Chapter- 1

INTRODUCTION

The idea of Value added taxation (hereinafter referred to as "VAT") traces back to the writing of Von Siemens a German businessman in the 1920s. However, not until 1948, the first value added tax was applied in France. At the beginning, France applied the GNP based VAT[1] covering up to the manufacturing level and subsequently replaced with a consumption VAT[2] in 1954. VAT proves to be an efficient tool for revenue collection; its performance, therefore, has direct impact on fiscal mobilization, macroeconomic stability, and development. Compared with alternatives in indirect taxation, the VAT has revenue potential: it is generally more broad-based and entails a trail of invoices that helps improve tax compliance and enforcement. In view of its numerous benefits, the VAT has become the sales tax of choice in OECD countries[3]. A similar trend is emerging in developing countries, which typically rely more on sales tax than OECD countries. The IMF assesses the growing importance and worldwide expansion of the VAT as follows:

"The VAT has become a key source of government revenue in over 120 countries. About 4 billion people, 70 percent of the world's population, now live in countries with a VAT, and it raises about $18 trillion in tax revenue—roughly one-quarter of all government revenue. Much of the spread of the VAT, moreover, has taken place over the last ten years. From having been largely the preserve of more developed countries in

Europe and Latin America, it has become a pivotal component of the tax systems of both developing and transition economies."

The various kinds of Indirect taxes and duties levied in India, at the state and Central level are illustrated hereunder: Both the Customs and Excise duties are levied and collected by the Central Government. While the Customs duties are levied, collected and retained by the Central Government, the Excise duties are shared by the Central Government with the State Governments. The State sales tax is levied and collected by the states on all intra state transactions. Central Sales Tax is levied by the Central Government and collected by the states and such levy is restricted to interstate sales originating in the concerned state. The former is regulated by the concerned State Sales Tax Act, while the Central Sales Tax is regulated by the Central Sales Tax Act, 1956.[4] In the budget for 2003, the Finance Minister of India, after various rounds of consultation with the states of India, proposed the introduction of VAT in India on a nationwide basis, replacing the State Sales Tax Act (India has 28 states and each state has enacted on sales tax). Broadly stated are the key features of VAT to be introduced in India:

VAT proposed to be introduced in India is a simple and a transparent tax collected on the sale of goods. VAT is to be consumption based and applied on destination principle[5]. Under the consumption type VAT, the base excludes the value of both intermediate inputs and investment items from the gross value of goods and services. The base—as defined—is close to the one in retail sales taxation. VAT computation is to be based on the invoice-based credit method. Under this method, a firm at any stage of the production-distribution chain charges its customers the VAT on its output, submits the tax to the treasury, and then claims for the VAT already paid on its input purchase. The emphasis placed on each transaction means that the evidence for each sale or purchase, the invoice, becomes a crucial document to monitor and administer the VAT.[6] Thus, the burden of VAT is not borne by producers or suppliers of taxable goods or services, but rather by the ultimate consumers thereof. Who is covered by VAT? All business transactions carried on with a state by individuals, partnerships, companies etc. will be covered by VAT. VAT will not cover small businesses with a turnover below a certain limit which will be decided by each state. The turnover limit for eligibility of retailers to opt for payment of tax at compounded rate of tax may be Rs 20-50 lakh (USD 40,000 to 80,000) as may be specified by the respective states.[5] All retail dealers9 with annual turnover above the limit specified will have to pay VAT even if their entire business is in retail. Retail dealers below a threshold limit of annual turnover, as may be specified in the respective State VAT legislation, may opt for payment of tax at a flat rate of 1-2 per cent. The terminology is not uniform in all the States. Presumptive tax, turnover tax or composition of tax has been used to describe the levy of tax on retailers. The `sales' not liable to tax under the VAT Act: Since the VAT Act applies only to sales within a State, the following sales shall not be governed by the VAT Act: a) sale in the course of inter-state trade or commerce which shall continue to be liable to tax under the Central Sales Tax Act, 1956; b)[7] sale which takes place outside the state; and c) sales in the course of export or import.

There are just four rates under VAT - The zero rate (for exports and other essential commodities), 1%10, 4% 11and a general rate of 12.5%. These rates will be uniform in all states across the country. The same set of goods will be charged at the same rates in all states. Most essential commodities are exempt from VAT or fall in the category of 4%. Policy decision has been taken to phase out the Central Sales Tax in 4 year and instead have adoption of uniform classification, etc.

Present situation regarding implementation of VAT in India

In India, states have exclusive domain to legislate with respect to value added taxation. After a broad consensus among the members of the Empowered Committee of the Finance Ministers of the 28 States of India, the April 1, 2003 budget speech of the Finance Minister of India, Mr. Jaswant Singh, announced implementation of Value Added Tax (VAT) all over the country. But many states subsequently dithered due to intense lobbying by the trader community of the respective states. At present, though 16 states of the Union of India have agreed to introduce VAT, the remaining 12 states have not even passed the necessary legislation for introduction of VAT replacing the local laws governing sales tax. Why is there an opposition to VAT in India. There has been opposition to VAT on several grounds. Firstly, the traders lobby is opposed to the introduction of VAT. The traders lobby cites the possibility of harassment by the tax inspectors as the outward reason for their opposition. Under the VAT system, records need to be maintained which according to some trade lobbyists, is very cumbersome and would lead to harassment. Further, the trade lobbyists claim that

VAT is good for manufacturers, but bad for traders. The traders lobbyists contend that the extensive procedural formalities that will have to be followed by traders under the new regime which may result in increased transaction costs. However the real reason is different. There is less scope for tax evasion under VAT and there will be stricter compliance. The traders lobby wants to retain the scope for tax evasion as it exists at present under the sales tax. This being the real underlying reason for their protest there can be no sympathy for their opposition. To exempt small traders from VAT the minimum turnover for VAT has been made Rs.5,00,000. But the traders lobby argues that this limit is too low. Secondly, some businessmen have expressed apprehensions that introduction of VAT would lead to inflation.[8]

Thirdly, some states in India have expressed reluctance to introduce VAT because it would reduce the revenue. The Central Government has acknowledged the possibility of reduction in revenue following substitution of sales tax by VAT and had offered to compensate the states for the revenue reduction for three years. Though initially there might be a fall in the revenue, after a period of time the revenue would be buoyant as the compliance would improve. Further, some politicians are opposed to VAT because it would be a negation of the federal principle as it would concentrate more powers at the Central Government and also because it is being introduced at the behest of the World Trade Organization (“WTO“).

In this way the experiences of the developed and transitional countries with VAT which may provide lessons for effective implementation of VAT in India---Cases in point for developed countries are France and United States; the case in point for the transitional economies is Russian Federation. The VAT in France ---- development and key success lesson: The value added tax (referred to in French as “taxesurla valeur ajoutee” or TVA) was instituted in 1955 and is the principal form of indirect taxation in France. Following are the broad features of the VAT as it exists in France: The rules applicable to French VAT are notably governed by European Union law (Sixth Directive). VAT is consumption based and applied on destination principle; VAT computation: Credit invoice type of VAT is applicable. VAT rate is 19.6%; Territorial Application of VAT in France: Although subject to certain territorial limitations, the scope of the VAT is very broad: it covers all transactions involving an ''economic activity,'' which term is deemed to include not only industrial, commercial and agricultural activities, but also the rendering of professional services and other activities which are classified as civil. Intra-Community Transactions: As a result of the single market which became effective in the EU on January 1, 1993, transfers of goods between EU Member States are no longer considered in terms of importations and exportations, but rather in terms of intra-Community acquisitions and intra-Community deliveries. As a general rule, where goods are sent or transported to France from another EU Member State, the EU seller is deemed to perform an intra-Community delivery which is not subject to VAT in the country of the seller. The French buyer then performs an intra-Community acquisition which is subject to French VAT17. The French buyer may be entitled to claim a VAT credit as a result of such VAT paid, under the normal rules.

The two principal exemptions from VAT relating to certain imported goods, also apply in the case of intra-Community acquisitions.

Where goods are sent or transported from France to another EU Member State, the French seller is deemed to perform an intra-Community delivery which is exonerated from VAT in France. The intra-Community acquisition then performed by the EU buyer is subject to the payment of VAT in the receiving EU Member State. The receiving EU buyer may be entitled to claim a VAT credit as a result of such VAT paid. However, special rules govern ''triangular transactions'' whereby a company located in a given EU Member State sells goods to a company located in another EU Member State, which resells them to a company located in a third EU Member State, the goods being delivered directly from the first state to the third one. In such case, the intermediary company does not need to identify itself in the first or third state, and the final client is subject to VAT on the last sale. Exempt Transactions: The principal activities or persons that are exempted from VAT are: certain insurance, banking and financial activities, certain non-profit activities of non-profit organizations, doctors and other medical professionals, athletes, and lessors of unfurnished premises and certain furnished premises19 In addition, rentals of agricultural land and buildings are exempt from VAT. Goods and services Exonerated from VAT : This category includes, inter alia, those economic activities which relate to foreign commerce, such as international transportation, the exportation of goods, intra-Community delivery, and the rendering of services relating to goods to be exported or goods which are imported pursuant to the temporary admissions procedure.[9]

An examination of the French VAT system provides some key lessons for the success which are illustrated hereunder: Strong political commitment from the government; Careful planning in all stages, from designing to administration; Close cooperation between the business and the government from the embryonic stage of VAT[10]; Public and taxpayers' education; Selection of capable staff for the administration; Adoption of the destination principle VAT as compared to origin principle21. In comparison with the origin principle, where the tax is imposed at the point of production: exports are taxed, but imports are not (tax on production), the destination principle promotes production efficiency—as it puts all firms at different jurisdictions on equal footing: they face the same prices on their input purchase. VAT is consumption based which is more production efficient as it relieves production from tax burden. In addition, as a general consumption tax, the consumption-typed VAT does not distort the investment and saving behavior. The items covered under the exemptions from VAT are limited; Experience of United States Case study of federal form of government like India, not adopting VAT. The United States has debated the possibility of adopting a VAT on numerous occasions. It has been seen as a way to reduce the budget deficit, finance Social Security, replace the corporate and personal income tax, and finance a health scheme or defense. The Congressional Budget Office[11] estimates that in the United States, a 5 percent VAT, if education, financial services, and all medical care are zero-rated, would yield about US$98 billion in 1998 (about 6.3% of revenues) . This yield is much lower than is common in Europe, and it suggests that to make the administrative costs worthwhile (US$1 billion for government and US$6–10 billion compliance costs for business) the rate might have to move toward the typical worldwide rates of VAT (10 to 20%). The Congressional Budget office in its report further states that a federally administered VAT would be supplemental to the existing sales tax typically levied at 4 to 8 %; Despite the benefits of the VAT regime, a reason that this tax has not been adopted in the United States is that the state governments make heavy use of sales taxes to raise revenue, and they fear that the federal government may eventually seriously undermine the abilities of the state governments to raise revenue if it adopts the VAT.[12] They prefer that the federal government stay away from sales taxes and leave sales taxes to the states. As a result, state governors and legislators have strongly lobbied against all proposals for any sort of federal sales tax in the United States. Russian Federation--- failure and success lessons VAT is one of the principal sources of revenue for the Government of Russia, and a cost of doing business there. The broad features of the Russian VAT are illustrated hereunder: The subtraction type VAT is applicable; Under the subtraction type VAT, the tax liability at any stage is equal to the tax rate multiplied by the tax base or value added measured as the difference between the value of the outputs and the inputs; VAT is consumption type and based on destination principle. VAT Rate: For the majority of domestic sales of goods and services in Russia, VAT is levied at rate of 20%. Certain basic food products and children's goods are subject to a reduced rate of 10%. Exempted Goods: Effective January 1, 2001 the list of goods and services exempted from VAT was significantly reduced, compared to previous years. The most significant change has been the abolition of the exemption on the transfer of intellectual property; all taxpayers are allowed to offset immediately VAT included in the costs of capital construction and are not permitted to capitalize such VAT and write it off through depreciation. Further, the mass media concession has been abolished and favorable VAT treatment afforded to healthcare products, goods produced by handicapped persons and some other concessions have been restricted further. The VAT exemption on education services have been restricted only to sales made by non-commercial educational institutions. Only specific "technological equipment and spare parts" contributed to the charter capital of Russian entities is exempt from VAT imposed on imported goods. VAT Exoneration: Services deemed to be supplied outside Russia are outside the scope of VAT with no credit for input tax. Threshold limit for the applicability of VAT: Taxpayers with monthly revenue over RUR 1 million (approx. $ 35,000) are required to pay VAT and file VAT returns on a monthly basis (by the 20th of the following month). Taxpayers with monthly revenue under RUR 1 million are required to file VAT returns and pay VAT quarterly. Small businesses and individual entrepreneurs are exempted from VAT where their tax base is less than 1 million Rubles over the previous quarter.[13]

Benefits of VAT in comparison with other indirect taxes

The present sales taxes regime in India is inherently troublesome in terms of both revenue leakage and economic inefficiency. Further there exists problems of cascading; vertical integration of firms (the present tax system distorts trade and production methods i.e. it induces shifting of production bases and/or changes in the constitution of the entity) and the sales tax regime requiring massive registration. How can VAT address these issues: The VAT is relatively more advantageous than the alternatives, be it turnover tax or single-stage tax. First, the VAT is generally more broad-based (it is extended to cover both goods and services). Second, it is less risky in terms of revenue leakage (the invoice-based credit mechanism in administering the VAT facilitates collection and enforcement; even if revenues are missed in one stage, they are still collected in other stages). The VAT has, therefore, greater revenue potential than its alternatives.[14] Thirdly, VAT would not cause cascading. Also, it provides total transparency of the incidence of tax. This is because, VAT is a multi-stage sales tax levied as a proportion of the value added. It is collected at each stage of the production and distribution process, and in principle, its burden may fall on the final consumer depending upon the elasticity of the demand and supply curves. Further a properly designed system of VAT would not cause vertical integration of firms as it does not distort trade and production methods- i.e. it does not induce shifting of production bases, and / or changes in constitution of the entity. Another feature of VAT regime is discontinuation of the sales tax based incentives to new industrial units. Until now, all the states in India were granting such incentives to new industries in the form of exemption from tax on the purchase of inputs as well as on the sale of finished goods, sales tax loans and/or tax deferral. Further, from the pure economic efficiency perspective, the VAT generates only distortion on the consumption side, whereas single stage tax / tariff induces distortion on both production and consumption sides. The VAT does not have discriminating effect on savings/investment because savings are essentially excluded from the consumption VAT base. The argument of opponents to VAT that significant impact on inflation is clearly misplaced. Experience of countries adopting the VAT such as Russia, indicates that the VAT is not inflationary. If the VAT is revenue-enhancing, it will help the government pursue tight monetary policy by contracting the money supply, the rate of growth of the general price level starts to fall and then the VAT may even exert downward pressure on inflation—in this case, the VAT is deflationary rather than inflationary. However, it is important to note that introduction of VAT during high inflation period tends to reduce the chance for its success. Invoice-based credit VAT, the type of VAT adopted in India is, in principle, self-enforcing and hence a buoyant tax. The description stems from the nature of the invoice-based credit VAT: a taxable business can claim for the refund of the input VAT only if the claim is supported by purchase invoices—the mechanism provides strong incentives for firms to keep invoices of their transactions and is an efficient means for tax authorities to check and cross-check for enforcement enhancement. The experience of the United States has shown it has not been able to adopt a federal VAT. This is primarily because of the following reasons: Assigning the responsibility of implementing- Federal government or the State Governments. Harmonization of tax rates by all the States means that States would lose fiscal autonomy in fixing tax rates (according to the ground realities such as extent of industrialization, development, State's financial position etc.) and be influenced by the need to ensure uniformity with other States in tax rates and policies. The VAT system does not ensure Revenue Neutrality for any state (at least in the initial years) with the result that States look for additional sources of revenue outside the VAT system to compensate for the loss of revenue. This gives place to the existence of VAT-able and Non-VAT-able duties or taxes at the same time. The experiences of various countries have shown that each country has to evolve its own system depending upon the circumstances prevailing in each country. In India, majority of states have realized that there exist more advantages than disadvantages with the introduction of the VAT regime. In a federal set-up like India, uniform VAT rates will eliminate competition among states to offer tax reduction concessions to attract investment and thereby it prevents reduction of revenues. Once VAT is implemented India will become a common market and sales between states will become totally free. Each producer will have a big common market before him. As regards to revenue sharing, I feel that there should be an entire field of commodity taxation to the National Government with a proper revenue sharing arrangement among the states. This approach is likely to reduce the possibility of conflicts among the states.[15]

The VAT in India may become a “money machine,” as the present form presented in the Union Budget for adoption is simple in rate structuring and broad-based. The present VAT rate structure is simply designed as it has only two VAT rates, has few exemptions, and zero rates the exports. Zero-rating or VAT exoneration generally provides strong incentives for frauds, creates excessive burden on tax administration, and effectively erodes the base. This problem can be handled with the appointment of knowledgeable and competent administrative staff to overview the VAT compliance. Two major problems related to exemption deserve special attention. First, exemption may induce cascading effect and hence makes the system economically inefficient. Second, excessive exemption tends to break up the integrity of the VAT regime and hurt its sustainability. As illustrated through the experience of Russia28, the VAT design should, therefore, minimize—to the extent possible—the number of exemptions. The standard advice by the IMF and the World Bank is that the VAT be structured with a single non-zero rate in addition to zero rate exclusively granted to exports, and few selective exemptions. It may be in the interest of the States in India introduce legislation with minimal exemptions and which may probably be limited to hard-to-tax sectors. For example, France and Russia, with an VAT regime, essentially limits the exemption in some form to education, agriculture, health, and financial services. From the economic efficiency perspective, these services (e.g., public health, and education) generate positive externalities and therefore deserve government subsidies—and therefore they should bear no tax burden. Taxing agriculture is an acute issue in India as a large populace is dependent on revenue derived from this sector. Despite tempting rationales—technical, political, and social—for sparing the sector from VAT, the sector, in principle, should be brought into the tax net. Exempting agriculture tends to ratchet up to exemption of agricultural inputs and dwarf the benefits of the zero-rating granted to exports of agricultural commodities. The chain of exemptions leading up to the agricultural sector would be a nightmare for the administration: it is always technically hard to distinguish agricultural from non-agricultural inputs. Rather than exempting agriculture and its inputs, the states of India while enacting on VAT should consider providing selective outright fiscal subsidies to agriculture—if necessary—through public funds. Further, taxing agriculture should be accompanied by setting a reasonable threshold, preferably the same as the one applied in other sectors, in order to maintain a manageable number of taxpayers in the net. Further, exemptions from VAT can be limited to critical and pure-for-agriculture inputs such as fertilizer and seeds. India has set a relatively high threshold level at the beginning—to accommodate the poor tax administration in the initial stage and to quench the nervousness of the public, when the tax is first announced—the aim being to lower the threshold when administration gets improved and the public becomes familiar with the new tax regime. This methodology is useful for successful implementation of VAT.

That the VAT is inherently regressive has long been widely held. This is true, if regressivity is defined conventionally on the basis of the tax burden-to-annual gross income ratio. To reduce regressivity, many countries attempt to incorporate in the VAT structure multiple exemptions and/or zero rates. The provisions prove ineffective, however, and yet costly in terms of revenue loss and administration complexity. It is critical that regressivity be studied in an overall context of the applicable fiscal policies including direct, indirect taxes, and public expenditures. The policy makers responsible for introduction of VAT regime in India may need to examine and return to VAT's main purpose (i.e., collecting revenues effectively and efficiently), to strengthen income taxes, and to rationalize pro-poor public expenditures. Regressivity can be addressed more effectively with sound income taxation and government expenditures. There could be cases where the VAT is collected by the dealer, but not paid to the Government. As a result, the set off of such VAT paid by the purchaser may not be allowed to the purchasers. A mechanism has to be devised to tackle such situations. A situation of refund would arise if no VAT is payable on the final sale. As a result, the set off cannot be availed. In such cases, the tax paid becomes the cost or the same has to be claimed as refund. If refunds get delayed—they become “hidden costs” to firms and hurt their financial cash flow. On the other hand, frauds, in various shapes forms, are widespread. Good cooperation between tax and customs agencies would be essential for identifying any unjustified refund claims. In addition, the tax regime should set transparent, severe penalty for refund fraud, specify mandatory time limit for refund processing, and impose interest on the part of refunds outstanding beyond the established mandatory time limit. The establishment of processing time period is critical to protect firms’ cash flow and to avoid abuse by the tax administration. Hence, the mechanism of refund has to be framed. Further, since Central Sales Tax Act (CST) continues to remain in force in India, there can be conflict between the VAT and CST and therefore the VAT council, in charge with the governance of VAT regime in India would need to devise a mechanism to limit the possibility of conflict between the two applicable legislations. An increasing number of countries around the world have switched from various types of consumption tax to the VAT. This trend has set its footprint in almost all recent comprehensive tax reforms. The common form of VAT is consumption-typed, and applied on destination principle with invoice-based credit method. The proposed model of VAT introduced in India incorporates the aforementioned three features of

VAT. Experiences of other countries have shown that for a VAT regime to be successful—apart from being well designed, carefully prepared (from both administration's and taxpayers' perspectives)—the VAT should be introduced in good timing. Therefore, it is essential that VAT should be introduced by all the States in India collectively at a time when the inflation in the economy is low33. Further, the need is for close cooperation between businesses and government from the embryonic stage of VAT and selection of capable staff for the administration. Last but not the least, public and taxpayers' education will play a pivotal role in the success of the VAT regime. With a strong political commitment from the governments at the State level to introduce VAT, India will surely derive benefits from the VAT regime.

The decision to introduce VAT was publicly discussed first at a conference of state chief ministers and finance ministers in November 1999. At that time, the deadline of April 2002 was agreed upon to bring in VAT. However political instability and a lack of initiative pushed this reform to the backburner. Now a year later, despite a backlash from the trading community and some political circles, there appears to be a realistic scope for VAT to be introduced. Twelve states have so far passed legislation to implement the VAT regime and of these five have sent their Bills for Presidential assent. Let us explore VAT and what it means.

What is VAT and why is it so critical?

VAT is a sales tax collected by the government (of the state in which the final consumer is located) – which is the government of destination state on consumer expenditure. Over 120 countries worldwide have introduced VAT over the past three decades and India is amongst the last few to introduce it. India already has a system of sales tax collection wherein the tax is collected at one point (first/last) from the transactions involving the sale of goods. VAT would, however, be collected in stages (instalments) from one stage to another. The mechanism of VAT is such that, for goods that are imported and consumed in a particular state, the first seller pays the first point tax, and the next seller pays tax only on the value-addition done – leading to a total tax burden exactly equal to the last point tax.

Why VAT is necessary

India, particularly the trading community, has believed in accepting and adopting loopholes in any system administered by the state or the Centre. If a well-administered system comes in, it will close avenues for traders and businessmen to evade paying taxes. They will also be compelled to keep proper records of their sales and purchases. Many sections hold the view that the trading community has been amongst the biggest offenders when it comes to evading taxes. Under the VAT system, no exemptions will be given and a tax will be levied at each stage of manufacture of a product. At each stage of value-addition, the tax levied on the inputs can be claimed back from the tax authorities. At a macro level, there are two issues, which make the introduction of VAT critical for India. Industry watchers say that the VAT system, if enforced properly, forms part of the fiscal consolidation strategy for the country. It could, in fact, help address the fiscal deficit problem and the revenues estimated to be collected could actually mean lowering of the fiscal deficit burden for the government. The International Monetary Fund, in its semi-annual World Economic Outlook released on April 9, expressed its concern over India's large fiscal deficit – at 10 per cent of the GDP. Further any globally accepted tax administrative system, will only help India integrate better in the World Trade Organisation regime.

Retail community protests

Small businessmen and traders are likely to be badly hit by the new system as many of them have used loopholes in the current system to avoid paying taxes. A section of the retail community went on strike last week stating that some anomalies linked to the proposed VAT system have not been addressed. A high-power committee, including senior state finance ministers, had pointed out the anomaly to the government last year. "However, the Centre continues to ignore the suggestions and this makes our situation only more difficult," a member of the retailers' association in Mumbai says. Sources in the sales tax department say that some issues will need to be ironed out in coming months. "The government is looking at the whole issue through a single dimension (of collecting revenues). The retail community will be hit by the multipoint VAT system. This is a complex system and may create more confusion."[16]

No extra paperwork for retailers

There are, however, sections of the VAT system which ensure lesser paperwork for the retail community. There will be no local statutory forms under VAT. The existing sales tax system requires dealers to maintain an account of sales and purchases, and the VAT system also requires maintenance of only such accounts. Further, the Central Sales Tax Act would be amended and there would be a single-page return form common for local and central Acts. The return would be required to be filed quarterly, as is being done currently.

Some states against VAT

Since large sections of the trading community have protested against VAT, both the Bharatiya Janata Party and the Congress have not made any categorical statements for or against VAT. Instead they have tried to befriend the trading community. The BJP has always been seen as supportive of the cause of the trading community at large. The ruling government has very effectively pushed the onus of responsibility onto the state governments (as it is a state-related issue). Further, each party sings a different tune in different states. VAT would mean higher revenues to the financially hit states in the country. It would also mean less tax evasion and more earning for the states. But, no political party can afford to ignore the agitating trading community, which becomes a vexed issue for the political parties. This directive codifies the provisions implementing the common system of VAT, which applies to the production and distribution of goods and services bought and sold for consumption within the European Union (EU). To ensure that the tax is neutral in impact, irrespective of the number of transactions, taxable persons for VAT may deduct from their VAT account the amount of tax which they have paid to other taxable persons. VAT is finally borne by the final consumer in the form of a percentage addition to the final price of the goods or services.

Value added tax (VAT) is a general tax on consumption applied to commercial activities involving the production and distribution of goods and the provision of services. This VAT Directive codifies the provisions governing the introduction of the common system of VAT in the European Union (EU). The common system of VAT applies to goods and services bought and sold for consumption within the EU. The tax is calculated on the basis of the value added to goods and services at each stage of production and of the distribution chain. The tax is collected through a system of partial payments which allows taxable persons (firms identified for VAT) to deduct from their VAT accounts the amount of tax which they have paid to other taxable persons on their purchases for commercial purposes during the preceding stage. This mechanism means that the tax is neutral, irrespective of the number of transactions. In the end, VAT is borne by the final consumer in the form of a percentage addition to the final price of the goods or services. This final price is the total of the value added at each stage of production and distribution. The supplier of goods or services (the taxable person) pays the VAT paid on the goods or services to the national tax administration after deducting the VAT already paid to his suppliers.[17]

Transactions carried out for consideration on the territory of an EU country by a taxable person acting in that capacity are subject to VAT. Imports by any person are also subject to VAT.

Taxable transactions include:

- supplies of goods by a taxable person;
- intra-EU acquisitions in an EU country of goods from another EU country;
- supplies of services by a taxable person;
- imports of goods from outside the EU (a third territory * or a non-EU country).[18]

An intra-EU acquisition of goods occurs only when goods are transported from one EU country to another. It occurs when goods sold by a taxable person in the EU country of departure are purchased in another EU country (of arrival) by a taxable person acting in that capacity or by a non-taxable legal person. It also occurs in the case of new means of transport * and of products subject to excise * duty purchased by other persons. If the total amount of intra-EU acquisitions of goods by non-taxable legal persons and certain categories of exempt taxable persons does not exceed a minimum threshold of EUR 10 000 per year, these acquisitions are subject to VAT only if the purchaser decides to register. Intra-EU acquisitions of second-hand goods, works of art, collectors' items and antiques are not subject to VAT when the vendor is a taxable dealer or an organiser of sales by public auction who has paid the tax on these goods by using the special scheme of taxation of the profit margin. EU VAT does not apply in the following third territories: the Island of Heligoland, the territory of Büsingen, Ceuta, Melilla, Livigno, Campione d'Italia and the Italian waters of Lake Lugano (territories which do not form part of the EU customs territory); Mount Athos, the Canary Islands, the French overseas departments, the Åland Islands and the Channel Islands (territories which form part of the EU customs territory). In accordance with the Treaty, VAT also does not apply in Gibraltar or the part of Cyprus which is not under the effective control of the government of the Republic of Cyprus. These regions are treated as third territories. Since the Principality of Monaco, the Isle of Man and the United Kingdom's sovereign base areas of Akrotiri and Dhekelia are not regarded as non-EU countries, VAT applies there. A taxable person is a person who, independently, carries out in any place any economic activity, whatever the purpose or results of that activity. Economic activity includes any activity of producers, traders or persons supplying services, including mining and agricultural activities and activities of the professions. To the extent that they are bound to their employer by a contract of employment or by any other legal ties creating the relationship of employer and employee, the activities of salaried and other persons are not regarded as being carried out independently. Any person who, on an occasional basis, supplies a new means of transport transported to another EU country is also regarded as a taxable person. An EU country may also regard as a taxable person anyone who carries out, on an occasional basis, an operation relating to an economic activity and, in particular, the supply, before first occupation, of a building or part of a building and of the land on which the building stands or the supply of building land. States, regional and local government authorities and other bodies governed by public law are not regarded as taxable persons in respect of the activities or transactions in which they engage as public authorities, except where their treatment as non-taxable persons would lead to significant distortions of competition. When they carry out certain commercial operations, such bodies are nevertheless taxable persons. The supply of goods is the transfer of the right to dispose of tangible property as owner. Any transaction which does not constitute a supply of goods constitutes a supply of services. The intra-EU acquisition of goods is the acquisition of the right to dispose as owner of movable tangible property transported to the person acquiring the goods in another EU country. The importation of goods is the entry into the EU of goods which are not in free circulation. The entry of goods which are in free circulation from a third territory is also an importation. The place of a supply of goods is: the location of the goods at the time of supply (where the goods are not dispatched or transported); the location of the goods at the time when dispatch or transport to the customer begins (where the goods are dispatched or transported); the place of departure of the passenger transport operation (where the goods are sold on board ships, aircraft or trains); the place where the customer is located (in the case of the supply of gas through a natural gas system within the EU or any network connected to such a system, the supply of electricity or the supply of heat or cooling energy through heating or cooling networks).

The place of an intra-EU acquisition of goods is deemed to be the place where transport of the goods to the person acquiring them ends. The place of supply of services to taxable persons is deemed to be the place where the customer has established his business or, if provided to a fixed establishment that the customer has elsewhere, the place where that fixed establishment is located or, in the absence of any establishment the place where the customer has his permanent address or usually resides. The place of supply of services to non-taxable persons is deemed to be the place where the supplier has established his business or, if provided from a fixed establishment that the supplier has elsewhere, the place where that fixed establishment is located or, in the absence of any establishment, the place where the supplier has his permanent address or usually resides. There are, however, some exceptions to these general rules. The services concerned include those connected with immovable property, passenger transport and transport of goods, those relating to activities relating to culture, art, sport, science, education and entertainment, those of restaurant and catering services and those of short-term hiring of means of transport. The main purpose of these exceptions is to ensure that the service is taxed at the place where it is actually consumed.

In relations with non-EU countries, to avoid double taxation, non-taxation or the distortion of competition, the EU countries may consider: the place of supply of certain services situated within their territory as being situated outside the EU, if effective use and enjoyment takes place outside the EU; the place of supply of certain services situated outside the EU as being situated within the EU country, if effective use and enjoyment takes place within their territory. The place of importation of goods is the EU country where the goods are located when they enter the EU.

Chargeable event and chargeability of VAT

Except in a number of specifically listed cases, the chargeable event * for tax occurs and tax becomes chargeable * when the goods or services are provided. In the case of intra-EU acquisition of goods, the chargeable event occurs when the acquisition is made and the tax becomes chargeable on the 15th day of the month following the acquisition. However, if an invoice is issued before that date, the tax becomes chargeable on the date the invoice is issued. However, from 1 January 2013, when Directive 2010/45/EU comes into force, VAT shall become chargeable on issue of the invoice, or on expiry of the time limit referred to in Article 222 of this directive if no invoice has been issued by that time. In the case of the importation of goods, the chargeable event occurs and tax becomes chargeable when the goods are introduced into an EU country.

Taxable amount

In respect of the supply of goods and services and the intra-EU acquisition of goods, the taxable amount includes everything which constitutes consideration obtained by the supplier for transactions by the customer. This includes subsidies directly linked to the price of these transactions. The amount also includes taxes, duties, levies and charges (excluding the VAT itself) and incidental expenses charged by the supplier to the customer but excludes certain price reductions, rebates and price discounts and repayments of expenses incurred. In the case of importations of goods, the taxable amount is the value for customs purposes. It includes taxes, duties, levies and other charges due outside the EU country of importation, and those due by reason of the importation (excluding the VAT itself) and incidental expenses (packing, transport, etc.).

Rates of VAT

Taxable transactions are taxed at the rates and under the conditions set by the EU country where they take place. The standard rate of VAT is set as a percentage of the taxable amount which, until 31 December 2015, may not be less than 15 %. EU countries may apply one or two reduced rates of not less than 5 %. The reduced rates may only be applied to supplies of goods and services in the categories listed in Annex III to the VAT Directive (as last amended by Directive 2009/47/EC).[19] The EU countries may also, after consultation of the VAT Committee, apply a reduced rate to supplies of natural gas, electricity and district heating. Finally, by way of derogation from the normal rules, certain EU countries have been authorised to maintain reduced rates, including those lower than the minimum, or zero rates, in certain areas. Some of these derogations provided for in the act of accession of the ten countries which joined the EU on 1 May 2004 only applied until 31 December 2010.[20] Others have been extended or incorporated into the general rules by Directive 2009/47/EC.

Exemptions

Goods and services which are exempt from VAT are sold to the final consumer without VAT applying to the sale. However, where the supply of goods or services is exempt, the supplier may not deduct the VAT on purchases. Such exemption without a right to deduct means that 'hidden' VAT remains included in the price paid by the consumer. This exemption should be clearly distinguished from a zero rate of VAT which certain EU countries have a derogation to retain and which means that the final price to the consumer includes no residual VAT. There are also exemptions with a right to deduct whose main aim is to take into account the place where the goods or services are deemed to have been consumed and so taxed: these transactions are relieved of all VAT in their EU country of origin because they will be taxed in the country of destination.

Exemptions without a right to deduct

For socio-economic reasons, the following are exempted:

Certain activities of general interest (such as hospital and medical care, goods and services linked to welfare and social security work, school and university education and certain cultural services); certain transactions including insurance, the granting of credit, certain banking services, supplies of postage stamps, lotteries and gambling and certain supplies of immovable property.

To facilitate trade, certain importations of goods from outside the EU are exempt. These include the final importation of goods the supply of which is exempt in the EU country of importation and goods the final importation of which is governed by Directives 2007/74/EC (goods carried in travellers' luggage), 2009/132/EC (goods imported for non-commercial purposes) and 2006/79/EC (small consignments of goods of a non-commercial character).

Exemptions with a right to deduct

To take account of the place where goods and services are deemed to have been consumed and hence taxed, the following transactions are exempt with a right to deduct: intra-EU supplies of goods, including new means of transport and products subject to excise duty dispatched from one EU country to another; exports of goods from the EU to a third territory or a non-EU country; certain transactions relating to international transport or treated as exports; supplies of services by intermediaries when they take part in transactions relating to exports; certain transactions relating to international trade, such as those concerning customs warehouses and other warehouses.

A taxable person who purchases goods or services has the right to deduct the amount of the VAT in the EU country where these transactions are carried out if the goods and services are used for his professional economic activity. A taxable person who has paid VAT in an EU country where s/he is not established may secure reimbursement through a special electronic procedure. There is no right to deduct in the case of an exempt economic activity or if the taxable person qualifies for a special scheme (e.g. exemption from VAT for small firms). In certain cases deductions may be limited or adjusted. To exercise the deduction requires certain conditions to be fulfilled, particularly the obligation to hold an invoice.

Obligations of taxable persons and certain non-taxable persons

VAT is payable:

By any taxable person carrying out a taxable supply of goods or services, except in certain specific cases where the tax is payable by another person, particularly a customer using the reverse charge procedure; by the person making an intra-EU acquisition of taxable goods; on an importation by the person designated or recognised as liable by the EU country of importation. A taxable person must state when his activity as a taxable person commences, changes or ceases and must keep sufficiently detailed records. A taxable person must ensure that a sufficiently detailed invoice is issued for goods and services which s/he supplies to another taxable person or a non-taxable legal person. An invoice must also be issued in certain other cases. Under certain conditions, EU countries may be authorised to introduce derogations to simplify the collection of VAT or to avoid certain tax fraud or evasion.[21]

There are special VAT schemes for:

- small firms;
- farmers (common flat-rate scheme);
- second-hand goods, works of art, collectors' items and antiques;
- investment gold;
- travel agents;
- electronically supplied services.

Some VAT schemes concern not only economic operators directly but also private persons and final consumers. This is the case for example where a private person buys goods in another EU country. When the consumer takes the goods home him-/herself, VAT is paid in the EU country where they were sold and bought (i.e. at their origin). Some exempt taxable persons and non-taxable legal persons also have the right to acquire a limited quantity of goods in another EU country as a result of the rules governing the taxation of trade between the EU countries. For those persons, the scheme is already based on the principle of taxation in the EU country of origin of the goods and services supplied (see end of this summary). However, the origin principle does not apply when the goods are sold at a distance, i.e. when the purchaser and the seller are in different EU countries and the goods are being dispatched. If the value of goods sold on an annual basis exceeds a certain threshold (EUR 35 000 or EUR 100 000 depending on the EU country), the supplier must apply the destination principle, and must do so in any event in the case of distance sales of products subject to excise duty. Under this principle, the supplier accounts for VAT in the EU country of destination at the rate applicable there. The origin principle does not apply when new means of transport are bought in another EU country. In that case, the purchaser pays the VAT in the EU country of destination.

Tax evasion obstructs the functioning of the internal market by creating unjustified flows of goods and by allowing goods to be placed on the market at abnormally low prices. To combat this scourge, Directive 2008/117/EC introduces the following measures:

The establishment of a one-month deadline for information on intra-EU supplies of goods; the introduction of the same tax period for both the supplier and the purchaser or customer in the context of intra-EU transactions; the reduction of administrative burdens; an authorisation for operators to submit on a quarterly basis the recapitulative statements concerning intra-EU supplies of goods. This VAT Directive is a recast of the Sixth Directive 77/388/EEC[22] on the common system of value added tax and the uniform basis for assessment which has been amended more than thirty times since it was adopted. It codifies the provisions of Directive 77/388/EEC from 1 January 2007 without altering the substance of the legislation in force. Third territories: territories forming part of an EU country but regarded for VAT purposes as lying outside the EU.

New means of transport:

Land vehicles the capacity of which exceeds 48 cubic centimetres or the power of which exceeds 7.2 kilowatts, where the supply takes place within six months of the date of first entry into service or where the vehicle has travelled for no more than 6 000 kilometres; vessels exceeding 7.5 metres in length (with the exception of vessels used for navigation on the high seas and carrying passengers for reward, and of vessels[23] used for the purposes of commercial, industrial or fishing activities, or for rescue or assistance at sea, or for inshore fishing), where the supply takes place within three months of the date of first entry into service or where the vessel has sailed for no more than 100 hours; aircraft the take-off weight of which exceeds 1550 kilograms (with the exception of aircraft used by airlines operating for reward chiefly on international routes), where the supply takes place within three months of the date of first entry into service or where the aircraft has flown for no more than 40 hours. Products subject to excise duty: energy products, alcohol and alcoholic beverages and manufactured tobacco, as defined by current EU legislation, but not gas supplied through a natural gas system situated within the territory of the EU or any network connected to such a system. Chargeable event: the occurrence by virtue of which the legal conditions necessary for VAT to become chargeable are fulfilled. Chargeability of VAT: when the tax authority becomes entitled under the law, at a given moment, to claim the tax from the person liable to pay, even though the time for payment may be deferred.

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Chapter- 2

VAT System

Value-Added Tax, one of the most radical reforms to be proposed for the Indian economy, could finally become a reality after four years of political and economic debate. Yet, the biggest hurdle before the government is not making India 'a common market' through a uniform sales tax structure, but removing a complicated tax structure that also allowed for fraudulent practices. The decision to introduce VAT was publicly discussed first at a conference of state chief ministers and finance ministers in November 1999. At that time, the deadline of April 2002 was agreed upon to bring in VAT. However political instability and a lack of initiative pushed this reform to the backburner. Now a year later, despite a backlash from the trading community and some political circles, there appears to be a realistic scope for VAT to be introduced. Twelve states have so far passed legislation to implement the VAT regime and of these five have sent their Bills for Presidential assent. Let us explore VAT and what it means.

VAT is a sales tax collected by the government (of the state in which the final consumer is located) – which is the government of destination state on consumer expenditure. Over 120 countries worldwide have introduced VAT over the past three decades and India is amongst the last few to introduce it. India already has a system of sales tax collection wherein the tax is collected at one point (first/last) from the transactions involving the sale of goods. VAT would, however, be collected in stages (instalments) from one stage to another. The mechanism of VAT is such that, for goods that are imported and consumed in a particular state, the first seller pays the first point tax, and the next seller pays tax only on the value-addition done – leading to a total tax burden exactly equal to the last point tax.[1]

India, particularly the trading community, has believed in accepting and adopting loopholes in any system administered by the state or the Centre. If a well-administered system comes in, it will close avenues for traders and businessmen to evade paying taxes. They will also be compelled to keep proper records of their sales and purchases. Many sections hold the view that the trading community has been amongst the biggest offenders when it comes to evading taxes. Under the VAT system, no exemptions will be given and a tax will be levied at each stage of manufacture of a product. At each stage of value-addition, the tax levied on the inputs can be claimed back from the tax authorities. At a macro level, there are two issues, which make the introduction of VAT critical for India. Industry watchers say that the VAT system, if enforced properly, forms part of the fiscal consolidation strategy for the country. It could, in fact, help address the fiscal deficit problem and the revenues estimated to be collected could actually mean lowering of the fiscal deficit burden for the government. The International Monetary Fund, in its semi-annual World Economic Outlook released on April 9, expressed its concern over India's large fiscal deficit – at 10 per cent of the GDP. Further any globally accepted tax administrative system, will only help India integrate better in the World Trade Organisation regime.

Small businessmen and traders are likely to be badly hit by the new system as many of them have used loopholes in the current system to avoid paying taxes. A section of the retail community went on strike last week stating that some anomalies linked to the proposed VAT system have not been addressed. A high-power committee, including senior state finance ministers, had pointed out the anomaly to the government last year. "However, the Centre continues to ignore the suggestions and this makes our situation only more difficult," a member of the retailers' association in Mumbai says. Sources in the sales tax department say that some issues will need to be ironed out in coming months. "The government is looking at the whole issue through a single dimension (of collecting revenues). The retail community will be hit by the multipoint VAT system. This is a complex system and may create more confusion," he said. There are, however, sections of the VAT system which ensure lesser paperwork for the retail community. There will be no local statutory forms under VAT. The existing sales tax system requires dealers to maintain an account of sales and purchases, and the VAT system also requires maintenance of only such accounts. Further, the Central Sales Tax Act would be amended and there would be a single-page return form common for local and central Acts. The return would be required to be filed quarterly, as is being done currently.

Various options discussed in the foregoing chapter suggest that in the short run it would be useful to follow a system of dual VAT. In the long run, however, it would be beneficial to have a system of comprehensive state VAT.

In view of the fact that the present policy of the government is to follow a system of dual VAT —Central VAT to be levied by the Central Government and State-VAT by the state governments, this chapter analyses the revenue implications of adopting dual VAT in India. This is basically a short-term measure for VAT implementation. The following section attempts to analyze how long-term reforms could help in harmonizing commodity taxes.

Central VAT

As a first step in the introduction of dual VAT, a central VAT was put in place of the then existing union excise duty (UED). In this context, a beginning was made by the central government, as far back as in 1986, when it introduced the principles of VAT in its UED, through modified value added tax (Modvat). This provided set-off in UED for taxes on inputs, as given in Chapter 3. It was initially for a select number of commodities but over time, the base of Modvat was extended to more commodities. Finally, it covered almost all commodities except high-speed diesel, motor spirit (gasoline) and matches. Modvat has now been replaced by a Central VAT (known as CenVAT).

Despite all efforts of the central government in introducing a CenVAT, at the state level, the states continue to levy a first-point sales tax, as explained in chapter 4. Bihar is the only state that has introduced State-VAT to replace its sales tax with effect from April 2003.[2]

To follow the model of dual VAT, it is important that sales tax, a state levy characterised by a large number of weaknesses, is also converted into a system of state VAT. Sales tax tends to distort the pattern of production and trade thereby adding to transaction costs and inefficiency.

Efforts have been made in the past several years to replace sales tax with VAT. The Committees of States' Finance Ministers (1995 and 1998, respectively) and the Committee of Chief Ministers (1999) have put forth recommendations to replace sales tax with VAT. The Conference of Chief Ministers and Finance Ministers ratified this in November 1999 and resolved to introduce some major reforms.

The first reform relates to the adoption of a four-rate structure (*i.e.*, zero, 4, 8 and 12%) in the existing sales tax. In addition, there are two special rates of 1% and 20% for a few specific items. The recommended rates are floor rates – the States have the freedom to adopt a higher rate on any of the commodities from the list, but they should not fix tax rates below these rates. This helps checking rate war and prevents diversion of trade. However, when the States started implementing the four-rate categories many of them found it difficult to follow these rates. Either the classification had some ambiguity or there were administrative difficulties in implementing the floor rates. Hence, the Committee of Finance Ministers made a few changes in the items falling under the exemption list and in other categories. The Committee had pointed out that problems could arise. The *Report of the Finance Ministers Committee (1995)* emphasized that "*fine tuning of this classification would have to be done by a special group*". The Empowered Committee has now come up with three rate categories of zero percent, 4% and a revenue neutral rate

(RNR)[3] of 12.5% (replacing the initial four rates structure) for VAT implementation in all the States.

The second reform pertains to the abolition of sales tax-related incentives. In the past, all the States granted such incentives to new industries. These were given in the form of exemption from sales tax on the purchase of inputs as well as on the sale of finished goods. Incentives were also available in the form of sales tax loans and/or tax deferral. Various studies and committee reports have argued against such incentives. In terms of loss of revenue, all the States put together forgo about 25% of the sales tax base due to these incentives. In addition, the incentives promote tax competition (war) or *harmful tax practices.* In view of this, all the new units that are likely to come up will now not be given any sales tax-related incentive. The States will find it convenient to adopt VAT, once these reforms are implemented.

While considerable efforts have already been made for the introduction of VAT, the States are apprehensive of losing revenue if sales tax is converted into VAT. The possible loss of revenue and various political factors are the reasons why the introduction of VAT has been postponed. It is important that to enable the states to implement state-VAT, the Twelfth Finance Commission (TFC) takes this into account while making its recommendations.

To estimate the revenue implications of introducing State-VAT under the umbrella of dual VAT, it is vital to note that the existing sales tax yields revenue from different components of sales tax, *viz.,* state sales tax (popularly known as GST) levied on intrastate transactions, motor spirit taxation (MST) levied on petroleum products-- sometimes levied under a separate enactment, purchase tax on sugarcane, additional sales tax, surcharge on sales tax and central sales tax (CST) levied on interstate transactions. The revenue implications on components concerning intrastate transactions and those related to interstate transactions would be different.

Revenue implications could be estimated through the following three approaches:

(a) Consumption approach,

(b) Turnover approach and

(c) Revenue approach.

Consumption approach estimates the exact tax yield in any state because the tax basically falls only on final consumption. Unfortunately, the data on consumption available from the NSS are not suited to meet this requirement because the break up of consumption is not available according to rate categories. The methodology used for the collection of data is also not very sound. Hence, use of these data for revenue estimates may not yield reliable results. In addition, using these data would give inflated estimates of the tax revenue of states, given the volume of existing tax evasion in the system.

Tax turnover method is more appropriate. This method can estimate the exact revenue loss in any state, provided the state has the requisite management information system to collect revenue and turnover statistics according to commodity classification. Efforts in this direction have already been made to estimate revenue implications for some select states. However, in view of the time constraint in collecting data from each state, this method could not be used in this study.

Revenue approach is based on the published data available from the RBI and data that were made available by some of the states. In this context, all the states were requested to supply data specifically related to a few components of revenue. Wherever the required data were not made available, estimated ratios were applied to the revenue base of different states. In this study, revenue approach is the method adopted and the estimation is based on the following formula:[4]

EVR=[{ST-(CST+MST+ICgst+ICcst)}+{(ABvat+SRvat+RRvat+ADLSvat)+MST}]

Where

- EVR = Estimated VAT revenue,
- ST = total sales tax revenue
- CST= central sales tax,
- MST= revenue from petroleum including petrol and diesel,
- ICgst= input credit due to manufacturers,
- ICcst= input credit due to exports out of state,
- ABvat= additional base due to VAT,
- SRvat=additional base due to service taxation given to the states,
- RRvat=additional base due to rate rationalization,
- ADLSvat=additional base due to taxation of additional excise duty items.

Following the revenue approach, this study presents estimates of loss of revenue for the year 2001-02 (RE), using revenue data in the state budgets.

To find out revenue implications of VAT implementation certain adjustments have to be made, as the new system will bring basic changes in the tax system. Adjustments required are related to CST treatment, MST to be deducted from VAT, input credit treatment for intrastate and interstate transactions, additional tax base due to VAT and services to be included in the tax base. Each one of these are analysed in the following segment.

Since CST is levied by the exporting state on the basis of 'origin', when goods are sold to another state, the revenue collected from the tax is at present being retained by the exporting state and is a substantial amount in most of the states. As shown in column 2, Table 7.1, it varies from 10 to 38 percent of sales tax revenue. While converting existing sales tax into VAT, which is truly a destination based tax, the incidence of CST has to be reduced to zero. When CST becomes zero, the revenue so collected by the exporting states then vanishes. Hence, the net tax revenue of the exporting states would be less, as shown in column 3 of Table 7.1. The net tax revenue .

Steps in Estimating Revenue Implications for Introduction of VAT

Total State Sales Tax Revenue
Minus
Central Sales Tax
Equals
Sales Tax Revenue from Intrastate Transactions (GST)
Minus
Revenue from Petrol and Diesel
Minus
Input tax Credit to Manufacturers
Minus
Input Tax Credit due to Insterstate Transactions
Equals
VAT Base of Existing GST
Plus
Revenue gain from capturing value added by the wholesalers and retailers
Plus
Base broadening due to Taxation of Services
Equals
VAT Revenue with Existing Rates
Plus
Base broadening due to Rate rationalization
Plus
Broadening of tax base due to better administration
Plus
VAT Revenue on sugar, textiles and tobacco
Plus
Revenue from Petrol and Diesel
Equals
Tax revenue Under VAT

is obtained by deducting CST revenue from the total sales tax revenue. The states would, therefore, have to raise additional resources or the TFC will have to compensate the states for this loss.

As suggested by the Empowered Committee of States Finance Ministers, the design of VAT that is being adopted by the states is such that revenue from diesel and petrol (referred to as revenue from MST) would not be covered under VAT. The revenue from these items would be collected through first-point sales tax as is done at present and no set-off on tax paid on these inputs would be provided, even when sales tax is converted into VAT. Hence for estimating revenue implications of VAT, revenue from these items has been excluded. The GST revenue of the states, net of CST as well as MST, is shown in column 5 in Tables 7.1 through 7.3. It indicates revenue realized by the states if VAT is implemented.[5]

The existing sales tax revenue collected from general sales tax (GST) of the state is inclusive of sales tax on inputs including raw materials, intermediary goods and capital goods used in the process of manufacture. Under VAT regime, however, tax is effectively levied only on final goods. All taxes levied on inputs will get set off. Hence, the value of inputs embedded in taxable intrastate turnover has to be estimated and subtracted to derive net VAT yield.

This is estimated by employing input-output model where the inter-industry demand (IID) is given as:

$$IID = \sum_{i=1}^{n} a_{ij} X_j$$

Where

a_{ij} = the input-output coefficient indicating the input of i^{th} commodity per unit of output of the j^{th} product; and

X_j = the total output of the j^{th} product.

In matrix form it can be expressed as

$IID = AX$

i.e. the coefficient matrix A is post multiplied by the vector X to obtain the IID for the State.[6]

To estimate set-off for inputs for each of the states, it would be most appropriate to use states' input-output table. However, such tables for each of the States, prepared on any uniform method, are not available. Hence, we have used the all-India input-output ratio for taxable commodities as per the latest input-output matrix available for 1993-94. On this basis we have arrived at input-output ratio of 50 percent. Many states have announced concessional tax rates on inputs, in this study the rate of input tax is assumed to be 4 percent in all the states. Accordingly, 20 percent (4% applied to the input-output proportion of 50%) of sales tax revenue is treated as input credit. To obtain tax revenue net of input tax, this component has been deducted from the total sales tax revenue net of CST as well as MST.

Another effect of introducing destination based VAT would be to give set-off for the taxes already levied and collected by the states, on all those transactions that enter into interstate trade. That is, in addition to not collecting any revenue from CST, the exporting states would have to give set-off for the taxes already collected in earlier transactions on inputs, raw materials, intermediate goods, and on finished goods prior to their export out of the state. This would further reduce the states' revenue from interstate transaction, through 7.3. Deducting this, as well as the input credit due to manufacturer, shown in column 6 from the GST net of CST and MST (column 5), we get the VAT base of existing GST.

Adoption of VAT would mean that the base of the tax would include not only the value at the manufacturing stage, as under the first-point tax, but also the entire value added to commodities, right down to the retail level. Hence, VAT would yield in the medium term much higher revenue than the first-point tax. Further, the introduction of VAT would also bring down under valuation at the manufacturing stage considerably. Although the last-point would be defined in terms of exemption threshold, it would certainly increase the base of the tax. To be conservative, one could take estimates for value addition by wholesalers and retailers, on the basis of data available from the *Directory of Trade Establishments* or of trade margins from *Sarvekshan* (Table 7.5). Both these sources indicate considerable increase in the base.

Taxation provisions of “declared goods” under the CST Act has already been amended to allow the states to levy tax on additional points, as compared to the earlier system of allowing the states to levy tax only at one point. As the list of declared goods is pretty large, there would be substantial increase in the tax base, given the states tax value addition of these goods at various levels of transactions.

It is also likely that the states would be able to raise additional revenue due to better administration brought about by the self-policing mechanism of VAT, as compared to the revenue raised through sales tax.

All states have already abolished the system of granting sales tax related incentives, as decided by the Conference of Chief Ministers and Finance Ministers in November 1999. This would also lead to a substantial increase in revenue to most of the states.

As per estimates, all these measures mentioned above would lead to an increase in VAT revenue of the states, at least by 5 percent of the base. Results have also been simulated for expansion in the base by assuming this proportion as 10 percent. The states would also be empowered to levy tax on services, as discussed at the Conference of Chief Ministers held in June 2000 and July 2001. Accordingly, the central government has already appointed a Committee to study the levy of VAT on services, its feasibility and modalities taking into consideration the views expressed by the other committees on the subject. Simultaneously, a Working Group was set up to prepare a Draft Service Tax Bill. The draft has been prepared and is presently being vetted by the Law Ministry. In the meanwhile the central government has already amended the Constitution to shift the power to levy tax services from the Residuary List to the Union List. When the Draft Service Tax Bill is enacted, the states would also be given concurrent or exclusive taxing powers.

Notwithstanding these developments, in view of the fact that already 58 services are being taxed by the centre (as shown in chapter 3), it is not clear how many services would be given to the states. However, it is estimated that the states would be able to raise at least 10 percent of their VAT revenue if empowered to tax services. The introduction of uniform floor rates under sales tax in 1999-2000 led to a substantial increase in revenue from sales tax in most of the states. When VAT is introduced, the states will have to convert their existing four-rate sales tax structure to a three-rate structure. Such rate rationalization would have positive revenue implications in the States. This is primarily because half of the goods falling in the category of 8 percent would then be shifted to the 12.5 percent category. Also, in most revenue yielding items of 12 percent, there is an increase in the tax rate by 0.5 percent, which means an increase of more than 4 percent. Also, the new tax regime would further reduce exemptions. All these measures would increase tax buoyancy and hence revenue due to VAT.

Revenue would also increase due to changes in the existing provision of taxation of sugar, textiles and tobacco—the items presently under additional excise duty in lieu of sales tax (AEDILST). As per the agreement made in 1956 between the union and the state governments, states were debarred from levying sales tax on these items. Instead AEDILST was levied by the centre on these goods in 1957. As agreed upon by the central government, the states are now allowed to levy tax on these goods if VAT is introduced by the states. This is considered as a measure of augmenting resources through the levy of 4% tax on sugar, tobacco and textiles, which are items of mass consumption. The states would now levy state VAT on these goods in addition to the AEDILST, which has now become part and parcel of the overall sharable pool.

The measures of rationalization in rates mentioned above would have considerable increase in VAT revenue of the states. It is estimated that this will lead to an increase of 10 percent of the states sales tax revenue. This is shown in Column 12 of Table 7.1. Simulation results by changing these to 15% and 20% are given in Tables 7.2 and 7.3, respectively.

Having obtained the estimated revenue from the GST exclusive of the yield drawn from petrol and diesel, the MST revenue is now added to the estimated revenue, as shown in column 4 of Table 7.1. The changes in the state revenue due to the introduction of VAT would be the difference between estimated VAT revenue and the existing total sales tax revenue. Assuming different proportions for these three variables, the effect on VAT revenue is shown in Tables 7.2 and 7.3. Here it is important to note that in these calculations, we have assumed that the centre would transfer services for additional revenue at least to the extent of 10% of the GST of the state. Estimates have also been made assuming this proportion to be 15% as well as 20%. As mentioned earlier, the revenue estimates given in the tables assume that services would be transferred to the states. If this does not come about, the adjustment in the net revenue would have to be done once again.

While the above section has presented revenue implications of adopting a dual VAT, it is proposed that in the long run it is important to take care of some of the issues that would be imperative from the point of efficiency and equity in a federal structure. This section, therefore, analyses long term restructuring of commodity taxes in India.

One of the important aspects in reforming commodity taxes in India relates to the vertical imbalance in assigning taxation powers under the Indian Constitution. This is evident from the given distribution of powers between the centre and the states, whereby most of the buoyant sources of tax revenue have been assigned to the central government and the expenditures have been assigned to the states. This imbalance in the assignment of powers is based *inter alia* on the belief that:

(a) Broad based taxes having all-India coverage should be given to the central government to have buoyancy and uniformity in the tax system. This has resulted in a situation whereby the states find themselves starved of revenues, causing a vertical fiscal imbalance.

(b) The central government needs "excess" revenue to carry out its allocative and distributive roles (via intergovernmental transfers) to influence state actions and achieve both "incentive compatibility" and horizontal equity.

Two Constitutional (Amendment) Acts of 1992 have further accentuated the imbalance with the creation of a third tier of government and introducing additional allocation of function for states.

To remove this imbalance, the Constitution provided for a mechanism of revenue sharing, revenue-assignment, revenue distribution and grants-in-aid for the states. All the Finance Commissions have contributed to this end through their recommendations. However, in the long run it is important that a fresh review of the provisions, related to assignment of taxation powers between the centre and the states, be made to rectify this fiscal imbalance.

In attempting this, it is vital to keep in mind the importance of a rational tax design. This is imperative in view of the adoption of the structural adjustment programme and the process of globalization of the economy. Also, the free trade agreement with SAARC countries makes it almost a necessity to review the system of commodity taxes so that there exists a neutral and efficient commodity tax structure in the country.

As explained in chapters 3 and 4, the Union List empowers the central government to levy UED and the State List provides the authority to the states to levy sales tax. The framers of the Constitution had conceived the UED as a tax levied by the central government on the manufacturers of a few commodities. Initially, it remained so and the revenue contribution from this was small. Over time, in their zeal to mop up larger revenues to fulfill the targets of "additional resource mobilisation", both the central and the state governments exploited these bases extensively. Consequently, UED is now levied on all the manufactured items, causing high incidence of tax. Also, UED and sales tax are levied primarily on the same base, causing extensive double taxation at the manufacturing level by the two tiers of government. The end result has been considerable cascading and pyramiding, bringing about distortions in the economy.

Introduction of dual VAT takes care of some of these weaknesses of both these commodity taxes (UED and sales tax). The dual VAT would remove cascading within the manufacturing sector as a result of

CenVAT and the state-VAT would do the same thing at the state level. The CenVAT levied at the manufacturing level would cascade when the sales tax is levied on CenVAT inclusive price. The same cascading effect will occur from state VAT on inputs, when CenVAT is levied on sales tax (or state VAT) inclusive price. Hence to avoid such cascading and to reduce the transaction cost for the manufacturers, it is important that the commodity taxes are reassigned in such a way so that the powers to levy both these taxes are assigned to the states. This means the centre withdraws from the field of commodity taxes for revenue purposes and the states levy a comprehensive state VAT covering all goods and services. In addition to eliminating deficiencies of the commodity taxes, this would also reduce vertical fiscal imbalance.

Another important problem under dual VAT relates to vertical tax externality in taxing the same base, by the two tiers of government. This happens when both the levels of government, Centre and States, levy tax on the same base. Then the tax policy decisions of one level of government affect the tax base of the other. Such an impact, known as vertical externality, is important in a federal structure. For instance, when the central government increases the tax rate levied on a commodity, the tax liability of taxpayers rises. In turn, the consumer reduces the demand for the commodity which reduces the total tax amount payable to both the levels of government. This leads to a reduction in the tax base, which adversely affects tax revenue of the states as well as the central government.

To illustrate, let us assume that there is no tax competition among states. We also assume the states are identical. Another assumption made is that the Central government recognizes the adverse impact of increasing its tax rate on state revenues but the state governments do not. If both the centre and the states now levy tax on the same base, this could give rise to two situations depending on whether the state is leviathan or benevolent.

If state government is leviathan and seeks to maximize its tax revenue, then the response of the state government to an arbitrary federal tax would be to have a revenue maximizing tax rate. Now suppose that the Central government raises the tax rate on a particular commodity. This raises the consumer price (which is the summation of producer price and tax amount payable). Consequently, the demand for the commodity declines, adversely affecting the tax base of the state government. In case the states are leviathan, they would try to maximize their total tax revenue collections by raising the tax rate.

If the states were benevolent, they would levy the tax with the aim of maximizing consumer's welfare. It encompasses the welfare loss that the consumer suffers due to the increased consumer price that reduces demand. This would lead to a reduction in their tax revenue, thereby leading to less provision for public goods provided by them. Less production of state public goods would result in an increase in their marginal valuation and offer the attractive option of raising the tax rate so as to provide more public goods. Thus the state governments would raise the tax rate.

Hence, whether the states are leviathan or benevolent, an increase in tax rate by the central government would motivate them to raise the state tax rate also. The total tax burden on consumer would go up and at equilibrium, the quantity of taxed goods (private goods) consumed would be too less.

The next issue that needs to be addressed is that whether or not the tax rate levied by State governments would be too high. Based on the assumption that the state governments do not recognize the loss suffered by the central government due to an increase in state tax rate, one can presume that the state governments would set a tax rate that is too high. This is because the marginal cost of raising public funds (MCPF)[7] calculated by the state governments would be less than the social marginal cost of raising public funds. Social marginal cost is obtained by adding up the loss incurred by the central and the state governments due to reduction in (common) tax base, while the marginal cost calculated by state governments covers only the loss incurred by the state governments themselves. The states would determine the equilibrium tax rate by equating the marginal value to the consumer of an additional rupee spent on state public goods with marginal cost of public funds and thus would set an excessively high tax rate, given the increase in the tax rate of the central government.

Here it is important to take note of the exceptions to this phenomenon.

1) When there exists tax competition among the states, then two types of forces viz., horizontal fiscal externality (among the states) and

vertical fiscal externality (between centre and states) would operate. If horizontal fiscal externality is dominant, then state tax rates would be too low at equilibrium. With an increase in central tax rate, when one of the states raises the state tax rate, the tax rates prevailing in all other states would be less as compared to that particular state. Consequently, the tax base would flee from the state with the high tax rates to the states with relatively low tax rates. The state that raised the tax rate would now have to reduce it. Conversely, if vertical fiscal externality were dominant, equilibrium state tax rates would be too high.

2) If state governments recognize the adverse impact of raising state tax rate on Central tax base, then they would not levy very high tax rates.

3) The Central government could reduce the loss incurred by state governments, due to an increase in Central tax rate, by providing grants to them. In this scenario, the State governments would not levy a State tax that is too high.

4) If the spending of the two levels of the governments is such that the increase in tax rate by one level results in an increase in the tax base of the other level of government, then vertical externality can be beneficial. Take the case where state governments levy tax on cigarettes and spend the amount on highways, while central government imposes tax on gasoline. Then an increase in tax on cigarettes, which is used to improve or extend highways, would lead to an increase in demand for gasoline. Thus the Central government gets a bigger tax base and a higher tax levy.

Thus, apart for the exceptional case of vertical externality being beneficial, in most cases there is a reduction in tax base for the states when tax is levied on the same base by the central government. In the current case of CenVAT being levied by the central government at the rate of 16%, can the states think in terms of raising their state-VAT rate beyond 12.5%?

In view of the vertical imbalance in distribution of tax powers and vertical externality in taxing the same base, it is proposed that instead of having a dual VAT, India should follow a comprehensive state VAT, wherein the centre withdraws from the field of taxes on commodities from the revenue point of view, but for administrative reasons it continues to levy cenVAT and the states levy state-VAT. The Finance Commissions would recommend distribution of cenVAT revenue.[8]

In the proposed scheme of a comprehensive state VAT the following features are an integral part of the system.

a) The scheme of CenVAT would be operative more or less the same way as is presently being done. However, the rate of CenVAT has to be compatible with the rate of state-VAT. This should be done in such a way that the combined incidence of both the taxes will be the same for all the dealers. For example, when the CenVAT rate at present is 16 per cent, the rate of state-VAT should be higher than the CenVAT so that the states could provide set-off for the CenVAT.

b) To have harmony in the commodity taxes in the country it would be useful to adopt a central mechanism on the pattern of

CONFAZ in Brazil or the Parliament of the European Union, with representatives from the centre and the states as its members. A VAT council of Centre and States could be the operational body to implement the rationalisation of rates.

c) mCenVAT would continue to be levied on the manufacture price at the time of clearance and collected by the central government. States would levy state-VAT on the sale price of the commodity.

d) To mitigate cascading of cenVAT under the State-VAT and of the State-VAT under the cenVAT, the system of set-offs should be operative for both the taxes. That is, the cenVAT levied on manufacturing level by the Central government would be provided set-off by the states under the state-VAT. The states would also be provided set-off for the CenVAT paid by the manufacturers. This can be expressed as follows: assume that the collection of CenVAT at the Central level from different states is X_1, X_2, X_3, X_4, ...X_n where the total tax collection equals

$$X = \sum_{i=1}^{n} X_j$$

Similarly, sales tax collection for n states is S_1, S_2, S_3, S_4,……… S_n. When a state has to give set-off for the tax under Central VAT, the state's collection from sales tax revenue will be reduced. This is indicated as S_1', S_2', S_3', S_4',....S_n' where $S_1' < S_1$, etc.[9]

Let $F_i = S_i - S_i'$ (where *i* varies from 1 to n)

Denote the fall in sales tax revenue due to set-off in various states.

e) Since the states would give set-off for the cenVAT paid by the manufacturers, it is important that the tax collected by the centre is transferred to the states. Therefore, the Finance commission should distribute this revenue to the states on the basis of collection; it should not form part of the divisible pool for transferring resources to the various states.

f) When the goods are exported out of state, the tax so collected by the producing state would be zero-rated by the states and hence refunded to the producer or to the next dealer in the chain. This would make the comprehensive VAT a truly consumption based tax.

g) The devolution of the CenVAT on the basis of the recommendation of the Finance Commission would be made in such a way that the principle of collection is followed only for those states that introduce a comprehensive state-VAT. For the states continuing to have cascade type sales tax, the Finance Commission would announce different principles of devolution.[10]

In assigning the power to levy state-VAT to the states and asking the centre to withdraw from the field of commodity taxes, the centre would be left with resources less than that required to carry out its allocative and distributive roles (through inter-governmental transfers) to influence state activities. This has to be done to achieve "incentive compatibility" and to achieve horizontal equity. In a federal set up this is required to provide justice to the poor states. To take care of the allocative and distributive functions of the centre, it is proposed that the centre should levy, in addition to the CenVAT, sumptuary excises (SEs) on a few select commodities. These would at the most be a dozen in number. The centre would retain the revenue generated from the SEs. The SEs would yield to the centre approximately half the revenue from the UEDs. The central kitty would, therefore, not be affected by the proposed change in the system. In addition to change in assignment of taxing powers, the states must make their existing assigned taxes broad-based and income-elastic to cope with their responsibilities. They should restructure their finances by expanding the existing bases of the taxes assigned to them. Some proposals in this regard are presented below:

In the long run, VAT would reduce economic distortions, encourage industrial development and consequently raise more resources. Also, this would capture the value added beyond the first point tax and would increase the tax base considerably.[11]

At present the state government is levying the following taxes on commodities and services:

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

7. Tax on animals and boats;
8. Tolls
9. Tax on luxuries including tax on entertainment, amusements, betting and gambling.

In the proposed scheme of restructuring of taxes, as suggested earlier, sales tax is converted into a state VAT. However, in the course of time, these other taxes too must become part of the state VAT. That includes tax on electricity, tax on entertainment, amusements, the luxury tax on hotels, passengers and goods tax. This should be integrated with the state VAT. After this restructuring the structure of indirect taxes levied by states would be as follows:

1. A comprehensive state VAT
2. Excise on alcoholic liquor
3. A toll tax on new roads and bridges
4. Motor vehicles tax for regulation of vehicles
5. A tax on gambling, horse races and lotteries.[12]

With these reforms in the state taxes on commodities and services (mentioned above), India would finally have a broad-based and economically rational indirect tax system.

Issues in Taxation of the same base by Central and State Governments. In federal countries, when both central and state governments co-occupy the same tax base, vertical externality arises and affects the tax revenue receipts of both levels of governments.

The following model examines the impact of such externality on the equilibrium levels of central and state tax rates.

The assumptions are as follows:

i. States are identical to each other.

ii. Each state consists of a single consumer.

iii. The states are not so large so that each can have a negative impact on the central tax base.

iv. Tax base is completely immobile across states, that is, horizontal tax competition among states does not play any role.

v. Preference function of consumers:

$$v(q) + \Gamma(g, G) \quad \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots(1)$$

Where

$v(.)$ and $\Gamma(.)$ are strictly concave.

Preference function is additive implying that the utility derived from private good is independent of that derived from public good. G and g represents the quantity of central public good and state public good respectively. Consumer price of taxed (private) good is q such that:

$$q = p + t + T \quad \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots(2)$$

Where

p is producer price

t is state tax rate

T is central tax rate.

States set the value of t, taking T and G as given.

There can be two cases:

A. State governments are leviathan, that is, it maximizes total tax revenue, $t.x(q)$ where $x(q)$ is the demand for the taxed good. It would use inverse elasticity rule to determine revenue maximizing tax rate:

$$t/q = 1/e\ (q) \qquad \text{……………………………………(3)}$$

Where

e (q) is price elasticity of demand and e (q) > 0.

When T changes and hence q changes, then 't' will generally have to change to restore equation (3), and the direction in which it must change is uncertain. The direction of change will depend on the way the elasticity of demand varies.[13]

With increase in central tax rate, price of taxed good (q) would go up and consequently, its demand would decline from OQ_0 to OQ_1 (Figure 1). The tax base and hence tax revenue of state government would reduce. In case e (.) is constant, t needs to be increased in order to restore equilibrium as given in eq. (3).

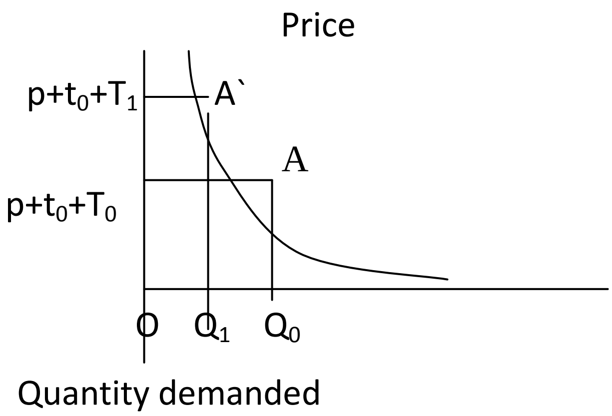

FIGURE 1: The Effect of a Higher Federal Tax on the Revenue-Maximizing State Tax.

If the demand curve is linear, the tax rate would be equal to:

$t = -\{1/x`(q)/x(q)\}$ where $x`(q)$ is constant. ……………..(4)

x (q) declines with increase in q and hence t declines.

B. If state governments are benevolent, then they would consider two more aspects of higher central tax rate. First, welfare loss that the consumer suffers due to increased consumer price. Second, decrease in demand for taxed good, leading to a decrease in tax revenue and the consequent decline in provision for public goods. This would initiate the state governments to raise the tax rate.

Therefore, in both cases the state governments would increase state tax rate with an increase in central tax rate.

The state governments would set t and g so that:

$$\Gamma_g = [1 - (t/q).\, e\,(q)]^{-1} \equiv \text{MCPF} \quad \text{…………………………..(5)}$$

Where

Γ_g is marginal value to the consumer of an additional dollar spent on state public good Γ.

MCPF refers to marginal cost of public funds and covers up the loss incurred by state government due to increase in central tax rate.[14]

But the true social marginal cost of public funds (SMCPF), which recognizes the erosion of central tax base, is equal to:

$$SMCPF = [1 - (\tau/q).\ e\ (q)]^{-1}……………………….(6)$$

where, τ = t +T, is the consolidated tax rate and at equilibrium, SMCPF > MCPF. The state governments would use eq. (5) so as to determine equilibrium tax rate, which implies that they would set excessively high tax rate. The crucial distinction is that while the MCPF recognized by the states directly depends only on the state tax t, the social MCPF reflects the consolidated tax rate.

Table 2.1

Concessional Rate of Sales Tax on Inputs in Indian States

State	Tax Rate (percent)
Andhra Pradesh	4
Assam	No concession
Bihar	3
Delhi	Ex.
Goa	Ex.
Gujarat	2 (except prohibited goods)
Haryana	Ex.
Himachal Pradesh	Ex.
Jammu & Kashmir	Ex.
Karnataka	3 (2 for SSIs)
Kerala	2
Madhya Pradesh	4
Maharashtra	3
Meghalaya	Set off on sale
Manipur	Ex.
Orissa	4
Punjab	Ex.
Rajasthan	3 to 4
Tamil Nadu	3
Uttar Pradesh	2 for declared goods; 2.5 for other goods; 4-8 for specified goods
West Bengal	3-4

Source :Survekshana, Aug-Oct 2009, Page 231

Note: Ex = Exempted

Table 2.2:Trade Margins under VAT[15]

Commodity Group	Trade Margin			
	Wholesale trade		Retail trade	
	Calculated	Observed	Calculated	Observed
1. Rice	5.5	7.8	11.9	10.3
2. Wheat	2.3	7.7	12.9	10.0
3. Other cereals	8.6	8.6	13.7	11.8
4. Arhur	8.2	6.9	11.4	10.7
5. Gram	7.8	7.8	11.2	10.9
6. Other pulses	3.7	7.8	12.1	11.5
7. Biscuits	14.0	11.2	17.9	15.4
8. Bread	13.4	13.0	17.1	14.6
9. Sugar	9.2	4.5	8.5	8.8
10. Gur, candy, batasa	11.2	9.6	13.9	12.5
11. Milk	15.3	15.1	15.0	14.1
12. Other dairy products	8.9	8.7	11.4	12.3
13. Edible oil	6.6	5.8	9.7	10.2
14. Meat and Poultry	10.3	15.7	19.7	18.3
15. Fish	12.7	29.1	24.4	25.7
16. Egg	11.8	12.9	14.7	13.9
17. Salt	8.1	16.9	26.9	21.6
18. Spices including garam masala	21.1	13.4	24.3	16.2
19. Potato and onion	14.7	15.2	23.4	22.2
20. Other vegetables	22.2	21.9	27.4	26.1
21. Fruits	16.1	28.9	29.2	23.1
22. Dry fruit and nuts	8.4	17.8	19.9	15.2
23. Tea, coffee	7.7	7.8	13.8	12.8
24. Pan and pan masala	8.3	16.5	27.3	24.9
25. Bidi, cigarette & other tobacco products	3.0	10.8	13.0	14.4
26. Soap, detergent & washing powders	6.6	8.4	14.2	12.6
27. Tooth paste	0.0	7.1	15.9	10.3
28. Hair oil and shampoo	0.0	8.9	16.4	12.6
29. Other toilet preparations	0.7	10.1	12.1	13.7
30. Leather footwear	19.2	15.4	18.9	17.7

Commodity Group	Trade Margin			
	Wholesale trade		Retail trade	
	Calculated	Observed	Calculated	Observed
31. Non-leather footwear	21.3	16.2	15.4	18.4
32. Other leather products	11.3	14.8	18.6	19.2
33. Cotton textile	19.9	9.4	16.6	16.8
34. Other textile	9.9	10.0	17.0	17.6
35. Hosiery goods	13.4	13.3	11.3	17.4
36. Readymade garments	12.5	13.2	21.5	20.7
37. Woolen goods	6.8	11.6	21.9	19.1
38. Plastic goods	11.6	13.6	17.6	19.8
39. Other synthetic goods	12.4	33.5	12.8	18.6
40. Jewellery	441.1	10.5	0.7	14.7
41. Precious stones	-8.1	8.1	9.9	22.4
42. Artificial jewellery	22.2	22.5	17.2	25.3
43. Bulbs and tubes	-2.4	10.6	12.9	13.5
44. Fan, heater, irons etc.	4.8	9.8	11.8	14.6
45. TV, VCP, VCR	15.4	11.4	8.5	11.7
46. Fridge, washing machine	11.1	16.3	6.6	10.5
47. Radio, transistor, tape	11.0	10.8	15.7	16.6
48. Calculator & other electrical appliances	10.7	11.8	3.9	16.0
49. Crockery & glassware	41.4	20.2	5.4	19.0
50. Potteries	0.0	31.0	128.0	24.3
51. Fertilisers	42.5	7.2	8.6	10.4
52. Pesticides	0.0	8.7	13.2	13.5
53. Utensils & metal containers	12.2	12.9	16.4	17.3
54. Note books, writing & drawing pads	12.9	11.9	14.8	16.9
55. Books and periodicals	0.8	10.7	-82.3	15.5
56. Wood, cane & bamboo products	15.8	28.6	7.5	20.6
57. Bicycle	13.1	7.4	12.4	12.9
58. Soft drinks	10.7	14.9	50.0	22.5
59. Fruit juice	12.0	15.8	50.0	31.0
60. Wine and intoxicants	24.4	18.5	25.0	26.9
61. Toys and sports goods	31.7	15.3	25.2	21.7

Commodity Group	Trade Margin			
	Wholesale trade		Retail trade	
	Calculated	Observed	Calculated	Observed
62. Cement	5.4	5.6	9.5	7.9
63. Bricks	10.1	17.1	11.9	13.7
64. Iron rods	-24.1	9.5	4.8	10.0
65. Coal, coke, fire wood	86.7	46.0	31.9	28.3
66. Watch, spectacles, sun glasses, lighters etc.	4.6	12.2	19.0	19.8

Source: *Sarvekshana*, April-June 2000.

Table 2.3

Concessional Rates Under CST in Different States of India[16]

States	Commodities	Rates
Goa	Chemical, Ore Pallets, Mining machinery spares, Electronic weighing scale, Photographic product, Electronic medical equipment, Betel nut, Cashew nut, Iron & steel, Raw cashew nut.	2%
Himachal Pradesh	Goods manufactured by Industrial units(other than these manufactured by breweries, distilleries, non-fruit/ vegetable based wineries and bottling plants (both of country liquor and Indian made foreign liquor).	1%
	Cereals like paddy, rice, wheat, jowar, bajra, maize, ragi, kodon etc.	1%
	All types of yarn.	1%
Kerala	Beaten rice and purchased rice	1%
	Bullion and spices	1%
	Kerosene stove	1%
	Arecanut	0
	Chloroquine Tablets	0
	Caprolactum	2%
	Coconut Oil	0
	Coconut Oil Cake	2%
	Cotton Yarn	0
	Declared goods other than Coconut (i.e. Cocos-Nucifera) or copra specified in schedule II to the KGST Act, 1963 (15 of 1963).	0

	Desiccated Coconut	2%
	Fibre foam	2%
	Ginger (Green or dried)	0
	Granite slab and Granite Tiles	2%
	News Print	2%
	Pepper (Garbled or ungarbled)	0
	Power Tiller	2%
	Pushbutton Telephone(*SRO. 304/99 GO (P) No. 63/99/TD dt.31.3.99)	2%
	Rubber (SRO 215/97)	0
Karnataka	Cotton yarn	2%
	KST suffered silk fabrics	0
	KST suffered Arecanut	0
	KST suffered Coffee beans and Coffee seeds	0
	KST suffered Dry chillies	0
	KST suffered Horsrgram and Halasande	0
	KST suffered Tamarind and Tamarind seeds	0
	Bicycles	2%
	Copra	2%
	Computers, Computer peripherals etc	0.25%
	Cotton seeds	2%
	Dessicated coconut	2%
	Edible oil refined and non-refined	2%
	Groundnuts and their seeds, safflower seeds and sun flower seeds	2%
	Khandasari sugar	2%
	Liquid glucose, dextrine etc	2%
	Medical diagnostic imaging equipments	2%
	Washed cotton seed oil	2%
	Bullion and specie	0.5%
	Earth moving equipments-hydraulic excavator etc	2%
	Rechargeable lanterns	2%
	Refrigerators, Washing machines, Microwave ovens and vaccum cleaners	2%
	Video cassette recorders, VCPs, audio and video CD players, radio, cassette recorders and radio cassette recorders	2%
	Pencils	0
	Kerosene wick stoves	0

Table 2.3

Concessional Rates Under CST in Different States of India

States	Commodities	Rates
Delhi	Sale of goods (other than the goods specified in the First Schedule of the DST Act 1975) in the course of inter-State trade or commerce by a dealer having his place of business in the territory of Delhi provided the sale is made to a registered dealer having his place of business outside the territory of Delhi and the goods are proved to have been imported into the territory of Delhi after being subjected to tax under the Central Act and then exported from the territory without undergoing any processing or change in identity.	2%
	Sale of goods (other than the goods specified in the First Schedule of the DST Act 1975) in the course of inter-State trade or commerce by a dealer having his place of business in the territory of Delhi provided the sale is made to a registered dealer having his place of business outside the territory of Delhi and the goods are proved to have been received by him in the territory of Delhi under the Central Sales Tax Act from his place of business in another State where he is registered under the sales tax law of the that State in respect of his such place of business or from the place of business of his Agent or Principal in another State where such agent or principal is registered under the Sales Tax Law of that State and in respect of which the importing dealer furnishes a certificate containing the declaration in the prescribed form that tax on the said goods has been paid or will be paid by him or his Agent or his Principal, as the case may be, under the Sales Tax Law of the State wherefrom the goods were received, and which are exported by the importing dealer from the said territory without under-going any processing or change in identity.	2%
	Dry Fruits	2%
	Tea	2%
	Sarson, toria, till or taramira oil (not being hydrogenated vegetable oil).	1%

Orissa	Television sets and electronic goods	1%
	Pig iron, gold and silver ornaments.	2%
Pondicherry	Milk powder, cotton yarn, cotton waste, technical grade pesticides, SSI products for 14 years after expiry of 5 years tax holiday.	1% 1.5%
	Aluminium, art silk, and SSI products as stated above.	2%
	Photographic goods, cinamatographic goods, medicines, surgical equipments, oil and oil cakes, hydraulic excavators, electronic goods and computers.	3%
	Gensets, plastic goods, rubber goods, packing materials, chemicals, asbestos, cement sheets, food colours, footwear, iron and steel, ferrous and non-ferrous alloys, paper products.	
Sikkim	Cardamom, ginger and orange	3%
West Bengal	Gold	1
	Gold and silver ornaments, articles and filigree	1
	Mustard seed, Rape seed	1
	Poultry feed additives	1
	Silver	1
	All non-cotton yarn other than pure silk yarn made in	2
	India	2
	Edible rice bran oil	2
	Feed additives for cattle and pig	2
	Jute goods except specified elsewhere	2
	Mustard oil, rape oil and mixture thereof	2
	Precious stone including preal-real, artificial or	2
	cultured	2
	Rice and broken particles of rice	2
		3
	Synthetic fibre such as, acrylic fibre or polyester fibre	
	Wheat and broken particles of wheat	
	Aluminium utensils	

Source : Source of Finance Govt. of India. 2010-2011

Table 2.3

Concessional Rates Under CST in Different States of India

States	Commodities	Rates
West Bengal Continued	Gas mantle	3
	Hawai Chappal, Chappal and Sandals made of plastic	3
	Hosiery goods excluding cotton, woolen	3
	Micro-cellular sheet, banawar sheet	3
	Parts, accs., comp. Of cycle-rickshaw	3
	Power tillers	3
	Readymade garments (excld. hosiery goods, garment of khadi)	3
	Umbrella and parts, comp. Thereof	3
	Mill-made cotton fabrics, rayon or artificial silk fabrics and wollen fabrics	0
	Tobacco, whether manufactured or not	0
	Sugar	0
	Newprint (for publishing newspaper)	0
	Betel leaves	1
	Condoms	0
	Bicycles	1
	Motor Vehicles for use as taxis	2
	Chloroquine phosphate tablets	0
	Interstate sale of locally purchased single point goods on which due tax has been paid in West Bengal.	0
	Non-ferrous metals-tubes, pipes, rods, sections, wires, and sheets	2
	Tea Purchased at Calcutta Tea Auction	2
	Tea Purchased at Siliguri Tea Auction	2
	Cycle-rickshaws and components thereof	1
	Iron and Steel	0
	Sale of motor cars:	
	i. Sales effected under Section 8(1)	2
	Television and Vanaspati	
	i. Sales effected under section 8(1)(b) of television……………………………………	1
	ii. Sales effected under section 8(1)(b) of Vanaspati	3
	tickets	0
	y industrial units holding eligibility certificate	0
	Aluminium foil, aluminium foiled paper, and aluminium foil backed or inter-leaved with paper	2
	nic audio equipments	1
	Personal Computer and peripheral devices, Refrigerator, Washing machine, Vacuum cleaner, Microwave oven, Video cassette recorder, Video cassette player, radio, Transistor radio, Music systems.	1
	Sale of inverter, generator and laminated jute bags	2
	Drugs or medicines manufactured by the Small Scale Industrial Unit	0
	Trekker	2
	Coir mattress with or without foam and acrylic fibre	1

Source: Information supplied by the Offices of the Commissioner of Commercial Taxes.

Table 2.4

Items to be brought under Sumptuary Excises for the Central Government[17]

(Rs crore)

Sl. No.	Items	Yield from 16% Tax from CenVAT (2000-01)	Input Credit due to Manufacturer (16% of 51%)	Revenue from Sumptuary Excises (2000-01)
1.	Petroleum Products	9466.49	757.32	10223.81
2.	Tobacco & its products	501.85	40.15	542
3.	Motor Cars, etc.	2291.61	183.33	2474.94
4.	Cement Clinkers, etc.	3855.67	308.45	4164.12
5.	Chemicals & Dyes	2264.15	181.13	2445.28
6.	Tyres & Tubes	2389.26	191.14	2580.4
7.	Plastics & articles thereof	3198.03	255.84	3453.87
8.	Arms & Ammunitions, etc.	27.81	2.22	30.03
9.	Precious Stones, etc.	33.97	2.72	36.69
	Total Revenue from Sumptuary Excises			25951.14

Source: Govt. of India, 2000-01, *Receipts Budget*, Febr

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Chapter- 3

VAT & INDIAN tax system

In, one of the most large scale reforms of the country's public finances in over past 50 years, India has finally agreed the launch of its much-delayed Value Added Tax (VAT) from 1st April 2005. At a rate of 12.5%, VAT will come in on April 1, 2005. The tax, agreed after state finance ministers met in New Delhi, is designed to make accounting more transparent, cut trade barriers and boost tax revenues. The system had been postponed many times, mainly because of opposition from the powerful trading lobby. Ashim Dasgupta, who heads a panel overseeing the implementation of VAT, said: "We are very happy to announce that a broad consensus among states was arrived at the meeting to introduce VAT on April 1, 2005." The Congress-led new left-leaning United Progressive Alliance (UPA) government has made implementing VAT one of its key priorities. According to analysts VAT is essential in tackling the problem of tax evasion. In India, all the state governments collect over Rs 85,000 crore (Rs 850 billion) by way of sales tax and further over 20,000 crore (Rs 200 billion) by way of Central Sales Tax. This is what officially comes mostly from petroleum, liquor, iron and steel and cement companies. Rough estimates suggest that these industries account for over 50 per cent sales tax for the states and the Centre. Majority of the officials in sales tax departments believe that what they actually collect is less than 50 per cent of the revenue that should otherwise accrue to them if all transactions are accounted for by the businessmen. March 24, 2005: The state finance ministers in consultation with Finance minister P. Chidambaran decided to scale down the composite tax to 0.25 per cent from the earlier one percent over sales Turnover. This levy will be applicable to traders out of the VAT ambit and having a sales turnover between Rs. 5 lakh-Rs. 50 lakh per year. The Next major decision by the state finance ministers is to phase out central sales Tax (CST) during next three years. While the 4 percent CST stays during 2005-06, it will be slashed to 2 percent in 2006-07. CST will not be levied from April 1, 2007. India has a large un-organised market, especially agro-based industries and here a large number of transactions go unrecorded. The menace of stock transfers adds to the problem of tax evasion. In India, introduction of VAT will only change the collection methods for sales tax rather than reform the indirect tax system. VAT is nothing but sales tax at source. Instead of collecting it after five months or so, the state governments would collect the same in advance and then allow set-offs to the businessmen. All tax paid on inputs, subject to rules made, shall be allowed to set-off against the tax on output. There would be exceptions like CST not allowed to be set off if sales are made locally in some other state; octroi not to be set off against output tax, etc. What about Central Sales Tax Act, 1956? Well, this will remain and might be the biggest stumbling block for successful introduction of VAT in India.[1] Double taxation under the Central Sales Tax Act, even for declared goods under Section 14, has been permitted. But the biggest problem is that the central sales tax paid by the businessmen will not be allowed to be set off against local output tax payable. A city like Delhi will suffer the most.

State governments have agreed not to start new incentive schemes giving sales tax exemptions. 'C' forms have been made mandatory even when the local sales tax is less than 4 per cent. 'C' forms are required even when sales are made from sales tax free zones. Therefore, the power given to the state government under Section 8(5) of the Central Sales Tax Act is now virtually redundant as even if the sales tax is reduced to zero, the 'C' forms would still be required. It would be a difficult scenario for local VAT and CST to co-exist. Single VAT, which should be a combination of sales tax, service tax and excise duty is what we should have aimed for. Necessity of Value Added Tax: The General perception of the existing single point sales tax system is that it is highly complex with multiplicity of rates, plethora of explanation, many rates in some group of item, extensive use of statutory forms, high and unrealistic quota of assessment, loss of revenue on value additions, Tax rate war between States , etc. The consensus was that a new system is needed and Value Added Tax has emerged as a principal instrument of taxing domestic consumption world wide during last four decades. It is now in operation in more than 100 Countries. The basic advantages of Value Added Tax can be stated as its neutrality, transparency, certainty and self policing mechanism. Value Added Tax is a multi point sales tax with set off for tax paid on purchases. It is basically a tax on the value addition on the product. The burden of tax is ultimately born by the consumer of goods. In many aspects it is equivalent to last point sales tax. It can also be called as a multi point sales tax levied as a proportion of Valued Added. State Value Added Tax. The discussion regarding the VAT and the implementation which is being planned is only confined to the State.

There is no proposed Central VAT at present in the time frame of 1.4.2003. All the States are drafting their separate Value Added Tax Act and as per the present position, every States will have a separate VAT Act with different provision not corresponding with each other. It can be stated that the proposed VAT Act is the primary stage of VAT. It is proposed that there would be Two tax rate slabs on which tax would be levied. The first one would be 4% and would covered all essential items. The second one is 10% and all luxury items would be covered. In addition special rate slabs are also proposed which are 1% for bullion and jewellery, 20% for Non Essential Goods and exemption to certain goods like agricultural produce etc. Petroleum products are not included in VAT rates. Separate rate would be notified for them. Set off. At present the set off would be available on the goods locally purchased within the State only. No set off would be available to the goods purchased in the course of inter state trade and commerce. It will be necessary to produce the tax invoice to claim set off. The tax should have been charged in the invoice. Exempted Goods: Some goods would be declared as exempted by the State Government under the proposed VAT Act. However the present view as per guide lines issued by the State Government are that no set off would be allowed on the exempted goods. It means that the tax suffered on the raw material for manufacture of exempted goods would not be refunded .

The manufacturer would be required to purchase raw material after paying full tax on the rate applicable on such material. Unlike the present system wherein the manufacturer can purchase the goods at a concessional rate of tax against declaration form no declaration form will be required to be issued by the Manufacturer. The input tax suffered by him would be adjusted \ set off from the sale of the finished product. The tax adjustment of input credit of the goods purchased within the State would be available on the sales made within the State and also on the inter state sales subject to the tax payable. No adjustment would be available of the input credit in case of branch transfer, consignment sale.

Trader: The trader would be required to collect tax on the sales made by him and the tax liability would be set off \ adjusted from the purchase \ input tax credit of the goods locally purchased in that State. Issue of Invoice: Under the proposed Value Added Tax Act issue of invoice would be mandatory. No set off \ input credit would be allowed unless the original tax invoice is produced wherein tax is clearly charged separately in the invoice. Declaration Form: Use of declaration form of purchase of goods on concessional rate of tax or NIL rate of tax under the State Act would be completely finished. There would be no requirement of declaration form under the proposed Value Added Tax. However the Road Permits like ST 18 A and ST 18 C declaration forms would continue. Declarations forms of CST Act would also continue Accounting: The basic account books required for the purpose of VAT Act are Purchase and Sale Register. Both the registers would be the basis on which the calculation of payment of tax would be made. The normal practice of entering the gross value of Purchase bill would be changed. The assessee would be required to enter the value of goods in the goods A\c and the amount of tax in the Tax A\c separately. Stock statement are required to be furnished as prescribed for the quarter ending and then monthly from January to March . Set off of tax paid stocks would be given. Tax paid stocks as on march ending would be the basis for claiming set of under the new VAT Act. However, no set off would be available for the tax paid stock purchased prior to 1.4.2005. Capital Goods: Set off would also be available on the tax paid goods at the time of purchase of capital goods under the VAT Act. Basis of set off is yet to be declared. However, it is presumed that set off would be available within a span of 3 years from the date of commercial production. Export would be zero rated. Tax paid on raw material used in manufacture of goods for export would be refunded by the State Government in cash \ adjustment. The exports would became more competitive in the world market as there would be no tax henceforth on raw material used for manufacture of goods for export. All Importers, Manufacturers, Exporters and Dealers having CST registration would be required to seek mandatory registration under the new VAT Act. The existing registered dealers are required to fill a FACT SHEET as notified by the department within a stipulated time which is at present 15.02.2006 and then they would not be required to seek fresh registration. There would be two types of registration. The first is VAT dealers registration and the second is composition scheme dealer registration. The dealers opting under composition scheme would not be able to charge tax in the invoice and he would pay lump sum fee as composition amount. It is apparently for retail traders and the expected limit of turn over for option under composition scheme is maximum Rs. 15 lacs.

Security amount for seeking registration is likely to be increased many fold in VAT Act. The security for registration under the present Act is Rs.10,000.00 which is likely to be increased to Rs.

25,000.00 for small scale industry, Rs. 1,00,000.00 for medium scale industry and Rs. 5,00,000.00 for large scale industry. Apart from it, the assessing authority would have a right to seek additional security equal to 25% of the tax liability. Every dealer having a turn over of over Rs. 40.00 lacs would be required to get his account audited by a Chartered Accountant and submit the audit report within the stipulated time. Failure to do so would attract penalty proceedings. Penalties had been increased many folds in the new VAT Act. As per discussion draft on VAT Act circulated, there is more emphasis on penalties. Works Contract and Leasing: No clarification, provision or guide lines had been issued by the department till date on works contract and leasing transaction. The continuation of existing composition scheme or by what method they would be taxed in future has not been informed. Concluding: VAT would change the nature of trade in the coming years, but the medium level of trade that is C&F agents, distributors, stockiest etc. would face problems as the companies would reduced the tier of marketing. Similarly small retail dealers would be required to maintained more accounts or pay composition money which cannot be collected from the customers. The present provision of CST and VAT can not go together. After the abolition of CST the direct marketing concept may gain ground and the necessity of having warehouse, godowns etc. in all states may decrease or finish. It would adversely affect the trade and employment of the states. America which has similar federal and state laws \ Constitution has not implemented VAT. It needs study as to why a develop and advance economy like America has not adopted VAT.

A value added tax (VAT) is a form of consumption tax. From the perspective of the buyer, it is a tax on the purchase price. From that of the seller, it is a tax only on the "value added" to a product, material or service, from an accounting point of view, by this stage of its manufacture or distribution. The manufacturer remits to the government the difference between these two amounts, and retains the rest for themselves to offset the taxes they had previously paid on the inputs. The "value added" to a product by a business is the sale price charged to its customer, minus the cost of materials and other taxable inputs. A VAT is like a sales tax in that ultimately only the end consumer is taxed. It differs from the sales tax in that, with the latter, the tax is collected and remitted to the government only once, at the point of purchase by the end consumer. With the VAT, collections, remittances to the government, and credits for taxes already paid occur each time a business in the supply chain purchases products. Maurice Lauré, Joint Director of the French Tax Authority, the *Direction générale des impôts*, was first to introduce VAT on April 10, 1954, although German industrialist Dr. Wilhelm von Siemens proposed the concept in 1918. Initially directed at large businesses, it was extended over time to include all business sectors. In France, it is the most important source of state finance, accounting for nearly 50% of state revenues.[1] Personal end-consumers of products and services cannot recover VAT on purchases, but businesses are able to recover VAT (input tax) on the products and services that they buy in order to produce further goods or services that will be sold to yet another business in the supply chain or directly to a final consumer. In this way, the total tax levied at each stage in the economic chain of supply is a constant fraction of the value added by a business to its products, and most of the cost of collecting the tax is borne by business, rather than by the state. Value Added Taxes were introduced in part because they create stronger incentives to collect than a sales tax does. Both types of consumption tax create an incentive by end consumers to avoid or evade the tax, but the sales tax offers the buyer a mechanism to avoid or evade the tax—persuade the seller that he (the buyer) is not really an end consumer, and therefore the seller is not legally required to collect it. The burden of determining whether the buyer's motivation is to consume or re-sell is on the seller, but the seller has no direct economic incentive to collect it. The VAT approach gives sellers a direct financial stake in collecting the tax, and eliminates the problematic decision by the seller about whether the buyer is or is not an end consumer.[2]

Value added tax (VAT) in theory avoids the cascade effect of sales tax by taxing only the *value added* at each stage of production. For this reason, throughout the world, VAT has been gaining favour over traditional sales taxes. In principle, VAT applies to all provisions of goods and services. VAT is assessed and collected on the value of goods or services that have been provided every time there is a transaction (sale/purchase). The seller charges VAT to the buyer, and the seller pays this VAT to the government. If, however, the purchaser is not an end user, but the goods or services purchased are costs to its business, the tax it has paid for such purchases can be deducted from the tax it charges to its customers. The government only receives the difference; in other words, it is paid tax on the gross margin of each transaction, by each participant in the sales chain. In many developing countries such as India, sales tax/VAT are key revenue sources as high unemployment and low per capita income render other income sources inadequate. However, there is strong opposition to this by many sub-national governments as it leads to an overall reduction in the revenue they collect as well as a loss of some autonomy. In theory sales tax is normally charged on end users (consumers). The VAT mechanism means that the end-user tax is the same as it would be with a sales tax. The main difference is the extra accounting required by those in the middle of the supply chain; this disadvantage of VAT is balanced by application of the same tax to each member of the production chain regardless of its position in it and the position of its customers, reducing the effort required to check and certify their status. When the VAT system has few, if any, exemptions such as with GST in New Zealand, payment of VAT is even simpler. A general economic idea is that if sales taxes exceed 10%, people start engaging in widespread tax evading activity (like buying over the Internet, pretending to be a business, buying at wholesale, buying products through an employer etc.) On the other hand, total VAT rates can rise above 10% without widespread evasion because of the novel collection mechanism. However, because of its particular mechanism of collection, VAT becomes quite easily the target of specific frauds like carousel fraud, which can be very expensive in terms of loss of tax incomes for states.

The standard way to implement a VAT involves assuming a business owes some percentage on the price of the product minus all taxes previously paid on the good. If VAT rates were 10%, an orange juice maker would pay 10% of the £5 per liter. By the method of collection, VAT can be accounts-based or invoice-based.[2] Under the invoice method of collection, each seller charges VAT rate on his output and passes the buyer a special invoice that indicates the amount of tax charged. Buyers who are subject to VAT on their own sales (output tax), consider the tax on the purchase invoices as input tax and can deduct the sum from their own VAT liability. The difference between output tax and input tax is paid to the government (or a refund is claimed, in the case of negative liability). Under the accounts based method, no such specific invoices are used. Instead, the tax is calculated on the value added, measured as a difference between revenues and allowable purchases. Most countries today use the invoice method, the only exception being Japan, which uses the accounts method. By the timing of collection,[3] VAT (as well as accounting in general) can be either accrual or cash based. Cash basis accounting is a very simple form of accounting. When a payment is received for the sale of goods or services, a deposit is made, and the revenue is recorded as of the date of the receipt of funds — no matter when the sale had been made. Cheques are written when funds are available to pay bills, and the expense is recorded as of the cheque date — regardless of when the expense had been incurred. The primary focus is on the amount of cash in the bank, and the secondary focus is on making sure all bills are paid. Little effort is made to match revenues to the time period in which they are earned, or to match expenses to the time period in which they are incurred. Accrual basis accounting matches revenues to the time period in which they are earned and matches expenses to the time period in which they are incurred. While it is more complex than cash basis accounting, it provides much more information about your business. The accrual basis allows you to track receivables (amounts due from customers on credit sales) and payables (amounts due to vendors on credit purchases). The accrual basis allows you to match revenues to the expenses incurred in earning them, giving you more meaningful financial reports. Consider the manufacture and sale of any item, which in this case we will call a widget. In what follows, the term "gross margin" is used rather than "profit". Profit is only what is left after paying other costs, such as rent and personnel.

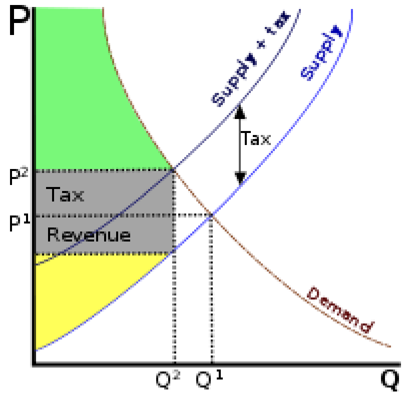
- A widget manufacturer spends 1.00 on raw materials and uses them to make a widget.
- The widget is sold wholesale to a widget retailer for 1.20, making a gross margin of 0.20
- The widget retailer then sells the widget to a widget consumer for 1.50, making a gross margin of 0.30
- The manufacturer pays $1.00 for the raw materials, certifying it is not a final consumer.
- The manufacturer charges the retailer $1.20, checking that the retailer is not a consumer, leaving the same gross margin of $0.20.
- The retailer charges the consumer $1.50 + ($1.50 x 10%) = $1.65 and pays the government $0.15, leaving the gross margin of $0.30.[3]

So the consumer has paid 10% ($0.15) extra, compared to the no taxation scheme, and the government has collected this amount in taxation. The retailers have not paid any tax directly (it is the consumer who has paid the tax), but the retailer has to do the paperwork in order to correctly pass on to the government the sales tax it has collected. Suppliers and manufacturers only have the administrative burden of supplying correct certifications, and checking that their customers (retailers) aren't consumers. This is, of course, all theory. In practice a retailer specializes in sales to consumers. Retailers tend to sell a large variety of products and have enough on hand for their trade until the next supply shipment comes in, but not enough on hand, for example, to sell 100,000 widgets to one customer. In another example, for clarification, a consumer cannot wander into a grocery store and make a point-of-sale purchase for 10,000 rolls of toilet paper. On the other hand, there is nothing to prevent a nonconsumer from avoiding tax at "retail" establishments that cater to both consumers and non-end-users. However the burden is on the non-end-users to provide the business license, exemption certificate, etc., necessary for exemption from sales taxes ordinarily collected by the retail establishment. A large exception to this state of affairs which is growing exponentially is online sales. Typically if the online retail firm has no "presence" in the state where the merchandise will be delivered, no obligation is imposed upon the retailer to collect sales taxes from "out-of-state" purchasers. Generally, state law requires that the purchaser report such purchases to the state taxing authority and pay the sales tax. It is fair to say that many citizens are unaware of this obligation and that states make little effort to raise that awareness or provide a reasonably easy way of complying with the obligation.

With a 10% VAT:

- The manufacturer pays $1.10 ($1 + ($1 x 10%)) for the raw materials, and the seller of the raw materials pays the government $0.10.
- The manufacturer charges the retailer $1.32 ($1.20 + ($1.20 x 10%)) and pays the government $0.02 ($0.12 *minus* $0.10), leaving the same gross margin of $0.20. ($1.32 - $0.02 - $1.10 = $0.20)
- The retailer charges the consumer $1.65 ($1.50 + ($1.50 x 10%)) and pays the government $0.03 ($0.15 *minus* $0.12), leaving the same gross margin of $0.30 ($1.65 - $0.03 - $1.32 = $0.30).

With VAT, the consumer has paid, and the government received, the same as with sales tax. The businesses have not incurred any tax themselves. Their obligation is limited to assuming the necessary paperwork in order to pass on to the government the difference between what they collect in VAT (output tax, an 11th of their sales) and what they spend in VAT (input VAT, an 11th of their expenditure on goods and services subject to VAT). However they are freed from any obligation to request certifications from purchasers who are not end users, and of providing such certifications to their suppliers. The advantage of the VAT system over the sales tax system is that under sales tax, the seller has no incentive to disbelieve a purchaser who says it is not a final user. That is to say the payer of the tax has no incentive to collect the tax. Under VAT, all sellers collect tax and pay it to the government. A purchaser has an incentive to deduct input VAT, but must prove it has the right to do so, which is usually achieved by holding an invoice quoting the VAT paid on the purchase, and indicating the VAT registration number of the supplier. There are no problems with online sales from businesses located within the country under a national VAT system. All buyers pay VAT and if the buyer is a company, they deduct the VAT. A company can buy consumer items they need in small quantities, like coffee and toilet paper, in a shop without certifying they are not a consumer. In the above example, we assumed that the same number of widgets were made and sold both before and after the introduction of the tax. This is not true in real life. The fundamentals of supply and demand suggest that any tax raises the cost of transaction for *someone*, whether it is the seller or purchaser. In raising the cost, either the demand curve shifts leftward, or the supply curve shifts upward. The two are functionally equivalent. Consequently, the quantity of a good purchased decreases, and/or the price for which it is sold increases. This shift in supply and demand is not incorporated into the above example, for simplicity and because these effects are different for every type of good. The above example assumes the tax is *non-distortionary*. A VAT, like most taxes, distorts what would have happened without it. Because the price for *someone* rises, the quantity of goods traded decreases. Correspondingly, some people are *worse* off by *more* than the government is made *better* off by tax income. That is, more is lost due to supply and demand shifts than is gained in tax.[4] This is known as a deadweight loss. The income lost by the economy is greater than the government's income; the tax is inefficient. The entire amount of the government's income (the tax revenue) may not be a deadweight drag, if the tax revenue is used for productive spending or has positive externalities - in other words, governments may do more than simply *consume* the tax income. While distortions occur, consumption taxes like VAT are often considered superior because they distort incentives to invest, save and work *less* than most other types of taxation - in other words, a VAT discourages consumption rather than production.



A Supply-Demand Analysis of a Taxed Market

In the above diagram,

- Deadweight loss: the area of the triangle formed by the tax income box, the original supply curve, and the demand curve
- Governments tax income: the grey rectangle that says "tax revenue"
- Total consumer surplus after the shift: the green area
- Total producer surplus after the shift: the yellow area

The "value-added tax" has been criticized as the burden of it relies on personal end-consumers of products. Some critics consider it to be a regressive tax, meaning the poor pay more, as a percentage of their income, than the rich. Defenders argue that excising taxation through income is an arbitrary standard, and that the value-added tax is in fact a proportional tax in that people with higher income pay more at the same rate that they consume more.[5] The effective progressiveness or regressiveness of a VAT system can also be affected when different classes of goods are taxed at different rates. To maintain the progressive nature of total taxes on individuals, countries implementing VAT have reduced income tax on lower income-earners, as well as instituted direct transfer payments to lower-income groups, resulting in lower tax burdens on the poor.[4] Revenues from a value added tax are frequently lower than expected because they are difficult and costly to administer and collect. In many countries, however, where collection of personal income taxes and corporate profit taxes has been historically weak, VAT collection has been more successful than other types of taxes. VAT has become more important in many jurisdictions as tariff levels have fallen worldwide due to trade liberalization, as VAT has essentially replaced lost tariff revenues. Whether the costs and distortions of value added taxes are lower than the economic inefficiencies and enforcement issues (e.g. smuggling) from high import tariffs is debated, but theory suggests value added taxes are far more efficient. Certain industries (small-scale services, for example) tend to have more VAT avoidance, particularly where cash transactions predominate, and VAT may be criticized for encouraging this. From the perspective of government, however, VAT may be preferable because it captures at least some of the value-added. For example, a carpenter may offer to provide services *for cash* (i.e. without a receipt, and without VAT) to a homeowner, who usually cannot claim input VAT back. The homeowner will hence bear lower costs and the carpenter may be able to avoid other taxes (profit or payroll taxes). The government, however, may still receive VAT for various other inputs (lumber, paint, gasoline, tools, etc.) sold to the carpenter, who would be unable to reclaim the VAT on these inputs (unless of course the carpenter also has at least some jobs done with receipt, and claims all purchased inputs to go to those jobs). While the total tax receipts may be lower *compared to full compliance,* it may not be lower than under other feasible taxation systems. Because exports are generally zero-rated (and VAT refunded or offset against other taxes), this is often where VAT fraud occurs. In Europe, the main source of problems is called carousel fraud. Large quantities of valuable goods (often microchips or mobile phones) are transported from one member state to another. During these transactions, some companies owe VAT, others acquire a right to reclaim VAT. The first companies, called 'missing traders' go bankrupt without paying. The second group of companies can 'pump' money straight out of the national treasuries. This kind of fraud originated in the 1970s in the Benelux-countries. Today, the British treasury is a large victim.[5] There are also similar fraud possibilities inside a country. To avoid this, in some countries like Sweden, the major owner of a limited company is personally responsible for taxes. This is circumvented by having an unemployed person without assets as the formal owner.

VAT is introduced into the Indian taxation system from 1 April 2005. Of the 28 Indian states, eight did not introduce VAT. Bihar had already adopted it on 1 April 2004. OECD (2008, 112-13) approvingly cites Chanchal Kumar Sharma (2005) to answer why it has proved so difficult to implement a federal VAT in India. The book says: "Although the implementation of broad-base federal VAT system has been considered as the most desirable consumption tax for India since the early 1990s, such a reform would involve serious problems for the finances of regional governments. In addition, implementing VAT in India in context of current economic reforms would have paradoxical dimensions for Indian federalism. On one hand economic reforms have led to decentralization of expenditure responsibilities, which in turn demands more decentralization of revenue raising power if fiscal accountability is to be maintained. On the other hand, implementing VAT (to make India a single integrated market) would lead to revenue losses for the States and reduce their autonomy indicating greater centralization" asserts: "political compulsions have led the government to propose an imperfect model of VAT" 'Indian VAT system is imperfect' to the extent it 'goes against the basic premise of VAT'. India seems to have an 'essenceless VAT' because the very reasons for which VAT receives academic support have been disregarded by the VAT-Indian Style, namely: removal of the distortions in movement of goods across states; Uniformity in tax structure. Chanchal Kumar Sharma (2005:929) clearly states, "Local or state level taxes like octroi, entry tax, lease tax, workers contract tax, entertainment tax and luxury tax are not integrated into the new regime, which goes against the basic premise of VAT, which is to have uniformity in the tax structure. The fact that no tax credit will be allowed for inter-state trade seriously undermines the basic benefit of enforcing a VAT system, namely the removal of the distortions in movement of goods across the states." "Even the most essential prerequisite for success of VAT i.e. elimination of [Central sales tax (CST)] has been deferred. CST is levied on basis of origin and collected by the exporting state; the consumers of the importing state bear its incidence. CST creates tax barriers to integrate the Indian market and leads to cascading impact on cost of production. Further, the denial of input tax credit on inter-state sales and inter state transfers would affect free flow of goods." The greatest challenge in India, asserts Sharma (2005) is to design a sales tax system that will provide autonomy to subnational levels to fix tax rate, without compromising efficiency or creating enforcement problems. The Andhra Pradesh experience In the Indian state of Andhra Pradesh, the Andhra Pradesh Value Added Tax Act, 2005 came into force on 1 April 2005 and contains six schedules. Schedule I contains goods generally exempted from tax. Schedule II deals with zero rated transactions like exports. Schedule III contains goods taxable at 1%, namely jewellery made from bullion and precious stones. Goods taxable at 4% are listed under Schedule IV. The majority of foodgrains and goods of national importance, like iron and steel, are listed under this head. Schedule V deals with Standard Rate Goods, taxable at 14.5%. All goods that are not listed elsewhere in the Act fall under this head. The VI Schedule contains goods taxed at special rates, such as some liquor and petroleum products.[6] The Act prescribes threshold limits for VAT registration - dealers with a taxable turnover of over Rs.40.00 lacs, in a tax period of 12 months, are mandatorily registered as VAT dealers. Dealers with a taxable turnover, in a tax period of 12 months, between Rs.5.00 to 40.00 lacs are registered as

Turnover Tax (TOT) dealers. While the former category of dealers are eligible for input tax credit, the latter category of dealers are not. A VAT dealer pays tax at the rate specified in the Schedules. The sales of a TOT dealer are all taxable at 1%. A VAT dealer has to file a monthly return disclosing purchases and sales.[7] A TOT dealer has to file a quarterly return disclosing only sale turnovers. While a VAT dealer can buy goods for business from anywhere in the country, a TOT dealer is barred from buying outside the State of A.P. The Act appears to be the most liberal VAT law in India. It has simplified the registration procedures and provides for across the board input tax credit (with a few exceptions) for business transactions. A unique feature of registration in Andhra Pradesh is the facility of voluntary VAT registration and input tax credit for start-ups. The act not only provides for tax refunds for exporters (refund of tax paid on inputs used in the manufacture of goods exported) but also provides for refund of tax in cases where the inputs are taxed at 12.5% and outputs are taxed at 4%.[8]

Increased growth and pressure on the GCC's governments to provide infrastructure to support growing urban centers, the Member States of the Persian Gulf Cooperation Treaty, which together make up the Gulf Cooperation Council (GCC), have felt the need to introduce a tax system in the region. In particular, the United Arab Emirates (UAE) has clarified that government officials are studying the situation and considering implementation of a Value Added Tax.

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Chapter- 4

Commodity taxation under VAT

In the initial phase of development, the economy is based on primary activities and industrial activities do not have a major role in the system. As a result, Gross Domestic Product (GDP) is not very high and the government has to depend upon taxes on commodities and services for mobilizing resources rather than on taxes on income and property. Such a situation prevails in almost all the primary economies. As the economy develops, the proportion of revenue generated from taxes on income and property rises. Tax-GDP ratio (tax revenue as percentage of GDP) of India is very low in comparison with not just the developed countries, but many developing countries as well. Whereas developed countries like Sweden, Greece, United Kingdom, and USA have tax-GDP ratio higher than 30 percent, many of the developing countries too have a higher ratio-Korea 26 percent, Brazil 21 percent, and Mexico 18.5 percent. In comparison, the tax-GDP ratio of India is very low, just 14.4 percent in 2001-02. While the tax-GDP ratio in India (centre and states combined) was 13.8 percent in 1980-81, it increased to 15.8 in 1991-92. Owing to structural adjustments and rationalization of tax structure during the nineties, the ratio declined to 13.4 percent in 1998-99. Since then the ratio has shown mild improvement. It reached 14.4 percent in 2001-02.[1]

As in other developing countries, in India too, indirect taxes have contributed significantly to the tax-GDP ratio. The ratio of indirect taxes to GDP was 11.53 percent in 1980-81 and increased to 13.68

percent in 1989-90. It plummeted to 10.56 percent in 1998-99 but then rose to 10.96 percent in 2001-02. Owing to implementation of some major tax reforms in the central government in the nineties, its tax-GDP ratio has declined but the tax revenue collected by the States, as a percent to GDP, has increased steadily. The tax-GDP ratio of the states, taking the states own tax revenue, has increased from 4.64 percent in 1980-81 to 5.30 percent in 1990-91 and reached a high of 5.8 percent in 2001-02. Similarly, the indirect tax-GDP ratio of states has moved from 4.45 percent in 1980-81 to 5.08 percent in 1990-91 and further to 5.62 percent in 2001-02.

Trends in total tax revenue in India indicate that whereas in 1980-81 total tax revenue was Rs. 19,844 crore, it increased to Rs. 1,03,198 crore in 1991-92 and to Rs. 3,30,229 crore in 2001-02. It recorded a growth rate of 14.5 percent per annum. Taxes on commodities and services have an important role. These contribute to almost three-fourth of the revenue received from all taxes taken together. These taxes have grown from Rs.16,576 crore in 1980-81 to Rs. 75,462 crore in 1990-91. It rose further to Rs. 2,51,728 crore in 2001-02, with a growth rate of 13.8 percent per annum. Taxes on income and property have contributed a small share, although over the years their stake has increased. Whereas its contribution in 1980-81 was just 16.5 percent, it increased to approximately 24 percent in 2001-02. The share of taxes on income and property has shown a fluctuating trend during 1980-81 to 1990-91, but thereafter it showed steady growth. During the overall period of 1980-81 to

2001-02, it has recorded an annual growth rate of 17 percent. Buoyancy of total tax revenue of centre and states during 1980-81 to 2001-02 (as shown in Table 2.5) is 1.05. Buoyancy has, however, declined from 1.11 during 1980-81 to 1989-90 to 0.88 during 1990-91 to 2001-02. This is primarily due to decline in the buoyancy of taxes on commodities and services, which has shown a declining trend in 1990-91 to 2001-02 as compared to the buoyancy in the earlier period i.e. during 1980-81 to 1989-90. As shown in Table 2.5, the buoyancy of these taxes was 1.14 during 1980-81 to 1989-90 and 0.81 during 1990-91 to 2001-02. Buoyancy of direct taxes has shown an increase from 0.94 during 1980-81 to 1989-90 to 1.24 during the second decade of the study, indicating an encouraging responsiveness.

Trends in tax revenue of centre and states, as given in Table 2.2, indicate that the Central Government collected total tax revenue of the order of Rs. 67,361 crore in 1991-92, which increased to Rs. 1,96,693 crore in 2001-02, recording a growth rate of 14.02 percent per annum over the period. The major contributing taxes in the central tax revenue are union excise duty and customs duty. The yield from union excise duty (UED), the major contributor to the share of commodity taxes, was of the order of Rs. 6,500 crore in 1980-81, contributing 63.83 percent to the indirect taxes of the centre. The share declined to 52.66 percent in 1990-91, which increased during 1994-95 and 1995-96 but again declined to 59.10 percent in 2001-02. Customs duty is yet another important source of revenue to the central kitty. It contributed to the order of Rs. 3,409 crore in 1980-81 and this increased to Rs. 40,268 crore in 2001-02. Its share in total commodity taxes has, however, changed considerably over the period. While its share in 1980-81 was 33.48 percent, it consistently increased up to 1990-91 and the share was recorded at 44.35 percent of total indirect taxes of the centre. Thereafter, ever since the policy of liberalization was adopted and customs duty was adjusted to a lower level, its yield has gone down. With minor fluctuations its share has been recorded at 32.80 percent in 2001-02. Service tax was introduced by the central government in 1994-95, when the share of this tax was less than 1 percent. By 2001-02, the share of this tax has increased to approximately 3 percent.

Yield from UED, the largest source of revenue obtained from taxes on commodities and services by the centre was Rs. 6,500 crore in 1980-81. The revenue has since increased to Rs. 24,514.4 crore in 1990-91 and to Rs. 72,555 crore in 2001-02 (RE). There has been a declining trend in the share of UED in the total tax revenue of the central government during the period 1980-81 to 1990-91. It has decelerated persistently from 63.8 percent in 1980-81 to 52.7 percent in 1990-91 except for the years 1983-84 and 1989-90, when its share was 63 percent and 53.8 percent, respectively. UED has witnessed upward trend in its share during 1991-92 to 1994-95. The trend reversed thereafter until 1996-97, when it came down to 50 percent. Since then there was a systematic increase in its share and it reached 59 percent in 2001-02. The growth rate of UED during the period (1980-81 to 1989-90) was 14.6 percent per annum. During the second phase i.e. 1990-91 to 2001-02, the growth rate was only 10.4 percent per annum. The overall rate of growth over twenty years was 12.18 percent.

Duties of customs, including export duties, are another source of revenue from indirect taxes to the centre. Among these, import duty forms a major source of revenue. Revenue collection from customs duty has shown a rising trend: it has increased from Rs. 3,409.3 crore in 1980-81, to Rs. 20,643.8 crore in 1990-91, and to Rs. 40,268.0 crore in 2001-02. But from 1990-91 onwards, the share of customs duties in total tax revenue of Central government has decreased steadily, with slight variations during mid-1990s. In 1980-81, its share in total tax revenue of Centre was 33.5 percent, which went up to 44.4 percent in 1990-91 and then declined to 33 percent in 2001-02. The annual rate of growth during 1980-81 to 2001-02 was 13.36 percent. However, during the first half of this period i.e. during 1980-81 to 1989-90, the growth rate was much higher-- 21.03 percent, as compared to growth rate of 8.6 percent during the latter half i.e. during 1990-91 to 2000-01. The share of customs duty in total tax revenue, Centre and States taken together, increased steadily from 17.2 percent in 1980-81 to 23.5 percent in 1990-91, and then decreased to 12 percent in 2001-02.

With structural reforms and significant changes in the institutional framework in India, the services sector has grown at a rapid rate. About 50 percent of GDP is obtained from services sector. This made it important to levy tax on services. At present, the Central government is levying and collecting service tax on 58 services. The revenue realized from this tax forms part of the 'divisible pool' and is shared between the Centre and the States, in accordance with provisions of Article 270 of the Constitution. This tax was levied, for the first time, in 1994-95 by the centre on five services. It generated revenue worth Rs. 407 crore. Revenue from this tax has increased over time bringing it to Rs. 3,302 crore in the year 2001-02. Among all the three taxes collected by Centre, service tax has increased at the rate of about 30.7 percent during the period 1990-91 to 2001-02. Since it is a new levy, its growth rate has been the highest.

As it is a new tax, service tax has proved to be the most buoyant source of tax revenue, having a buoyancy rate of 2.04 for the period 1994-95 to 2001-02. Customs duty had also shown good responsiveness and recorded higher buoyancy in the first half of the period as compared to the latter half. Its buoyancy was 0.95 during 1980-81 to 2001-02. Similarly the buoyancy recorded for UED is 0.86 for the same period. As in other taxes, the buoyancy of both the UED and of customs duty has fallen during this period. It was 1.03 in 1980-81 to 1989-90 and 0.75 in 1990-91 to 2001-02 for UED whereas it was 1.44 and 0.64, respectively for customs duties. Total tax revenue of all the State governments has increased from Rs. 35,837 crore in 1991-92 to Rs. 1,33,536 crore in 2001-02, showing a growth rate of 15.3 percent per annum. Consequently, the States' share in total revenue has gone up from 33.6 percent in 1980-81 to 34.4 percent in 1990-91 and to 40.5percent by 2001-02. Revenue of the States, from taxes on commodities and services, shows a rising trend. The revenue has increased from Rs.6,394 crore in 1980-81, to Rs. 28,915 crore in 1990-91 and to Rs.1,28,979 crore in 2001-02. It has increased by as much as 20 times during the entire period, a growth rate of 15.35 percent per annum. The important taxes on commodities and services levied by the states are sales tax, state excise, motor vehicles tax, passengers & goods tax, electricity duty and entertainment tax. Sales tax alone contributes around 60 percent of taxes on commodities and services, while state excise, motor vehicles tax and passengers & goods tax together contribute 23 to 24 percent. Thus, these taxes contribute approximately 84 percent of the states revenue from taxes on commodities and services.

This tax constitutes a major source of revenue for the State governments. The yield from sales tax has shown an upsurge from Rs. 3,853.0 crore in 1980-81 to Rs. 17,460.0 crore in 1990-91 and to Rs. 79,855 crore in 2001-02. Sales tax revenue collected by all the States expressed as a percentage of taxes on commodities and services has risen steadily from 60.3 percent in 1980-81 to 62 percent in 2001-02. The same trend is observed in its share in total tax revenue of Centre and States. This has gone up from 19.4 percent in 1980-81 to 24 percent in 2001-02. Sales tax revenue has witnessed a growth rate of 14.41 percent during 1990-91 to 2001-02 as compared to 15.82 percent during 1980-81 to 1990-91. Sales tax is the most buoyant source of revenue, even though its buoyancy has declined from 1.11 to 1.02 over time.

This is another indirect tax levied by State governments and can be regarded as the second largest source of revenue from such taxes. The yield from State excise has recorded about a three-fold increase from Rs. 838.3 crore in 1980-81, to Rs. 4,798.4 crore in 1990-91 and to Rs.17,987 crore in 2001-02. However, the revenue collected from State excise as a percentage of revenue collected from taxes on commodities and services shows a different pattern. It increased from 13 percent in 1980-81 to 16.6 percent in 1990-91 but was 13.9 percent in 2001-02. The share of state excise duty in the total revenue of the centre and the states was 4.1 percent in 1980-81. That has increased to 5.5 percent in 1995-96.

Since then it has moved downwards and reached 5.4 percent in the year 2001-02. It has recorded a growth rate of 12.85 percent during 1990-91 to 2001-02 as compared to the growth rate of 17.09 percent during the period 1980-81 to 1989-90. The buoyancy of State excise was higher in the first half of the period as compared to the latter half. It has reduced from 1.20 to 0.92 during the latter half of the period.

The primary reason for levying tax on motor vehicles is to regulate and control motor traffic in the cities. But it has been observed that motor vehicles tax can also serve as a good source of revenue. The revenue yield from it has increased from Rs. 1,535.4 crore in 1990-91 to Rs. 8,694.2 crore in 2001-02. The share of passengers and goods tax in total revenue obtained from taxes on commodities and services is lesser than that of motor vehicles tax. In 2001-02, it was about 2.8 percent. The yield from this tax has gone up from Rs. 1,187.2 crore in 1990-91 to Rs. 3,735.5 crore in 2001-02. While examining the trends in revenue receipts from tax on motor vehicles and passengers and goods, it is important to note that its revenue has almost doubled during the period 1990-91 to 2001-02. It has steadily increased from Rs. 698.9 crore in 1980-81, to Rs. 2,597.2 crore in 1990-91 and to Rs. 11,489.5 crore in 2001-02. However, its share in total revenue receipts from taxes on commodities and services has decreased from 10.9 percent in 1980-81 to 8.9 percent in 2001-02. It has recorded a growth rate of 14.59 percent during 1980-81 to 1989-90 and 13.50 percent during 1990-91 to 2001-02. Similarly, its buoyancy has also decreased from 1.03 to 0.96 during the same time periods. The consumers pay an additional amount, known as electricity duty, along with the electricity rates for consuming electricity. This acts as a good source of revenue for the State governments. The revenue from this tax was Rs. 228 crore in 1980-81 but went up to Rs. 1,596 crore in 1991-92 and stood at Rs. 5,677.7 crore in 2001-02, recording a growth rate of 20.45 percent during 1980-81 to 1989-90 and 13.64 percent during 1990-91 to 2001-02. Accordingly, its buoyancy is also recorded at 1.41 and 0.97 during the two periods of time.

Entertainment tax, levied on admission to places of amusement or entertainment namely cinema, circus, theatrical performances, exhibition, sports and games, variety entertainment etc. generated revenue to the tune of Rs. 233.6 crore in 1980-81. It went up to Rs. 1,203.7 crore in 2000-01 but has shown a slight decline in 2001-02. It has recorded a growth rate of 6.25 percent during the period 1980-81 to 1989-90 and of 9.19 percent during the period 1990-91 to 2001-02. Accordingly, its share in the states own tax revenue from commodities and services (from all States taken together) has also reduced from 3.7 percent in 1980-81 to 1.5 percent in 1990-91 and to 0.72 percent in 2001-02. Revenue obtained from taxes on commodities and services has increased steadily overtime and with the development of the services sector, it is expected to grow further. However, as pointed out earlier in this chapter, the tax-GDP ratio in India is low due to various factors including non-taxation of agriculture and service sectors, both of which contribute considerably to the GDP. Lack of adequate tax compliance, resulting in considerable evasion of tax, has also been responsible for low tax-GDP ratio. In recent years there has been some down fall in tax-GDP ratio, as shown in Table 2.1, due to tax reforms in consonance with structural reforms and the adoption of liberalization.

These factors have had a major impact on the indirect tax-GDP ratio. An analysis of tax wise break-up during recent years indicate that the main reason for decline in tax-GDP ratio in the nineties was slump in the revenue from customs duty and the union excise duty (UED) that account for over two-thirds of the central tax revenues. The buoyancy of these two taxes with respect to GDP declined during this period. It fell down from 1.03 for UED and 1.44 for customs duty in the eighties to 0.75 and 0.64 in the nineties.

An analysis of the causal variables responsible for this decline points out that from the time of the advent of the policy of liberalization, the rates of customs duty have gradually been brought down to bring these at par with other countries of the world and to follow the WTO bindings. In the process of rationalization of UED, as recommended by the *Tax Reforms Committee, 1991-93,* the tax rates on many of the commodities were reduced. Extension of Modvat and efforts at conversion of UED, from the production type VAT to consumption type VAT by giving input credit for capital goods in one go, had a dampening effect on the revenue of UED. Sizeable dampening effect of Modvat credit for raw materials as well as for capital goods has been noticed during the period on the revenue from UED. An analysis of the trends in Modvat credit in 1995-96, for example, indicates that while net revenue (gross revenue minus input credit) would have grown at 16.4 percent (instead of 4.4 percent) if no change had been made with respect to the scheme of Modvat credit. Interestingly, the larger effect of Modvat credit that has been witnessed, on account of credit for raw materials as compared to the credit for capital goods, is the decline of the rate of growth of revenue. Finally, the global recession seems to be another possible reason of sluggishness in revenue from customs and UED, due to its adverse effects on industrial production. All these factors have adversely affected the tax-GDP ratio in the nineties.

Table 4.1

Tax-GDP Ratio

Year	**Tax-GDP Ratio (percent)**	**Direct Tax-GDP Ratio (percent)**	**Indirect Tax-GDP Ratio (percent)**
1980-81	13.80	2.27	11.53
1981-82	14.32	2.45	11.87
1982-83	14.47	2.39	12.08
1983-84	14.36	2.24	12.13
1984-85	14.59	2.17	12.41
1985-86	15.56	2.25	13.31
1986-87	15.92	2.21	13.70
1987-88	16.08	2.11	13.97
1988-89	15.87	2.31	13.56
1989-90	15.98	2.30	13.68
1990-91	15.42	2.16	13.27
1991-92	15.80	2.55	13.25
1992-93	15.25	2.59	12.66

1993-94	14.19	2.53	11.67
1994-95	14.60	2.85	11.75
1995-96	14.75	3.01	11.74
1996-97	14.62	3.00	11.62
1997-98	13.49	3.32	11.17
1998-99	13.38	2.82	10.56
1999-2000	14.18	3.14	11.03
2000-01	14.51	3.41	11.10
2001-02(RE)	14.38	3.42	10.96

Source: Govt. of India (2002-03), *Indian Public Finance Statistics*, Ministry of Finance, New Delhi

Table 4.2

Tax Revenue: Centre and States (Combined)

(Rs. Crore)

Year	Centre			States			Combined		
	Taxes on Income & Property#	Taxes on Commodities & Services#	Total Central Taxes^	Taxes on Income & Property*	Taxes on Commodities & Services*	Total State Taxes^	Taxes on Income & Property	Taxes on Commodities & Services	Total of Central & State Taxes
1980-81	2997 (22.7)	10182 (77.3)	13179 (66.4)	271 (4.1)	6394 (95.9)	6665 (33.6)	3268 (16.5)	16576 (83.5)	19844 (100.0)
1981-82	3786 (23.8)	12061 (76.1)	15847 (65.6)	347 (4.2)	7948 (95.8)	8295 (34.4)	4133 (17.2)	20009 (82.8)	24142 (100.0)
1982-83	4139 (23.3)	13557 (76.6)	17696 (65.0)	353 (3.6)	9193 (96.3)	9546 (35.0)	4492 (16.5)	22750 (83.5)	27242 (100.0)

1983-84	4498 (21.7)	16223 (78.2)	20721 (65.7)	409 (3.7)	10395 (96.2)	10804 (34.3)	4907 (15.5)	26618 (84.4)	31525 (100.0)
1984-85	4798 (20.4)	18673 (79.5)	23471 (65.5)	532 (4.3)	11811 (95.6)	12343 (34.5)	5330 (14.8)	30484 (85.1)	35814 (100.0)
1985-86	5620 (19.6)	23051 (80.3)	28671 (66.3)	632 (4.3)	13965 (95.6)	14597 (33.7)	6252 (14.4)	37016 (85.5)	43268 (100.0)
1986-87	6236 (18.9)	26601 (81.0)	32837 (66.3)	653 (3.9)	16048 (96.1)	16701 (33.7)	6889 (13.9)	42649 (86.1)	49538 (100.0)
1987-88	6752 (17.9)	30914 (82.1)	37666 (66.1)	731 (3.7)	18580 (96.2)	19311 (33.9)	7483 (13.1)	49494 (86.8)	56977 (100.0)
1988-89	8830 (19.8)	35644 (80.1)	44474 (66.4)	928 (4.1)	21524 (95.8)	22452 (33.6)	9758 (14.5)	57168 (85.4)	66926 (100.0)
1989-90	10003 (19.3)	41633 (80.6)	51636 (66.4)	1162 (4.4)	24895 (95.5)	26057 (33.6)	11165 (14.3)	66528 (85.6)	77693 (100.0)
1990-91	11030 (19.1)	46547 (80.8)	57577 (65.6)	1230 (4.1)	28915 (95.9)	30145 (34.4)	12260 (13.9)	75462 (86.0)	87722 (100.0)
1991-92	15353 (22.7)	52008 (77.2)	67361 (65.2)	1304 (3.6)	34533 (96.3)	35837 (34.8)	16657 (16.1)	86541 (83.8)	103198 (100.0)
1992-93	18140 (24.3)	56496 (75.6)	74636 (65.3)	1247 (3.1)	38283 (96.8)	39530 (34.7)	19387 (16.9)	94779 (83.0)	114166 (100.0)
1993-94	20299 (26.8)	55443 (73.2)	75742 (62.1)	1414 (3.1)	44805 (96.9)	46219 (37.9)	21713 (17.8)	100248 (82.1)	121961 (100.0)
1994-95	26973 (29.2)	65324 (70.7)	92297 (62.4)	1905 (3.4)	53647 (96.5)	55552 (37.6)	28878 (19.5)	118971 (80.4)	147849 (100.0)
1995-96	33564 (30.1)	77660 (69.8)	111224 (63.4)	2213 (3.4)	61822 (96.5)	64035 (36.6)	35777 (20.4)	139482 (79.5)	175259 (100.0)
1996-97	38898 (29.9)	90864 (70.0)	129762 (64.5)	2163 (3.0)	69131 (96.9)	71294 (35.5)	41061 (20.4)	159995 (79.5)	201056 (100.0)
1997-98	48282 (34.6)	90938 (65.3)	139220 (63.1)	2256 (2.7)	79183 (97.2)	81439 (36.9)	50538 (22.9)	170121 (77.1)	220659 (100.0)
1998-99	46601 (32.4)	97196 (67.5)	143797 (61.7)	2518 (2.8)	86702 (97.1)	89220 (38.3)	49119 (21.1)	183898 (78.9)	233017 (100.0)
1999-00	57960 (33.7)	113792 (66.2)	171752 (62.5)	2904 (2.8)	99927 (97.1)	102831 (37.5)	60864 (22.1)	213719 (77.8)	274583 (100.0)
2000-01	68305	120298	188603	3457	113260	116717	71762	233558	305320

	(36.2)	(63.7)	(61.7)	(2.9)	(97.0)	(38.3)	(23.5)	(76.4)	(100.0)
2001-02 (RE)	73944 (37.5)	122749 (62.4)	196693 (59.5)	4557 (3.4)	128979 (96.5)	133536 (40.5)	78501 (23.7)	251728 (76.2)	330229 (100.0)
Growth Rate	17.43	12.76	14.02	13.12	15.35	15.27	17.13	13.87	14.47

Source: Government of India, *Budget Documents* (various issues).

Table 4.3

Taxes on Commodities & Services: Central Government

(Rs. Crore)

Year	Union Excise Duty	Customs Duty	Service Tax	Total Taxes on Commodities & Services
1980-81	6500 (63.83)	3409.3 (33.48)		10182
1981-82	7420.7 (61.52)	4300.4 (35.65)		12061
1982-93	8058.5 (59.44)	5119.4 (37.76)		13557
1983-84	10221.8 (63.0)	5583.4 (34.41)		16223
1984-85	11150.8 (59.71)	7040.5 (37.70)		18673
1985-86	12955.7 (56.20)	9525.8 (41.32)		23051
1986-87	14470.2 (54.39)	11475 (43.13)		26601
1987-88	16425.7 (53.13)	13702.4 (44.32)		30914
1988-89	18841.3 (52.85)	15805.1 (44.34)		35644
1989-90	22406.3 (53.81)	18036.1 (43.32)		41633

1990-91	24514.4	20643.8		46547
	(52.66)	(44.35)		
1991-92	28109.8	22256.7		52008
	(54.04)	(42.79)		
1992-93	30831.5	23776.4		56496
	(54.57)	(42.08)		
1993-94	31696.6	22192.7		55443
	(57.16)	(40.02)		
1994-95	37347.2	26789.1	407	65324
	(57.17)	(41.0)	(0.62)	
1995-96	40187.3	35756.8	862	77660
	(51.74)	(46.04)	(1.10)	
1996-97	45037.8	42851	1059	90864
	(49.56)	(47.15)	(1.16)	
1997-98	47961.6	40192.8	1586	90938
	(52.74)	(44.19)	(1.74)	
1998-99	53246.2	40668.3	1957	97196
	(54.78)	(41.84)	(2.01)	
1999- 2000	61901.8	48419.6	2128	113792
	(54.39)	(42.55)	(1.87)	
2000- 2001	68526.1	47542	2613.4	120298
	(56.96)	(39.52)	(2.17)	
2001-02 (RE)	72555	40268	3302	122749
	(59.10)	(32.80)	(2.69)	
Growth Rate	12.18	13.36	30.72	12.76

Source: Government of India, *Budget Documents* (various issues).

Table 4.4

Taxes on Commodities & Services: State Governments

(Rs. Crore)

Year	Sales Tax	State Excise	Motor Vehicles & Passengers & Goods Tax	Electricit y Duty	Entertain ment Tax	Total taxes on Commod ities & Services
1980-81	3853.0 (60.3)	838.3 (13.1)	698.9 (10.9)	228.3 (3.6)	233.6 (3.7)	6394
1981-82	4858.9 (61.1)	1128.5 (14.2)	770.6 (9.7)	269.1 (3.4)	269.1 (3.4)	7948
1982-93	5440.7 (59.2)	1355.7 (14.7)	986.9 (10.7)	307.2 (3.3)	307.2 (3.3)	9193
1983-84	6203.2 (59.7)	1582.8 (15.2)	1087.6 (10.5)	367.5 (3.5)	304.1 (2.9)	10395
1984-85	7028.9 (59.5)	1857.4 (15.7)	1198.4 (10.1)	454.7 (3.8)	360.1 (3.6)	11811
1985-86	8392.3 (60.1)	2071.1 (14.8)	1385.3 (9.9)	632.6 (4.5)	391.3 (2.8)	13965
1986-87	9568.7 (59.6)	2426.7 (15.1)	1594.6 (9.9)	802.2 (5.0)	365.6 (2.3)	16048
1987-88	11139.7 (60.0)	2880.3 (15.5)	1848.4 (9.9)	806.7 (4.3)	354.4 (1.9)	18580
1988-89	13093.2 (60.8)	3098.0 (14.4)	2162.3 (10.0)	999.2 (4.6)	425.7 (2.0)	21524
1989-90	15001.0 (60.3)	3886.0 (15.6)	2323.5 (9.3)	1084.0 (4.4)	427.5 (1.7)	24895
1990-91	17460.0 (60.4)	4798.4 (16.6)	2597.2 (9.0)	1187.2 (4.1)	422.1 (1.5)	28915
1991-92	20682.3 (59.9)	5466.8 (15.8)	2976.6 (8.6)	1596.0 (4.6)	468.5 (1.4)	34533
1992-93	23004.5 (60.1)	6287.3 (16.4)	3404.0 (8.9)	1753.2 (4.6)	487.6 (1.3)	38283
1993-94	27296.2 (60.9)	7120.8 (15.9)	3987.0 (8.9)	1739.4 (3.9)	560.4 (1.3)	44805
1994-95	33089.0 (61.7)	7759.5 (14.5)	4555.4 (8.5)	2234.0 (4.2)	544.0 (1.0)	53647
1995-96	35530.8 (57.5)	8606.9 (13.9)	5195.4 (8.4)	2375.6 (3.8)	703.4 (1.1)	61822
1996-97	42027.4 (60.8)	8848.7 (12.8)	5793.3 (8.4)	2718.2 (3.9)	796.0 (1.2)	69131
1997-98	45351.3 (57.3)	11383.9 (14.4)	6816.7 (8.6)	3194.3 (4.0)	1035.1 (1.3)	79183
1998-99	49250.9 (56.8)	13438.8 (15.5)	7018.7 (8.1)	3772.9 (4.4)	926.6 (1.1)	86702

1999-2000	57592.7 (57.6)	15093.0 (15.1)	8269.4 (8.3)	3667.3 (3.7)	907.4 (0.9)	99927
2000-01	72547.7 (64.1)	15825.8 (14.0)	8548.2 (7.5)	4396.1 (3.9)	1203.7 (1.1)	113260.0
2001-02(RE)	79854.8 (61.9)	17987.6 (13.9)	11489.5 (8.9)	5677.7 (4.4)	853.2 (0.7)	128979.0
Growth Rate	15.33	15.24	13.13	15.84	7.19	15.35

Source: Government of India, *Budget Documents* (various issues).

Table 4.5

Buoyancy: Total Tax Revenue, Direct Tax, Indirect Tax

	1980-81 to 1989 -90	1990-91 to 2001-02	1980-81 to 2001-02
Combined (Centre and States)			
Total Tax Revenue	1.11	0.88	1.05
Direct Tax	0.94	1.24	1.22
Indirect Tax	1.14	0.81	1.02
Centre			
Total Tax Revenue	1.12	0.84	1.03
Direct Tax	0.92	1.25	1.24
Indirect Tax	1.18	0.69	0.95
1. Union Excise Duty	1.03	0.75	0.86
2. Customs Duty	1.44	0.64	0.95
3. Service Tax	-	2.04*	2.04*
States			
Total (States' Own) Tax Revenue	1.09	0.97	1.11
Direct Tax	1.14	0.71	0.95

Indirect Tax	1.09	0.98	1.12
1. Sales Tax	1.11	1.02	1.08
2. State Excise	1.20	0.92	1.07
3. Motor Vehicles Tax & PGT	1.03	0.96	0.93
4. Electricity Duty	1.41	0.97	1.11
5. Entertainment Tax	0.46	0.68	0.52

Source: Government of India, *Budget Documents* (various issues).

India's indirect tax system is unique in that under the Constitution, the Union government has the authority to impose a broad spectrum of excise duties on production or manufacture while the States are assigned the power to levy sales tax on consumption. In addition, States are empowered to levy tax on many other goods and services in the form of entry tax, octroi, entertainment tax, electricity duty, motor vehicles tax, passengers and goods tax, etc. Due to this dichotomy of authority under the Constitution, India has been rather slow in the adoption of VAT. Also, it has created an obstacle in introducing European-style VAT in India, although over the years, tax reform committees have recommended that union excise duty, sales tax, and other domestic trade taxes be replaced by a comprehensive VAT that could tax all commodities and services.

At the Union level, at the time of Independence, India inherited a system of commodity taxes in which Union excise duties (UEDs) were levied on about a dozen articles yielding a small proportion of total tax revenue to the Centre. Following Independence, the rates were raised, the base was enlarged, as more and more items were brought into its net. Over time, there was a speedy extension of UEDs. It was not only levied on finished goods but also on raw materials, intermediate goods and capital goods.

Structure of CenVAT

In 1986, for the first time, reforms were initiated in the basic UEDs through the introduction of modified value added tax (Modvat). This provided for set-off for taxes on inputs. Initially, it was introduced for a selected number of commodities. The coverage was limited to 37 chapters out of a total of 91. Over time, Modvat was extended to some additional commodities. Finally, it has been extended to almost all commodities except light diesel oil, high-speed diesel, motor spirit (gasoline) (as input) and matches (as final product). In effect, it has been replaced by Central VAT (known as CenVAT) in the Budget 2000-01. The existing rate under CenVAT is 16 percent.

In common parlance, CenVAT is sometimes known as basic excise duty which becomes payable at the time of clearance of such goods. This duty is specified against each sub-heading in the First Schedule to the Central Excise Tariff Act, 1985. There are, however, notifications issued by the Central Government which grant either total or partial exemption from duty. These exemptions are both general and conditional in nature. The effective rate of basic excise duty is thus determinable only after reference to the relevant exemption notification. The rate as applicable at present is given in Table 3.1. In addition to the basic excise duties, some other taxes are also levied. These include: Special Excise Duty, Additional Duties of Excise, and Cess, as given below: *Special Excise Duty (SED)*: This duty is leviable only on a few items. The rate of duty and the items on which it is leviable are specified under the Second Schedule to the Central Excise Tariff Act, 1985 (as shown in Table 2). In general, the SED is levied at the rate of 8 percent, which is levied over and above CenVAT (Basic excise duty). This makes the effective rate of most commodities covered under SED 24 percent. In the years to come, the Union government aims at having one rate category for all items under CenVAT.[2] Most of the items under SED are final products but some of the items also fall in the category of intermediate goods.

Additional Duties of Excise: There are a number of additional duties leviable under different enactments on various commodities. Under Additional Duties of Excise (Textile and Textile Articles) Act, 1978, duty of excise is chargeable on specified textiles and textile articles. Additional Duties of Excise (Goods of Special Importance) Act, 1957, prescribes additional duties on sugar, tobacco products and textile articles in lieu of sales tax. AEDILST is a tax rental arrangement between the Centre and the States. According to this arrangement, the Union government levies additional excise duty in lieu of sales tax and the States refrain from levying sales tax on these items. The net proceeds of this duty were being distributed among the States until the Report of the Eleventh Finance Commission, which has recommended its inclusion under the sharable taxes. Considering these recommendations and taking note of the views of the States expressed in the States' Finance Ministers Committee, the Centre has amended the Additional Excise Duties Act in 2003 to enable the States to levy sales tax on these items at a rate not exceeding 4 percent, without being denied the share (1.5 percent) of revenue from AEDILST.

Cess : Different items are subject to levy of Cess at varying rates under different enactments. Also, cesses on specified commodities are levied in addition to CenVAT and AEDILST. However, these are primarily meant to raise resources for the development of concerned industries. The revenue department administers these levies but some other departments also contribute in this endeavour. The CenVAT Scheme allows instant credit for excise duty, special excise duty (SED), additional duty of excise (ADE) and countervailing duty (CVD) paid on inputs and capital goods received in a factory for the manufacture of any dutiable final product (except matches). The credit could be utilised to pay excise duty on any final product. That is, all raw materials or inputs are covered except light diesel oil, high-speed diesel and motor spirit (gasoline). Similarly, credit could be availed on capital goods including pollution control equipment, components, spares, accessories, moulds, dyes and paints, packaging material, greases/coolants and fuels.

Through the introduction of CenVAT, credit can be taken by the manufacturer immediately on receipt of eligible and duty-paid goods in the factory. There is no need for the manufacturer to file any declaration or obtain any permission. For capital goods, however, only 50 percent of the duty paid on the goods can be availed of in a financial year; the remaining credit can be claimed in the next financial year, provided the goods are still in use (except for spares and components, refractories, moulds and dyes). Further, no depreciation should be claimed by the manufacturer under Section 32 of the Income Tax Act, 1961 on that part of the value of these capital goods which represents the amount of duty paid on such goods. A manufacturer who manufactures only tax-exempt final products is not allowed to take this credit. However, a manufacturer producing both dutiable and exempted final products in the same factory is eligible to avail of its benefits. This is subject to certain conditions *viz.*, maintenance of separate records in respect of inputs used to manufacture exempted products or payment of 8 percent of the total price (excluding all taxes) of the exempted final products or in the case of a few specified items, on reversal of the credit availed. Similarly, credit can be availed of on capital goods, if not used exclusively for the manufacture of exempted final products.

The scheme of CenVAT, *inter alia*, provides the following facilities:

- Removal of inputs or capital goods on payment of an amount equal to the credit availed in respect of such inputs or capital goods;
- Removal of goods to job-workers for processing, testing, reconditioning or for any other purpose, provided that the goods are received back within 180 days or are removed from the premises of the job-worker;
- Refund of credit accumulated due to export under bond of the final products is also permissible;
- Unutilised CenVAT credit can be transferred on account of shifting of a factory to another site or due to change in ownership by sale, merger, amalgamation, lease or transfer to a joint venture wherein liabilities are also transferred; and

- A special dispensation has been made in the case of goods manufactured in specified areas of the North-East, Kutch district of Gujarat, state of Jammu & Kashmir and State of Sikkim.

The manufacturer should take reasonable steps to ensure that the appropriate duty has been paid on inputs or capital goods on which credit is availed, as indicated in the documents accompanying the goods. The reforms introduced in the last few years have resulted in transparency of the tax burden under the UEDs. In addition, it has reduced the cascading effect of input taxation as well as the pyramiding effect of the tax. It has also generated a mechanism to check evasion of tax through self-policing. Empirical studies on the impact of the introduction of CenVAT show that there is a definite positive effect. In fact, industrial units have been able to save on interest (ranging between 0.5 and 1 percent of the total duty paid). Also, the overall effect has been revenue neutral and has not caused any price effect. In addition, the reforms implemented under UEDs during last 15 years have simplified its structure especially through CenVAT. While previously there was a large number of rates, over the years it has been brought down considerably. As of now, the general rate of CenVAT is 16 percent. However, in many cases the actual duty paid on inputs could be less than the tariff rate through exemption notifications. Also, a few commodities are subjected to 8 or 16 percent special excise. These are also given credit for tax paid on inputs. Apart from rationalization of rate structure, exemption notifications have also been curtailed and most specific rates are converted into *ad valorem* rates. Further, the rate structure of CenVAT is linked to the Harmonised System of Nomenclature (HSN). The HSN system is in vogue in most countries and facilitates international trade.

Administrative Controls under CenVAT

The administrative controls under CenVAT (or the UEDs) fall in some categories, described below:

a. Physical Control: This is the oldest form of control under the Union excise duty. Under this control, there is an assessment of tax by the Central Excise Officer posted at the factory, before the removal of goods. Thereafter, the goods are moved under his supervision and under the cover of an invoice countersigned by him. This system is now restricted to cigarettes only.

b. Self-Assessment Procedure: Under this procedure, earlier known as self-removal procedure, the assessee assesses the duty liability himself and pays it into the account of the government. If duty rate is *ad valorem* and the assessee sells goods to a related person or he has factories manufacturing similar goods in different Central Excise Divisions or Commissionerates or he removes goods for captive consumption etc., he can resort to self assessment. The assessee self-assesses his tax liability and pays it monthly.

c. Compounded Levy Scheme: This procedure is meant for small-scale decentralised sector and at present covers stainless steel, aluminium circles and *Pattis/Pattas*. Under this scheme, the duty for a specified period is fixed on the basis of the number and type of machines. Payment of tax under this procedure absolves the manufacturer from observing day-to-day formalities of CenVAT regarding maintenance of accounts and removal of goods etc.

d. Collection of Duty at the Point of Consumption: Tax under this system is confined to Khandsari Molasses going for manufacture of alcohol, whether for potable or industrial use. The duty is paid by the distillers on the date of receipt of *khandsari* molasses. The CenVAT credit is admissible on *khandsari* molasses to the extent that it is used for manufacture of excisable goods.

Obligations under CenVAT

As in the case of dealers under VAT in other countries, CenVAT has also introduced VAT procedures under the new system. It has placed some obligations on the part of the dealers paying CenVAT.

Declarative Obligations:

The administration of CenVAT requires various declarative obligations as given below:

a. Tax Payer Registration: Every manufacturer of excisable goods (except small-scale manufacturer) is required to get himself registered before the commencement of production. Registration is valid for the premises it is granted. That is, a manufacturer having more than one premises must obtain a separate registration for each of the premises from the respective Range Superintendent having jurisdiction over the premises, be it a factory or a depot/branch office. If a manufacturer desires to start production of a new product, he should get his registration duly endorsed to this effect. There is no fee for registration and there is no need for its renewal. In addition to the manufacturer, since 1994, even wholesalers (*i.e*., dealers who intend to pass CenVAT credit to its buyers) could be registered. This system has been introduced to help small manufacturers.

b. Issue of Invoices: With effect from April 1, 1994, invoice has replaced the gate pass (GP-1) as the clearance document. It is prescribed that an invoice must accompany the consignment, each time the goods are transported from the factory to the godown of the manufacturer. To keep track of the clearance of goods from the factory, each accompanying page of the invoice book should be pre-authenticated by the owner or working partner or the Managing Director or Company Secretary or any other authorised officer of the assessee and be serially numbered in the book and the numbers intimated to the Superintendent of Central Excise in advance. It is provided that the CenVAT credit could be taken through the invoices issued by the first and the second stage dealers of excisable goods only. The credit cannot be taken on the basis of the invoices that are issued by the third and the subsequent stage dealers. Thus, the scheme of invoices has the following features:

i. The first stage dealer is defined as one receiving inputs directly from a manufacturer or his depot under the cover of an invoice.
ii. The second stage dealer is one who purchases from the first stage dealer.
iii. Both the first stage and the second stage dealers should be registered with the Central excise department.

c. Monthly Return: The manufacturer is required to pay CenVAT on a fortnightly basis and submit a monthly return (ER1) to the Superintendent of Central Excise by the 10th of the month following the month during which duty was paid. Manufacturers availing of the small-scale exemption, based on value or quantity of clearances during a financial year, need to file their returns only on a quarterly basis. The return must contain:

Particulars of goods manufactured and cleared, and amount of excise duty paid;
Particulars of inputs received during the month and the amount of duty taken as credit; and

Information on total duty paid through Personal Ledger Account (PLA) (account current) and CenVAT credit giving details of disposal of inputs and utilisation of the credit.

Accounting Obligations:
With the introduction of CenVAT, maintenance of statutory accounts has been done away with. That is, the manufacturer himself shall maintain his records regarding receipt, disposal, consumption and inventory of goods containing relevant information. If CenVAT credit is taken or utilized wrongly, the same, along with interest, will be recovered and if the same involves fraud, willful mis-statement, collusion, suppression of facts or contravention of the provisions of the Act or the Rules, mandatory penalty and interest will also be attracted.

The duty is paid monthly. The amount of duty payable is recorded in the daily stock account before clearance.

Manufacturers who are to pay duty on the final products cleared by them can pay duty in cash or through the CenVAT credit.

Special Audit: In addition to the already existing powers, under section 14 of the Central Excise Act (to summon persons to give evidence and to produce documents), the Excise Department is empowered to go into the cost structure of the goods manufactured through a cost audit to decide whether there is under-invoicing.As far as the Department is concerned, the cost audit report would prevail to determine the assessable value, notwithstanding any cost audit done in the unit under any law *viz.* the Companies Act, 1956. The expenses, including the fee for the cost accountant, are borne by the Department.

Weaknesses of the System under CenVAT

The existing structure of CenVAT (*i.e.* UED) and the procedures for its administration calling for specified obligations are characterised by the following weaknesses:

Firstly, the existing procedures for physical controls are outmoded. In the context of the liberalised economy, it is immaterial whether the tax is levied through UED or CenVAT; physical control should have no place in the administrative system. It needs to be replaced by a self-assessment procedure. Secondly, the provision of registration of wholesalers has created a plethora of loopholes in the system to avoid payment of tax. While it does help small dealers to claim set-off for the tax on their inputs, the practice has created an additional work-load for the

Department, of cross-checking the sales and purchases with the claim of set-off by the small manufacturers. The resulting cases of evasion are also large. Earlier, when Modvat provisions were liberalised and dealers in excisable goods were also permitted to register themselves under Rule 174 of the Central Excise Rules, 1944, any dealer of excisable goods could register himself with the Superintendent of Central Excise in charge of the Range in which he had his premises. Under the liberalised procedures, there was no distinction between a manufacturer, a first-stage dealer, second-stage dealer or a subsequent-stage dealer. This led to fraud at a large scale when fictitious dealers were issuing modvatable invoices said to cover duty-paid excisable goods, on the basis of which Modvat credit was being taken fraudulently by various manufacturers. The detection of such fictitious invoices and fraudulent dealers became difficult because cross-verification could not be done within a reasonable time, through correspondence or through other means. As a result, a number of fictitious invoices, said to cover duty-paid excisable goods, were floating in the system resulting in an enormous loss of revenue. When this was detected, the Modvat credit was restricted to manufacturers, first-stage dealers and second-stage dealers. This has reduced fraud and issue of fictitious invoices to some extent. In fact, it could be further reduced if this facility is restricted to only the first-stage dealers and all the Central Excise Ranges and Divisions in the country are linked through a computer network. Thirdly, the coverage of CenVAT, as noted above, has not been extended to all the commodities. Initially (under Modvat), half the revenue was being derived through the commodities covered under it. Over the years the coverage has been expanded. Now it accounts for approximately 92 percent of the revenue through commodities under CenVAT. The time is ripe to incorporate other excises also into the ambit of CenVAT. Fourthly, deemed credit scheme on the central excise side was visualized as an administrative friendly measure to provide for Modvat credit in respect of various items, which are bought from the market and for which duty paying documents may not be readily available to link the purchase to the original manufacturer. Over the years, it has been found that this measure has been misused and Modvat credit has been availed not on genuine duty paying documents. Further, this diluted the broad objective of maintaining the CenVAT chain, where duty is paid at every stage and Cenvat credit is taken on the basis of actual duty paying documents. This has been particularly a problem in the textile industry where the scheme was allowed in respect of various chemicals and yarn. In the budget of 2003-04, the deemed credit scheme was done away with and now Cenvat credit is being allowed only on the basis of actual duty paying documents. However, in the case of textiles a variant of the deemed credit facility has been permitted. In the Budget 2003-04, the Government had imposed excise duty on grey fabrics produced by power looms. Subsequently, however, exemption has been allowed to small power looms on turnover basis. The exempted power looms do not pay duty. However, power loom owners have been allowed to endorse invoiced or issue challans in respect of the excise duty paid on yarn and on the basis of these invoices and challans, the processors can take Cenvat credit for the duty paid on yarn. Similar facility has been extended to garments or accessories manufacturers. It is visualized that this would discourage evasion of duty and ensures documentary discipline, which is so vital in a VAT system. This would have the additional benefit of ensuring duty payment at all stages, with the down stream process ensuring duty compliance by the upstream manufacture of yarn and chemicals. Finally, while it is true that the declarative and accounting obligations have been reformed considerably, there is room for reforms in the procedures for PLA.

Although there is no specific provision in the Constitution of India on the levy of tax on services, the Union Government, by virtue of Entry 97 of the Union List in the Constitution of India, levies taxes on selected services. Through the Finance Act, 1994, the Union Government has used its powers to tax a few services. The tax was levied with effect from 1st July 1994 under the Service Tax Rules 1994, which give details of administration procedures and operation of the tax. Historically, the *Taxation Enquiry Commission* (1953-54) did not recommend levy of tax on services due to administrative considerations. The *Indirect Taxation Enquiry Committee*, (1978) suggested that service tax could be levied only after estimating its revenue potential and carefully examining the practical problems associated with it. However, with a significant rise in share of services in GDP over the years, the *Tax Reform Committee* (1991) recommended that some services should be taxed, but over time these must be brought under the VAT regime.[3] *The Expert Group on Taxation of Services* (2001) also suggested that the tax base is required to be expanded by bringing in services under the tax net. The *Advisory Group on Tax Policy and Tax Administration* for the Tenth Plan (May 2001) recommended the integration of services with the CenVAT so as to arrive at a full-fledged VAT at the Centre. Recently, the *Task Forces on*

Indirect Taxes (December 2002) further recommended that the tax base be expanded by including more and more services in the tax net. Based on the recommendations of various Committees and Study Groups, the base of service tax was extended to some more services through the Finance (No. 2) Act 1996. It covered services provided by advertising agencies, courier agencies, and of radio paging, which were made applicable from 1st November, 1996.

The Finance Acts of 1997, 1998 and 2003 further extended the scope of service tax to cover as many as 58 services. The rate of service tax has also been increased from 5 percent to 8 percent on all the taxable services with effect from 14th May 2003.

Under Section 67 of the Finance Act, 1994, service tax is levied on the gross or aggregate amount charged by the service provider on the receiver. However, in terms of Rule 6 of Service Tax Rules, 1994, the tax is permitted to be paid on the value received. This has been done to ensure that providers of professional services are not inconvenienced, as in many cases, the entire amount charged/billed may not be received by the service provider and calling upon him to pay the tax on the billed amount in advance would mean asking him to pay from his own pocket. It would also make the levy a direct tax, which is against the scheme of service tax.

Administration of Service Tax

Service tax is administered by the Central Excise Commissionerates, working under the Central Board of Excise & Customs, Department of Revenue, Ministry of Finance, Government of

India. The unique feature of service tax is reliance on collection of tax, primarily through voluntary compliance. The tax is levied, as stated above, on specified 58 services and the responsibility of payment of the tax rests with the service providers. System of self-assessment has been introduced in this tax with effect from April 1, 2001. The jurisdictional Superintendent of Central Excise is authorized to cross verify the correctness of self assessed returns. Tax returns are expected to be filed half yearly.

Central excise officers are authorized to conduct surveys to bring the prospective service tax assessees under the tax net. Directorate of service tax at Mumbai oversees the activities at the field level for technical and policy level coordination.

Corporate assessees are required to pay tax on the value of taxable service, provided by them in a month, by the 25th of the following month to enable them to finalize the accounts. Further, the individual assessees are required to pay the levy only once in a quarter. The process of registration of assessees has been considerably simplified. No separate accounts have been prescribed for the purposes of service tax. It has been provided that accounts being maintained by the assessees under any other law in force would be sufficient. Frequency of filing the returns has been made half yearly in place of monthly/quarterly returns prescribed earlier.

The service tax credit rules were amended in 2003 so as to allow credit for the service tax paid on any input-service towards payment of the tax to be paid on any final service. This is a step in the right direction. It will reduce the cascading impact of tax and help in restoring competitiveness of service sector. This facility will go a long way in raising the tax compliance level and reducing disputes in administration of tax on services.

The authority to levy tax on commodities and services vests with both the centre and the states. The centre levies CenVAT and some excises at the level of manufacturing. The states also levy a variety of taxes on commodity and services. The authority to levy tax on services, however, was not explicitly provided in the Constitution. Article 265 of the Constitution lays down that no tax shall be levied or collected except by the authority of law. This authority is provided by the Seventh Schedule which provides for three Lists: *(i)* Union list (only Central Government has power of legislation); (ii) State list (only State Government has power of legislation); and (iii) Concurrent list (both Central and State Government can pass legislation). In view of the fact that 'tax on services' does not find specific mention in any of the above lists, the Central Government has introduced tax on services taking recourse to the residuary powers vested in it under Entry 97 in the Union List of the Seventh Schedule of the Constitution.

The States have now decided to introduce VAT in lieu of the existing sales tax system and suggested to the Central Government, through the auspices of the Empowered Committee, that they would eventually be having VAT on commodities as well as services.

Taking note of the request of the States, the Union Cabinet has recently legislated 95th Constitutional Amendment Act, 2003. Consequently, it has approved a proposal to amend the Constitution by:

i. Inserting a new entry (no. 92C – Taxes on services) in the Union List, Seventh Schedule of the Constitution, to give the Union Government the power to levy taxes on services as a specific item of taxation.

ii. Introducing a new Article (Article 268A) in the Constitution to enable the Union Government to levy the said tax and empowering both the Union and the State Governments to collect and appropriate the proceeds of the tax in accordance with a (new) law to be enacted by the Parliament, and

iii. Including, as a consequential measure, Article 268A among the Articles excluded from the purview of operation of Article 270.

This would enable parliament to formulate by law, principles for determining the modalities of levying service tax by the Central Government and collection of the proceeds thereof by the Centre and the States. Thus, the Centre would be able to

i. levy tax on services as a specific entry by the Union Government.

ii. Collect and appropriate proceeds of this tax by the Union Government as well as the State Governments, i.e., without the revenue from the tax on services becoming a part of the divisible pool under Article 270, and

iii. Enable the State Governments to fully exploit the potential of tax on services in order to enhance their financial resources.

A Working Group, comprising representatives of Central Government (Ministry of Finance and Company Affairs) and some selected State Governments was constituted by the Central Government to prepare the draft of a new legislation to govern tax on services, as envisaged in clauses (2) of the proposed new Article 268A. Based on the recommendations of the Working Group, draft legislation has been prepared. It is being examined by the Ministry of Finance and Company Affairs. On completion of this examination, the draft legislation on tax on services would be forwarded to the Empowered Committee of State Finance Ministers on VAT for detailed consideration, comments and suggestions for changes, if any, consistent with the proposed Constitutional amendment. The Central Government would like the process to be completed as expeditiously as possible, with the active collaboration of the States, so as to be able to introduce the new legislation after the proposed Constitutional amendment comes into effect and VAT is introduced by the States and Union Territories.

Table 4.6

Rates under CenVAT

Sl. No.	Commodities	CenVAT rate
1.	Plastic lay flat tubing	8
2.	100% wood free particles or fibre board made from bagasse or other agro-waste	8
3.	Paper, paperboard or articles thereof made from pulp containing not less than 75% by weight of pulp made from non-wood materials	8
4.	T.V. chassis for B & W T.V. sets	8
5.	Electrically operated vehicles	8

6.	Cars for physically handicapped persons	8
7.	Sugar confectionery	8
8.	Biscuits	8
9.	Scented supari	8
10.	Matches made with use of power	8
11.	Rough ophthalmic blanks	8
12.	Pressure cookers	8
13.	Dentists' chairs	8
14.	Cakes and pastry	8
15.	Wafer biscuits	8
16.	Ceramic tiles manufactured in a factory not using electricity or LPG or propane gas for firing the kiln	8
17.	Candles	8
18.	Table and kitchenware of glass	8
19.	Imitation jewellary	8
20.	B & W T.V. sets	8
21.	Electrical bulbs of retail price not exceeding Rs. 20 per bulb	8
22.	Sunglasses for correcting vision	8
23.	Watches and clocks of retail price not exceeding Rs. 500 per piece	8
24.	Toothbrushes	8
25.	Solid or hollow building blocks in which more than 25% by weight of red mud, press mud or other specified materials are used	8

26.	Blocks, slabs, concrete beans and stairs used in pre-fabricated buildings	8
27.	Laboratory glassware	8
28.	Power driven pumps for handling water	8
29.	Crankshafts intended for use in sewing machines	8
30.	Specified medical equipment	8
31.	Mechano-therapy appliances, massage apparatus, etc.	8
32.	Prefabricated buildings	8
33.	Cotton yarn	8
34.	Cotton fabrics (woven)	8
35.	Woollen fabrics	8
36.	Woven synthetic fabrics	8
37.	Pile or chennile fabrics of wool, cotton or man made fibres	8
38.	Long pile fabrics of cotton or man made fibres	8
39.	Looped pile fabrics of cotton or man made fibres	8
40.	Terry toweling and similar woven terry fabrics of cotton or man made fibres	8
41.	Knitted or croacheted fabrics of cotton	8
42.	Terry toweling and similar woven terry fabrics of textile materials other than cotton or man made fibres	10
43.	Long pile fabrics, other than that of cotton or man made fibres	10

Rates under CenVAT

Sl. No.	Commodities	CenVAT rate
44.	Looped pile fabrics, other than that of cottn or man made fibres	10
45.	Woven fabrics of metal thread or of metallic yarn	10
46.	Narrow woven fabrics	10
47.	Woven fabrics of coarse animal hair or horse hair	10
48.	Woven fabrics of flax	10
49.	Woven fabrics of jute	10
50.	Woven fabrics of paper yarn	10
51.	Woven fabrics of other vegetable textile fibres	10
52.	Pile and chennile fabrics of textile material, other than wool, cotton, man made fibres	10
53.	Ready-made garments and specified clothing accessories	10
54.	Embroidery, in the piece, in strips or in motifs	10
55	High speed diesel	14
56	All other goods not enumerated above in any other Table	16

Table 4.7

Rates of Special Excise Duty (in addition to 16% CenVAT)

Sl. No.	Commodities	SED rate (%)
1.	Pan Masala	16
2.	Aerated water	8
3.	Chewing tobacco, snuff	16
4.	Petrol	14
5.	Special Boiling Point Spirits	16
6.	Tyres for cars, buses, trucks, multi-utility vehicles	8
7.	Tyre flaps	8
8.	Tyre tubes	8
9.	Polyester yarn	8
10.	Air-conditioners	8
11.	Cars, multi-utility vehicles	8
12.	Chassis for cars, multi-utility vehicles	8

Table 4.8

LIST OF SERVICES PRESENTLY BEING TAXED

Initially, the following three services were taxed:

(1) Telephone

(2) Stockbroker

The Finance Act (2) 1996 enlarged the scope of levy of Service Tax covering three more services, viz.,

(3) Advertising agencies,

(4) Courier agencies

(5) Radio pager services.

But tax on these services was made applicable from 1st November, 1996.

The Finance Acts of 1997 and 1998 further extended the scope of service tax to cover a larger number of services rendered by the following service providers, from the dates indicated against each of them.

(6)	Consulting engineers	(7th July, 1997)
(7)	Custom house agents	(15th June, 1997)
(8)	Steamer agents	(15th June, 1997)
(9)	Clearing & forwarding agents	(16th July, 1997)
(10)	Air travel agents ---	(1st July, 1997)
(11)	Tour operators	(exempted upto 31.3.2000 Notification No.52/98, 8th July, 1998, reintroduced w.e.f. 1.4.2000)
(12)	Rent-a-Cab Operators	(exempted upto 31.3.2000 Vide Notification No.3/99 Dt.28.2.99, reintroduced w.e.f. 1.4.2000)
(13)	Manpower recruitment Agency	(1st July, 1997)
(14)	Mandap Keepers	(1st July, 1997)

The services provided by goods transport operators, out door caterers and pandal shamiana contractors were brought under the tax net in the budget 1997-98, but abolished vide Notification No.49/98, 2nd June,1998.

The Service Tax is leviable on the 'gross amount' charged by the service provider from the client, from the dates as notified and indicated above.

Service Tax has been announced on 12 new services in 1998-99 union Budget. These services listed below were notified on 7th October, 1998 and were subjected to levy of Service Tax w.e.f. 16th October, 1998.

(15) Architects

(16) Interior Decorators

(17) Management Consultants

(18) Practicing Chartered Accountants

(19) Practicing Company Secretaries

(20) Practicing Cost Accountants

(21) Real Estates Agents/Consultants

(22) Credit Rating Agencies

(23) Private Security Agencies

(24) Market Research Agencies

(25) Underwriters Agencies

In case of mechanized slaughter houses, since exempted, vide Notification No.58/98 dtd. 07.10.1998,[4] the rate of Service Tax was used to be a specific rate based on per animal slaughtered. In the Finance

Act'2001, the levy of service tax has been extended to 14 more services, which are listed below. This levy is effective from 16.07.2001.

(26) Scientific and technical consultancy services

(27) Photography

(28) Convention

(29) Telegraph

(30) Telex

(31) Facsimile (fax)

(32) Online information and database access or retrieval

(33) Video-tape production

(34) Sound recording

(35) Broadcasting

(36) Insurance services

(37) Banking and other financial services

(38) Port

(39) Authorised Service Stations

(40) Leased circuits Services

In the Budget 2002-2003, 10 more services have been added to the tax net which are listed below. This levy is effective from 16.08.2002.

(41) Auxiliary services to life insurance

(42) Cargo handling

(43) Storage and warehousing services

(44) Event Management

(45) Cable operators

(46) Beauty parlours

(47) Health and fitness centres

(48) Fashion designer

(49) Rail travel agents.

(50) Dry cleaning services.

(51) Auxiliary Insurance Services

(52) Business Auxiliary Services

(53) Commercial Coaching & Training Services

(54) Commissioning & Installation

(55) Franchise Services

(56) Maintenance or Repair Services

(57) Pager

(58) Technical Testing & Analysis and Technical Inspection & Certification

Table 4.9

Trends in Revenue from Services

(Rs. Crore)

Financial Year	No. of Services Taxed	No. of Assessees	Revenue Received
1994-95	3	3,943	410
1995-96	3	4,866	846
1996-97	6	13,982	1022
1997-98	18	45,991	1515
1998-99	30	1,07,479	1787
1999-00	27	1,15,495	2072
2000-01	26	1,22,326	2540
2001-02	41	1,87,577	3305
2002-03	51	2,32,048	4125
Growth Rate			29.38

State Taxes on Commodities and Services

The structure of domestic trade taxes levied by the central government has been analyzed in the preceding chapter. This included an analysis of union excise duty on goods produced or manufactured in India and taxes levied by the central government on services. The present chapter deals with an analysis of the taxes on commodities and services levied by the State Governments. The most important of these are sales tax, state excise, motor vehicles tax, passengers & goods tax, entertainment tax, electricity duty etc.

Sales Tax

Sales tax is the most important tax on commodities levied by the states. Most of the states levy sales tax at the first-point of sale, i.e. on the sale made by the manufacturer or the wholesaler. Some of the states levy tax on the last registered dealer who sells commodities to the consumer or to the unregistered dealer. Bihar is the only state that has replaced its sales tax by value added tax (VAT).

The rate structure of sales tax is so designed that many of the commodities used by the poor strata of society are exempted from the tax. Necessities, raw materials and capital goods are taxed at the rate of 4 percent. However, the general rate of sales tax in most of the states is 8 percent, levied on majority of the commodities. Goods falling in the category “Luxuries” are taxed at a high rate of 12.5 percent. In addition, there are two exceptions: bullion and precious stones are taxed at 1 percent and liquor is taxed at 20 percent or higher.

The existing rate structure of sales tax in Indian states indicate that most of them now follow the uniform floor rates of 0%, 4%, 8% and 12%, as recommended by the Empowered Committee of States Finance Ministers. In spite of this, variations do exist because the states have the freedom to levy rates higher than the uniform floor rates. Owing to these variations, there are umpteen rate categories.

The rate of sales tax for inputs, including raw materials, intermediary goods and capital goods, generally has a differential treatment under sales tax statute. As shown in Table 4.2, this treatment could be classified into three categories:

First, inputs are allowed total exemption from tax in some of the states/territories such as Delhi, Goa, Himachal Pradesh, Jammu & Kashmir, Manipur and Punjab. However, with the exception of Jammu & Kashmir and Delhi, all these states grant exemption only for raw materials used in the manufacture of taxable goods sold within the state. That is, the exemption is not available when the inputs are used to manufacture goods which are exempted from sales tax or when the manufactured taxable goods do not pay any tax to the state because of their consignment transfer to another state. However, in states like Delhi and Punjab where sales tax is imposed at the last-point on approximately half the commodities, no tax is levied on inputs used for producing goods falling under the last-point system. The tax is collected when the final goods are sold within the state.

Second, inputs are given concessional treatment in some states. The form and extent of concession, however, varies from state to state. Andhra

Pradesh, Gujarat, Maharashtra, Orissa and Tamil Nadu tax raw materials at a concessional rate of four percent; Bihar and Tamil Nadu at three percent while Kerala and West Bengal have a rate of two percent. Rajasthan levies a concessional rate of 3 percent when the inputs are used to manufacture taxable goods and 4 percent when used to produce tax-exempt goods.[5]

Finally, Assam does not grant any concessional treatment or exemption of tax on raw materials purchased for manufacturing purposes. However, small-scale manufacturing units (whose total fixed capital investment does not exceed Rs. 6.5 lakh), registered as small scale industrial units with the Director of Industries, are allowed a set-off or draw back by way of refund of taxes, paid on raw materials after assessment.

In brief, between the two principles of taxation of inputs, *viz*., physical ingredient rule and the direct use rule, all the states follow the former. Even when the physical ingredient rule is adopted, it varies in its application.

In addition to general sales tax, many of the states levy a turnover tax on all transactions; surcharge (SC) on the basic sales tax liability and additional sales tax (AST). Most of the states levy different combinations of these variants.

Surcharge is levied in 14 states. The nomenclature of the tax in some of the states is, however, different. In Gujarat, for example, it is known as AST, although the tax is in the nature of a surcharge. Seven of the states levy surcharge which covers all tax paying dealers but other states differentiate the levy as per turnover or tax liability or levy tax on a few select commodities. Maharashtra, for example, levies surcharge of one rupee per litre on petrol and diesel only. The rate of surcharge, in general, varies between 5 and 20 percent. Some of the states levy surcharge with a graduated rate structure.

AST is imposed in nine states. The rates vary between 0.5 and 15 percent in different states according to the turnover of tax paying dealers. Kerala levies 15 percent AST on all goods (except petroleum products and liquor). In some of the states, AST is known as turnover tax. Rajasthan levies turnover tax on all dealers except those having turnover up to Rs 30 lakh. West Bengal levies a turnover tax to the tune of 0.5 percent on resale of goods other than LPG, diesel, petrol, kerosene and furnace oil. In addition, it has increased the rate of turnover tax for large dealers. Seven of the states levy both surcharge and AST.[6]

In addition to AST and surcharge, some of the states levy an entry tax. Kerala levies an entry tax on a variety of goods. Coverage includes electrical goods, water supply and sanitary equipment & fittings, edible and inedible oils (including refined oil, hydrogenated oil and margarine), timber and a host of other items including petroleum products. Assam levies entry tax on some items on which sales tax is not collected. At the same time it has introduced entry tax on certain items, which have been exempted from the purview of sales tax, to prevent diversion of trade. Maharashtra imposes entry tax on selected commodities. Rajasthan has also imposed an entry tax ranging from 1 to 4 percent. The rate of tax is 1 percent on petrol, high-speed diesel, kerosene and other petroleum products, 2 percent on furnace oil and 4 percent on light speed diesel oil.

On the same pattern, Tamil Nadu also levies entry tax on 15 items. These include petroleum products, aluminium, asbestos cement sheets, PVC pipes, woven fabrics, sanitary ware, newsprint, iron and steel, tobacco, wheat products etc. The rate is 4 percent for all items except tobacco, which is taxed at 10 percent. In Karnataka too, some of the items that have a high rate of sales tax, also have an entry tax levied on them to prevent diversion of trade.

Luxury tax is yet another tax imposed in some of the states. It is levied on consumer items imported into the state. It is levied over and above the levy of existing sales tax. Such a tax earlier existed in West Bengal. Now other states are also levying this tax. Assam has introduced this tax in the budget for 2002-03 on items such as tobacco, *gutka*, tobacco mixed *pan-masala*, hand-made and mill-made silk fabrics, woollen and terry wool suiting. It has also levied a cess on crude oil. On similar lines, Delhi has also introduced luxury tax on a few selected commodities, viz., cigarettes, *gutka*, *pan-masala*, smoking mixtures and other tobacco products.

Bihar has switched over to VAT from April 1, 2003. In view of the fact that the other states have not switched over to VAT, it has adopted the rates levied by the rest of the states, *viz.,* 0, 4, 8, and 12 percent. However, the levy is 1 percent for bullion and precious stones and is 20 percent for petrol and diesel. It gives full credit for all inputs including capital goods. Input tax credit on capital goods is, however, restricted for use in manufacture of taxable goods for sale. However, on lines similar to provisions of the CST Act, 1956, manufacturers and certain other categories of VAT dealers have been allowed to buy inputs taxable at a higher rate, on payment of tax at the rate of 4 percent. To have low compliance cost for small dealers, Bihar has provided for payment of lump sum tax for specified category of dealers. The dealers included in this category are: works-contractors, halwaii (dealers in sweetmeats), plywood manufacturers, lottery dealers and retailers (not including importers).

Sales tax exemption already given to industrial units has been converted into deferment of tax for the remaining period and for the balance amount of benefit. In addition, these units have been granted the option for making payment at 50% of tax liability (along with tax-returns), which will be deemed as full payment and full credit passed on to the purchasing VAT dealer. In case of deferment, deferred tax is to be converted compulsorily into interest free loan, so that the tax credit could be passed on to the purchasing VAT dealer.

The following table shows the growth rate in tax receipts (Figures are in rupees in lakh):

Month	2003	2002	% Increase
April	22705	20077	13.09%
May	31745	29604	7.23%
June	22417	19611	14.31%
July	23069	17249	33.74%
August	21639	15988	35.34%
September		16306	

Growth rate in ST receipts in 2001-02 & 2002-03 has been 16.8% & 14.4%, respectively. Here it is important to note that Bihar has not given input credit for goods going out of the State. Also, the CST continues to be levied at the existing rate.[7]

Variants of VAT

While Bihar has already introduced VAT to replace the existing sales tax from April 1, 2003, some other attempts at introducing VAT on select transactions or on select commodities have also been made.

Experience of the introduction of VAT (in some form or the other), by some of the state governments in the past is of great importance to the other states experimenting with VAT.

From April 1, 1995, Andhra Pradesh levied VAT, on some select items, for resellers, at the rate of 4 percent rate on inputs. It is applicable to all manufacturers. Prior to the introduction of VAT, Andhra Pradesh abolished the (then) existing surcharge and turnover tax. It also reduced the rate slabs to six only.

Madhya Pradesh followed the threshold approach and introduced sales tax in addition to first-point tax on the value added for dealers with turnover higher than Rs. 1 crore, with effect from April 1, 1997. It brought down the threshold to Rs 50 lakh with effect from April 1, 1998. Also, it introduced one rate slab of 8 percent for all dealers falling under VAT.

State Excise:

Another important state tax on commodities is state excise. This is duty on "alcoholic liquors for human consumption and opium, Indian hemp and other narcotic drugs and narcotics; but not including medicinal and toilet preparations containing alcohol". A major part of the revenue under this tax comes from production and consumption of spirituous beverages, of which alcohol is the most important component.

Consumption of alcohol being injurious to health, individuals have not been granted any right to trade in this commodity; state governments have pre-empted monopoly in this trade. The revenue from this, however, depends upon the policy of prohibition of the state.

A system of auction or licensing is followed by which the individuals are given the right to trade in this commodity. In this context, it is observed that the present base is narrow and yields considerable low revenue in most of the states. This is primarily because the auction price of the shops or licenses has no relevance to the sale price of the commodity. It is proposed that the base of the tax should be changed to collect tax in relation to the price charged at the last-point of levy.[8]

To implement this suggestion, all the states have to enact legislation, on the pattern of Maharashtra legislation, to empower it to levy this tax on maximum retail price (MRP). To enable the government to do so, some amendments have to be done in the Excise Act. The important points that have to be focused on are as follows:

a. The government has the power to levy differential tax according to the place of consumption, strength of quality and the manufacturing cost of the commodity.

b. The manufacturing cost has to be determined and declared with reference to the principles enunciated by law.

c. The MRP has to be printed on the bottles sold.

Motor Vehicles and Passengers & Goods Tax

Motor vehicles tax is levied on acquisition of vehicles and includes one-off payment under Indian Motor Vehicles Act, 1939. The main objectives of this Act are to control and regulate the vehicular traffic in the country. The levies charged under this Act are for: (i) registering motor vehicles (ii) obtaining driving licenses (iii) transfer of ownership of motor vehicles (iv) trade certificates issued to manufacturers, dealers and repairs of vehicles (v) permit for transport vehicles (vi) certificate of fitness for transport. The levies include fees for registration, permit and driving license. The fees are raised and restructured from time to time. The states also levy tax on mechanically propelled vehicles. Although it is a central tax, its yield is assigned to the state.

The states, under their respective Motor Vehicles Taxation Acts, also levy this tax. The tax rates, as shown in Tables 4.5 and 4.6, vary from one state to another according to type of vehicle (such as private motor car, taxi, stage carriage etc.) or laden/unladen weight or cost of vehicle. Generally, private carriers are taxed at a higher rate as compared to public carriers.

The existing structure shows wide variations in tax rate. In fact, it is difficult to make comparisons of rates levied in different types of vehicles in different states. First, there are different schemes of classification of vehicles. Second, there is no uniformity in the bases of various levies.[9] Third, the tax is sometimes specific and some times *ad valorem.* Finally, in some states there is a one-off levy and in others, there is an *ad valorem* levy payable every year.

Lack of uniformity exists even in the case of scooters (two wheelers). Some states levy on the basis of engine capacity defined in terms of c.c. while in others it is on the basis of unladen weight (ULW). Some other states like Andhra Pradesh and Maharashtra levy on an *ad valorem* basis. The rate of tax on personal cars is levied on the basis of ULW and also on the basis of number of seats. Bihar and Punjab levy the tax on the basis of the number of seats while Andhra Pradesh, Gujarat, Himachal Pradesh. Karnataka, Kerala, Maharashtra, Orissa, Tamil Nadu, and West Bengal follow the basis of ULW.

In the case of passenger transport vehicles, like stage or contract carriage, the seating capacity and route length on which the carriage plies, form the tax base. The period of payment also varies; some states charge the tax quarterly while others charge annually. The tax on goods transport vehicles is primarily based on weight, i.e. registered laden weight (RLW) or unladen weight (ULW).

Apart from using it as a source of revenue, motor vehicles tax is used as an instrument for regulating and controlling vehicular emissions. This is done to protect the environment. Similarly, passengers & goods tax is used as a tool for regulating the flow of goods and the movement of people from one state to another.

Passengers & goods tax is levied on passengers and goods carried by road or by inland waterways. Both these taxes are similar in nature. In fact, these are treated as user charges or charge for construction and maintenance of roads. These taxes fall on the same base and are paid ultimately by the same group of persons. Some of the states levy both the motor vehicles tax and the passengers & goods tax, while others have merged the two and levy a single tax. Some of the states levy an additional surcharge on this tax. The rates of this tax, as given in Table 4.7, indicate considerable variation. They vary according to the nature and use of vehicles. Accordingly, vehicles are subjected to differential rates of tax. This is partly justified through the "benefit principle", i.e. the users of the vehicles should bear the costs of the construction and maintenance of roads.

As per the definition of this tax in the Acts, it is levied on the use of motor vehicles. The tax is known as road tax and regarded as the price charged by the states for the services provided by them. Even in practice, a major proportion of this tax is earmarked by the states for the construction and maintenance of roads in the state concerned.[10]

The overall burden of the two taxes in different states shows that the incidence is in the range of Rs. 24, 000 to Rs. 26,000 per vehicle per annum. Many of the states, however, levy a substantially lower tax. Also, the combined tax incidence, captured on the basis of compounded levy, indicates a burden in the range of Rs. 4,000 to Rs. 6,000. In some of the states, the burden is relatively low (ranging from Rs. 2,000 to Rs. 2,400). A comparative analysis of the combined burden of certain passengers and goods vehicles.

Entertainment Tax

This is a levy on admission to places of entertainment or amusement. The base includes admission to cinema, circus, theatrical performance, exhibition, sports, games, variety entertainment etc. Most of the states levy this tax at the state level but some of the states have given this tax to local bodies. In general, the revenue of this tax has declined over the years due to poor administration of the tax.[12]

Electricity Duty

Electricity duty is charged along with electricity rates. The charges of electricity are collected by the electricity authorities in different states as user charges for the supply of power, whereas the electricity duty is a tax collected for state Government. The yield of this tax primarily depends upon the consumption of electricity by consumers. Normally, the revenue from this tax would go up with the industrial development of the state, as the bulk consumers would in fact be industrial users .

Octroi

It is a tax on the entry of goods into a local area for consumption, use or sale therein. The local bodies levy it. Octroi is mostly a specific tax, based on quantity or weight of the commodity.[13] As a result there is a plethora of rates. This is a check-post based levy and not account based, therefore, more prone to evasion. Accordingly, keeping in view the demerits of this levy, most of the Commissions and Committees have recommended its abolition.

Various Committees and Study Groups have recommended that this tax should be abolished. Hence, it is now prevalent only in a few municipal corporations or municipalities. It is levied in four states *viz.,* Gujarat, Maharashtra, Orissa and Punjab yielding revenue to the tune of Rs. 300 crore in Gujarat, 928 crore in Maharashtra and 300 crore in Orissa. Imphal Municipal Council in Manipur is also levying this tax. However, the fiscal importance of octroi among different municipalities in a state is not uniform. While in some of the states, the revenue from octroi has equal fiscal importance in different municipalities/corporations, in the states like Maharashtra and Gujarat, the revenue collection is basically from one particular municipal corporation.

It is important to note that in order to levy octroi, the concerned local body (such as urban local body –ULB) has to erect a check-post barrier to verify the goods passing through its territory. It has to confirm that the goods entering into the said local area are meant for consumption, use or sale therein and collect octroi on only such goods that are meant for use or consumption in its territory. In view of the very nature of collection of tax at the check-post, the assessment is arbitrary and causes considerable corruption in the administration of the tax[14]

Environmental taxes:

Like motor vehicles tax, environmental taxes are also regulatory in nature. With economic development, it would be important to introduce taxes as a fiscal measure to protect the deteriorating environmental conditions in the states. To improve environmental standards in the states, it is important to recognize two important factors that affect environment.

First, the process of industrial production, which is a technical transformation of inputs into output, leading to the production of economic goods as well as waste-products (residuals). While the economic goods are taken care of rationally and carefully, the residuals (which are unimportant commercially) are dumped indiscriminately. Consequently, these residuals become a major source of pollution. Secondly, the management of residuals is a costly affair for the entrepreneur. Nineteen "polluting" industries have been identified by the Ministry of Environment and Forests. It is essential that the foreign direct investment should not be permitted into these industries. To accord an equal treatment to all the industries and to check the outputs of the residuals of the existing units (foreign or domestic) that fall in the category of polluting industries, it would be useful to introduce a *carbon tax* on the pattern of the *carbon tariff* on all the industries that fail to follow the minimum ambient standards (MINAS) prescribed by the Pollution Control Boards. The rate of the tax should be equal to marginal abatement cost, which is equal to the amount to be spent on reducing pollution caused by production of one additional unit of output. This could be obtained by calculating the additional amount to be spent for installing a better machinery or using better technique of production.[15]

Service Tax

The services sector in India has been growing rapidly over the years. The share of services in Gross Domestic Product (GDP) which was roughly 37.68% in 1960-61 and 36% in 1980-81, rose to nearly 47.1% in 1993-94 and approximately 48.8% in 2001-02. In 1953-54, Taxation *Enquiry Commission* didn't recommend the implementation of service tax due to some administrative and other considerations. The *Indirect Taxation Enquiry Committee*, in 1978, also suggested that service tax could be levied only after estimating its revenue potential and carefully examining the practical problems associated with it. However, with a significant rise in share of services in GDP by 1990-91, the *Tax Reforms Committee* recognized the revenue yielding capacity of this sector and recommended that some services should be taxed.[16] Overtime, more services have been brought under the tax net. Although there is no specific provision in the Constitution of India on the levy of tax on services, the Government of India, by virtue of Entry 97 of the Union List in the Constitution of India, levies taxes on selected services. It is important to levy tax on services sector to stabilize the tax-GDP ratio of our country, which has been declining since 1990-91.[17] This would not only enable the government to raise more resources, but would also rationalize the tax structure by expanding the tax base and reducing the tax rate levied on goods. Further, this would simplify the administrative procedures as the taxpayers as well as tax officials would not be required to distinguish between goods and services used as inputs in the production process. It has been noticed that traders who use services as inputs, find it difficult to claim VAT on their service inputs that are largely untaxed. Introduction of service tax would have a positive impact on relative prices of labour and capital leading to better resource allocation. This would have positive effects on the prices of the final products. Finally, it would make the tax structure more progressive.

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Chapter- 5

Commercial Taxes in Bihar

An Act to consolidate and amend the law relating to levy of tax on sales or purchases of goods in the State of Bihar and to provide for matters connected therewith or incidental thereto. BE it enacted by Parliament in the Fifty-sixth Year of the Republic of India as follows:- 1. Short title, extent and commencement.-(1) This Act may be called the Bihar Value Added Tax Act, 2005. (2) It shall extend to the whole of the State of Bihar. (3) It shall be deemed to have come into force on the 1st day of April, 2005. 2. Definitions.-In this Act, unless the context otherwise requires,- (a) "Assessing Authority" means any of the authorities referred to in section 10 who is directed under sub-section (2) of that section to exercise or perform all or any of the powers and functions conferred on an Assessing Authority under this Act; (b) "Assistant Commercial Taxes Officer" means an Assistant Commercial Taxes Officer appointed under sub-section (1) of section 10; (c) "Assistant Commissioner of Commercial Taxes" means an Assistant Commissioner of Commercial Taxes and Additional Assistant Commissioner of Commercial Taxes appointed under sub-section (1) of section 10; (d) "business" includes,- (i) any trade, commerce, manufacture or any adventure or concern in the nature of trade, commerce, manufacture, whether or not such trade, commerce, manufacture, adventure or concern is carried on with a motive to make gain or profit and whether or not any gain or profit accrues from such trade, commerce, manufacture, adventure or concern; (ii) any transaction of sale or purchase in connection with, or incidental or ancillary to, such trade, commerce, manufacture, adventure or concern; and (iii) any transaction in connection with, or incidental or ancillary to, the commencement or closure of such business; (e) "capital goods" means plant, machinery and equipment used in trade or manufacturing of goods; (f) "casual trader" means a person, who, whether as principal, agent or in any other capacity undertakes occasional transactions in the nature of business involving buying, selling, supply or distribution of goods or conducting any exhibition-cum-sale in the State of Bihar, whether for cash, deferred payment, commission, remuneration or other valuable consideration; (g) "Commercial Taxes Officer" means a Commercial Taxes Officer appointed under sub-section (1) of section 10; (h) "Commissioner" means the Commissioner of Commercial Taxes appointed under sub-section (1) of section 10 or Additional Commissioner of Commercial Taxes[1] and any other officer upon whom the State Government may, by notification, confer all or any of the powers and duties of the Commissioner under this Act; (i) "dealer" means any person who, whether regularly or otherwise, in the course of business, buys, sells, supplies, distributes or does anything incidental to such buying, selling, supplying or distributing of goods, directly or indirectly, whether for cash, or for deferred payment or for commission, remuneration or other valuable consideration and includes- (A) a local authority; (B) a Hindu undivided family; (C) a company, or any society (including a co-operative society), club, firm, association of persons or body of individuals, whether incorporated or not, which carries on such business; (D) a society (including a co-operative society), club, firm or association which buys goods from, or sells, supplies or distributes goods to its members; (E) an industrial, commercial, banking or trading undertaking, whether or not, of the Central Government or of any of the State Governments or of a local authority; (F) a casual trader; (G) a commission agent, broker, factor, a del credere agent, an auctioneer or any other mercantile agent, by whatever name called, who carries on the business of buying, selling, supplying or distributing goods on behalf of the principal. Explanation.- Every person who acts as an agent on behalf of a dealer residing outside the State of Bihar and buys, sells, supplies or distributes goods in the State or acts on behalf of such dealer as - (a) a commission agent, broker, factor, a del credere agent, an auctioneer or any other mercantile agent, by whatever name called; or (b) an agent for handling goods or documents of title to goods; or (c) an agent for the collection or the payment of the sale price of goods or as a guarantor for such collection or payment; or (d) a local branch of a firm or company situated outside the State, shall be deemed to be a dealer for the purposes of this Act; (j) "declared goods" means goods declared under section 14 of the Central Sales Tax Act, 1956 (74 of 1956) to be of special importance in inter-State trade or commerce; (k) "Deputy Commissioner of Commercial Taxes" means the Deputy Commissioner of Commercial Taxes or Additional Deputy Commissioner of Commercial Taxes appointed under sub-section (1) of section 10; (l) "goods" means all kinds of movable property including livestock, computer software, any electronic chip used for the purpose of storing or transmitting data or voice and all materials, commodities and articles (as such or in some other form) but excluding newspapers, electricity, actionable claims, stocks, shares or security. Explanation.- For the purposes of this clause, materials, commodities and articles,- (i) attached to or forming part of an immovable property which are agreed to be severed under the contract of sale; or (ii) sold or supplied as such or in some other form in the execution of works contract, lease or hire purchase, shall be deemed to be goods within the meaning of this clause; (m) "goods carrier" means a motor vehicle, vessel, boat, animal and any form of conveyance used for carrying goods; (n) "Government" means the Government of the State of Bihar; (o) "gross turnover" means, - (i) for the purposes of levy of tax on sales, in respect of sale of goods, aggregate of sale prices received or receivable by a dealer on sales and includes sale of goods made outside the State of Bihar or in the course of inter-State trade or commerce or export but does not include sale price of goods which have borne the incidence of tax on purchases under sections 4 and 5; (ii) for the purposes of levy of tax on purchase, aggregate of purchase prices paid or payable by a dealer during any given period in respect of purchase of goods or class or description of goods which are liable to tax under sections 4 and 5; and (iii) for the purposes of section 3, the aggregate of the amounts under sub-clauses (i) and (ii) above. Explanation.- For the purposes of this clause, the amount received by a dealer on account of price variation or price escalation in respect of sale or supply of goods shall be deemed to form part of gross turnover of the financial year during which it is actually received; (p) "importer" means a dealer who brings any goods into the State of Bihar or to whom any goods are despatched from any place outside the State of Bihar; (q) "input" means goods (excluding goods specified in Schedule IV) purchased in the course of business - (a) for re-sale; (b) for use in manufacture of goods including packing materials; (c) for use as capital goods as defined in clause (e); (r) "input tax" means the amount paid or payable by a registered dealer, by way of tax under this Act, in respect of purchase of any taxable goods; (s) "Inspector" means an Inspector of Commercial Taxes appointed under sub-section (3) of section 10; (t) "month" means a calendar month; (u) "notification" means a notification published in the Official Gazette; (v) "output tax" means the tax charged or chargeable in respect of sale or supply of goods made by a registered dealer; (w) "place of business" means any place where a dealer, either usually or for the time being, manufactures, sells or purchases goods or keeps accounts of stocks, manufactures, sales or purchases, execution of works contracts, hire purchase contracts and lease contracts or any other place where business activity takes place and includes - (i) the place of business of an agent, in case of a dealer carrying on business through an agent; or (ii) any place or building in which a person carrying on a business, keeps any of his books of account, documents, stocks or other things, relating to his business; (x) "prescribed authority" means the authority prescribed by the rules made under this Act to exercise powers conferred under different provisions and perform such functions as may be conferred by or under this Act; (y) "prescribed" means prescribed under the rules made under this Act; (z) "purchase price" means the amount paid or payable by a dealer as a valuable consideration in respect of purchase of goods and includes - (i) any amount charged for anything done by the vendor in respect of the goods at the time of, or before, the delivery thereof; (ii) transport costs or freight, if any; (iii) trade commission, if any, by whatever name called; (iv) clearing, forwarding and handling charges, if any; (v) insurance charges, if any; (vi) taxes or duties under any law for the time being in force (other than tax paid or payable under this Act) by whatever name called, if any; (vii) cost of packing, if any; and (viii) the amount paid or payable by the purchaser by way of non-refundable deposit, whether by way of a separate agreement or not, in connection with or incidental or ancillary to, the said purchase of goods; (za) "quarter" means the quarter ending on the 30th June, 30th September, 31st December and 31st March and the expression "quarterly" shall be construed accordingly; (zb) "registered dealer" means a dealer in possession of a valid certificate of registration granted to him under section 19 or under the provisions of the Bihar Finance Act, 1981 (Bihar Act 5 of 1981), as it stood before its repeal by section 94; (zc) "sale" with all its grammatical variations and cognate expressions means any transfer of property in goods for cash or deferred payment or for other valuable consideration and includes- (i) a transfer, otherwise than in pursuance of a contract, of property in any goods for cash, deferred payment or other valuable consideration; (ii) a transfer of property in goods (whether as goods or in some other form) involved in the execution of a works contract; (iii) a delivery of goods on hire purchase or any system of payment by instalments; (iv) a transfer of the right to use any goods for any purpose (whether or not for a specified period) for cash, deferred payment or other valuable consideration; (v) a supply of goods by any unincorporated association or body of persons to a member thereof for cash, deferred payment or other valuable consideration; (vi) a supply, by way of or as part of any service or in any other manner whatsoever, of goods, being food or any other article for human consumption or any drink (whether or not intoxicating) where such supply or service is for cash, deferred payment or other valuable consideration, and such transfer, delivery or supply of any goods shall be deemed to be a sale of those goods by the person making the transfer, delivery or supply and purchase of those goods by the person to whom such transfer, delivery or supply is made; (zd) "sale price" means the amount payable to a dealer as valuable consideration for the sale or supply of any goods and includes- (i) any amount charged for anything done by the vendor in respect of the goods at the time of, or before, the delivery thereof; (ii) transport costs or freight, if any;[2] (iii) trade commission, if any, by whatever name called; (iv) clearing, forwarding and handling charges, if any; (v) insurance charges, if any; (vi) taxes or duties levied under any law for the time being in force (other than tax paid or payable under this Act) by whatever name called, if any; (vii) cost of packing, if any; and (viii) the amount received or receivable by the seller by way of non-refundable deposit, whether by way of a separate agreement or not, in connection with or incidental to or ancillary to, the said sale of goods; Explanation I.- Where goods are sold on hire purchase or any system of payment by instalments, the sale price of such goods shall be inclusive of insurance charges, interest and hire charges and such other charges related to hire purchase or any system of payment by instalments. Explanation II.-Where goods are sold by way of transfer of right to use such goods, the sale price thereof shall be the amount of valuable consideration received or receivable by the transferor for such transfer; (ze) "tax" means the tax leviable and payable under this Act; (zf) "taxable goods" means all goods in respect of which tax is payable under section 14; (zg) "Tribunal" means the Tribunal constituted under sub-section (1) of section 9; (zh) "works contract" means any agreement for carrying out for cash or deferred payment or other valuable consideration, the construction, fitting out, improvement or repair of any building, road, bridge or other immovable or movable property; (zi) "year" means the financial year.[3]

VAT by Indian states has been hailed as one of the biggest tax-related reforms in several decades. The Empowered Committee (EC) of state Finance Ministers was the central body which coordinated the design and implementation of VAT. Currently, all Indian states have implemented VAT and the transition to VAT has been fairly smooth. One of the objectives of VAT implementation was the expected increase in revenues of state governments. This paper attempts to analyze the impact of VAT on revenues of state governments by comparing the group of states which implemented VAT in 2005 with those that implemented it later. Differences among the VAT states are also analyzed. Section 2 traces the developments on VAT in India over the years, including the political factors that were at play at the time of VAT introduction in 2005. Section 3 gives a justification for the study while section 4 details the main assumptions and methodology. Section 5 analyzes the revenue performance based on various parameters and also explains the differences between VAT and non-VAT states. Based on the analysis, Section 6 suggests a few policy recommendations and Section 7 concludes.

The White Paper on VAT mentions that '*VAT is a state subject derived from Entry 54 of the State List, for which states are sovereign in taking decisions*'.[4] The Empowered Committee (EC) of State Finance Ministers (created by the Ministry of Finance, Government of India) is the body which drafted the details of VAT through several rounds of consultations and also tried to get the assent of all states for implementation. After missing two previous deadlines of April 1, 2002 and April 1, 2003 (Bihar implemented VAT from April 1, 2003), VAT was finally implemented with effect from April 1, 2005 by all states apart from the five Bharatiya Janata Party (BJP – opposition party at the centre) ruled states of Gujarat, Rajasthan, Madhya Pradesh, Chhatisgarh and Jharkhand and three other states – Uttar Pradesh (UP), Uttaranchal and Tamil Nadu. The decision of the BJP ruled states was political while severe resistance by traders was cited as the reason for non-implementation by UP. Uttaranchal's decision was dictated by that of UP as the former has recently been carved out of the latter. In the case of Tamil Nadu, the reasons included opposition by traders and issues on VAT compensation though the real reason seemed to be the impending state elections in 2006. As of January 1, 2008, VAT has been implemented by all states and union territories. The primary justification for this reform was based on the inherent advantages of VAT over the existing sales tax regime. This included rationalization of tax burden, reduction in prices, simplification of tax structure, greater transparency, improvement in tax compliance, reduction in inter-state 'tax war' and increase in state government revenues. Hence, the beneficiaries would include consumers, the business community as well as the government.

The main disadvantages of the existing sales tax regime were the multiplicity of taxes and the double taxation of commodities resulting into a cascading effect on prices. While designing the main structure of VAT, the EC kept in view the need to have common features across states but at the same time allowed for some flexibility within states. However, states have not strictly adhered to the EC recommended guidelines on VAT and hence there are other differences among them.

VAT has been referred to as an 'efficient and fair' system of taxation. In order to judge the efficiency of VAT systems worldwide, the IMF conducted a study to ascertain whether countries with VAT systems had higher tax revenues to GDP ratios. The idea behind the study was the fact that if VAT systems did result into higher efficiencies and a consequent lower cost of collection, then countries with VAT systems should be able to collect higher revenues. The study found that countries following the VAT system did have higher general government revenues and grants to GDP, holding other things constant.[5] One of the stated objectives of VAT introduction in India, as outlined by the EC in its White Paper on VAT, was the advantages that would accrue to state governments in the form of higher tax revenues. The EC expected that the greater transparency and wider tax net of VAT would result into plugging of taxation loopholes and hence would result into higher revenues for state governments. One of the conclusions of a study done by the Confederation of Indian Industry (CII) after the first 3 months of VAT was '*One thing is clear that VAT will ultimately result in increase in revenue due to widening of tax base and better compliance*'. The study showed a buoyant increase in VAT revenues of states in the first three months of fiscal year 2005-06 compared with the corresponding period in the previous year. Now that VAT has been under implementation for more than a year, this study aims to find out the impact of VAT introduction on the revenues of state governments. A comparison has been done between the group of states which implemented VAT from April 2005 and those which implemented it later.[6]

This study evaluates the sales tax/VAT revenue performance of all the major general category states except the National Capital Territory (NCT) of Delhi and Goa (total of 16 states). It excludes the 11 special category states of Arunachal Pradesh, Assam, Himachal Pradesh, Jammu and Kashmir, Manipur, Meghalaya, Mizoram, Nagaland, Sikkim, Tripura and Uttaranchal. The decision not to include special category states was because they are primarily dependent on the centre for their revenues and have limited own revenue generating capacity. The period under consideration is 2001-02 to 2006-07. Sales tax figures up to 2004-05 are audited. However, revised estimates are used for 2005-06 (based on actuals for 9 months and projections for the next 3 months) and budget estimates for 2006-07. The period before 2001-02 has not been considered because 3 new states were formed in 2000-01 and the full year data for them is available only from 2001-02 onwards. For population, the 2001 census has been used as the base and the average annual growth rates for the previous five years have been used to extrapolate the population figures for the rest of the years. For the newly created states of Chhattisgarh and Jharkhand, the population growth rates of Madhya Pradesh and Bihar (respectively) have been used. The Gross State

Domestic Product (GSDP) figures are available up to 2004-05. For the next two years, projected figures are used based on the average growth rate in the previous three years.[7]

The table below gives the per capita VAT/sales tax collection for VAT states (those in which VAT was introduced with effect from April 1, 2005 or before) and non-VAT states (those in which VAT was introduced from April 1, 2006 or later) for the fiscal year 2005-06.

Table 1: VAT and non-VAT states as of April 2005

	VAT states	Per capita sales tax collection 2004-05 (INR)		Non VAT States	Per capita sales tax collection 2004-05 (INR)
1	Andhra Pradesh	1396	1	Chhatisgarh	749
2	Bihar	212	2	Gujarat	1547
3	Haryana	2119	3	Jharkhand	617
4	Karnataka	1567	4	Madhya Pradesh	603
5	Kerala	2031	5	Rajasthan	791
6	Maharashtra	1854	6	Tamil Nadu	2019
7	Orissa	650	7	Uttar Pradesh	491
8	Punjab	1498			
9	West Bengal	674			
	AVERAGE	1333		AVERAGE	974

Source: RBI Bulletin on State Finances

The treatment as well as control groups have a random geographical mix. However, it is interesting to note that the average per capita sales tax collection in the treatment group was higher than that in the control group. Nearly three fourths of the states in the control group have a per capita sales tax collection of under INR 1000 while the situation is just the reverse in the VAT states. However, the reasons why certain states did not go in for VAT implementation with effect from April 1, 2005 were varied. On baseline characteristics like population, GSDP, sales tax revenues and per capita sales tax collections, the differences between VAT and non-VAT states is not statistically significant, as the table below indicates.

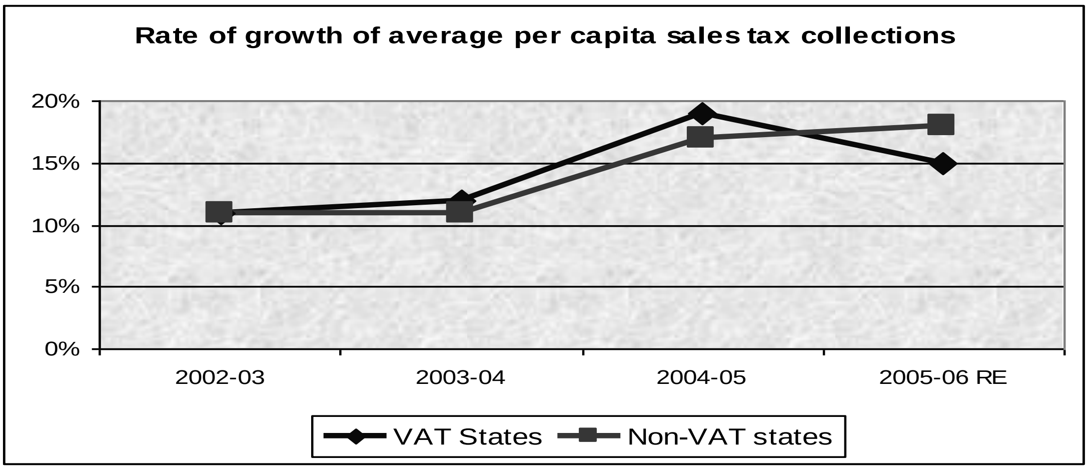
Table 2: Baseline characteristics between Treatment and Control Groups

Variable	Difference in Means	t-statistic
Sales tax revenues	10502.67	0.43
Population	-9.23	-0.44
GSDP	176747.1	0.38
Per capita sales tax	359.5	1.13

Source: RBI Bulletin on State Finances, CSO, Indiastatonline.com

Hence, randomization seems to have worked well. Therefore, any other confounding variables which could be present would not unduly affect any one of the cohorts. The figure below shows the performance of the treatment and the control groups over the past five years.[8]

Figure 1: Average per capita sales tax/VAT growth



Source: RBI Bulletin on State Finances and Indiastat online

The figure above shows results contrary to the expectations of the EC. The rate of growth of sales tax collections during 2002-03 and 2003-04 were broadly similar for both groups. The VAT states performed better than the non-VAT states during 2004-05 while the performance reversed during 2005-06, the first year after implementation of VAT. There is reason to believe that the actual collections under VAT for the year 2005-06 will be lower than those given in Figure 1. This is because the tax collections for 2005-06 have not been fully adjusted for refunds. Some refunds were provided during 2005-06. However, comprehensive data on refunds is not available. An IMF study had estimated the average VAT refunds (as a percent of gross VAT collections) as given in the table below.

Table 3: Region wise average refunds

Country/Region	Average refund level*
Canada	50.3%
European Union	38.1%
Eastern Europe	36.8%
New Zealand	35.5%
Former Soviet Union countries	29.6%
Latin America	17.4%
Middle East	16.2%
Asia (excluding Singapore)	7.0%
Africa (excluding S. Africa)	6.0%

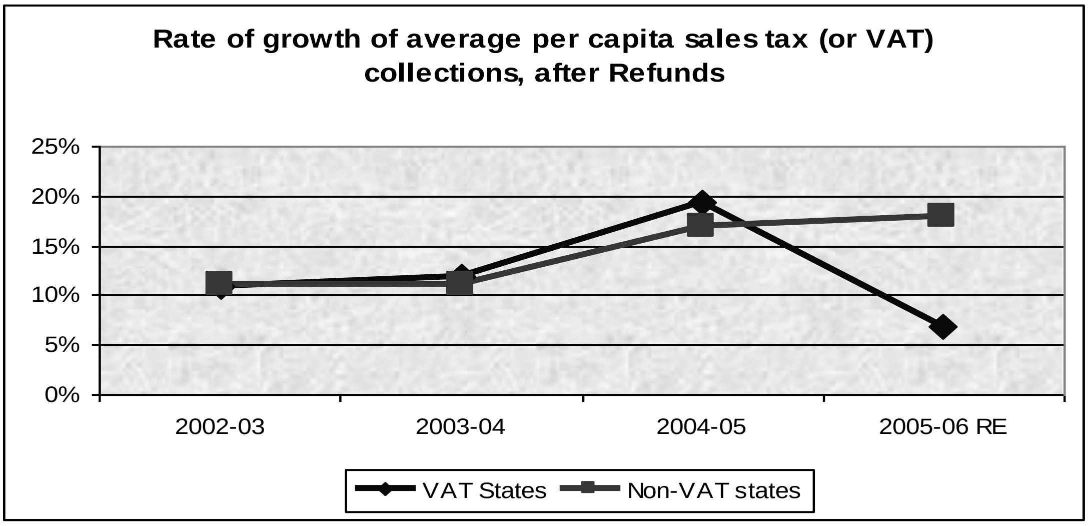
** As a percentage of gross VAT collections over a four-year period (1998-2001)*

Source: IMF survey responses, IMF staff estimates and World Economic Outlook

As can be seen from table 3, refunds are typically higher for advanced countries and countries in transition. The study calls refunds the 'Achilles heel' of the VAT system. This is because refunds usually presents a host of problems for the administration like fraud, corruption and delay or denial of refunds by some governments which are facing cash shortages. Refunds mostly accrue to exporters whose sales are zero rated. As the study points out, one of the major reasons for delay in VAT refunds is because of extensive verifications by governments to prevent fraudulent claims.

If we assume a 7% refund level for India (the estimate for Asia), the difference between VAT and non-VAT states is even greater, as shown in figure 2.

Figure 2: Average per capita sales tax/VAT growth after refunds



Source: RBI Bulletin on State Finances and Indiastat online

The figure above shows that there was a significant decline in the rate of growth of per capita collections in VAT states in the first year of implementation.

In the regression analysis, the dependent variable is growth in per capita VAT (or sales tax) collection. The growth rate (as opposed to the level) has been chosen because the absolute amount of collections varies significantly across states. This indicator also controls for population. The base year on which VAT/sales tax growth for 2005-06 is calculated is 2004-05.[9] The independent variables are the treatment dummy, that is whether the state went in for VAT or not, and the rate of growth of GSDP over the same time period. A first differenced regression analysis is used to find out the differences between the VAT and non

-VAT states between 2005-06 and 2004-05. This regression shows that without considering refunds, the difference between VAT and non-VAT states is not statistically significant. However, if refunds are taken in to account (at the rate of 7% for all states), this difference is statistically significant, as the table below indicates.

Table 4: Regression results with 2004-05 as the base year

	Coefficient	t-statistic
Difference in growth rate without refunds	-0.04	-1.31
Difference in growth rate with refunds	-0.11	-3.85***

*** Significant at the 1% level

A sensitivity analysis on the percentage of refunds shows that the difference between VAT and non-VAT states continues to be statistically significant (at the five percent significance level) even if refunds are reduced to 2% of VAT revenues. Another set of first differenced regressions were done using the average per capita sales tax revenues of 2002-03 to 2004-05 as the base (instead of 2004-05 as the base) and the growth of per capita VAT (sales tax) revenues in 2005-06 was calculated on this new base. In the absence of any deductions on account of refunds, the results are not statistically significant. However, if we take into account refunds, at the standard 7% level, the difference between the two cohorts was statistically significant, as the result below indicates.

Table 5: Regression results with average of 2003-05 as the base

	Coefficient	t-statistic
Difference in growth rate without refunds	-0.03	-0.72
Difference in growth rate with refunds	-0.10	-2.66***

*** Significant at the 1% level

Here again, a sensitivity analysis was carried out with different levels of refunds. Results indicate that the difference between VAT and non-VAT states continues to be statistically significant (at the five percent significance level) even if refunds are reduced to 5% of VAT revenues. The numbers which have been used for the analysis of states' performance in 2005-06 are revised estimates. However, it is not expected to have a significant impact on the end result. For example, actual audited sales tax collections in 2004-05 (for the 16 states we have considered) were 1.7% higher than revised estimates. This can vary on a year to year basis. However, this will not affect our analysis as the differences are spread across the treatment and control groups. India's experience, in terms of a decline in the rate of growth of revenues post VAT implementation is not unique. There have been other countries like Kenya and Philippines which have undergone a similar experience.

In the Indian states, the VAT/GSDP ratio was between 2.8-6.5% for 2005-06. However, some of the VAT states showed a decline in this ratio during 2005-06 RE.[10] The table below shows the sales tax (or VAT)/GSDP ratios for the treatment and control groups.

Table 6: Sales tax (or VAT) revenues as a percentage of GSDP

VAT states	2001-02	2002-03	2003-04	2004-05	2005-06 RE	006-07BE
Andhra Pradesh	5.1%	5.1%	5.0%	5.5%	5.7%	6.3%
Bihar	3.1%	3.1%	3.1%	3.3%	3.9%	3.6%
Haryana	4.9%	5.0%	5.2%	5.7%	6.0%	6.2%
Karnataka	4.9%	4.6%	5.1%	5.9%	6.5%	6.8%
Kerala	6.1%	6.6%	6.7%	6.7%	6.5%	6.5%
Maharashtra	4.5%	4.5%	4.7%	5.1%	5.4%	5.7%
Orissa	3.3%	3.7%	3.4%	4.2%	4.0%	3.8%
Punjab	3.8%	4.2%	4.1%	4.3%	4.7%	5.3%
West Bengal	2.5%	2.5%	2.6%	2.8%	2.8%	3.0%

Source: RBI Bulletin on State Finances and CSO

Control States	2001-02	2002-03	2003-04	2004-05	2005-06 RE	2006-07BE
Chhatisgarh	3.2%	3.5%	3.4%	4.2%	4.9%	5.0%
Gujarat	4.8%	4.5%	4.3%	4.6%	4.9%	4.7%
Jharkhand	4.6%	4.5%	3.9%	4.1%	4.5%	4.6%
Madhya Pradesh	2.8%	3.6%	3.4%	3.8%	4.1%	4.5%
Rajasthan	3.5%	4.1%	3.8%	4.3%	4.6%	4.8%
Tamil Nadu	5.8%	6.2%	6.5%	6.9%	7.2%	8.0%
Uttar Pradesh	3.4%	3.6%	3.6%	3.8%	4.7%	5.2%

Source: RBI Bulletin on State Finances and CSO

Table 6 shows that during the first year of VAT implementation (2005-06), there was a reduction in VAT collections/GSDP for two states – Bihar and Orissa. During 2006-07, Orissa continues to budget for a decline in VAT/GSDP ratio while Bihar also shows a decline from the year 2005-06.[11] Among the control states which implemented VAT from April 2006, Gujarat has estimated a decline in this ratio. Even among states which implemented VAT, there were significant variations in performance. The annual growth rate in per capita sales tax (VAT) revenues for the VAT states is given below.

Table 7: Sales tax (or VAT)/GSDP ratio for VAT states

	2002-03	2003-04	2004-05	2005-06 RE	2006-07BE
Andhra Pradesh	6%	9%	19%	14%	20%
Bihar	10%	-1%	14%	22%	-1%
Haryana	12%	13%	22%	14%	14%
Karnataka	3%	20%	29%	22%	14%
Kerala	19%	11%	11%	8%	11%
Maharashtra	10%	12%	21%	19%	15%
Orissa	13%	15%	31%	7%	4%
Punjab	13%	6%	14%	17%	18%
West Bengal	9%	14%	17%	12%	16%

Source: RBI Bulletin on State Finances

The fiscal year 2004-05 seems to have been a particularly good year in terms of sales tax collections. Bihar and Punjab performed even better (in terms of rate of growth of per capita revenues) during the first year of VAT implementation compared with the previous year. However, all the other states showed a decline in the growth rate of per capita VAT collections compared with 2004-05 sales tax collections per capita. Compared with growth performance prior to 2004-05, there was a significant decline in the performance of Bihar and Orissa during the first year of VAT implementation. There could be several reasons for the decline in the rate of growth of revenue collection of VAT states in 2005-06 compared with the non-VAT states as well the variations among the VAT states. Some of these factors have been analyzed below in the Indian and international context.

(1) Single vs. multiple VAT rates: An empirical study on 34 countries shows that single VAT rates (between 10-20%) with minimal exemptions and hence a broad base is better (in terms of generating revenues) than a system with multiple rates and exemptions which reduces the base and increases compliance costs and administrative work load. Typically, multiple rates help include various social and political objectives into the VAT system which however, are detrimental to revenue generation. This World Bank study recommends that for superior revenue collections, VAT should be levied at one rate on as broad a base as possible and must be accompanied by strong and efficient tax collection machinery.

The Indian context does have multiple rates and several exemptions and zero rating of some commodities. In a polity like that of India, where states have the constitutional power to tax some of the items, it will be difficult to enforce a uniform rate across all states. Hence, there will be some negative impact on revenues on account of the multiple rates. This could have resulted into the dip in rate of growth of collections during 2005-06 and could also result into a decline in revenues in the coming years.

(2) VAT rates and exemptions: The IMF study on VAT in Russia and other countries of the Former Soviet Union indicates that these countries did not see wide proliferation of tax rates after three years of introduction of VAT. However, the number of exemptions increased progressively and resulted into an erosion of the tax base and a reduction in revenue collections. The main reason for exempting certain commodities from VAT is the argument of progressivity, that is, to ensure that the poor do not end up paying more for essential commodities.

The Indian context seems similar to that cited above. Most of the states have adhered to the rates of 12.5%, 4%, 1% and 0% for vatable commodities. However, there have been considerable differences among states on the commodities listed under each category. Also, Bihar has introduced a new slab of 20% for certain category of goods. The list of exempted commodities in several states is also much higher than that prescribed by the EC. Also, some categories of goods have been exempted from VAT though it does not find mention in the VAT legislations of states, for example, sales by defense canteens. As a result, the effective rate of VAT across states would vary considerably.

Hence, the higher number of VAT exempted commodities could be one of the reasons for a decline in revenues as it leads to an erosion of the tax base. Also, variations in categorizing commodities under different rate slabs could explain some of the differences among VAT states.

(3) VAT rates in comparison with sales tax rates: There could be differences in the effective sales tax and VAT rate across states. In some of the states, especially the South Indian states, VAT rates are lower than the erstwhile sales tax rates. The table below shows some of the comparative rates under the two regimes in the state of Bihar .

Table 8: Sales tax and actual VAT rates for Bihar

Commodity	Bihar Sales Tax Rate	VAT rate
All Acids	9.2%	4.0%
All Arms and Ammunitions	23.0%	12.5%
Cement including white cement	17.25%	12.5%
Chewing Gum	13.8%	12.5%
Coconut oil	4.6%	4.0%

Source: Bihar Value Added Tax Act

Hence, the rate differential under the two regimes could also have contributed to the decline in rate of growth of VAT revenues. Another reason could be the abolition of other taxes like octroi, entry tax etc. However, while some states have abolished these taxes, others continue to impose them.

(4) Differences in definitions: Several definitional differences have also arisen among states because the EC did not precisely define some of the terms like capital goods, inputs and the like. As a result, states have defined them in their own ways or not defined them at all. Some of the examples are given below:

As a result of the differences in these definitions, there could be variations among VAT states in terms of revenue collections. For instance, tax credits are to be provided on inputs and capital goods and if they are not defined clearly, it could result into delays/denial of input tax rebate. There are several other definitional differences among states which could lead to disputes in the future and could have an impact on revenue collections.

(5) Differences in tax legislation: The core VAT legislation also varies among states. For example, as the table below shows, VAT legislations of different states have different registration thresholds which would result into differences in the number of registered tax payers and the consequent differences in revenue collections and cost of compliance and administration. There are also differences in the time within which states would refund input claims and while some of them provide for penal interest rates, others do not. The table below outlines some of these differences.

On the issue of registration threshold, international experience suggests that a high threshold typically yields better revenues. It certainly has its drawbacks in terms of traders trying to show smaller sales and businesses splitting up so that they remain below the threshold limit. However, the gains in terms of lower administration costs are much higher. Also, resistance to VAT is typically higher from smaller traders and hence a high threshold would face lesser impediments to acceptance. Threshold limits for VAT registration for some of the countries is given below:

The table above indicates that there is wide variation in the threshold limits across countries. The threshold adopted by Indian states seems to be on the lower side. While a higher threshold is preferable, care should be taken to ensure that it is not too high such that it excludes the majority of traders and businesses liable for VAT find it difficult to pass on the tax to consumers.

(6) Tax evasion and fraud: This could also result into lower revenue growth if the complete chain of VAT goes underground or if there is undervaluation of output or inflation of input credit. There are bound to be some unscrupulous dealers who would evade taxes and this could be one of the factors contributing to a decline in rate of growth of revenues.

Internationally, invoice fraud alone accounts for 20% of VAT frauds.

(7) Inclusion of 'capital goods' and 'industrial inputs' in the 4% category: Majority of the countries where VAT is under implementation do not allow concessional rates for inputs unless there are special circumstances. This is because the VAT system allows for rebate on inputs.

However, the Indian VAT system allows for a concessional rate of 4% on capital goods and inputs. Several commodities are sold both as inputs and final products. A lower rate on inputs implies a loss of revenue on the latter kind of sales. Also, a manufacturer may prefer to pay the input tax of 4% and not declare final sales at all as the differential in rates (4% for inputs compared with 12.5% for finished products) is significant.

This could also have been one of the factors responsible for lower growth in revenues.

(8) Compensation by Center: The fact that the central government agreed to compensate 100% of the revenue loss owing to VAT (in the first year of implementation) could also be one of the reasons for poor performance of VAT states compared with the non-VAT states. This could have resulted into slackened revenue collection efforts by the VAT states, the typical example of moral hazard.

(9) Initial teething problems: Since our analysis looks at VAT revenue performance in the first year of implementation, one cannot rule out the initial teething problems which could have contributed to a decline in revenue growth. Once the initial glitches are resolved, growth in revenue collections could show an improvement. The reason for these initial problems could be either because the state governments were not adequately equipped and prepared or because of limited administrative capacities. This would impact collection efficiencies and could contribute to decline in revenues.

The EC along with the cooperation of most state governments was successful in bringing about a smooth transition from the sales tax to the VAT system. While there are some provisions of the current VAT regime which will continue in their present form, there are others which could be changed so as to better achieve some of the objectives of implementing VAT. While proposing these recommendations, the structure of the Indian polity has been kept in mind which gives taxation rights to states in lieu of several commodities and states do have the flexibility to decide on tax rates for these commodities. Even if the decline in rate of growth of revenues of VAT states during 2005-06 was on account of initial teething problems, the following recommendations will help in the smooth functioning of the VAT system over time.

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Chapter- 6

VAT & Commercial Taxes in Bihar

VAT is a tax on all goods and services (except exports and government services) on the value added at each stage from production to the retail stage. To simplify the calculations of value added, each taxpayer is allowed to deduct the tax paid on his inputs from the tax payable on his output. VAT, in its comprehensive form, should replace all other domestic indirect taxes and also be extended to cover imports. Imported goods and domestically produced goods are treated at par and subjected to a single system of commodity taxation. The introduction of VAT in a country requires a number of decisions regarding the design of VAT such as (a) what type of VAT to adopt, *viz.,* gross product, income variant or consumption type (b) should it be origin based or destination based and (c) last but not the least, in a federal country like India, which level or levels of government should levy VAT?

There are three different variants of VAT. *Gross product VAT* covers all value added without giving any credit for the taxes paid on capital purchases or depreciation. This provides the broadest base for tax. In the *income type VAT,* the tax is initially levied on consumption as well as capital goods. Full tax credit on consumption inputs would be given but for the capital inputs, refund of tax would be given over economic life of the capital inputs, which is equal to the depreciation. Thus under income type tax, input credit would be provided on non-capital inputs and depreciation. In *consumption type VAT,* tax credit is allowed for all business purchases including capital assets. The economic base of this tax is, therefore, equivalent to total private consumption. This form is neutral between different methods of production. Most of the countries have adopted consumption type VAT.

If VAT is levied where goods and services are produced, it is known as origin based tax, whereas if it is levied on the basis of consumption, it is said to be destination based. In fact, consumption type VAT should necessarily be destination based. Under the destination based system, all value added in goods sold within the country, irrespective of whether produced domestically or imported, are taxed. Exports are zero-rated and interstate transactions are taxed on the basis of consumption.[1]

India being a federal country, tax powers are distributed between the centre and the states. If VAT is to replace all domestic commodity and service taxes, then some constitutional amendment is required to authorize the concerned governments to levy one comprehensive VAT.

Various Committees such as Jha Committee, Chelliah Committee, Study Team of the National Institute of Public Finance and Policy and some other experts on the subject have different views regarding the form of VAT. Broadly speaking, there are the three forms of VAT in a given federal structure. These are:

As suggested by the Jha Committee and further reiterated by the Chelliah Committee, one school of thought believes that in any country, especially in a federal form of government, the most suitable and attractive proposition, for a unified system of taxing domestic trade, is to have a national VAT imposed and administered by central government. This system would bring harmonization in taxation of interstate trade. Federal countries like Argentina, Australia, Germany and Mexico have central VAT. In such a system the tax is entirely regulated by the centre. It is completely harmonized across the states. However, the revenue could either be collected by the centre and shared with the states or alternatively collected by the states on behalf of centre, the revenue share being decided by an independent body or organization. The central VAT would have the advantage of having a uniform rate across the country, thereby avoiding all the complexities that would arise if different states had different rates. Due to the existence of a uniform rate system, taxpayer would need to be familiar with a single set of VAT rules. The states would find it easier to share the information as central VAT ensures a unified administration and limits the occurrence of tax evasion.

However, this could have significant consequences for the distribution of revenues between the centre and states. The States would be deprived of their main source of revenue and the right to decide the tax structure. In the Indian context, the sales tax alone provides approximately 60 percent of the states own tax revenue and its share in total commodity taxes is around 38 percent. The States lose the revenue that they get from sales tax and other indirect taxes. This implies that they would have to depend upon the Central government for approximately 70% of their current expenditure that is financed through the sales tax and other transfers from the centre, in the form of tax devolution. Thus they would oppose this transition. Under the present circumstances, a constitutional amendment has to be passed which would allow the Centre to impose VAT.

Central VAT would also have adverse effects on states initiatives to raise more revenues and efficient utilization of funds. It will also be against the efficiency criteria, which is the base for fiscal decentralization. It would seriously undermine fiscal accountability, as the revenue raising and expenditure decisions will increasingly be divergent. Also, the centre would have to depend upon states for administering central VAT as given the existing tax machinery, the centre would not be able to handle the increased number of dealers due to implementation of VAT. If revenue is collected by the states but pooled and distributed by the central government, states would have little incentive to effectively administer the tax unless the tax revenue is distributed on the basis of revenue collection.

It is possible that the earlier option, i.e., centrally run VAT would not be acceptable to the states. Also, to implement this option a constitutional amendment has to be made, especially in the seventh schedule. In view of lack of agreement amongst different political parties on these issues, it may not be possible to make the necessary amendments to the Constitution. Under these circumstances, the only option available is to have some form of dual VAT, as recommended by the Chelliah Committee and many other experts. Such a VAT may have three variants:

The First option is to have a system of VAT where both the centre and state governments have the power to levy tax with common base, where both governments have the freedom to decide the base and the rate of the tax. That is, both the tiers of government would levy tax on manufacture, wholesale and the retail level. This option is used in Canada where the federal VAT (GST) is levied on all transactions and provides concurrent jurisdiction to the states in taxation of goods and services. Canada provides a combination of various choices. First, state VAT, known as QST, is levied by Quebec on almost a similar base as in GST. Second, three of the provinces: Newfoundland, Nova Scotia and New Brunswick levy a Harmonized Sales Tax (HST).[2] Both QST and HST are value-added taxes. Finally, rest of the provinces, viz., British Columbia, Ontario, Manitoba, Prince Edward Island and Saskatchewan levy Retail Sales Tax (RST) on all goods and a few services. It is important to note that some of the provinces levy retail sales tax on price exclusive of GST, while others levy inclusive of GST. Responsibility of collecting VAT at both the levels of government also varies among states. For example, one state (Quebec) collects both the GST and the state VAT and gives the GST revenue to the federal government. Three states (Newfoundland, Nova Scotia and New Brunswick) levy a Harmonized Sales Tax (HST), which is a combination of GST and state VAT. The federal government, on the basis of collection, gives the state revenue of 8% to them. The rest of the states collect their own RST and retain the revenue.

The Tax Reforms Committee (TRC) headed by Dr. R. J. Chelliah recommends the second option. The TRC has suggested that under present circumstances to have fiscal reforms, the only possible solution is to have an admixture of VAT (then called Modvat and now known as CenVAT) at the central level extended up to the wholesale level (extending the existing base of union excise duties from the manufacture to the wholesale) with the condition that the wholesale level would be administered by the states and the revenue so generated would also be retained by the states. At the state level, existing sales tax is converted into a system of VAT being levied on all transactions. The TRC had proposed that for this purpose, wholesaler be defined to include dealers in excisable goods with an annual turnover in excess of say Rs. 50 lakh or 1 crore. These dealers would pay tax on their value added. Notwithstanding the merits of the proposal, its implementation would also require constitutional amendment. It would also involve identification of dealers dispatching goods from where the goods originate and of those dealers receiving goods where these are consumed. Lack of coordination among states, as well as between centre and states, would also cause many problems in implementing this option.

The Third Option relates to having independent dual VAT system. That is, central government continues to have the existing union excise duty but converts this into a central VAT up to the manufacturing level and the existing sales tax is converted into a state VAT, both operating independently with or without harmonization and coordination.

Under the state VAT system, central government has to retreat from the domestic trade tax arena. Each state has to convert its present sales tax into VAT, which would be levied and administered by the states. This system would promote fiscal responsibility and discipline on the part of states.

However, this system will reduce the revenue of the central government. The revenue loss due to changed system can be taken care of in two ways:

-By permitting centre to levy special excise duty, which is non-rebatable and non-sharable, on some select sumptuary items which yield equal amount of revenue as retained by the centre under the existing situation after devolution and

-By bringing down the level of transfers from the central funds to states

The states would be empowered to levy a full-fledged state VAT on all commodities and services in the country. The taxes levied at the stage of manufacture (i.e. CenVAT at present) would be given set-off at the time of levy of state VAT (i.e. at the time of sale). Thus, all late transactions would cover additional value added in the process till it reaches the consumer. However, for the reasons of administrative efficiency, the centre should continue to levy VAT at the manufacturing stage.[3] The revenue so collected should be distributed to the states on the basis of collection. This would enable states to allow set-off from the VAT on sales for successive transactions.

Inter-state transactions would be treated on destination principle. Each state would tax the interstate sales but the importing state would give set-off for the tax already paid in the exporting state. Alternatively, the exporting state would tax CST at the rate of zero percent and provide set-off for the taxes already paid by the dealers. In any case, the documentation formalities of the CST would continue.

Under this system different degrees of harmonization can be applied. Either there can be complete harmonization among the states regarding the tax base, rate structure and administrative procedures or states can choose to have different tax bases depending upon the level of development, type of activities, and size of administrative facilities available. If states have harmony in rate structure and administration, it would help checking evasion of tax through cross checking between centre and states, and also between states.

As stated in an earlier chapter, Brazil has a state VAT. Even the VAT in the European Union could be considered an example of state VAT. However, the implementation of state VAT in India could confront some problems. First, a pure state VAT would involve rethinking about the fiscal relationship between the centre and the states. There is one school of thought suggesting that such a system will have adverse effect on the revenue position of the centre. It is believed that there would be no possibility that the centre would be able to increase its non-sharable portion of revenue, unless there is a major shift in the distribution of powers and functions between the centre and the states.

Also, it is believed that shifting of union excise duty from the centre to the states will impair centre’s capacity to give grants to the states. These have a perceptible equalizing effect on the distribution of resources.

As there are significant differences in the levels of development of the states, without the interference of the central government, it would be difficult to correct it by inducing flow of trade and industry in the backward states. On the contrary, it may accentuate the disparity by aggravating the concentration of revenue in relatively advanced states.

Another school of thought propagates state VAT as a long-term policy measure, which is argued on the line of decentralization of powers, efficiency criteria and fiscal responsibility. It is, however, important to note that the state VAT system would require a mechanism for taxing or regulating interstate trade, which at present requires involvement of the central government due to the interstate tax being origin based. If the interstate tax is changed to destination based consumption tax, then the interstate disparity can be resolved to some extent as the states' revenue earning potentiality would improve.

Interstate trade tax may have four options. First option provides exports to VAT registered dealers to be zero-rated. Imports would be taxed and rebated at a rate chosen by the importing states (this mechanism is used in the EU). Second, exports to VAT registered dealers would be taxed by exporting states at the same rate as exports to non-registered dealers. Inter-state imports would be tax free, but the tax paid by the exporter would be rebatable to the importer from its own government if the importer is a VAT registered dealer. Such a system is followed in Brazil. Third, option is to have a clearinghouse mechanism added to the second option so that rebate becomes the fiscal responsibility of exporting states. Fourth option is to zero-rate the exports. That is, no tax is levied on the transaction entering into interstate trade and any tax that has already gone into it in previous transactions, in the form of raw material or intermediate stage, has to be refunded at the time of export.

The state VAT thus provides a harmonized system of taxation of domestic trade, where states can opt for uniform tax rates and tax procedures. Since states have already adopted a system of uniform floor rates under sales tax, it would be possible for them to do the same under VAT as well.

Within the context of law, the mischief rule is a rule of statutory interpretation that attempts to determine the legislator's intention. Originating from a 16th century case in the United Kingdom, its main aim is to determine the "mischief and defect" that the statute in question has set out to remedy, and what ruling would effectively implement this remedy. When material words are capable of bearing two or more constructions the most firmly established rule for construction of such words "of all statutes in general" is the rule laid down in Heydons case[1] also known as mischief rule.[4] This rule is also known as purposive construction.[3] The rules lay down that the court should adopt the construction which shall suppress the mischief and advance the remedy.[4] In Indian context the rule was best explained in the case of Bengal immunity co. v State of Bihar.[5] The appellant company is an incorporated company carrying on the business of manufacturing and selling various sera, vaccines, biological products and medicines. Its registered head office is at Calcutta and its laboratory and factory are at Baranagar in the district of 24 - Perganas in West Bengal. It is registered as a dealer under the Bengal Finance (Sales Tax) Act and its registered number is S.L. 683A. Its products have extensive sales throughout the Union of India and abroad. The goods are dispatched from Calcutta by rail, steamer or air against orders accepted by the appellant company in Calcutta. The appellant company has neither any agent or manager in Bihar nor any office, godown or laboratory in that State. On the 24th October, 1951 the Assistant Superintendent of Commercial Taxes, Bihar wrote a letter to the appellant company which concluded as follows :-

"Necessary action may therefore be taken to get your firm registered under the Bihar Sales Tax Act. Steps may kindly be taken to deposit Bihar Sales Tax dues in any Bihar Treasury at an early date under intimation to this Department".

On the 18th December, 1951 a notice was issued by the Superintendent, Commercial Taxes, Central Circle Bihar, Patna calling upon the appellant company (i) to apply for registration and (ii) to submit returns showing its turnover for the period commencing from the 26th January, 1950 and ending with the 30th September, 1951.[6] This notice was issued under section 13(5) of the Bihar Sales Tax Act, 1947 (hereinafter called the Act) read with rule 28. It was drawn up according to Form No. 8 prescribed by the rules and was headed "Notice of hearing under section 13(5)'. The reason for issuing this notice, as recited therein, was that on information which had come to his possession the Superintendent was satisfied that the appellant company was liable to pay tax but had nevertheless willfully failed to apply for registration under the Act. Suffice it to say that while the appellant company denied its liability on the ground, inter alia, that it was not resident in Bihar, it carried on no business there, none of its sales took place in Bihar and that it did not collect any sales tax from any person of that State, the Bihar Sales Tax authorities maintained that under section 33, which was substantially based on article 286 of the constitution and was inserted in the Act by the President's Adaptation Order promulgated on the 4th April, 1951, all sales in West Bengal or any other State under which the goods had been delivered in the State of Bihar as a direct result of the sale for the purpose of consumption in that State were liable to Bihar Sales Tax. Eventually on the 29th May, 1952 the Assistant Superintendent of Sales Tax, Bihar called upon the appellant company to comply with the notice by the 14th June, 1952 and threatened that, in default of compliance, he would proceed to take steps for assessment to the best of his judgment. The appellant company by its letter dated the 7th June, 1952 characterized the notice under section 13(5) as ultra vires and entirely illegal and called upon the Superintendent to forthwith rescind and cancel the same. On the 10th June, 1952 the appellant company presented before the High Court at Patna a petition under article 226 claiming the reliefs hereinbefore mentioned. The respondents did not file any affidavit in opposition controverting any of the allegations of facts made in the petition and it must, accordingly, be taken that those facts are admitted as correct by the respondents. The High Court dismissed the petition on the 4th December, 1952 but on the next day issued a certificate, under article 132(1) of the Constitution, that the case involved a substantial question of law as to the interpretation of the constitution. Hence the present appeal.

The principal question is whether the tax threatened to be levied on the sales made by the appellant company and implemented by delivery in the circumstances and manner mentioned in its petition is leviable by the State of Bihar. This was done by construing article 286 whose interpretation came into question and the meaning granted to it in the case of The State of Bombay v. The United Motors (India) Ltd[6] was overruled. It raises a question of construction of article 286 of the Constitution.

It is a sound rule of construction of a statute firmly established in England as far back as 1584 when Heydon's case[7] was decided that -

"......... for the sure and true interpretation of all Statutes in general (be they penal or beneficial, restrictive or enlarging of the common law) four things are to be discerned and considered :-

> 1st. What was the common law before the making of the Act.,
>
> 2nd. What was the mischief and defect for which the common law did not provide.,
>
> 3rd. What remedy the Parliament hath resolved and appointed to cure the disease of the Common wealth., and
>
> 4th. The true reason of the remedy; and then the office of all the judges is always to make such construction as shall suppress the mischief, and advance the remedy, and to suppress subtle inventions and evasions for continuance of the mischief, and pro privato commodo, and to add force and life to the cure and remedy, according to the true intent of the makers of the Act, pro bono publico". This rule is

equally applicable to the construction of article 286 of our Constitution. In order to properly interpret the provisions of that article it is, therefore, necessary to consider how the matter stood immediately before the Constitution came into force, what the mischief was for which the old law did not provide and the remedy which has been provided by the Constitution to cure that mischief.

The position with respect to taxation on sales or purchases of goods that prevailed in the country had better be stated in the language of Patanjali Sastri, C.J. who delivered the majority judgment in the State of Bombay v. The United Motors (India) Ltd.[7] it was not necessary that the sale should take place within the territorial limits of the State in the sense that all the ingredients of a sale, like the agreement to sell, the passing of title, delivery of the goods, etc., should have a territorial connection with the State and that, broadly speaking, local activities of buying and selling carried on in the State in relation to local goods would be a sufficient basis to sustain the taxing power of the State, provided of course that such activities ultimately resulted in a concluded sale to be taxed.

By Government of India Act, 1935 the Provincial Legislatures enacted Sales Tax laws for their respective Provinces, acting on the principle of territorial nexus; that is to say, they picked out one or more of the ingredients constituting a sale and made them the basis of their sales tax legislation. Whether the territorial nexus put forward as the basis of the taxing power in each case would be sustained as sufficient was a matter of doubt not having been tested in a Court of law. And such claims to taxing power led to multiple taxation of the same transaction by Provinces and cumulation of the burden falling ultimately on the consuming public. This situation posed to the Constitution makers the problem of restricting the taxing power on sales or purchases involving inter-State elements but they had to maintain the State power of imposing non-discriminatory taxes on goods imported from other States, while upholding the economic unity of India by providing for the freedom of inter-State trade and commerce. In their attempt to harmonize and achieve these somewhat conflicting objectives, they enacted articles 286. The above chaos was to cure this mischief of multiple taxation and to preserve the free flow of inter-State trade or commerce in the Union of India regarded as one economic unit without any provincial barrier that the Constitution makers adopted article 286 in the Constitution which runs as follows :- 286. (1) No law of a State shall impose, or authorise the imposition of, a tax on the sale or purchase of goods where such sale or purchase takes place -

(a) outside the State; or

(b) in the course of the import of the goods into, or export of the goods out of, the territory of India.

Explanation. - For the purposes of sub-clause (a), a sale or purchase shall be deemed to have taken place in the State in which the goods have actually been delivered as a direct result of such sale or purchase for the purpose of consumption in that State, notwithstanding the fact that under the general law relating to sale of goods the property in the goods has by reason of such sale or purchase passed in another State.

(2) Except in so far as Parliament may by law otherwise provide, no law of a State shall impose, or authorise the imposition of, a tax on the sale or purchase of any goods where such sale or purchase takes place in the course of inter-State trade or commerce :

Provided that the President may by order direct that any tax on the sale or purchase of goods which was being lawfully levied by the Government of any State immediately before the commencement of this Constitution shall, notwithstanding that the imposition of such tax is contrary to the provision of this clause continue to be levied until the thirty-first day of March, 1951.

(3) No law made by the Legislature of a State imposing, or authorising the imposition of, a tax on the sale or purchase of any such goods as have been declared by Parliament by law to be essential for the life of the community shall have effect unless it has been reserved for the consideration of the President and has received his assent".

In clause (1)(a) of article 286 the mischief of multiple taxation as cured based on nexus theory. In clause (1)(b) they considered sales or purchases from the point of view of our foreign trade and placed a ban on the States' taxing power in order to make our foreign trade free from any interference by the States by way of a tax impost. In clause (2) they looked at sales or purchases in their inter-State character and imposed another ban in the interest of the freedom of internal trade. Finally, in clause (3) the Constitution makers' attention was riveted on the character and quality of the goods themselves are they placed a fourth restriction on the States' power of imposing tax on sales or purchases of goods declared to be essential for the life of the community.[8] The States' legislative power with respect to a sale or purchase may be hit by one or more of these bans. Thus, take the case of a sale of goods declared by Parliament as essential by a seller in West Bengal to a purchaser in Bihar in which goods are actually delivered as a direct result of such sale for consumption in the State of Bihar. A law made by West Bengal without the assent of the President taxing this sale will be unconstitutional because (1) it will offend article 286(1)(a) as the sale has taken place outside the territory by virtue of the Explanation to clause (1)(a), (2) it will also offend article 286(2) as the sale has taken place in the course of inter-State trade or commerce and (3) such law will also be contrary to article 286(3) as the goods are essential commodities and the President's assent to the law was not obtained as required by clause (3) of article 286 . This was the interpretation given to Honble J Das. The Legislatures of the States were empowered by article 246(3) read with Entry 54 of List II to make a law with respect to taxes on sales or purchases of goods and hence the State Legislatures considered themselves free to make a law imposing tax provided they had some territorial nexus with such sales or purchases. This resulted in prejudicing the interests of the ultimate consumers and also hampered the free flow of inter-State trade or commerce. So the Constitution makers had to cure that mischief. The first thing that they did was to take away the States' taxing power with respect to sales or purchases which took place outside their respective territories. This they did by clause (1)(a). If the matter had been left there, the solution would have been imperfect, for then the question as to which sale or purchase takes place outside a State would yet have remained open. So the Constitution makers had to explain what an outside sale was and this they did by the Explanation set forth in clause (1). It is quite obvious that it created a legal fiction. Legal fictions are created only for some definite purpose. Here the avowed purpose of the Explanation is to explain what an outside sale referred to in sub-clause (a) is. The judicial decisions referred to in the dissenting judgment in The State of Travancore-Cochin v. Shanmugha Vilas Cashew Nut Factory[9] and the case of East End Dwellings Co. Ltd. v. Finsbury Borough Council[10] clearly indicate that a legal fiction is to be limited to the purpose for which it was created and should not be extended beyond that legitimate field. It should further be remembered that the dominant, if not the sole, purpose of article 286 is to place restrictions on the legislative powers of the States by article 286 by imposing several bans.

For clause 2 it was said that until Parliament by law made in exercise of the powers vested in it by clause (2) provides otherwise, no State can impose or authorise the imposition of any tax on sales or purchases of goods when such sales or purchases take place in the course of inter-State trade or commerce.

It was decided that Bihar Sales Tax Act, 1947 in so far as it purports to tax sales or purchases that take place in the course of inter-State trade or commerce, is unconstitutional, illegal and void. The Act imposes tax on subjects divisible in their nature but does not exclude in express terms subjects exempted by the Constitution. In such a situation the Act need not be declared wholly ultra vires and void. Until Parliament by law provides otherwise, the State of Bihar do forbear and abstain from imposing sales tax on out-of-State dealers in respect of sales or purchases that have taken place in the course of inter-State trade or commerce even though the goods have been delivered as a direct result of such sales or purchases for consumption in Bihar. The State must pay the costs of the appellant in this Court and in the court below. Bhagwati, J. had agreed to the above interpretation. Venkatarama Ayyar, J. , Sinha, J. along Jagannadhadas, J. had declined the above interpretation. The Explanation to article 286(1)(a) of the Constitution has created a legal fiction as a result of which a transaction of sale or a purchase partaking of an inter-State character has been treated as a domestic transaction. The fiction has localized sales or purchases contemplated by the Explanation, by converting such transactions as would otherwise have been inter-State sales or purchases into sales or purchases inside one State in a sense in which it is placed in a class distinct and separate from what is referred to as sales or purchases "outside the State" in the main body of article 286(1)(a) which prohibits imposition of tax by any State.

The main purpose of creating the fiction is to prevent multiple taxation of the same transaction, but, it may be added, not altogether to stop the taxation of such transactions. The next question is how far the legal fiction should be carried in its actual application. The fiction created by the Explanation brings such a sale within the taxing powers of the State within which such a sale is said to have taken place. Such a result is brought about not by holding that the Explanation has conferred positively the power on the relevant State to impose sales tax, but by holding that such an inside sale is beyond the scope of the prohibition contained in the main body of article 286(1)(a) which interdicts the imposition of tax on a sale "outside the State". The Explanation has got to be read as an integral part of article 286(1)(a) and thus read, it means negatively that a sale or purchase outside a State cannot be taxed; and by necessary implication, that a sale or purchase inside a State may be taxed by that State as falling outside the mischief of the prohibition directed against the imposition of a tax on a sale or purchase of goods outside a State; in other words, as soon as a sale or purchase of goods is declared to be outside the pale of the prohibition contained in article 286(1)(a), the State's power of imposing a tax contained in article 246 read with item 54 of List II of 7th Schedule comes into operation.[9] The view of the former 3 judges goes beyond the purpose of the creation of the fiction which admittedly was to prevent multiple taxation. The view as propounded by them besides preventing multiple taxation goes to the length of prohibiting any imposition of sales tax by any State. Such was not the intention of the Constitution. Whereas the imposition of multiple sales tax on transactions of sale or purchase may be an obstacle to the free flow of inland trade and commerce, the imposition of sales tax by a single State in which the sale is deemed to have taken place by virtue of the Explanation cannot be predicated as having such an effect. Clause (2) of article 286 of the Constitution is subject to article 286(1)(a) read with the Explanation.

Finally, the former view was adopted and it was declared that until Parliament by law provides otherwise, the State of Bihar do for bear and abstain from imposing Sales Tax on out-of-State dealers in respect of sales or purchases that have taken place in the course of inter-State trade or commerce even though the goods have been delivered as a direct result of such sales or purchases for consumption in Bihar.

As it can be seen from the case, mischief rule can be applied differently by different judges. It is mainly about the discretion and understanding of the person applying it. Though, it as a far more satisfactory way of interpreting acts as opposed to the Golden or Literal rules. It usually avoids unjust or absurd results in sentencing but it also seen to be out of date as it has been in use since the 16th century, when common law was the primary source of law and parliamentary supremacy was not established. It gives too much power to the unelected judiciary which is argued to be undemocratic. In the 16th century, the judiciary would often draft acts on behalf of the king and were therefore well qualified in what mischief the act was meant to remedy. This is not often the case in modern legal systems. The rule can make the law uncertain, susceptible to the slippery slope.

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Chapter- 7

Finding and Conclusion

The VAT has become a key source of government revenue in over 120 countries. About 4 billion people, 70 percent of the world's population, now live in countries with a VAT, and it raises about $18 trillion in tax revenue—roughly one-quarter of all government revenue. Much of the spread of the VAT, moreover, has taken place over the last ten years. From having been largely the preserve of more developed countries in Europe and Latin America, it has become a pivotal component of the tax systems of both developing and transition economies." This paper covers the mechanism of the VAT and presents critical issues in the tax design, implementation, and policy implications. The paper consists of five sections. Section I: Reviews the broad features of VAT introduced in India; also considered are the broad features of the present tax system in India.

Discusses the rationale for the opposition of VAT as is introduced in India. Reviews the experiences of the developed and developing countries with VAT which may provide lessons for effective implementation of VAT in India---Case in point for developed countries is France; United States; which represents a federal structure like India is also briefly considered as an illustration for federal structure not adopting

VAT; Case in point for transitional countries is the Russian Federation; Section IV reviews the rationales for the VAT in comparison with other types of indirect taxes. Also considered is the proper system of administration of VAT for India: should VAT be implemented at the state level or at the federal level; Also stated are the authors view on the proper implementation and administration of VAT in India. Section V analyzes critical issues in the VAT design, implementation, and policy implications and provides concluding remarks.

Value-Added Tax, one of the most radical reforms to be proposed for the Indian economy, could finally become a reality after four years of political and economic debate. Yet, the biggest hurdle before the government is not making India 'a common market' through a uniform sales tax structure, but removing a complicated tax structure that also allowed for fraudulent practices. The decision to introduce VAT was publicly discussed first at a conference of state chief ministers and finance ministers in November 1999. At that time, the deadline of April 2002 was agreed upon to bring in VAT. However political instability and a lack of initiative pushed this reform to the backburner. Now a year later, despite a backlash from the trading community and some political circles, there appears to be a realistic scope for VAT to be introduced. Twelve states have so far passed legislation to implement the VAT regime and of these five have sent their Bills for Presidential assent. Let us explore VAT and what it means.

VAT is a sales tax collected by the government (of the state in which the final consumer is located) – which is the government of destination state on consumer expenditure. Over 120 countries worldwide have introduced VAT over the past three decades and India is amongst the last few to introduce it. India already has a system of sales tax collection wherein the tax is collected at one point (first/last) from the transactions involving the sale of goods. VAT would, however, be collected in stages (instalments) from one stage to another. The mechanism of VAT is such that, for goods that are imported and consumed in a particular state, the first seller pays the first point tax, and the next seller pays tax only on the value-addition done – leading to a total tax burden exactly equal to the last point tax.

India, particularly the trading community, has believed in accepting and adopting loopholes in any system administered by the state or the Centre. If a well-administered system comes in, it will close avenues for traders and businessmen to evade paying taxes. They will also be compelled to keep proper records of their sales and purchases. Many sections hold the view that the trading community has been amongst the biggest offenders when it comes to evading taxes. Under the VAT system, no exemptions will be given and a tax will be levied at each stage of manufacture of a product. At each stage of value-addition, the tax levied on the inputs can be claimed back from the tax authorities. At a macro level, there are two issues, which make the introduction of VAT critical for India. Industry watchers say that the VAT system, if enforced properly, forms part of the fiscal consolidation strategy for the country. It could, in fact, help address the fiscal deficit problem and the revenues estimated to be collected could actually mean lowering of the fiscal deficit burden for the government. The International Monetary Fund, in its semi-annual World Economic Outlook released on April 9, expressed its concern over India's large fiscal deficit – at 10 per cent of the GDP. Further any globally accepted tax administrative system, will only help India integrate better in the World Trade Organisation regime.

In one the most large scale reforms of the country's public finances in over past 50 years, India has finally agreed the launch of its much-delayed Value Added Tax (VAT) from 1st April 2005. At a rate of 12.5%, VAT will come in on April 1, 2005. The tax, agreed after state finance ministers met in New Delhi, is designed to make accounting more transparent, cut trade barriers and boost tax revenues. The system had been postponed many times, mainly because of opposition from the powerful trading lobby. Ashim Dasgupta, who heads a panel overseeing the implementation of VAT, said: "We are very happy to announce that a broad consensus among states was arrived at the meeting to introduce VAT on April 1, 2005." The Congress-led new left-leaning United Progressive Alliance (UPA) government has made implementing VAT one of its key priorities. According to analysts VAT is essential in tackling the problem of tax evasion. In India, all the state governments collect over Rs 85,000 crore (Rs 850 billion) by way of sales tax and further over 20,000 crore (Rs 200 billion) by way of Central Sales Tax. This is what officially comes mostly from petroleum, liquor, iron and steel and cement companies. Rough estimates suggest that these industries account for over 50 per cent sales tax for the states and the Centre. Majority of the officials in sales tax departments believe that what they actually collect is less than 50 per cent of the revenue that should otherwise accrue to them if all transactions are accounted for by the businessmen. March 24, 2005: The state finance ministers in consultation with Finance minister P. Chidambaran decided to scale down the composite tax to 0.25 per cent from the earlier one percent over sales Turnover. This levy will be applicable to traders out of the VAT ambit and having a sales turnover between Rs. 5 lakh-Rs. 50 lakh per year. The Next major decision by the state finance ministers is to phase out central sales Tax (CST) during next three years. While the 4 percent CST stays during 2005-06, it will be slashed to 2 percent in 2006-07. CST will not be levied from April 1, 2007. India has a large un-organised market, especially agro-based industries and here a large number of transactions go unrecorded. The menace of stock transfers adds to the problem of tax evasion. In India, introduction of VAT will only change the collection methods for sales tax rather than reform the indirect tax system. In the initial phase of development, the economy is based on primary activities and industrial activities do not have a major role in the system. As a result, Gross Domestic Product (GDP) is not very high and the government has to depend upon taxes on commodities and services for mobilizing resources rather than on taxes on income and property. Such a situation prevails in almost all the primary economies. As the economy develops, the proportion of revenue generated from taxes on income and property rises. Tax-GDP ratio (tax revenue as percentage of GDP) of India is very low in comparison with not just the developed countries, but many developing countries as well. Whereas developed countries like Sweden, Greece, United Kingdom, and USA have tax-GDP ratio higher than 30 percent, many of the developing countries too have a higher ratio- Korea 26 percent, Brazil 21 percent, and Mexico 18.5 percent. In comparison, the tax-GDP ratio of India is very low, just 14.4 percent in 2001-02. While the tax-GDP ratio in India (centre and states combined) was 13.8 percent in 1980-81, it increased to 15.8 in 1991-92. Owing to structural adjustments and rationalization of tax structure during the nineties, the ratio declined to 13.4 percent in 1998-99. Since then the ratio has shown mild improvement. It reached 14.4 percent in 2001-02.

As in other developing countries, in India too, indirect taxes have contributed significantly to the tax-GDP ratio. The ratio of indirect taxes to GDP was 11.53 percent in 1980-81 and increased to 13.68 percent in 1989-90. It plummeted to 10.56 percent in 1998-99 but then rose to 10.96 percent in 2001-02. Owing to implementation of some major tax reforms in the central government in the nineties, its tax-GDP ratio has declined but the tax revenue collected by the States, as a percent to GDP, has increased steadily. The tax-GDP ratio of the states, taking the states own tax revenue, has increased from 4.64 percent in 1980-81 to 5.30 percent in 1990-91 and reached a high of 5.8 percent in 2001-02. Similarly, the indirect tax-GDP ratio of states has moved from 4.45 percent in 1980-81 to 5.08 percent in 1990-91 and further to 5.62 percent in 2001-02.

Trends in total tax revenue in India indicate that whereas in 1980-81 total tax revenue was Rs. 19,844 crore, it increased to Rs. 1,03,198 crore in 1991-92 and to Rs. 3,30,229 crore in 2001-02. It recorded a growth rate of 14.5 percent per annum. Taxes on commodities and services have an important role. These contribute to almost three-fourth of the revenue received from all taxes taken together. These taxes have grown from Rs.16,576 crore in 1980-81 to Rs. 75,462 crore in 1990-91. It rose further to Rs. 2,51,728 crore in 2001-02, with a growth rate of 13.8 percent per annum. Taxes on income and property have contributed a small share, although over the years their stake has increased. Whereas its contribution in 1980-81 was just 16.5 percent, it increased to approximately 24 percent in 2001-02. The share of taxes on income and property has shown a fluctuating trend during 1980-81 to 1990-91, but thereafter it showed steady growth. During the overall period of 1980-81 to 2001-02, it has recorded an annual growth rate of 17 percent. Buoyancy of total tax revenue of centre and states during 1980-81 to 2001-02 is 1.05. Buoyancy has, however, declined from 1.11 during 1980-81 to 1989-90 to 0.88 during 1990-91 to 2001-02. This is primarily due to decline in the buoyancy of taxes on commodities and services, which has shown a declining trend in 1990-91 to 2001-02 as compared to the buoyancy in the earlier period i.e. during 1980-81 to 1989-90. As shown in Table 4.5, the buoyancy of these taxes was 1.14 during 1980-81 to 1989-90 and 0.81 during 1990-91 to 2001-02. Buoyancy of direct taxes has shown an increase from 0.94 during 1980-81 to 1989-90 to 1.24 during the second decade of the study, indicating an encouraging responsiveness.

VAT by Indian states has been hailed as one of the biggest tax-related reforms in several decades. The Empowered Committee (EC) of state Finance Ministers was the central body which coordinated the design and implementation of VAT. Currently, all Indian states have implemented VAT and the transition to VAT has been fairly smooth. One of the objectives of VAT implementation was the expected increase in revenues of state governments. This research work attempts to analyze the impact of VAT on revenues of state governments by comparing the group of states which implemented VAT in 2005 with those that implemented it later. Differences among the VAT states are also analyzed. Further at traces the developments on VAT in India over the years, including the political factors that were at play at the time of VAT introduction in 2005. It gives a justification for the study. It also details the main assumptions and methodology. Section 5 analyzes the revenue performance based on various parameters and also explains the differences between VAT and non-VAT states. Based on the analysis, suggests a few policy recommendations.

The White Paper on VAT mentions that '*VAT is a state subject derived from Entry 54 of the State List, for which states are sovereign in taking decisions'*. The Empowered Committee (EC) of State Finance Ministers (created by the Ministry of Finance, Government of India) is the body which drafted the details of VAT through several rounds of consultations and also tried to get the assent of all states for implementation. After missing two previous deadlines of April 1, 2002 and April 1, 2003 (Bihar implemented VAT from April 1, 2003), VAT was finally implemented with effect from April 1, 2005 by all states apart from the five Bharatiya Janata Party (BJP – opposition party at the centre) ruled states of Gujarat, Rajasthan, Madhya Pradesh, Chhatisgarh and Jharkhand and three other states – Uttar Pradesh (UP), Uttaranchal and Tamil Nadu. The decision of the BJP ruled states was political while severe resistance by traders was cited as the reason for non-implementation by UP. Uttaranchal's decision was dictated by that of UP as the former has recently been carved out of the latter. In the case of Tamil Nadu, the reasons included opposition by traders and issues on VAT compensation though the real reason seemed to be the impending state elections in 2006. As of January 1, 2008, VAT has been implemented by all states and union territories. The primary justification for this reform was based on the inherent advantages of VAT over the existing sales tax regime. This included rationalization of tax burden, reduction in prices, simplification of tax structure, greater transparency, improvement in tax compliance, reduction in inter-state 'tax war' and increase in state government revenues. Hence, the beneficiaries would include consumers, the business community as well as the government. The main disadvantages of the existing sales tax regime were the multiplicity of taxes and the double taxation of commodities resulting into a cascading effect on prices. While designing the main structure of VAT, the EC kept in view the need to have common features across states but at the same time allowed for some flexibility within states. However, states have not strictly adhered to the EC recommended guidelines on VAT and hence there are other differences among them.

VAT is a tax on all goods and services, on the value added at each stage from production to the retail stage. To simplify the calculations of value added, each taxpayer is allowed to deduct the tax paid on his inputs from the tax payable on his output. VAT, in its comprehensive form, should replace all other domestic indirect taxes and also be extended to cover imports. Imported goods and domestically produced goods are treated at par and subjected to a single system of commodity taxation. The introduction of VAT in a country requires a number of decisions regarding the design of VAT such as (a) what type of VAT to adopt, *viz.,* gross product, income variant or consumption type (b) should it be origin based or destination based and (c) last but not the least, in a federal country like India, which level or levels of government should levy VAT?

There are three different variants of VAT. *Gross product VAT* covers all value added without giving any credit for the taxes paid on capital purchases or depreciation. This provides the broadest base for tax. In the *income type VAT,* the tax is initially levied on consumption as well as capital goods. Full tax credit on consumption inputs would be given but for the capital inputs, refund of tax would be given over economic life of the capital inputs, which is equal to the depreciation. Thus under income type tax, input credit would be provided on non-capital inputs and depreciation. In *consumption type VAT*, tax credit is allowed for all business purchases including capital assets. The economic base of this tax is, therefore, equivalent to total private consumption. This form is neutral between different methods of production. Most of the countries have adopted consumption type VAT.

If VAT is levied where goods and services are produced, it is known as origin based tax, whereas if it is levied on the basis of consumption, it is said to be destination based. In fact, consumption type VAT should necessarily be destination based. Under the destination based system, all value added in goods sold within the country, irrespective of whether produced domestically or imported, are taxed. Exports are zero-rated and interstate transactions are taxed on the basis of consumption.

India being a federal country, tax powers are distributed between the centre and the states. If VAT is to replace all domestic commodity and service taxes, then some constitutional amendment is required to authorize the concerned governments to levy one comprehensive VAT.

Various Committees such as Jha Committee, Chelliah Committee, Study Team of the National Institute of Public Finance and Policy and some other experts on the subject have different views regarding the form of VAT. Broadly speaking, there are the three forms of VAT in a given federal structure. These are:

As suggested by the Jha Committee and further reiterated by the Chelliah Committee, one school of thought believes that in any country, especially in a federal form of government, the most suitable and attractive proposition, for a unified system of taxing domestic trade, is to have a national VAT imposed and administered by central government. This system would bring harmonization in taxation of interstate trade. Federal countries like Argentina, Australia, Germany and Mexico have central VAT. In such a system the tax is entirely regulated by the centre. It is completely harmonized across the states. However, the revenue could either be collected by the centre and shared with the states or alternatively collected by the states on behalf of centre, the revenue share being decided by an independent body or organization. The central VAT would have the advantage of having a uniform rate across the country, thereby avoiding all the complexities that would arise if different states had different rates. Due to the existence of a uniform rate system, taxpayer would need to be familiar with a single set of VAT rules. The states would find it easier to share the information as central VAT ensures a unified administration and limits the occurrence of tax evasion.

☆☆☆☆☆

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SYNOPSIS

Revised Synopsis for P.D. Degree

Faculty of Commerece (M.B.A)

L.N. Mithila University, Kameshwar Nagar, Darbhanga - 846001

1. Title of the Research Project:

A study of VAT in Indian Tax System – An evaluation

2. Introduction:

The essence of VALUE ADDED TAX (VAT) lies in the inherent qualities of transparency, productivity, equitability, non-cascading & non-interfering effect and above all in its simplicity. The concept of Value Added Tax is almost a century old. History of sales tax may be traced back to remote antiquity. France was the first country to introduce tax in 1914. Then after several European countries followed. In our country, it was firstly introduced through Government of India Act, 1935. VAT was first pioneered by France in 1954. But a full-fledged VAT was initiated first in Brazil in mid of 1960's and then it was adopted by European countries in 1970's. With the rapid global economic changes, VAT has acquired a high esteem and currently it is being levied in more than 150 countries including our close neighbours Nepal, China, Pakistan & Bangladesh. Value Added Tax is a tax which is levied on value addition effected throughout the production-distribution chain. It has qualities of a good tax system. VAT is revenue friendly because taxes are imposed on entire value additions allowing minimum exemptions. VAT is broad based and very simple in implementation and also in its incidence bearance. It is based on tax invoice method and it leaves audit trail. Its transparent, non-cascading, self-policing, non-interfering, increasing registrations, making exports more competitive nature further makes it a very scientific method of indirect taxation. Basically, VAT is a tax on consumption in which Commodity is the subject, the Consumer is the target and Transparency is the objective.

Indian Union is a quasi federal State. Under the Indian constitution power to impose tax has been assigned both to the Union as well as the States. Certain categories of subjects for taxation have been assigned to Union and States in List I and List II of the Seventh Schedule to the Constitution of India. Residuary powers to tax vest with the Union. With the liberalization of the economy, India as a signatory to World Trade Organization Protocol has to reduce and rationalize customs duty and this will actually result in more pressure in indirect taxation. Indirect Taxation in the Indian context offers few opportunities. Commodity Taxes as of now comprise of Customs Duty, Union Excise Duty, State Excise Duty, Entry Tax, Luxury Tax and Sales Tax related other levies imposed by the States. Same commodities are taxed at different stages under different Acts in an un-integrated manner. This has resulted in cascading effect. Besides the value of the goods, tax on tax in a series of change of hands from manufacturer to consumer result in economic distortions. When the cosmetic goods are to compete with goods imported, the retail price to consumers have to be cost effective. In the manufacturing side if the inputs are taxed without discretion, manufacturing cost of a finished product increases. Raw materials for a particular manufacturer may be a finished product for another industry. This has effected the ancillary industries. Different Committees appointed by Government of India since 1970's have mainly concentrated on the levies made by the Centre. No comprehensive study of Sales Tax Administration in any of the States has been undertaken. In spite of the same, there is a feeling that the Sales Tax Administration in States has been commented upon. One of the draw backs of the levy of Indirect Taxes is that there is absolutely no exchange of information on the goods produced or imported from outside the country by the Union Administrators of Excise

Duties and Customs with Sales Tax Authorities of the goods slip through the Union Excise Duties or Customs and if the goods in case of goods levied to first-point tax in the State slips through a wholesaler or distributor, the evasion cannot be checked easily. Under the existing system maintenance of accounts as well as issue of authentic sale memos or vendor's receipt by the purchaser leaves much to be desired. Such inherent deficiencies can hopefully be rectified through VALUE ADDED TAX regime.

In pursuance to recommendations of the Indirect Taxation Enquiry Committee Government of India have adopted Mod VAT since 1986. Indirect Taxation Enquiry Committee of 1978 examined the following important questions to consider the necessity and desirability of switch over to Value Added Tax System in India:

(a) First, after the recommendations that we have made in regard to excises, and import duties have been implemented, what would be the further benefits to be derived by the introduction of VAT ?

(b) Second, should the long-term objective be the replacement of the existing systems of excises, sales taxation and certain other indirect taxes by the comprehensive VAT ?

(c) Third, if a comprehensive VAT system is ruled. out, to what stages should VAT be confined ?

(d) Fourth, would the advantage to be gained be significant in quantitative terms so that the attempted reform would be worth the cost and efforts involved ?

(e) And, finally, would the administration of VAT be feasible in India ?

The Committee recommended switch over to VAT. Tax Reforms Committee during the years 1991, 1992 and 1993 have recommended move towards Value Added Tax covering services and committees. To make the

VAT system simple and easily administrable, it should be levied at two or three rates only. They have recommended broadening of tax based and simplified assessment procedures. It is of interest to see that the Committee disregarding the possible erosion of resources base of States favoured extending the collection of Mod VAT at wholesale stage. They have recommended taxation on the following services by the Union: Advertising Services; Services of stock brokers; Service of automobile insurance; Service of insurance of residential property, personal effects and Jewellery; and Residential telephone services. The Committee further advised the Centre to agree: to impose a consignment tax subject to certain conditions; to give back to the States the power of levy Sales Tax on sugar, textiles and tobacco; and to share a given percentage of its gross tax revenues with the States. This would mean that the States would automatically share in the expanding revenues from taxes on services.

3. Statement of Research Problem:

In case of India, where the consumption variant operated through Credit Invoice Method VAT has been introduced, it is hopefully thought that on the whole, the positive growth in revenue, control of inflation will take place and trade and commerce will more competitive and also tax-leakages will be checked. Rate-path has been significantly simplified under VAT-zero rated, 1%, 4% and rest on 12.5% rated, while exports are zero-rated and petroleum products have been kept initially out of the rate classification under VAT.

Commercial Taxes in Bihar are the most important constituents of the state's revenue. Sales tax has come to occupy the most important place among the state taxes in Bihar. Bihar introduced this tax in 1944 through Bihar sales Tax Act 1944. Before the introduction of VAT in Bihar, sales tax was regulated by the Bihar Finance Act 1981 along with some other commercial taxes through different acts like Entry Tax, E1rrtertainment Tax, Luxury Tax, Electricity Duty, Advertisement Tax. Since its inception, the sales tax in Bihar has registered increasing growth rate. In 1950-51 growth rate was around 11.1% while in 2004-05 it has reached the growth rate of about 20%. In pre VAT era, in Bihar sales tax, there were provisions of imposition of Additional Tax and Surcharge also. In old tax system goods were generally taxed on first point basis. But, with the advent of VAT in Bihar, scenario has changed totally as the tax administration and structure are concerned. The implication of VAT in Bihar is expected to be most significant. The huge number of dealers will be registered and grabbed in to tax net hitting even the last points of sales largely in production distribution chain. Four type of tax rates as per the national standards under VAT instead of 17 type of tax rates in old system, will further check the illegal trespassing and make the trade environment cordial and competitive. Simple procedure for registration, zero-rated export, input tax rebate, rebate on entry tax, freedom from regular traditional type assessments, easy forms procedures, compounding facilities etc in one under VAT will created a path of building confidence in traders and that will open the numerous channels of revenue generations. On the other hand, new and useful provisions of risk-analysis, cross verifications, auditing, tools of debt management & automation and harsh penal provisions will equip the tax administration to curb the tax evasion and tax avoidance.

A well drafted law which should be simple, transparent and unambiguous, attitudinal changes, publicity, education of tax payers, much facilitating environment and mechanism for the settlement of disputes, online answering of quarries system, a good advisory cell and overall a cordial linkage between tax payers and administration will check the obstructions in the way of success of VAT in future.

4. Aims /Objectives & Relevance:

The main purpose of the research is to examine the implications of VAT on streamlining Tax System in India with special reference to commercial taxes in Bihar. The theme will mainly cover the implications of VAT on streamlining Tax System in India in the light of the changing global scenerio and further it will discuss its impact on the changing age of commercial Taxes in Bihar.

The objective of research is to evaluate the implications of VAT on streamlining and restructuring of the Tax System in India and specially in Bihar in the broader light of the role of commercial taxes in Bihar since tis emergence to the age of VAT. It will also discuss the suggestions to combact the drawbacks and to stabilize the Value Added Tax System and will further explore the pavement for its smooth functioning.

5. Methodology :

A suitable and scientific methodology will be applied to conduct this research project in proper and scientific manner. The research will be conducted through statistical, imperical and scientific methods.

6. Hypothesis :

The following hypothesis will be tested in this research project.

(i) Commercial Tax plays important role in economic development of Bihar.

(ii) VAT has strengthen the tax structure of Bihar.

(iii) VAT has accelerate the revenue generating sources.

7. Work Plan:

The proposed research work will contain the following chapters:

Chapter -1	Introduction
Chapter -2	VAT System
Chapter - 3	VAT & Indian Tax System

Chapter- 4	Commodity Taxation under VAT
Chapter- 5	Commercial Taxes in Bihar
Chapter -6	VAT & Commercial Taxes in Bihar
Chapter 7	Findings & Conclusion
	Bibliography

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