is also a prerequisite for external neutrality, especially in an increasingly competitive world.

3. Directions of Reform

If the ills of the present system are to be remedied, the problems have to be attacked at their roots and not by symptoms. The guiding principles should be neutrality, simplicity and equity. Due note must also be taken of the compulsions of a federal polity and the revenue needs of different levels of government.

It can be demonstrated that the value added tax could provide a solution to most of the ills of the present system. If levied on a comprehensive base including goods and

services at a uniform rate, a VAT would help restore neutrality, simplify the laws, reduce litigation and provide an elastic and stable source of revenue.

3.1 Design features of VAT

Introduction of VAT calls for several choices in regard to its design features. Some of the basic questions that arise are: How to compute the tax - by subtraction method or by the tax credit method? Should it follow the principle of origin or of destination? What should be the threshold for a dealer to be liable to pay tax? How to treat farmers and small producers/dealers? What should be the treatment of foreign trade? What about exemptions? Should the base be tax inclusive or should it exclude the tax?

The commonly adopted form of VAT is the destination-based, consumption type, operated through the tax-credit or invoice method. While a single uniform rate enhances simplicity and transparency, VAT is levied in some countries at two rates (one standard rate and another for essential consumption goods) and rarely at more than three. Essentials are also exempted in many countries instead of being taxed at a lower rate. For administrative simplicity, small businesses (that is, those having sales below a specified limit) are left out of the liability to pay VAT.

If VAT is to be introduced in India, the choice should be the invoice operated consumption type with a uniform or at the most two or three rates and a cut off point that would leave out small businesses without undue risk to revenue. Also, if common market is to grow, *the tax should adhere strictly to the principle of destination.*

In implementing the VAT based on the destination principle in a federal country like India two additional important choices centre around the questions: (i) which level of government should levy the tax (the Centre or the States, or both) and (ii) what should be the mechanism for operating the destination rule?

3.2 The options

The options for introducing a VAT in

the Indian context are:

- i. *A National 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 excise and sales tax, covering all goods and services, with arrangement for revenue sharing.
- ii. *State VAT* - Centre withdrawing from domestic trade taxation and leaving it to the States to levy the tax on domestic trade in the form of VAT, replacing both Central excises and sales taxes (allowing a few special excises on sumptuary and luxury items to be levied by the Centre).
- iii. *Dual or Joint System* - Both the Centre and the States levying VAT either concurrently or independently, converting their excise and sales taxes into VAT.

The pros and cons of the various options are briefly discussed below.

3.2.1 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.

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 two-thirds of the 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.

Though attractive from many angles, a scheme of tax reform that takes away the most important tax powers of the States and increases their dependence on the Centre would not be acceptable to the States. The

States then would have to depend on the Centre for over 70 per cent of their tax revenue as compared to 32 per cent at present. Nor would that be desirable in principle. It would go against the tenets of fiscal decentralisation which is widely believed to be crucial for the effective functioning of a multi-level system of governance, allocation of resources for public spending according to the preferences of the people and promoting fiscal responsibility at all levels. It would call for a major amendment to the Constitution, which, given the present political configuration in the country, will not be easy to carry out. Moreover, in a vast country like India, the Centre would inevitably have to depend on the States in administering such a tax. (The Central excise department now handles only about 1,50,000 assesseees. A nationwide VAT would involve dealing with at least a million taxpayers. For all these reasons this option does not seem to be either desirable or feasible.

3.2.2 State VATs

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 consumption to the sub-national levels (although the contrary view is also held by some). The diminution in the Centre's revenues 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).

However commendable in principle, replacing both Central excises and sales taxes by a regime of State VATs does not seem to be feasible at present. First of all, it would call for a drastic reallocation of tax powers between the Centre and the States, the implications of which need to be gone into in depth. Secondly, it would entail a sharp drop

in Centre's revenue since collections from excises contribute about one-third of its total tax revenues at present (Rs 18,000 crore out of about Rs 58,000 crore)¹ and, even with special excises on selected items, the Centre's revenue would drop by at least Rs 12,000 crore. With the revenue from customs dwindling in the wake of liberalisation of foreign trade, the Centre may not be able to balance its budget under such a regime, or be in a position to play a significant role in bringing about some equalization in the level of public services in the country through transfers to poorer States unless: (i) its revenue from income taxes improves dramatically, and/or (ii) the share of the States in the Central revenues comes down sharply, or (iii) the Centre sheds some of its functions or responsibilities. None of these seems likely to come about in the foreseeable future. Moreover, given the uneven quality of sales tax administration in the States, for the Centre to withdraw from the indirect tax field immediately might also be a little too risky for revenue. One also wonders whether it would be possible to set up a destination-based system of domestic trade taxation without Centre's active involvement. In any case, reform along these lines would involve a radical shift in the powers and functions of the Centre and the States which cannot be brought about without a national consensus.

3.2.3 A dual VAT system

For reasons mentioned above, in exploring the possibilities of introducing VAT in India, 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.

3.2.3.1 Concurrent VAT

A theoretically appealing variant of the dual system is one in which the Centre as well as 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, there would be a common base for both Central and State VATs. The States

1. As of 1992-93 (R.E).

would have the powers to fix the rates but within a harmonized system of narrow rate bands. Inter-State sales will carry a rebatable Central VAT while State VATs would be zero-rated and taxed by the importing State. A concurrent VAT extended upto the 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.

However, effective administration of a concurrent system would call for a degree of coordination between the Centre and the States that is lacking at present and would be difficult to achieve even with the best of intentions. There could also be conflicts between the tax authorities at the two levels over assessment of the base that would not be easy to resolve. Moreover, the administration of a VAT by the Centre beyond the manufacturing level would require the help of the States since the Central Excise Department is simply not equipped to handle the number of dealers who would come within the tax net under a VAT regime even if the threshold is fixed at a relatively high level.

Considering the problems that the Centre would face in implementing a VAT beyond the manufacturing level the Tax Reforms Committee (TRC) of which Prof Raja Chelliah was the Chairman, while recommending that the Central VAT be extended to the wholesale stage, had suggested that the tax on the wholesalers be administered by the States who could also retain the revenue so collected. This, the TRC had felt, would not call for any constitutional change. In essence, however, the TRC proposal would only be a variant of the concurrent VAT and encounter similar problems.

Apart from the conflicts which it might generate, a concurrent VAT would be seen by the States as an invasion into their tax powers. The arrangement favoured by the TRC, viz., the States be called upon to collect the Central VAT at the wholesale stage also does not seem to be very satisfactory as it could also lead to conflicts between the

Centre and the States since the VAT paid at the Central level would be rebatable against the VAT leviable by them on wholesalers. Also, if a manufacturer buys inputs from a wholesaler, the Centre would have to give rebate for the tax collected by the States at the wholesale stage.

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.

3.2.3.2 Independent dual 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, reform on these lines would go a long way to remove many of its ill effects and perhaps lay the foundation for an even more rational regime in the future. The main elements of reforms envisaged under this scheme are outlined below.

3.3 A feasible scheme of reform towards VAT

3.3.1 A Central VAT on manufacturers²

MODVAT can be reformed and made into a fullfledged manufacturer level VAT with the following measures:

- a. Widening of the base to include all goods produced, manufactured or imported and a few selected services;

2. These proposals were drawn up before the Central Budget for 1994-95 was unveiled.

- 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.

Measures outlined above might help avoid many of the problems and worries which a concurrent VAT or extension of MODVAT to wholesale traders would give rise to.

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 large loss of revenue. There could, in fact, be a gain of about Rs 1,000 crore to provide a cushion for the change.

Eventually, in order to keep the burden of taxation by both levels of government within reasonable limits and allow more room to the States, the rate of Central VAT should be brought down to a uniform rate of 10 per cent.

Under a tax rental agreement, the Centre now levies an additional excise duty in lieu of sales tax on three commodities, viz., textiles, tobacco and sugar but the States are unhappy with the arrangement. In a reformed regime of commodity taxes, the States should ultimately get back the powers to tax these commodities even though the Centre would also be free to levy Central VAT on them at appropriate rates.

3.3.2 Reforming State sales taxes into State VATs

Measures which could go a long way to remove the non-neutralities and harmful effects of sales tax systems operating at present and achieve a measure of simplicity 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 existing 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 (the latter for the Union

Territories). If the States signal their agreement on such a package, the Centre should permit the States to tax three additional excise duty items, viz., textiles, tobacco and sugar under State VATs.

Further, under the CST at present, there is a ceiling on sales taxes that can be levied by the States on certain commodities considered vital for inter-State trade and commerce (called declared goods) even when sold within their own territories. 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. However, the Central legislation to fix the ceiling rate for declared goods may be retained to ensure that the States accept and adhere to a harmonized rate structure.

The most convenient method of operating a destination-based system of State VATs is to zero-rate inter-State sales between registered dealers. As a safeguard against misuse, a system of advance payment of tax by the importing dealer can be devised. Under this system inter-State movement of goods through consignment transfers should be treated on the same footing as inter-State sale between registered dealers. As an interim system, exporting States may levy a tax on inter-State sales at a low rate for which importing States would grant rebate and the revenue will be shared through a pooling arrangement.

Informal discussions with State government officials suggest that such a scheme of reform as outlined above might receive favourable consideration in general. The rate bands proposed are: 4 to 5 per cent for essential goods and 12-14 per cent for all other goods. Basic, unprocessed food items may be exempt while tobacco, alcohol, petroleum, aviation fuel and narcotics may be subjected to a non-rebatable VAT at a floor rate of 20 per cent (see Statement 1). The tax on the high rated items will not be rebatable although the tax paid on their inputs will be credited against the VAT payable on them. Resellers would however be entitled to deduct the tax paid on their purchases from the VAT payable on their sale.

Eventually the States should be given the

power to tax services in general. A beginning can be made by bringing under the State VATs, services which are ancillary or incidental to the production or supply of goods and also those which form a significant part of final consumption like photo processing. VAT on such items of consumption need not be rebatable. The Parliament can pass a legislation empowering the States to levy the tax on services so selected. Pending a general extension of the tax base to services, the taxes on entertainments, electricity duty and taxes on passengers and goods carried on road may continue to be levied by the States.

Statement 1

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%)

The potential benefits of the proposed reform scheme include mitigation of economic distortions, greater fairness and uniformity in taxation, better tax compliance,

transparency in tax incidence and simpler tax design. However, there may be some initial problems such as opposition from tax practitioners, large initial investment in administration, and rise in costs of both compliance and administration.

Exercises based on available data show that such a regime can be revenue neutral even with zero-rating of inter-State sales, provided the reform scheme is implemented as a whole. However, some States where the level of taxation is high may have to pitch their rates high (e.g., in Gujarat, a rate structure of 5, 14 and 32 per cent would be called for to make the reform revenue neutral). The average rate of tax in high tax States might be in the region of 12 or 13 per cent. This, however, takes no account of the likely gains from better enforcement that VAT should facilitate. With even a 10 per cent increase in revenue with better administration the revenue neutral rates would come down appreciably (e.g., for Gujarat, the rates could be 5, 13, 26 vide Table 1).

Table 1
Revenue Neutral VAT Rates
for Selected States : 1992-93

State	With no administrative improvement		With administrative improvement*	
	Tax rate regime	Average rate	Tax rate regime	Average rate
Andhra Pradesh	(4,9,20)	10.3	(4,8,20)	9.5
Gujarat	(5,14,32)	13.0	(5,13,26)	12.0
Maharashtra	(4,11,23)	11.7	(4,10,22)	10.7
Rajasthan	(4,8,20)	10.7	(4,7,20)	10.0
Tamil Nadu	(4,14,20)	13.1	(4,12,22)	12.1

- Notes:**
1. Figures in brackets give VAT rates for low rated, standard rated and high rated goods, respectively.
 2. Figures for Gujarat relate to 1991-92.
 3. These computations are based on tax turnover data furnished by the State Sales Tax Administrations.
 4. * Assuming a resulting increase of 10 per cent in the tax yield.

Combined with the Central VAT, which, under the proposed scheme, would contain rates going up to 20 per cent (even though the average would come to 15 per cent), standard rates of this order might appear to be a little too high. However, this is in reality the level prevailing now. Only the incidence of excise duties remains invisible. The position will not worsen with the proposed reform rather the rates can be brought down if the base is truly widened and substantial improvement takes place in administration.

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 probably 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 show that with the widening of the base and withdrawal of exemptions and some improvement in administration, it should be possible to protect the revenues of even the exporting States with tax rates within the suggested bands. In most countries where VAT has been introduced on a comprehensive base, the additional revenue accrual has outstripped the estimates.

As for price effect, international experience suggests that a revenue-neutral replacement of sales taxes by VAT is not inflationary.

3.4 Legal, administrative and institutional requirements

Reforms proposed in the preceding paragraphs will require appropriate legislation for implementation and overhaul of administrative organisation and methods. Suitable institutional arrangements also would have to be evolved to formulate action plans and oversee their implementation. In particular, attention will be required on the following aspects of law and administration and institutional set up:

1. Drafting of the law and regulations
2. Formulation of procedures and design of the forms
3. Reform of administrative systems and organisation
4. Computerization and modernization of administrative methods
5. Training and reorientation of staff
6. Taxpayer education
7. Creation of institutional infrastructure.

3.4.1 Legislation

Once a decision has been taken in principle to introduce VAT and broad agreement reached about its basic design features, steps would be needed to prepare the necessary legislation along with supporting regulations.

Considering that uniformity of basic structure and procedures would be necessary for the harmonization and smooth operation of the system all over the country, a model law should be devised which the States can adopt with suitable changes but retaining the basic structure.

Drafting, being a specialised job, has to be undertaken by a team of experts. The States should jointly set up a team consisting of experts drawn from the law departments/legal cell of sales tax departments and officers with background of sales tax administration to undertake the task of drafting the law. Since VAT would be an unfamiliar concept and its rationale may not be apparent to legal experts, it would be necessary to include a fiscal economist in the team. The tasks of the team should include, besides drafting the basic law, formulating regulations and resolving operational issues. It may be useful to hire consultants from abroad to help the team in some of these tasks.

The scheme of State VATs proposed in this study will call for some far reaching amendments in the Central Sales Tax Act of 1956 (e.g., to bring down the rate of CST to nil when the sale is between registered dealers, remove the ceiling on State sales taxes on declared goods and so on).

3.4.2 Procedures and forms

Implementation of any tax calls for prescribing operational procedures for

- . Registration of taxpayers
- . Filing of returns
- . Payment of tax
- . Assessment and reassessment
- . Appeals against assessment.

3.4.3 Registration

Under a system of destination-based VAT, inter-State movement of goods would need to be monitored and transactions between registered dealers across States cross-checked from time to time, even though on a sample basis. Hence, it would be necessary to evolve an all-India coding system and allot tax identification numbers to all registered dealers accordingly.

3.4.4 Tax return and other forms

Unlike under a sales tax with multiple levies and rates of tax, the VAT return form can be very simple, especially if the rate of tax is uniform. With more than one rate, space has to be provided in the return form for reporting sales and purchases under the different rate bands. Even so, the form should be simpler than those in vogue for sales taxes at present.

The periodicity of return filing and payment of tax would have to be determined in the light of the experience and requirement of each State. Some uniformity in this regard among all States would be desirable.

3.4.5 Invoices and accounts

Requirement of documents and forms to support a tax return should be kept to a minimum. The most important document for the operation of tax credit-based VAT is the invoice. The tax invoices which only VAT registered dealers should be authorised to issue, should provide all relevant information regarding the seller, the buyer and also date of issue, serial number, particulars of goods sold and amount of VAT charged.

Dealers registered for VAT (other than those coming within the "small dealers" category) must maintain record of all tax invoices issued and received by them indicating their serial number, date, price charged and the VAT.

3.4.6 Filing of returns and tax payment

It would simplify life if banks were authorised to receive returns along with taxes with the responsibility to pass on the returns to the tax authorities.

3.4.6.1 Assessment and appeals

Procedures for both assessment and appeal should also be standardised. Tax administration all over the world is now moving towards a system in which returns filed by the assesseees are accepted and thorough scrutiny or audit of only a few cases is taken up on a sample basis. The basis of selection and the proportion of cases to be taken up for audit have to be decided keeping in view the costs and the likely results.

3.4.7 Administrative system and organisation

Success in the implementation of VAT hinges critically on financial or accounts-based controls supplemented by field visits by authorised officers. Hence, with the introduction of VAT, tax officers will have to orient their approaches towards examination of accounts instead of relying heavily on physical controls. This would call for reassessment of staff needs, staffing pattern, and retraining and redeployment of the existing staff. It would also require a reorganisation of the tax departments.

There should be no fear of any retrenchment of staff with VAT. Only some reallocation of functions and redeployment with emphasis on examination of accounts might be needed.

To meet the need for qualified and competent staff at senior levels, consideration may be given to the creation of a unified

independent Value Added Tax Administration or authority with All India and State Services.

3.4.8 Computerisation and modernisation of administrative methods

Modernization of administration with extensive use of computers is a crucial element of reform. Computers provide an extremely powerful and at the same time affordable instrument for administration of taxes and are particularly useful in the operation of a tax like the VAT which calls for monitoring of tax payments and credits availed of continuously and also cross-verification of tax-credit claims even if selectively.

It is absolutely necessary to draw up plans for computerising tax administration in all States in a time bound programme. Administration of Central excise department also needs to be modernized for the MODVAT to be expanded and operated efficiently.

3.4.9 Institutional set-up : Need for a VAT Council of States

Implementation of the reforms will require consultation and discussion among the State governments on a continuing basis. Consultation and involvement of the States would be needed for steering the implementation of VAT in the initial stages and also later for overseeing its operation. The process should be initiated as soon as the Central and State governments agree on the whole package.

To facilitate consultation and chalk out lines of action it would be advisable to set up an All-India VAT Council of the States. This Council will provide the mechanism for bringing all States together and ensuring their active participation. It will concentrate expertise, prepare the draft of a common tax base (like the Sixth Directive of the European Union) and common procedures, play a major role in educating and guiding State VAT officials, provide for review and continuity of the VAT adoption process, integrate

policy/analysis with legal drafting, etc.

The permanent statutory institution for consultation among States and overseeing the introduction and the operation of VAT should be in two tiers: one, the apex body (VAT Council) and another, a functional one below it.

The apex body should be constituted with finance ministers of all the States. At the second tier, there should be a Standing Committee of officials (Commissioners of Commercial Taxes) who would meet regularly to identify issues and propose solutions.

3.4.10 Taxpayer education and publicity

Dissemination of information regarding VAT and the case for reform is crucial for the success of any scheme for replacing the present system with a scheme of VAT. Before embarking on the reform, it would be necessary to launch a programme of public discussion about the ills of the present system, how VAT could remedy them and the benefits likely to be derived.

3.4.11 Lead time

Introduction of VAT without adequate preparation or institutional backing can be disastrous. A lead time of 2 to 3 years, would be needed for moving towards a system of VAT at the Centre and in the States.

4. Concluding Observations

Because many parties would be involved, a package reform with inter-dependent gains and losses would be preferable to incremental change which is favoured by some on practical grounds. Incremental reform may soon get bogged down and lead to nowhere.

Reform of this magnitude cannot be carried through without strong political will, real interest on the part of the Central and State governments, and support from the people. Obviously the task will be arduous but, as stressed at the outset, needs to be addressed boldly if the Indian economy is to get free of the shackles of its irrational and injurious tax system and move forward fast.