VAT AND STATES:
Misconceived Fears

Amaresh Bagchi

No.5 February 1995

VAT AND STATES : Misconceived Fears

by

*Amaresh Bagchi**

Following the initiative of the Union Finance Minister, introduction of the Value Added Tax (VAT) is now figuring prominently in the agenda of governments, both at the Centre and the States. While the Central excises are well on their way to transformation into a manufacturers' VAT, progress at the States level seems to be slow and half-hearted. Apart from lack of conviction about the need for any basic reform such as adoption of VAT would imply, fear of losing revenue and fiscal autonomy has been a major deterrent. Some economists have added to these fears by calling the move an intrusion by the Centre. "Why should the States forgo their revenue from inter-State sales tax (CST)?", it is asked. This is unfortunate. For such fears and questions reflect inadequate appreciation of what value added taxation in essence implies (and why it is necessary to replace our sales taxes with VAT).

That the sales tax systems as they are operating at present are unworkable cannot possibly be denied. Multiple cascading levies, numerous rates drawing hairsplitting distinction among commodities, exemptions of all kinds narrowing the base, "tax war" among the States with bizarre results, cumbrous laws and procedures,thousands of cases pending before the courts - all these surely do not conjure up a comfortable picture of commodity taxation in the country. That taxation cannot be carried on in this way and the system calls for some radical reform will be readily conceded even by congenital sceptics of change. It may still be argued, why go the whole hog towards a destination based VAT to cure these ills? Why not let the States rationalise and simplify their sales tax systems by incorporating the principles of VAT such as by giving credit for tax on purchases, eliminating the exemptions, cutting down the number of rates and harmonising them among themselves by settling for some floor rates but leaving the CST alone? No doubt, changes on these lines would help to improve the current system significantly and cure some of its ills. It must be pointed out however that this is not quite what VAT is all about.

---

* Published in the Economic Times, 8 February 1995.

The superiority of VAT over other forms of indirect taxation lies primarily in two things: one, it provides an instrument of taxing consumption of goods and services in the economy while avoiding needless interference with market forces. Two, it helps to free exports from domestic trade taxes in a way which is not possible otherwise. In short, it ensures neutrality, both internal and external. Additionally, it offers a buoyant but non-distortionary source of revenue for governments by virtue of its wide base and structure. An invoice-operated VAT also aids tax enforcement by providing an audit trail through different stages of production and trade. These are the reasons for which the popularity of VAT has spread so fast across the world including many developing countries.

If, however, the benefits enumerated above are to be reaped, VAT should (i) apply to all goods and services with minimum exclusions, and (ii) adhere strictly to the principle of destination, following, preferably, the tax-credit method whereby exports are easily freed of tax and imports taxed on the same footing as domestic products. These are necessary to ensure that the tax system does not distort resource use or act as a drag on competitiveness and also that revenue goes to the country/state of destination.

In a country where the powers of indirect taxation belong exclusively to the national government, as is common in a unitary polity, the destination rule is relatively simple to implement. The position is different in a federation where the powers are shared among different levels of government. For when commodity taxes are levied at subnational (States) levels, operation of the destination principle requires zero-rating of inter-State sales. This is imperative from the angles of both trade neutrality as well as inter-jurisdictional equity (so that no State treads on the tax space of another). But administratively, zero-rating of inter-State sales poses problems because of the absence of "border control" on the movement of goods across State boundaries. Moreover, where, as in India, taxes on trade are levied at two levels of government, there are intractable problems of "vertical" harmonisation.

For all these reasons China has gone in for a national VAT while reforming its tax system radically last year. Even in a staunchly federal country like Switzerland the people have voted for having a VAT levied at the federal level. In Canada too a national VAT is being seriously talked about to replace the federal Goods and Services Tax and the provincial retail sales

taxes.

A national VAT in place of all major and minor taxes on goods and services would no doubt solve most of our indirect tax problems and rid the system of its inanities. But, given the character of our polity, this option is not open to us. Nor would it be desirable to divest the States of the most potent tax power that our Constitution has vested in them. However, given the will, it is possible to operate a destination-rule VAT within the present constitutional framework. The European Union provides a model. In order to complete the creation of a single market, fiscal frontiers within the Union were abolished in 1993. The destination principle is now operating there through an accounts based system, relying on computerized information.

The degree of sophistication in tax administration required to run such a system is not available in India at present. One has to think of alternatives. As a safeguard against fraud, the recent study of the National Institute of Public Finance and Policy on the issues and options for VAT puts forward a proposal for advance payment of tax by the importing dealer to entitle the vendor in another State to zero-rate his inter-State sales.

Another alternative could be to require inter-state sales between registered dealers to be taxed uniformly at 2 per cent with rebate given by the importing State. Ideally, the revenue should go entirely to the consuming States, that is, the States of destination. However, to create a stake for the States of origin to collect it, one half of the revenue may be allowed to be retained by the exporting State and the other half, pooled for sharing according to some agreed formula. Sales or transfers to unregistered dealers would be taxable at the local rate of the exporting state. This arrangement would have the effect of zero rating (except that a part of the revenue would go to the State of origin) combined with a monitoring mechanism and also obviate the need for any tax on consignments. It might look politically expedient to allow the CST to continue without any set-off to protect the revenue of exporting States but that would be contrary to the principles of VAT even if the ceiling on the tax rate is lowered.

It must be stressed that there can be no real reform of the domestic trade taxes and progress towards a common market in India unless the States stop taxing inter-State trade. There should be a clear recognition on their part of the damage that inter-State trade taxation causes to the economy and the inter-jurisdictional inequity that results from it. No other

country in the world practises such suicidal taxation.

Revenue gain from inter-State sales tax is illusory. For the importing States it is an iniquitous encroachment on their tax room as is evident from the fact that States with only 20 per cent of the population hogs 45 per cent of the revenue from CST. For the States of origin it is essentially tax on exports that inhibits their economic growth and so their tax potential and, in any case, cannot be sustained very long with the opening up of the economy. The question of revenue loss can be tackled by enlarging the tax base of the States as suggested in the NIPFP report. The reforms however should come in a package, balancing the gains and losses. Piecemeal, they may not go far, on the contrary, may block the chances of further movement forward.