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Delhi's VAT Department- Mixed Results and Lessons for GST

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Revenue & Finance



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Delhi's VAT Department: Mixed Results and Lessons for GST

1. Introduction

The Value Added Tax (VAT) system is a system of indirect taxation that replaced the previous sales tax regime in India. Like its predecessor, VAT is implemented at the state level and applies to all goods traded within the state. The Delhi Value Added Tax Act was passed in 2004 and there were follow-up Rules in 2005. The new consumption tax system was finally put in force from 1 April 2005 in Delhi, along with 20 other states. Delhi VAT Act replaces the old Delhi Sales Tax Act, Delhi Sales Tax on Works Contract Act, Delhi Sales Tax on Right to use goods Act and Delhi Sales Tax on entry of motor vehicles. The Department of Trade and Taxes is the state department in charge of all matters related to VAT administration.

In Delhi, up till 2005, there was a system of sales tax whereby, depending on the nature of the goods it was either a first point or last point tax or some combination of both. VAT is a multi-point tax collected at each stage of trade of goods. It allows for set-off of tax paid previously when the goods were purchased against the tax charged when the goods are sold. As such the tax that is charged is only on the *value added* by the trader, i.e. the mark-up by the trader.

Value Added Tax is applicable to the trade/transfer of goods within state; it is not applied on services. The tax charged on the transaction will equal the tax rate multiplied by the value of taxable sales. Output Tax is the tax charged on sale of goods, collected as part of the sale price from the customer. Input Tax is the tax paid to the supplier for the input goods, i.e. the part of the cost price which went toward taxes charged. Now, the Net Tax is the output tax collected minus the input tax paid. In case the input tax exceeds output tax, the trader will be entitled to a tax refund.

There is an in-built incentive in the system for taxpayers to comply with authorities in order to claim their input credit. Several problems of the earlier sales tax regime, such as cascading, under-invoicing, multiplicity of taxes and inter-state tax variations, were sought to be eliminated by the introduction of VAT.

About 135 countries worldwide have introduced this ad-valorem system for collecting consumption taxes, and India was amongst the last few to introduce it. ¹ It is well established in Europe and several Latin American countries. In India, unlike other countries, VAT is under the administration of the state government. While this goes against the basic premise of VAT systems (that it should be federally administered so as to remove multiplicity of taxes, authorities, unify markets, etc.), in India this is not constitutionally feasible for states fear that it would reduce their autonomy and revenue share. ² Also note that Delhi VAT is only applicable for transactions carried out within the state. The Central Sales Tax Act, 1956 continues to be in place for inter-state transactions. While the administration of Central State Tax is carried out by the state department, the Centre government has the power to decide rules and policies pertaining to it.

VAT/sales tax has historically been the largest contributor to state governments' revenue receipts. It is estimated that VAT will be 73.61% of Delhi's total own-tax revenue for the year 2009-10. ³ Out of total revenue receipts, that is including non-tax and tax revenue, VAT collections account for 62%. A cursory analysis of revenue figures below would show that revenue from sales tax/VAT has grown consistently over the last 10 years. It was feared that with the introduction of VAT revenues might actually go down because traders would shy away from the fixed costs of filing regular returns and due to rationalization of the numerous type of taxes and tax rates. ⁴ Yet, when it was introduced in 2005-06, revenue jumped by 25%. As shown in Table 1, comparing the growth rate of sales tax/VAT before and after the introduction, the pre-VAT five-year period had an average growth of 11.02% whereas the corresponding post-VAT period clocked an average growth of 14.19%. While economic growth should be regarded as the main driver behind any growth in tax receipts, it seems that VAT could only have served to maintain or add to this increase. Even in 2008-09, when growth of tax revenue reduced to only 3.38% due to the economic meltdown. With stamp paper collection and luxury tax falling by 40% and 7.3% respectively, VAT collection growth rate declined marginally from 12.8% to 10.3%. ⁵ This is important because it indicates that in spite of growth being hit, VAT revenues have held up. The tax to GDSP (Gross Domestic State Product) ratio is another indicator of improved tax collection and this has gone up from an average of 7.53% in the 3 years preceding VAT to 8.25% in the 3 years since it. ⁶ Delhi's tax to GDSP ratio has also stayed consistently above the national average.

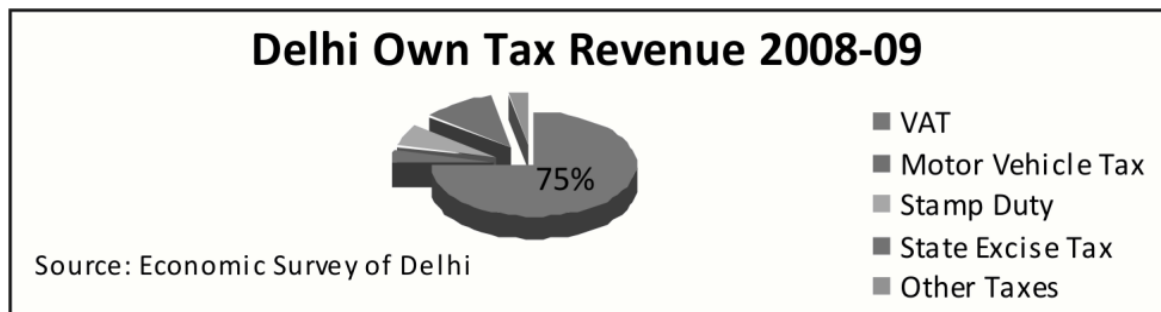


Figure 1: Share of different taxes in total tax revenue for the year 2008-09

Year	Sales Tax/ VAT receipts (Rs. Crores)	Growth year-on-year (%)
2000-01	3388.9	9.5%
2001-02	3712.8	9.56%
2002-03	3848.4	4.62%
2003-04	4435.7	14.19%
2004-05	5200.9	17.23%
2005-06	6500.7	24.99%
2006-07	7365.8	13.31%
2007-08	8310.5	12.83%
2008-09	9152	10.31%
2009-10	10000	9.5%
5 year Average growth pre-VAT (2000-01 to 2004-05) = 11.02%		
5 year Average growth post-VAT (2005-06 to 2009-10) = 14.19%		

Table 1: Sales Tax/VAT receipts and year-on-year growth 1

In the future, the Central government is working on a comprehensive Goods and Services Tax (GST) to replace the VAT system in all states. It is hoped that GST will be introduced in the Union Budget for fiscal year 2010-11. VAT was aimed at laying a suitable groundwork for this more comprehensive indirect taxation regime. Therefore, lessons learned from the implementation of VAT are important to consider when formulating legislation and rules for the new GST administration. When VAT was launched, it served as an opportunity to modernize the IT infrastructure and simplify procedures. Similarly, the introduction of GST should be seen as an opportunity to revamp administrative functioning. The shortcomings of the administration, which could not be successfully eliminated with the introduction of VAT, as well as the new problems that cropped up with VAT, should both be addressed for a successful GST regime.

2. Tax is Tax: Even VAT cannot be Perfect

While it may seem that VAT eliminates the desire for dealers to sell goods to a customer without an invoice, do not be misled. First, if the dealer purchases inputs from a supplier who is not registered or goods

are purchased without an invoice, it does not make sense for him to charge tax on his output, because it would only increase price of product without any benefit to him because he cannot claim input credit.

Secondly, suppose a situation where the dealer has purchased goods with a legal invoice, entitling him to input credit. Now assume that his profit is greater than input tax paid. If the dealer's customer is unwilling to pay him the extra tax amount, then it still makes sense for the dealer to make a sale. He will still receive a new profit equal to his original profit minus input tax paid (that could have been claimed with invoice). This decision will depend on the dealer and the amount of mark-up and costs that go into running his business.

Also, remember that under-invoicing not only saves VAT, but also saves Income Tax. So the incentive to sell goods without a receipt is difficult to remove even with a more efficient and taxpayer-friendly indirect tax system.

3. Delhi Department of Trade and Taxes

In Delhi, the Department of Trade and Taxes is in-charge of VAT administration. Located in IP Estate, adjacent to the Income Tax Office and Police headquarters, this Department is also known as the Delhi Sales Tax Department or the Delhi VAT Department. It is overseen by Joint Secretary (Taxes and Expenditure), Finance Department, who reports to the Finance Minister of Delhi. Unlike other states, where VAT Departments have several branches spread throughout the state, Delhi has only one office where all the employees sit. Some main functions it performs are issuance and collection of forms, assessment, audit, enforcement, returns, registration, appeals, online facilities and tax policy.

The Delhi region is carved up into 10 zones, and each zone is further divided into wards. There are a total of 106 wards. Each ward is taken care of by assigned VAT officers (VATOs).

Scrutiny

The self-assessment nature of VAT was instituted in order to compensate for the large number of dealers who would be brought under the tax net. The Department now is supposed to just focus on a small percentage of dealers for audit. Large taxpayers, who provide a bulk of tax revenue, are given priority in selecting audit.

The Appeals process is shown in the chart below:

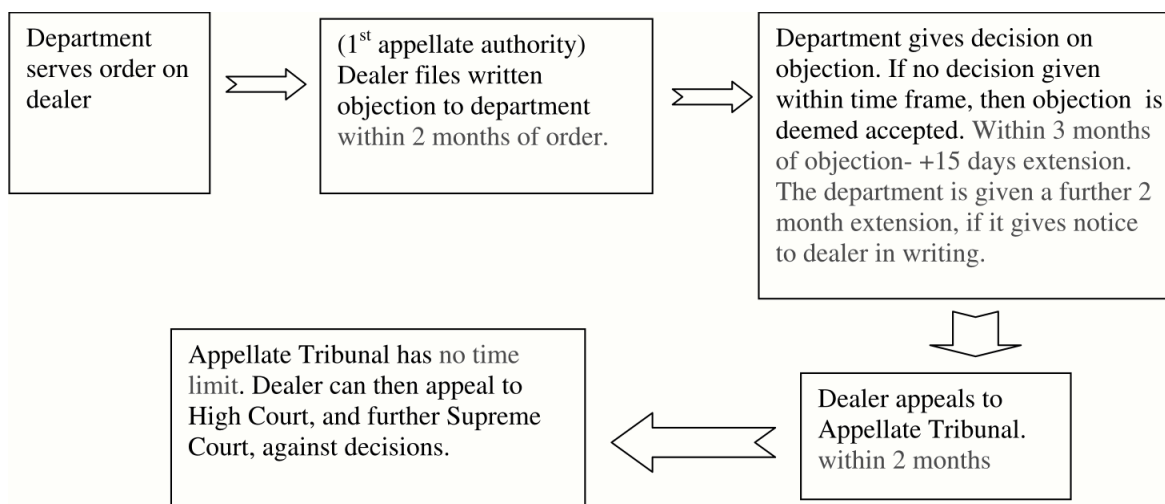


Figure 1: The appeals process in the Department of Trade and Taxes

Making appeals time-bound under the first appellate authority has been a major reform. This has made the grievance redressal mechanism for taxpayers much faster and more approachable. The Appellate Tribunal does not have a time limit, but since the cases there are to be decided by experienced judges it is appropriate to not put an external time constraint on them. For this there could be some sort of time frame that the tribunal can set for itself when it first hears a particular case. Currently traders waste time waiting for hearings and in finding out status of appeal application. The appeal process could be further streamlined better by introducing online service for checking status of appeal and appeal application, date, timing of hearing, and other details.

The CAG reports from 2005-06 till 2007-08 do not shed good light on the Department. In 2005-06 there was underassessment/short payment/loss of revenue and other irregularities totalling 320.01 crores in 1,303 cases. In 2007-08, the losses shot up to a shocking Rs. 973.50 crore in 778 cases. That was more than 10% of the total tax collected during the year. A major portion of this (Rs.782 crores out of 973.5 crores) was due to poor performance appraisal of exemption of Central Sales Tax on account of branch transfer/consignment sale. When branch transfer of stock is made across borders, it is exempt from Central Sales Tax. However many dealers got away without paying the CST by fraudulently using this exemption clause. So while it does seem that loss as a percentage of revenue has generally reduced with VAT, the Department's carelessness with one type of evasion can lead to loss of substantial revenue.

Arrears continue to be a problem; it is reflective of the revenue collection efforts of the Department. Yet, as one can see, the Department's performance in this regard is improving. Arrears have been going down since the launch year of VAT, and arrears as a percentage of revenue collected has gone down substantially. Yet the amount of arrears outstanding is large and if a strong push was made to recover them, they could be used to fund a number of social service projects and investments.

4. Departmental Issues

Some key issues that will be looked at are manpower shortage, training and functional versus geographical classification.

Manpower Shortage

The most difficult problem facing the Department is shortage of staff. This problem has prevented them from carrying out a number of their responsibilities efficiently. Work and cases pile up. Senior officers are kept busy with day-to-day operations rather than being able to spend time on continuous structural reforms of the organization. This is a dangerous situation to persist, for a tax authority in particular, because delays lead to loss of revenue to the exchequer. An overburdened staff may mean that a lot of potential revenue is just left uncollected, since officers do not have enough time on their hands.

Scrutiny is one key function that is adversely affected by the lack of officers. Only 5-10% of registered traders are scrutinized, even though the appropriate number was to be 10-20%. Officers are stretched when time comes for scrutiny, not able to cover all the dealers they would like to. Scrutiny is arguably the most important function with respect to recovering taxes and deterring other traders. A weak scrutiny process, caused due to inadequate number of officers, contributes both directly and indirectly to revenue loss.

There is a shortage of staff at the VATO and AVATO (Asst. VAT officer) levels. Many traders and accountants have complained that there are some wards with fewer officers than needed. Consequently, work gets delayed, amendments are not carried out and assessments remain pending. In addition information that needs to be fed in by the VATO may remain incomplete. The only solution for this is to hire more officials, because work at the VATO level may not be prudent to outsource.

Finally the record-keeping staff also needs to be increased and made more efficient. One way to fix this is outsource the routine work

related to file keeping to an outside contractor. To avoid problems as seen with the data-feeders, performance standards must be explicitly mentioned in the contract, as well as penalisation for not adhering to them. The Department officials made in-charge of overseeing and reviewing the work of outside contractor must give regular performance reports. The reports should be checked so that feedback from traders, tax consultants and others who come to the Department regularly concur with the review.

No Dedicated Revenue Cadre

Officers appointed to the Delhi Department of Trade and Taxes come from the general pool of IAS officers, not from any dedicated revenue cadre. In other states as well as at the Centre, there is a dedicated revenue cadre of officers from where they may be sent to the state's sales tax/VAT Department or the Central Income Tax/Excise/ Customs departments. In Delhi as in other states, the Commissioner is appointed from the general IAS, while the deputy/joint commissioners are from *Dainik Services*. At this level, the officials are well-educated and well-trained to carry out functions. But rest of the officers are from administrative services, not from revenue. Consequently they are untrained about working in tax administration. Posting to the VAT Department is sometimes seen as a lucrative option, undermining merit capabilities as a qualification for transfer into VAT.

While civil servants are usually well educated and capable to migrate from one executive function to the next, VAT requires specific knowledge of accounting, law and procedures. Officers must be able to understand the causes and objectives of tasks that they perform, instead of just following prescribed instructions. This can be a problem when the officer is hesitant to use his own understanding to make decisions, because his knowledge is vague about the issue. In day-to-day operation of a tax administration, where a variety of issues and cases crop up regularly, each with its own unique aspects, those officers are needed who can logically tackle issues keeping in mind the rationale behind rules, not just the exact text of them. Moreover, it is only when the officer is highly knowledgeable about his subject matter that he can recommend modifications/changes in procedure to adapt them to new circumstances. As such, training is a necessary condition for effective responses to constructive criticism and feedback from taxpayers.

Delhi's VAT Department is in urgent need for a dedicated revenue cadre. The Public Accounts Committee (PAC) of the Delhi Assembly headed by Congress MLA SC Vats had recommended this way back

in October 2005. Action has still not been taken in spite of the numerous problems faced by the Department due to this situation. The lower and mid-level officials require some more permanency in case they are expected to become knowledgeable about the job.

The Department can also solve this issue by instituting a more rigorous and thorough training programme. The training programme should be designed so that it is extensive and includes follow-up sessions, with a focus on explaining the rationale and reason behind rules, procedures and the law. An effort should be made to ensure that the officers will be confident at the end of training to use their own understanding of laws/rules to make judgments. Moreover a robust training programme would have positive fall-out effect on several other issues discussed till now.

Functional Versus Geographical Classification

One structural reform suggestion for tax administration is to classify itself along functional lines instead of geographical lines. Currently, the officers in Delhi VAT are assigned to wards in particular zones. There is some degree of division of responsibilities based on function but this is only to an extent and for only very specific wings like audit, internal administration, etc. In general, VATOs working in a particular ward take care of most issues related tax for dealers registered under their area.

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The recommendation for functional classification is mainly for two reasons. First, functional classification improves specialization. The officers in charge of a particular task can be chosen from the respective fields that they are experts in. Second, geographical classification encourages the VATOs to hold wide discretionary power and develop a relationship with the dealer, which encourages harassment and corruption. In functional classification, different officers will be responsible for separate tasks, so the power of each officer declines.

Though this seems like an excellent reform suggestion in general, there are reasons why it may not be fruitful as expected. Firstly, in Delhi there is only one head office where everyone is located. The culture of corruption is a problem in general and cannot be simply broken by making them perform specific duties. As mentioned before, this requires an attitudinal shift, both among tax authorities and taxpayers. Also, even with functional classification, there is no reason why there will be less corruption when dealing with officers within a particular functional division. Secondly, and more crucially, functional

classification will greatly increase the time and cost of dealing with department for dealers, since they will have to approach different sub-authorities for different issues. It is easier, faster and cheaper to deal with one officer, who will be able to look at the dealer's tax problems in a holistic manner.

Instead of functional classification, the Department should merely focus on better training of VATOs in general. They should not compromise much on either breadth or depth of knowledge when it comes to law, accounting concepts, rules and procedures. In any case, some functional classification has already been done for certain specific tasks. Further classification can be encouraged, though the Department should be given flexibility to decide for itself the pace of such reform.

Voices of Traders

For any government Department, the active participation of citizens in functioning and reform discussions is necessary for good governance. In this regard, the Department hires external consultants to give tax policy advice and regularly organizes forums to discuss problems and concerns of dealers, tax advocates and accountants. The senior officers are approachable and amenable to suggestions. The Department has also set up a VAT Advisory Committee consisting of over 250 traders across Delhi.

However, for tax, the participation of citizens in discussions with government officials is a tricky issue. Traders are scared to openly criticize the Department for fear of being hounded by Department officials later. Every single trader spoken with strictly requested to keep his name confidential. While the VAT Advisory Committee does serve as a good forum, tangible response can only be given to written complaints. Consequently, a lot of potentially constructive feedback that traders could provide remains unheard. This is detrimental to the Department because traders have several useful suggestions regarding small rules and procedures that would reduce costs in the long run for the Department itself. Additionally, the input of dealers is a must for effective monitoring of performance of low-level office staff in charge of filing and data feeding. It is only when such feedback is collected that the Department can come to terms and make amends to eliminate sub-standard work by its staff.

The issue of traders' participation still remains a tricky issue, because it is ill advised for the Department to act on general verbal complaints by dealers. Instead, the Department should summarize grievances/suggestions put forth at the various forums it organizes. It

should have periodic review of any suggestions to do with rules/ procedures that have come up in that period - either in writing from traders, during forums or from various VATOs themselves. Recording and responding to advice from the people it serves and deals with is a policy that would greatly improve the Department's performance.

5. Computerization

When VAT was introduced, the Department seized the opportunity to undertake modern computerization of its systems and infrastructure. Computerization and upgradation of IT systems is still in its nascent stage. CMC Limited and HCL Technologies are carrying out the software and hardware work respectively. Currently the Department is in a transition period. ³³ It is supposed to be completed in the next 3-6 months.

Therefore the issues related to computerization should be judged with patience.

Online Facilities for Taxpayers

The Department has made many services available online for the dealers. Online payments are now accepted through authorized banks. The dealer can file e>Returns now. There are a number of other web-based facilities available to the dealer such as online availability of application status for forms and registration, finding out TIN, etc. Mobile-SMS based application and information services have also been implemented for dealers. The websites are well maintained and have ample information for taxpayers. The introduction of this vast array of web-based facilities for dealers has surely made their job of paying taxes and filing returns significantly easier.

Many traders are annoyed that in spite of having e>Returns, they still have to submit manual documentation to the Department. This results in duplication and defeats the purpose of having an online facility. However requiring only e>Returns cannot be allowed unless a foolproof system for digital signatures is available. The Department is aware of this and is in process of obtaining hardware for the same.

Training of Department Staff

While the Department has made commendable strides in computerization since the launch of VAT, there is a serious problem regarding lack of proper computer-trained officers. Many officers are not adept at using computers and may delegate computer work to younger officers. CMC, which is in charge of computer software

solutions for the Department, has had to install biometric devices for officers who were not able to learn how to use a mouse. This is a severe hassle because now a lot of departmental work is computerbased. As a result, the existence of computer-illiterate officers can lead to several delays and errors.

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Endnotes

- ¹ Presentation on www.tinxsys.com
- ² Chanchal Kumar Sharma, 2005, as quoted in OECD, 2008, 112-13
- ³ Budget Estimate from Annual Financial Statement
- ⁴ This same fear can be seen in state administrations during their current deliberations with the Central government over GST policy.
- ⁵ *Economic Survey of Delhi 2008-09* , pg. 41
- ⁶ *Economic Survey of Delhi 2008-09* , pg. 44
- ⁷ Economic Surveys of Delhi- 2004-05 and 2008-09
- ⁸ *The Hindu: Business Line. A dedicated cadre for VAT Department sought.* New Delhi, October 04, 2005
- ⁹ Apart from KDU ward, which looks after large dealers.
- ¹⁰ It is supposed to be completed in the next 3-6 months.

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