*The Issues Involved in Implementing VAT in India: Need for a Broader View

by

Arun Kumar
(arunkumar@mail.jnu.ac.in)

*An earlier version of this article was previously published in **Bhartiya Samajik Chintan** in India, April-June 2005. Vol. IV, No. 1. pp. 6-9. We are very grateful for the author and D. Panda, the editor of Bhartiya Samajik Chintan, for permission to reprint.

The Issues Involved in Implementing VAT in India: Need for a Broader View

Implementation of VAT in its various versions has been going on in India for a long time but it has gathered momentum in the last few years and specially from April 1, 2005 (See, GOI, 2005 :46-47) . Its earlier suggested versions have been MANVAT and MODVAT. The former was suggested by the Indirect Taxation Committee in 1978 and the latter in the Long Term Fiscal Policy 1985. MODVAT began to be implemented for collection of Excise duty on some items from 1986-87.

After independence, India embarked on rapid development to eradicate the extreme poverty that has afflicted this land since the time of British rule in India. The state was given an interventionist role for achieving optimum growth and to quickly accomplish an economic transition from an underdeveloped to a developed country. This required the government to collect the surplus funds where available and to mobilize them for rapid development.

Hence taxes had to be raised for this purpose. Taxes are supposed to be a contribution for running the government and the various tasks assigned to it. They are paid by the citizens – either directly or indirectly out of their income. Hence the name direct and indirect taxes. Tax on property is also paid out of the income of the individual owning the property. In India, Income tax, Corporation tax, Wealth tax are examples of direct taxes whereas, Customs, Excise and Sales taxes are examples of indirect taxes.

All those who have incomes/wealth above a certain exemption limit pay direct taxes. In India, effectively 1% of the population pays direct taxes even though about 3.5% of the population is in the direct tax net. However, everyone including the poorest pay indirect taxes through their consumption. Thus, those who are considered to be too poor to pay direct taxes because their incomes are low are also forced to pay taxes. This is applauded by some who argue that this way everyone pays for the nation's development. The reason few people pay direct taxes is that the distribution of income and wealth is highly skewed in the country and the exemption limits are rather high. Consequently, India has had one of the lowest direct tax to GDP ratio in the world.

Indirect taxes are levied at the stage of production, sales and importation into the country. The idea is that at each stage of production and distribution, there is value addition and a part of that should be given to the government for social development. Thus, the indirect taxes are built into the price that the consumer pays. Hence the citizens have no choice and pay the indirect taxes as a part of the price they pay in the market when they purchase something.

Indirect taxes may be levied in three different forms – specific, ad valorem or value added. Specific taxes are fixed. So, as the prices of goods increase, the revenue collection does not automatically rise. They are simple to collect but are not `buoyant'. Ad valorem taxes are levied on the value of the goods and are `buoyant' since as prices of goods rise, more of tax is collected. However, they lend themselves to tax evasion due to misdeclaration of the price. The Value Added Tax is levied on the value added at each stage of production and distribution.

In brief, Value Added Tax (VAT) is **not a new tax** but only a way of collecting an indirect tax. If collected from the producer, it is Excise duty and if collected on sales, it is a Sales tax. Each of the three forms in which the indirect taxes may be collected is equivalent to a certain rate of Value Added Tax.

Indirect taxes are associated with what is called **cascading effect**. If excise duty is levied at the different stages of production then the tax is carried in the price of the product from one stage to the next stage of production. Since the price increases due to the tax from the previous stage, the ad valorem tax is also higher and that is added to the next stage of the production. Hence there is a tax on tax and the effective rate of tax becomes higher than the tax rate applicable. Further, as shown in Kumar (1986) there is also profit on tax in a mark up pricing system and the profit also increases. In brief, the cascading effect consists of **two parts**, **a tax on tax and a profit on tax** and the consumer has to pay these as higher prices.

Further, if there are other indirect taxes levied on sales, transportation and storage, then the cascading effect continues from one kind of indirect tax to the other. It is not easy to figure out the total impact of the taxes (referred to as lack of transparency) and give a relief to the exporter or the investor. Hence, the cascading effect, by raising prices, adversely effects exports and investments.

If the tax is on value addition (VAT) at each stage, it is argued that the cascading effect will be eliminated and the consumer would benefit in terms of lower prices. Here the value addition and the tax paid in the previous stage are subtracted while calculating the tax. However, this is only likely if the government is willing to sacrifice revenue or the profit earners are willing to forego a part of the profit. If neither is willing to forego their share, then the price will not fall (see Kumar, 1986). In other words, **if government wants to have `revenue neutrality' and the businessmen want to earn the same amount of profit, prices will not fall even with the implementation of VAT**. This is because to collect the same amount of tax revenue, the government has to levy the tax at a higher rate under VAT (Kumar, 1986).

VAT is more difficult to calculate than ad-valorem tax. In the latter case, the tax rate is applied to the price of the good to calculate the payment. In the case of VAT, one needs to know detailed production accounts to calculate value added at each stage of production and distribution. Thus, how much material was bought and how much waste was generated have to be known and the value of these subtracted from the value of the product produced. Hence VAT is much more difficult to calculate and for small businesses who do not keep such detailed accounts it is impossible to calculate.

However, the way VAT is being applied currently, the calculation is sought to be simplified by calculating the amount that would have to be paid on the price of a good and then subtracting from it the tax paid on the materials used in its production (i.e., by the producer of the previous stage). In other words, credit is given for the tax paid at the earlier stage of manufacture and sale (GOI, 2005). Thus, each commodity has to carry with it a receipt/ voucher of the tax paid on it. This is also complicated and in an economy where stamp papers, currency and financial instruments are easily forged, it is a simple matter to forge the tax receipts. Thus, VAT lends itself to more tax evasion in Indian conditions.

Further, it would be detrimental to the interest of the small businesses which are exempt from VAT or that do not have the wherewithal to calculate VAT. Thus, small businesses would not be able to provide the receipts/ vouchers to later stage manufacturers who will then not buy from them unless they lower their prices. Thus, the purpose of the concessions to small scale sector would be defeated. This would have a detrimental effect on employment.

For VAT to be really meaningful, it would have to be applied at all the stages of production, distribution and storage, i.e., a full VAT. However, if it is only applicable at some of the stages, it would create problems. The chain of credit would tend to stop and the cascading effect would begin to take hold. Full Vat would be very complex and require enormous computerization to be effective. Not only would this be expensive but it would be impractical in Indian conditions. Simplification is the key to effective taxation in India. In fact, effective ad-valorem taxation would require much less computerization for effectiveness.

If revenue neutrality is not maintained, then the budget deficit will tend to increase, *ceteris paribus*. Given the domination of the Centre over taxes, the problem would not be so much for the Centre as for the states. Since 1991, while the Centre has been able to control its budgetary deficit, the states have seen their deficits balloon. This has forced them to cut back on developmental expenditures and specially on the social sectors (Kumar, et.al, 2005). Hence many of the states fearing loss of revenue have been reluctant to implement VAT. The Centre has assured them that it would compensate for the loss of revenue but some states are not certain how long that will last and have not bitten the bait.

VAT can only yield higher revenue if the tax rates are substantially raised or it is levied at many more stages of the economic chain than at present. This would be very cumbersome and administrative costs would go up substantially. Either way, if VAT collects more, prices will rise.

If matters are not straight forward, then why go in for implementation of VAT? The pressure is from international agencies who are pressing for opening up of the Indian markets and their integration with the international markets. This would be facilitated by having similar tax systems across all countries. Most countries in the world have gone in for VAT so the pressure on India is mounting. USA is a notable exception to this. This idea of common tax systems undermines the basic tenets of federalism – namely, each entity should have the autonomy to do what it thinks is best for it. Different economies at different stages of development have different requirements and this also applies to taxation.

Theoretically, indirect taxes are stagflationary (Kalecki, 1971). In contrast, direct taxes have the opposite effect and therefore more desirable. Further, indirect taxes taken as a whole are regressive while if direct taxes are properly designed and collected, they are progressive. This is important in a poor country like India. Thus, government should collect more from direct taxes and as little as possible from indirect taxes. Hence, even if it is accepted that VAT is more efficient, government should try to reduce its scope. Such a scheme was presented in the Alternative Budget (Kumar, 1994). However, matters are complicated by the existence of a large and flourishing black economy.

The well off sections resort to the black economy and are not enthusiastic about paying direct taxes. So, the government has been forced to depend on indirect taxes. The share of tax in GDP rose from 6.31% in 1950-51 to 15.42% by 1991 and the indirect component rose from 3.99% to 13.27%. In brief, the rise in the tax-GDP ratio was predominantly due to the rise in the share of indirect taxes. After the New Economic Policies were launched, the share of tax in GDP fell to 13.38% by 1998-99 and since then it has risen to the peak of 1991. The direct to indirect tax ratio rose to 1:3 in 2000-01 as compared to 1:6 in 1990-91. The rise in the tax-GDP ratio in the last 7 years is predominantly due to a rise in the share of the direct taxes. It has been shown recently in Kumar, et. al. (2005) that this is predominantly a result of the rising disparities in the economy between the upper income groups and the rest. However, in spite of this rise, the government is still heavily dependent on indirect taxes to raise a bulk of the resources.

There are two reasons for this. The growing black economy and the exploitation of the public sector by the private sector. The black economy has been draining the public sector of its surplus and channeling it into the hands of the ruling elite consisting of the corrupt businessmen, corrupt politicians and the corrupt bureaucracy in league with the top echelons of the management of the public sector. Consequently, the public sector has been losing a considerable part of its profits to households rather than reinvesting it to achieve higher growth.

Not only is the public sector seen to be inefficient and running at a loss but it has not been able to achieve its assigned goals so that policy is seen to have failed and the public sector has lost credibility with the public. Further, it has remained dependent on the budget for support. Corruption has also sapped the will of its staff – workers and management – without which the public sector cannot be successful. It has to have the commitment of its employees at all levels since it is not run on any simple criterion like, profit motive.

It has multiple social objectives and to achieve them it has to take steps that run counter to the narrowly defined profit motive. Fulfillment of these objectives requires a high degree of commitment. Often, to achieve the wider national goals, steps have to be taken that seem to be irrational from the point of view of `profit maximisation'. For instance, even when there is over capacity in industry, new investment has to be put in place to prevent a slow down of the economy. Similarly, industry may have to be located in a backward area for developmental purposes even though it would be unprofitable. Short term profit maximization is not the goal. Further, the private sector for its rapid development has depended on the public sector to provide it with cheap infrastructure. Public sector suffered losses so that the private sector could make more of profit.

For all the above reasons, not only has the public sector not generated resources to finance further development but it has had to depend on the budget for resources for investment. Hence, more and more resources were required to be raised through the budget either through taxes or borrowings.

The growing black economy led to more and more tax evasion by the well off. Hence in spite of their obviously rising incomes, the direct tax to GDP ratio stagnated at a low value. Government’s attempts to raise the rates of direct taxes did not make a dent. Nor did the lowering of the rates of direct taxes (Kumar, 1999).

As the deficit in the budget rose, the government borrowed more and paid more of interest getting into a vicious cycle of borrowing and repayment. Borrowing rose so fast that the interest burden on the Union budget became the largest single item of expenditure in the Nineties.

Since direct taxes did not yield much due to the growing black economy and borrowing became counterproductive with rising interest burden, government was forced to collect more and more from indirect taxes. In an economy based on self-reliance the nascent industry argument was used to raise customs duties and this yielded considerable amount of resources. But it was also found easy to collect taxes through other indirect taxes – excise and sales taxes. This was especially true when taxes were levied on the basic and intermediate goods. Hence as a share of GDP, the indirect taxes rose while the direct taxes stagnated accentuating the regressive character of our taxes and strengthening the stagflationary tendencies in the economy.

In addition to the above theoretical considerations there can be discussion of many practical issues regarding VAT, like, what to do when goods cross state boundaries and pay a central sales tax (CST), what to do about resellers, what should be the rate structure, etc.? One can also discuss the issue of why traders are agitating against VAT? Clearly, they are not doing it for any larger national interest but for their own narrow considerations one of which is that they think that it may get them into the tax net. They are also worried that it would be more complex and result in harassment, etc. However, these issues can be resolved if there is theoretical clarity on above mentioned issues.

If VAT is implemented efficiently and more taxes are collected through it, regressivity would increase and the need to collect more direct taxes would decline. Both these would benefit profit earners and as markets open out and foreign capital enters India it would derive benefit from this. Further, since there are limits to which indirect taxes can be raised without effecting the size of the market and in a regime where the fiscal deficit has to be held in check, the role of the state and of the public sector in the economy would have to be limited – a key aim of international finance capital. This would reduce any potential challenge to it in the national markets.

In brief, the issue of VAT cannot be divorced from the other policy aspects and viewed in isolation. If India is to eradicate poverty and accelerate development, public sector will remain relevant and resources are needed for investment. Ideally, these should be obtained through direct taxes and not indirect taxes. The black economy will have to be curbed. VAT may be levied on final stage of production and consumption of luxury goods and inessentials. The rest of the goods should be exempted from internal indirect taxes. The debate needs to be broadened from VAT implementation to the nature of the development path India should pursue.

References

1. Government of India, Ministry of Finance, Economic Division. 2005. **Economic Survey, 2004-05.**
2. Kalecki, M. 1971. **The Dynamics of Capitalist Economies**. London: Cambridge University Press.
3. Kumar, A. 1986. 1986-87 Budget: Signs of Growth Pains without Growth. **Economic & Political Weekly.** April 12.
4. ------------. 1994. Proposals for a Citizens Union Budget for the Nation for 1994-95. An Alternative to the Fund-Bank Dictated Union Budget for 1994-95. Mimeo. Presented to the Citizens' Committee on February 12, 1994 at Gandhi Peace Foundation, New Delhi. Prepared for the Preparatory Committee for Alternative Economic Policies.
5. ------------. 1999. **The Black Economy in India.** N Delhi: Penguin (India).
6. Kumar, A., Chattopadhyay, S. and Dharan, S. 2005. Fiscal Reform And The Deficit Of The States: Declining Social Sector Spending. **Alternative Economic Survey, 2004-05.** (forthcoming) N Delhi: Rainbow Publishers.