

Value Added Tax: Current Issues in India

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Introduction

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.

Statement of the Problem

The study of value added tax is an important subject matter, consequent upon its recent implementation in different states in India. The value added tax has been introduced in different states after severe opposition from the trade unions and political parties. It is expected that VAT revenue will add additional income to the state governments. The state governments have frequently changed the VAT rates for different commodities and this situation leads to conflict between government and consumers. The study of revenue impact of VAT on state governments is an important aspect of policy analysis. The revenue generation through VAT is an additional source of revenue on the part of the state governments. An analysis trends in VAT revenue enables one to understand the sustainability of introducing VAT. It is essential to trace out the growth of VAT revenue and factors determining VAT revenue generation in different states.

Objectives

1. To analyze the VAT GSDP ratio in different state in India.
2. To study the impact of value added tax on state governments in India.
3. To study the trends in value added tax collections with reference to the selected the Governments in India
4. To examine the cost of VAT collection with reference to selected the Governments in India
5. To suggest some policy measures to improve the VAT revenue collections in India

Hypothesis

1. There is a significant interstate variation in VAT GSDP ratio in different state in India.
2. There is a significant impact of value added tax on state governments in India.
3. There is a significant variation in trends in value added tax collections with reference to the selected the Governments in India.
4. The cost of VAT collection differs with reference to selected the Governments in India

Methodology

This study aims at analyzing the impact of value added tax on state governments in India. This study is undertaken in two dimensions. The first dimension relates to the major impact of value added tax on Indian states. This analysis is carried out on the basis of data relating to 2008-09. This year only data has been available to the 29 states in India. This analysis is carried out on the basis of specific equation model. The second dimension of the study relates to the individual state wise analysis with reference to Tamil Nadu, Maharashtra, Haryana, Orissa, Andhra Pradesh and Jammu and Kashmir. Here analysis is carried out with reference to growth of state revenue, growth of VAT revenue, cost VAT collection, trends in the growth of state revenue and VAT revenue.

Data and Modeling Issues

To assess the revenue impact of the state VAT, the (a) Gross State Domestic Product (GSDP) buoyancy of sales taxes (ST) and (b) the revenue to GSDP ratio, before and after VAT are examined. GDP (here GSDP) is the standard proxy for the base of general consumption taxes in most revenue performance studies. Two issues are examined. First, has the VAT done better than the sales tax it replaced? Second, has the VAT contributed to an improved own revenue performance? The latter is not assured if VAT gains are eroded by losses from other revenue sources, unintended or intended.

For the first question two equations, ST revenue pre- and post VAT implementation were compared:

$$\text{LNST}_t = B_0 + B_1 \text{LN}G_t + B_2(\text{VAT}_t \cdot \text{LN}G_t) \quad (1)$$

$$(\text{ST}/G)_t = B_0 + B_1 \text{VAT}_t \quad (2)$$

In (1) LN prefixed to a variable name denotes its natural logarithm, GSDP_t is abbreviated to G_t and the t is an annual time period subscript ranging from 193-94 to 2008-09. VAT_t is a dummy variable taking the value 1 for years in which the VAT prevailed and zero otherwise. Thus VAT_t · LN G_t is a slope dummy variable. An increased coefficient of the VAT dummy in the buoyancy equation (1) is consistent with higher secular revenue productivity of the VAT compared to the earlier sales tax. An increase only in the VAT/GSDP ratio may reflect a onetime increase in revenues due to the VAT, with no trend impact.

For the second question, the same two equations but with state's own revenue receipts (SORR) replacing ST are estimated:

$$\text{LNSORR}_t = B_0 + B_1 \text{LN}G_t + B_2(\text{VAT}_t \cdot \text{LN}G_t), \quad (3)$$

$$(\text{SORR}/G)_t = B_0 + B_1 \text{VAT}_t \quad (4)$$

An alternative to equations (1) and (3) with lagged G_{t-1} replacing current G_t, (equations 1a and 3a) is also reported below.¹¹

A fifth equation was estimated to check if, even if there was no revenue increase, the VAT at least contributed a larger share of state revenue:

$$(\text{ST}/\text{SORR})_t = B_0 + B_1 \text{VAT}_t \quad (5)$$

These models do not include other possible determinants of revenue performance. Keen and Lockwood (2007), for example, estimate pooled regressions and so include additional "tax effort" determinants including a per capita income variable, a trade openness variable and the share of agriculture in GDP. These variables, which will vary little over the sample period in Indian states, are unlikely to contribute to the explanatory power of the time series models analysed here. Furthermore trade openness data are not available for Indian states.¹³ However,

as in other Indian studies, states are classified as major states and non-major states, the latter including the ten special category states. Special category states are officially held to suffer from poor infrastructure, difficult terrain and in most cases large tribal populations.

The equations above neglect the indirect impact, if any, of VAT introduction on the VAT base. To assess this two more equations were estimated using pooled data for the jurisdictions studied. The reason for data pooling was to take into account possible cross-state economic spillovers on the VAT base. Using the subscript j for the j th state, the estimated equations were:

$$\text{LNGSDP}_{jt} = B_0 + B_1\text{VAT}_{jt} + B_2\text{Time}_{t} + B_3\text{State}_{j}, \quad (6)$$

$$\text{LNGSDP}_{jt} = B_0 + B_1\text{VAT}_{jt} + B_2\text{Time}_{t} + B_3\text{State}_{j}. \quad (7)$$

There is little alternative to the admittedly weak methodology of using a VAT dummy variable to assess the impact of the VAT. This methodology, with all its problems, is also used in earlier VAT impact studies including Keen and Lockwood (2006, 2007). However, this implies that differences between VAT and pre-VAT periods rather than the impact of the VAT are being studied. The technique cannot distinguish between the VAT's impact and the impact of other tax and fiscal reforms during the period. For this detailed, state by state, inquiries on the quality of VAT implementation and also other reforms are needed. The quality of VAT implementation is partly examined below by drawing on a VAT performance audit. Two other statistical exercises to check the robustness of the basic results are described below.

Current rupee data on GSDP, ST and SORR are used for all 29 Indian states (clubbed into 26 jurisdictions as explained below) for 2003-04 to 2008-09. ST and SORR data were from the website of the Reserve Bank of India (RBI) and GSDP data were from the website of the Ministry of Statistics and Programme Implementation (MOSPI).¹⁸ Four data problems and the manner in which they were dealt with are now described.

Chattisgarh, Jharkhand, and Uttarkhand were carved respectively out of Madhya Pradesh, Bihar and Uttar Pradesh in 2000. So combined data for Bihar-Jharkhand (BJ), Madhya Pradesh-Chattisgarh (MPC), and Uttar Pradesh-Uttaranchal (UPU) were used. This reduced the number of jurisdictions to 26 instead of 29. Since differences could arise after the split, an additional dummy variable term, $B_3\text{Splitt}$, was added to equations (1) to (5) for these states, with Splitt equalling one from the year of the split (2000 in all three cases) and zero before that. Furthermore, in BJ and UPU, Bihar and Uttarkhand implemented the VAT before their sibling states (see Table 2). So additional dummy variable terms, $B_4\text{VAT}_{1t}$, were added for BJ and UPU in all equations. VAT_{1t} equals 1 for years in which only one sibling state had the VAT and zero otherwise. Data for two states, Jammu and Kashmir and Karnataka were only available to 2007-08. Tamil Nadu and Uttarkhand (then Uttaranchal) implemented the VAT mid-year rather than on April 1. A dummy variable for mid-year implementation was tried but, being insignificant, was dropped from the regressions reported here.

GSDP data were from three different series: 1993-94, 1999-2000 and 2004-05. A chained GSDP series was estimated by projecting the ratio of overlapping years of these series backward using a linear projection equation fitted by ordinary least squares. The resulting chained series thus has GSDP even for years before 2004-05 converted to the base year 2004-05. Equations (1) to (4) were estimated with both chained and unchained GSDP series. With unchained GSDP data, VAT revenue performance turns out to be worse than with chained GSDP. So only chained series results are reported in the main text. Differences with the unchained GSDP series are footnoted.

Data collection

The relevant data are collected from the various statistical reports such as reports of state commercial tax department, central statistical organization, reports of planning commission, reports of finance ministry and reports of various committees.

Data analysis

The collected data are classified and tabulated with the help of computer programming. Cross tabulation is done with the help of state wise data and year wise data. The general data interpretation is done with the help of growth rate, percentage and average analysis.

Limitations

The findings of the study are applicable value added tax and it does not represent other taxes. The state wise analysis is restricted only to 2008-09 and such data are not available in all the states in the remaining years of VAT implementations. In this study only 6 states are taken for individual case analysis. The remaining states are not covered due to non-availability data.

The findings of the present study lead to the following concluding remarks.

1. Deficiencies in VAT acts and rules existed in many states.
2. The large backlog of pending assessments under the predecessor taxes burdened TAs.
3. Incomplete automation, limited electronic return filing, and differences in VAT returns and documents across states seriously handicapped cross-verification of information in VAT returns across VAT dealers within and across states.
4. Inability or unwillingness to cross check information with that available in other tax departments like the Central Excise and Customs Departments.
5. Ineffective procedures for verifying ITC claims and detecting fake ITC claims.
6. Most states were without tax administration procedure manuals.
7. Problems with VAT dealer registration procedures allowing non-registration of some dealers and multiple registrations of others.
8. Penalties for VAT non-compliance were at the discretion of TAs and often not levied.

On account of these TA deficiencies audit test checks of around 1, 00,000 dealers found widespread tax evasion and avoidance through a variety of channels including

1. Under-declaration of sales and incorrect or false ITC claims by 50 percent of VAT dealers.
2. Granting of incorrect VAT exemptions.
3. Collection of VAT from customers which was not remitted to state treasuries by some exempt dealers who continued to receive transitional benefits from earlier tax incentive schemes.

These official performance audit findings, based on extensive test checks, provide independent verification of the relatively poor revenue performance of the VAT found in this paper. The audit traces this to incomplete reforms and ineffective TAs. It would be of interest to see if TA weakness can statistically explain poor revenue performance if state by state information for the CAG report were made available. Note, however, that administration of the predecessor sales taxes was also ineffective as documented by several studies and official reports. The incapacity of TAs to successfully cope with administering a new, sophisticated, tax like the VAT is strongly suggested by the CAG performance audit.

The state VAT was implemented in 2005 after a decade of preparation and at an unknown but large cost. From the statistical results and the CAG audit it can be inferred that the economic return in terms of revenue and efficiency gains to this expenditure of public funds is at best zero for the country as a whole. However, in Haryana, Orissa and the 6 identified special category states in Table 5, the return may have been large enough to justify the cost of reform planning and implementation. Given the apparent lack of readiness of states, implementing the GST in 2012-13 is a high risk step whose returns may not repay the cost of planning and implementing the GST.

Further state by state investigation is needed, particularly of tax administration and tax compliance, to throw more light on the costs and benefits of the 2005 VAT reform and devise more extensive benchmarks for the proposed GST reform.

The findings of state level analysis reveal the following facts.

The sales tax revenue constitutes more income in Karnataka Kerala Goa Andhra Pradesh Haryana Tamil Nadu Gujarat and Uttarakhand than those of other states in India. The contribution of VAT to the GSDP is found to be low in Arunachala Pradesh Bihar Manipur Megalaya Mizoram Tripura and West Bengal and it is relatively it high in Goa Jammu & Kashmir Karnataka Kerala Delhi and Tamil Nadu.

The total VAT along with sales tax revenue of Maharashtra state was Rs. 31214 crores in 2007-08 and it increased to Rs. 47302.14 crores in 2010-11, showing a 28.06 per cent growth in the period of analysis. The total VAT along with sales tax revenue of Andhra Pradesh state was Rs. 20106.09 crores in 2007-08 and it increased to Rs. 32880.10 crores in 2010-11, showing a 31.16 per cent growth in the period of analysis. The total VAT along with sales tax revenue of Tamil Nadu state was Rs. 19738.04 crores in 2007-08 and it increased to Rs. 30491.00 crores in 2010-11, showing a 26.90 per cent growth in the period of analysis. The total VAT along with sales tax revenue of Gujarat state was Rs. 15817.39 crores in 2007-08 and it increased to Rs. 27281.13 crores in 2010-11, reporting a 49.77 per cent growth in the period of analysis. The total VAT along with sales tax revenue of Karnataka state was Rs. 16163.50 crores in 2007-08 and it increased to Rs. 23721.81 crores in 2010-11, showing a 26.40 per cent growth in the period of analysis. The total VAT along with sales tax revenue of Kerala state was Rs. 9372.00 crores in 2007-08 and it increased to Rs. 16155.95 crores in 2010-11, indicating a 22.86 per cent growth in the period of analysis.

Suggestions

Given the poor ability of states to cope with tax reforms documented by the CAG and the possible negative impact of this on revenue in several states, further large scale tax reform at this stage appears premature, despite the 3 years of planning. TAs will have to cope with a greatly expanded number of dealers under the GST. Furthermore state TAs have no experience dealing with dealers providing services as there have been no general state taxes on services. So while base broadening by including services is desirable in due course, this should not be attempted unless TAs expertise in taxing service providers.

Instead, performance benchmarks for TAs should be laid down with respect to current TA weaknesses and procedures in implementing the VAT on goods. Moving to a GST should only be suggested if states can achieve the performance benchmark as verified, for example, by another CAG performance audit.

For states which had a positive VAT revenue performance but poor own revenue performance, attention should possibly be diverted to other revenue sources. Such states include

Chhatisgarh, Karnataka, Kerala, Madhya Pradesh Nagaland, Punjab and Rajasthan. For Goa and Gujarat causes of apparently declining tax effort should be identified and corrected. For Arunachal, Sikkim and Maharashtra further assessment to identify causes of apparently contradictory or insignificant revenue performance indicators is needed.

Are any base broadening (and consequent tax rate lowering) options available for the existing VATs on goods? One option is a move from 100 percent ITC to partial ITC at, say, 20 percent of input taxes paid by suppliers. As noted in the introduction, there is no theoretical justification of any efficiency benefit in countries like India from a 100 percent ITC. Evidence in Table 6 also suggests the absence of efficiency benefits, though data and methodological weaknesses are present. Instead revenue loss due to evasion and TA inability to administer the ITC documented by the CAG will be limited as will loss from a narrow base with a partial ITC. Furthermore, "self-enforcement" benefits from an ITC, if present, will continue with a 20 percent ITC.

1. It could be noted that VAT and state autonomy' rightly points out that tax coordination and harmonization across states can be achieved by floor rates of VAT for different goods.
2. It would be in the interest of both state governments and tax payers to have uniform laws and procedures for tax administration. In the medium term, a consensus tax administration act will greatly reduce the cost & will lead to increase in the profitability of an organization.
3. Universally VAT & GST has been adopted for correcting the fiscal imbalances as it works well within all political and legal constraints. The existing VAT system has increased the tax revenue as well as the profitability of the organization.
4. VAT has simplified the paper work, proved to be user friendly, reduced transaction costs and time since e- registration has been made compulsory for every dealer.
5. It is suggested and emphasized that VAT reduces the cascading effect and improves neutrality. Therefore, rather than prescribing different rates for different goods, a uniform VAT will improve economic efficiency.
6. It is suggested to prepare the infrastructural setup requisite for adequate automation in tax administration and engineer the business processes before the GST implementation.

Conclusion

The transition to the VAT regime in India has been smooth and as of January 1, 2008, all states and union territories have implemented VAT. This paper has analyzed VAT/sales tax revenue performance in the first year of VAT implementation between VAT and non-VAT states. Results indicate that the rate of growth of VAT collections was lower in 2005-06 for VAT states compared with non-VAT states. Based on international experience, the paper explores a variety of reasons which could explain these differences. However, it is difficult to apportion the difference to the various factors that were identified.

Based on the current analysis and international experience, various policy recommendations have been made. The paper acknowledges the fact that the decline in the rate of growth of VAT revenues could be on account of the initial teething problems. Despite this, the proposed recommendations will beneficially impact state government revenues and also ensure smooth functioning of the VAT system in India in the future.

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