REUTERS/PUNIT PARANJPE

Shoppers stroll in a Mumbai mall, where the goods they purchase are subject to a value-added tax (VAT). The VAT is levied on each transaction in the chain until the final product reaches the consumer, who pays the last business the full amount.

Indian states agree to create a value added tax

Goods and services tax could be next if New Delhi and the states agree

BY SUKUMAR MUKHOPADHYAY

MANY GOVERNMENTS HAVE stumbled on the difficult politics of tax reform. The economic imperatives of a more rational system bump up against the difficult politics of winners and losers – and in federations, against the turf wars between governments.

Few tax reforms have proven more important, or difficult, than the move from sales and manufacturing taxes to value added taxes – what is known as the VAT. India finally introduced a VAT in 2005 and the last eight holdout states gave in and replaced their sales taxes with a VAT in 2008.

The manufacturing tax, which is imposed by the central government in India, is already under a value added system called CENVAT (Central VAT), a transformation that began in 1986 and has been extended further since then. It has been a struggle for the new regime both at the central government and at the state level, and it is still far from optimal.

The federal challenge comes from the fact that constituent units in many federations have the power to levy sales and manufacturing taxes. Such taxes are quite easy to administer at the sub-national level. But a VAT is much more difficult to administer at the sub-national level and requires, at a minimum, that major elements of its design be co-ordinated across the federation. So federal countries wishing to move to a VAT must also work out how to go from a decentralized regime to a co-ordinated one.

Why bother? Sales and manufacturing taxes are economically flawed in that they are a tax on the inputs into a country's goods and services. Thus, they favour imports over domestic production, they can involve repeated or

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"cascading" taxation as elements of the production chain move towards the final product (thus putting heavier taxes on products with longer production chains) and unless a specific exemption is made, they also tax exports.

A VAT avoids these problems. It is levied on each transaction in the chain of production as businesses buy inputs and sell their outputs onward to other businesses until the final product reaches the consumer. Each business collects the VAT at its point of sale, but is credited for VAT it has already paid on its inputs; thus on any one transaction, the net new tax is only on the "value added" at that stage in the chain. The final consumer pays the last business the full amount of the VAT. This system is neutral, taxing all final products the same way. The VAT is normally refunded when a product is exported and it is imposed on imports.

Many exemptions from the old taxes were abolished in India during the changeover to the VAT in order to make the new regime more neutral. However, loss of exemptions could spark protests, as happened in 2007 when weavers in the state of Orissa objected to the tax exemption on saris, towels and other items being yanked.

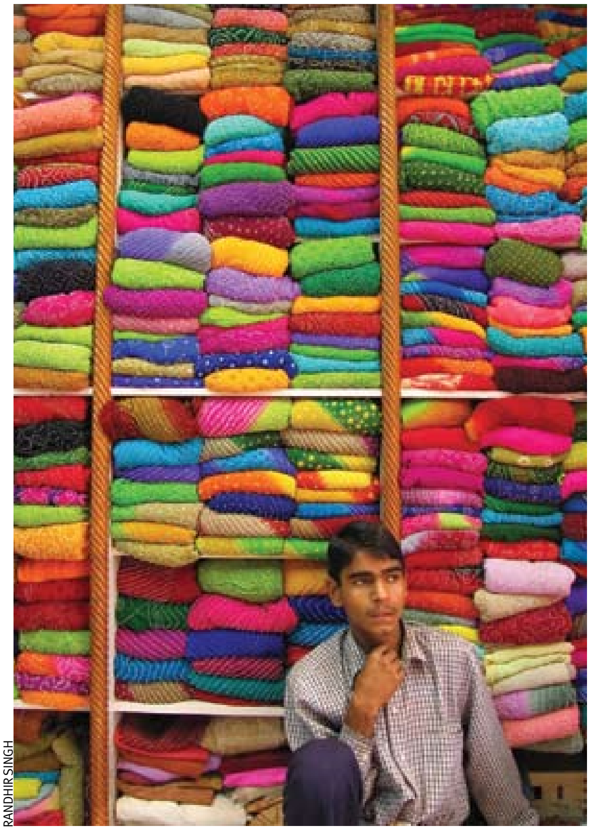
Small-scale businesses were against the VAT since it would require them to keep detailed documents and accounts. For many businesses, there was a simple lack of will to co-operate with the government on the new tax.

Large industries, however, were in favour of the VAT because of the distinct benefit to them since it would give them credits on their inputs. As it turned out, VAT revenue fell short of previous sales tax collections in many states in the first two years. As a result, the central government had to give substantial compensation to the states, as that was the arrangement for three years.

Also, critics of the tax said that changing to a VAT was no guarantee of raising more revenue or reducing tax evasion, two principal justifications for the new order.

Support from central government

The VAT system was adopted by the states with the active approval of Prime Minister Manmohan Singh's Congress-Party-led coalition in New Delhi. In 2004, when Singh's coalition came to power, many states were still governed by the opposition Bharatiya Janata Party (BJP). In these states, the governments led by the BJP and its allies were in no mood to co-operate with the Congress Party, which had defeated them nationally. They said they would not introduce the VAT because it would trigger agitation by traders. Ironically, a BJP-led coalition government earlier had actively canvassed for introduction of a VAT. The government of Tamil Nadu, though not ruled by BJP, also refused to co-operate.



RANDHIR SINGH

A shopkeeper in Jaipur, Rajasthan, sitting among his multi-coloured array of saris. Sari weavers protested the 2007 levy of the VAT on their handmade goods.

The states that objected to the VAT wanted to maintain the sales tax because it gave them a steady revenue increase. However, the VAT is meant to benefit governments, which end up having less tax leakage due to the paper trail retailers have to maintain.

The key question before implementation of the VAT was how the central

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Which state should get the VAT?

India is a federal country in which each state imposes its own VAT. Decentralized VAT regimes present major challenges.

In federal countries with decentralized regimes, there is always the question of who should get the VAT when goods cross internal borders. In an origin-based system, the VAT rate is decided by the state of the seller, while in a destination-based system it is decided by the state of the buyer.

India has a destination-based system, but it offers no tax credits on interstate trade. This means that the state where the buyer lives charges the full VAT and does not provide credits to those in other states who paid on earlier stages of production. A state in India with very high sales to out-of-state customers would find that it was taxing inputs, while one which imported heavily would be getting a disproportionate share of tax on final sales.

While a decentralized origin-based system is easier to administer in that it does not require cross-border sales to be closely monitored, it has the disadvantage that it taxes certain production inputs. In principle, a destination-based system can avoid these distortions if there are interstate credits.

In decentralized systems, destination based regimes with interstate credits are more consistent with VAT principles. However, the administrative cost and complexity of such systems can be very high. A purely federal regime is a great deal simpler and cheaper.

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government and the states would share the revenue, and whether different states could set varying tax rates. A second question was who would collect the new tax – the central government or states? India had observed how a VAT was introduced relatively effectively in Canada. It took negative lessons from the experience of Brazil in how not to introduce a VAT, since in Brazil the federal government and states each impose different VATs.

Next came the question of how to implement a GST (Goods and Services Tax) by combining the existing Service Tax with VAT. The key question, before implementation of a GST system became universal in India this year, was the state of the existing VAT, which is neither uniform nor comprehensive – goals long sought by economists, businesses and most politicians.

Debate over tax rates

Each federation's VAT has three essential aspects to it: the tax base (the value of the taxed item), the tax rate and the mechanism for collection.

There are three lists of powers in India's federal constitution: the Union list, or powers of the central government; the state list, or powers of states; and the concurrent list, or powers shared by states and the centre.

India's constitution gives taxation power to the central government for levying customs duties on imports and exports and excise duty on manufactured goods, in addition to the power to tax services.

India's list of state-government powers includes the power to tax the sale of goods. The states implemented a state VAT with four rates: zero for commodities (unprocessed and natural products) and those with social implications; one per cent for gold, silver, ornaments and bulk-auctioned tea; four per cent for raw materials, medicines and drugs, capital goods and nearly 300 other categories; and 12.5 per cent on remaining items, which are usually manufactured goods. The list has varied over time.

Although the central government's eventual objective is to have a uniform rate, many locally important goods were presented as special cases deserving lower rates.

Gradually, more exceptions began to appear. The latest came in March 2007 when the state of West Bengal announced reduced duties on industrial components and items such as kerosene. Some economists support this practice in the name of fiscal federalism, but others call it "fiscal mayhem."

'Complicated bookkeeping'

The state VAT is applied up to and including the retail stage though. Sometimes retailers absorb the VAT, especially when they are clearing stock.

For merchants, keeping the necessary financial records for the VAT is complicated. For one thing, an input-tax credit is given only for materials or labour purchased in the same state. A further frustration is that no credit is given for payment of the central sales tax that has not yet been merged into the VAT. This is an inter-state sales tax imposed by the state in which the goods are sold. This tax was four per cent in 2005, is now two per cent and is to be reduced to zero by 2010. However, the loss to the states, especially major exporting states, will possibly be offset by the central government.

Thus the successful merger of India's sales and manufacturing taxes into a VAT and CENVAT is only the first step. Many economists and governments have their eye on something bigger. Their ultimate goal is to create a more encompassing tax to extend the VAT to services, as well as goods. This is called the goods and services tax or GST.

Giving states the right to charge a services tax would be a crucial step in this regard. Discussions are underway between the central government and the states on a GST. A committee analyzing political and economic relations between governments may recommend sweeping changes in the federal structure. These discussions have taken place behind closed doors, but media reports speculate that both states and the central government will have their own GST, which will be called the dual GST.

The unanswered administrative question is: "Who will collect a tax on a single combined base – the central government or the states?" It may be very difficult to get the states and the central government to agree on an answer.

In the end, there could be one of three possible solutions:

- a single nation-wide GST collected by the central government
- a single GST collected by the states – possibly with different rates in each state
- a "dual GST" composed of a state GST and a central government GST

If India were to give up on establishing a single national GST, then the existing CENVAT could be merged with service tax at the state level. The current VAT could be improved by allowing an inter-state input credit, establishing just one or two tax rates rather than the four existing ones. No serious attempt has been made by current governments at the state and central levels to move in this direction.

At the national level, the central budget for 2008-2009, announced in February 2008, was the last effective budget of the current government and another budget will be presented after the next national election. Thus, analysts do not expect that there is much of a chance of a comprehensive GST even by April 2010.