Implementing VAT in India: Implications for Federal Polity

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IMPLICATIONS FOR FEDERAL POLITY

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Over the last few years, many attempts have been made to implement VAT in India. Initially, all states were to move to VAT system by 2000, but administrative problems and concern over the revenue implications of the change delayed the scheduled implementation. It has been postponed for five times in past five years. In fact, introduction of a full fledged VAT in India seem to present numerous administrative and constitutional difficulties, including the vexed question of union-state relations. In addition to this, implementing VAT in India in context of economic reforms has paradoxical dimensions. On one hand economic reforms have led to more decentralization of expenditure responsibilities which in turn demands more decentralization of revenue raising powers if fiscal accountability is to be maintained. But on the other hand the process of implementation of VAT can lead not only to revenue loss for the states but can also steal away the states’ autonomy indicating more centralization. Thus the need is to develop such a ‘federal friendly model’ of VAT (along with a suitable compensation package) that can be implemented in India without compromising federal principles.

Introduction

VAT has emerged as one of the most fundamental component of the ambitious agenda of tax reforms since 1991. Initial renditions of VAT were evident in the report and recommendations of the Tax Reforms Commission of 1992. Though the initial phase of tax reforms can be said to be crisis driven in the sense that the economic reforms of which it was a part was itself crisis driven, the present phase however intends to bring about systemic improvements in tax structure. The reforms are aimed at attending to the necessities of a market economy that India is committed to become. The agenda is to make the tax system responsive to the requirements of the international competition. In fact in the changing global economic scenario, economy can be kept competitive only by making the tax system comprehensive, broad based, simple and transparent. The concept of a broad based VAT (that theoretically became most favoured form of tax
worldwide during the 90’s) promises to achieve these goals in case of indirect taxation. But the process of implementation of VAT is likely to face constraints in a federal country like India since it entails revenue loss and loss of autonomy for the sub-central levels. The aim of this paper is to explore these constraints and to give suggestions for making the implementation of VAT more federal friendly.

Present paper is divided into five sections. Section I makes a case for adopting VAT system in India and highlights its repercussions for the sensitive Center-State relations. Section II demonstrates how three main variants of VAT interact with the constraints imposed by India’s federal structure. Section III looks at various attempts in direction of tax rationalization by the GOI that have done away with some of the constraints. The attempts to deal with the major constraints of compensation have been separately dealt with in section IV. The concluding section (Section V) draws attention towards certain rethinking and prospects for federal polity.

I

Vat is a fiscal innovation that began tentatively with French sales tax reform of 1954-55 and spread quickly to cover 130 countries with in just about 50 years. VAT has gained so much popularity that today it is considered as the only good sales tax. VAT is a general tax that applies, in principle to all commercial activities involving the production and distribution of goods and the provision of services. VAT is assessed and collected on the value added to goods in each business transaction. Under this concept the Government is paid tax on the gross margin of each transaction. VAT has many positive gains to offer to Indian tax structure. For instance, it will eliminate the cascading effect (tax on tax) of multi point taxation associated with the existing sales tax regime. A uniform VAT rate will also eliminate competition among the states to offer tax concessions to attract investment. More specifically, in context of economic reforms in India it will make sales between states totally free thereby making India a common, integrated market. Each producer will have a big
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common market before him. In fact in recent literature (Bird 2000) VAT is considered as the most desirable form of tax from an international perspective especially after global integration of the markets. But it is to be noted that VAT has repercussions for the sensitive Center state relations.

VAT proposes to replace the sales tax that has conventionally been considered the best form of ‘regional’ taxation. The traditional literature on taxation favours sales tax as best source of revenue for sub national governments (for instance, Musgrave 1983) In fact in India it is the only major revenue source for intermediate level of governments since low per capita income and unemployment render income tax inadequate as a revenue source.

VAT thus poses serious problem for the finance of regional governments in India. Such problems become more evident when the context of ongoing economic reforms is also taken into account. In fact implementing VAT in India in context of economic reforms has paradoxical dimensions for Indian federalism. On one hand economic reforms have led to more decentralization of expenditure responsibilities which in turn demands more decentralization of revenue raising power if fiscal accountability is to be maintained. But on the other hand implementation of VAT (to make India a single integrated market) will lead not only to revenue loss for the states but also will steal away the states’ autonomy indicating more centralization.

After economic reforms of 1991 expenditure responsibilities of the states vis a’ vis center have increased. Thus to support and sustain economic reforms, it becomes essential to devolve power for revenues to the sub central levels if adequate fiscal accountability and much desired "Wicksellian connection" (Breton, 1996) is to be maintained. However, the proposed implementation of VAT (also to support economic reforms) can do exactly the opposite ie. loss of revenue to the states. Thus while objective behind introduction of VAT is to eliminate much of the complexity and associated compliance costs of the current system and also
to increase India’s competitiveness in the international market yet at the same time it poses serious problem for the finance of regional governments. Thus the challenge in implementation of VAT in context of economic reforms is to reconcile the opposing forces; one forcing toward centralization and other towards decentralization. The need is to work out a variant of VAT that is acceptable to states.

II

A wide study of the experiences of different countries with VAT across the globe shows that there can be different models of VAT depending upon the circumstances prevailing in each country. Theoretically speaking VAT is mainly of two kinds viz national and sub-national VAT but there are some hybrid types as well. In this section the federal constraints in implementing three models namely; (i) the national vat, (ii) sub-national vat; and, (iii) dual vat have been discussed.

(i) The National Model:

The Tax Reform Committee (1992) chaired by Raja J. Challiah suggested the conventional model of vat (National VAT) for India. This was seen as an arrangement that will reduce administrative and compliance costs. Conventionally, National VAT is considered as an ideal form of VAT. It has been argued that VAT operates more successfully as a national VAT (McLure 1993, Tait 1988). Norregaard (1997) states that the requirements needed to operate VAT are generally best met by the central government. For instance the extensive administrative capability required to manage vat is at best a function of the central government. Similarly the need to make VAT neutral with respect to the spatial allocation of production and consumption and the need to exercise extensive border control between jurisdictions strengthens the belief that it is appropriate to assign value added taxes to the central government. Tax Reforms Committee (TRC) concluded that the ideal solution to India’s sales tax
problems would be a single VAT to replace not only the present federal sales tax (the Union excise) but also the state sales taxes (which are, for the most part, imposed at the production level), with the revenue being shared between the levels of government.

In fact, a single ‘National VAT’ is of distinct advantage even if all or some of the proceeds of the tax are to be distributed to the states, either on the basis of estimated consumption or on some formula basis. This approach of intergovernmental transfer may be the best approach to finance sub-central levels of governments. While the total to be transferred is fixed as designated share of VAT collections, the amount to be allocated to each state is determined by a formula laid down by the central government. This model is in operation in Germany. TRC thus recommended a “German solution.” But it is to be kept in mind that even in Germany the federal issues were not easily resolved and the formula of revenue sharing with sub-national levels could not be implemented without considerable disagreement.

In Indian case, strong regional governments (in the era of coalition politics and regionalization of national politics), will make it extremely difficult either to enforce a centrally determined formula or even to arrive at a mutually agreed tax-sharing formula. The regional governments may also oppose the said arrangement because they will not be ready to lose control over jobs that will become inevitable under single administration of national VAT. The governments will also grudge the loss of revenue due to loss of power over sales tax, which is the only major source of revenue for sub-national governments.

Thus federal issues may stand in the way of smooth switchover to a central VAT in India. As Alan.A.Tait (1988) argues, “(The) system can not work in a federal system where the states try to retain more discretion over their own exemptions, rates and revenues.” Thus the successful implementation of VAT (esp the conventional model) in a federal country lacks theoretical backing. In fact A.A. Tait (1988) concluded in his study that in a federal system the workability of vat was uncertain. In USA (being
a federation of States) VAT has not been introduced due to the fear of Federal Government usurping the States’ power of sales taxation.

(ii) The Sub-national Model:

It has been argued that the conventional/national model of vat is the most popular and workable model. (supported by the fact that even some of the federal countries like Argentina, Austria, Germany and Mexico have chosen to adopt national model despite difficulties in resolving federal issues). However, in India where regional governments are quite strong (especially after regionalization of national politics) consensus among states is a precondition to introduce VAT and more so when it is apprehended that implementation of vat in context of economic reforms can create problems for finances of the regional governments in India.

This is the reason behind attempts in India to develop and implement a model of VAT that will not compromise decentralization principles. In fact, Charles McLure (2000) and Bird and Gendron (1998) discuss the problem of imposition of VAT at two levels of government and that of application of VAT to interstate trade within the same country. Richard M. Bird (1999, 2000) argues that the conventional model of tax assignment is no longer viable because subnational governments are increasingly being asked to pick up a larger portion of social expenditures on health and education. As a consequence the sub-national VAT is being considered in context of countries like India with important regional governments.

It has been argued that in India, sub-national vat would enable the regional governments to deal with the new expenditure responsibilities shifted to them especially after 1991. It is to be noted that Ip and Mintz (1992) in their subnational vat model recommended that the Federal government should turn over all sales taxes to the provinces to reduce the administrative and compliance costs of taxation and to give more revenue discretion to provinces and hence make them more responsible for financing more of their own spending on health or education. McLure (2000) also emphasizes the desirability of permitting
state governments to set their own VAT rates. But in case of India sub-national VAT would pose problem as to which state should receive revenues from VAT on imports and which should bear the burden of VAT refunds on exports. The difficulties associated with the levy of VAT at the sub-national level can be judged from the experience of Brazil. According to Norregard, Brazil offers an example of VAT assignment system that is generally believed to have had detrimental effects on economic performance.

In fact international experience suggests that the developed and non-federal countries have a better record of smooth transition to VAT. When VAT is sought to be implemented in a federal state, various problems prop up pertaining to federalism in general and fiscal federalism in particular. Problems are more severe when the country where VAT is sought to be implemented is a developing country in addition to being federal.

The difficulties associated with the levy of VAT at subnational level can be appreciated from the experience of Brazil (a developing federal economy). Shome and Spahn (1996) Silvani and dos Santos (1996) Serra and Afonso (1999) and Versano(2000) have shown in their studies that Brazil’s enthusiastic adoption of VAT at two levels had resulted in complex administrative and technical problems that seemed insurmountable.[Silvani and dos Santos (1996) have suggested a ‘German solution’ for Brazil]. Norregard (1997) also affirms that Brazil’s VAT assignment system had detrimental effects on economic performance. It is to be noted that subnational VAT arrangement is quite unpopular. Out of 130 countries implementing vat, the province of Québec in Canada, the state of Michigan in USA and Brazilian states are the only examples (of subnational vat) so far. Michigan’s VAT being slated to be repealed by 2009 and Brazil being an unsuccessful case Quebec is the only successful experience. Yet the illustrative effect of the Canadian experience has contributed towards the emergence of interest in the theory of Subnational VAT. This theory is based on the idea of extending the application of VAT to state or provincial level of the government.
It is to be noted that in case of subnational vat system the most challenging issue is to find a uniform solution to deal with cross border shopping problems associated with taxing sales at the two levels of the government. In VAT arrangement that is envisaged for India by the white paper, this significant issue of ‘how vat would be administered at State borders’ has not been addressed. Even the most essential prerequisite for success of VAT ie elimination of 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.

According to the literature on Subnational VAT, it can be implemented on the basis of either of the two principles (i) Origin principle and (ii) Destination principle.

Conventional literature supports implementing a sub national VAT on origin principle. Neumark (1963) states that the only way in which sub national units can effectively levy a VAT was on origin basis. But to avoid any distortion they have to levy VAT at uniform rates. This however involves a federal predicament because the above mentioned system can work only if sub national governments give up their fiscal autonomy. Thus it defeats the very purpose of the sub national VAT which is to preserve federal principle of sub national autonomy. Moreover, if a nationally uniform VAT is administered by sub national authorities and revenues shared on the basis of origin as in case of Russian Federation, then the same distortions would be created as in the case of non-uniform subnational origin based VATs (as revealed by Baer, Summers and Sunley 1996).

The theoretical debate about relevant merits and demerits of the two principles of origin and destination, clearly converge in favour of the destination principle [Lockwood, de Meza and Myles(1994,1995), Bovenberg (1994), Lopez-Garcia (1996) and Genser (1996)].
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The conditions needed to avoid distortions in efficiency if different jurisdictions levy different rates under the origin principle seem unlikely to be satisfied in most federal states. The destination principle on the other hand is not only considered compatible with independent taxation of consumption but is also less likely to result in distortions (Keen and Smith 1996). At present EU applies the destination principle using the ‘deferred payment method’ (Cnossen and Shoup, 1987). This does not mean that the destination principle solve all cross-border trading problems, it however helps to diminish the serious ones. R.M. Bird have stated that no one has yet found any simple and uniform solution to deal with all cross border shopping problems associated with taxing sales at the two levels of government (Bird 1993).

In case of India there seems to be only one practical solution for inter-state taxation and that is ‘zero rating of inter-state sales’. This option envisages reduction of rate of tax under CST, initially to 2% and gradually to zero percent.

(iii) Dual VAT Model:

In the report on “Tax policy and tax administration for the Tenth Plan” (May 2001) Dr Parthasarthy Shome recommended a national integrated Centre-State VAT in parallel or dual format. Taxonomically Dual VAT is a type of Subnational VAT where each level sets its own rates independently (thus retaining autonomy) but on similar bases. The base for a sub-national VAT system is a well-designed and comprehensive national VAT. In the dual VAT system, the only VAT rate set centrally is that of the central government itself. According to Bird and Gendron (2000) in this system there is no need for any ‘central’ edict with respect to either the range or level of state taxes applied to interstate trade since no such taxes are applied. Thus dual VAT approach obviously requires a central VAT (although perhaps one that collects no revenue) and some degree of information exchange and co-operation amongst tax authorities. It can be recalled that way back in 1994 the Government of India appointed a study group to recommend measures to harmonize and rationalize the domestic
trade tax system in the country. The study group made a thorough analysis of the distortions of the prevailing system of taxation and recommended the gradual moving over to destination based, consumption type value added taxes at the state level. At the central level, the study group recommended complete switching over to the manufacturing stage VAT. At the state level, the existing sales taxes were to be transformed into retail stage destination type VAT. In other words development of dual VAT – a manufacturing stage VAT by the centre and a consumption type destination based retailed stage VAT by the states was suggested as a solution. NIPFP (1994) also recommended for a system of ‘independent dual VATs’. State VATs were to be restricted to the retail stage, with the central VAT being levied only on manufacturers. Bagchi (1997) suggested that the long-run solution should be a concurrent or dual VAT with a nationally-determined base but independently-set federal and state rates. The major constraint in case of India for applicability of a dual vat is that the system works well when there is a high level of administrative cooperation. It is difficult to expect this model to work as such in India because the extent of improvements required to be made in India’s existing central government sales tax before attempting any reform in subnational tax regimes will be enormous, if anything similar to this solution is to be implemented. Even otherwise the quality of administration in India to generate the required extent of mutual support among the two levels of the government is quite low.

III.

Though it has been observed that the TRC recommendation fell short of developing a coordinated domestic trade tax system in the country (Rao, 2000) as it failed to make a dent in the independent and overlapping commodity tax systems at the central and state levels, yet some healthy changes have occurred in the tax structure since 1991. For instance there has been a considerable simplification and rationalization of union excise duties. Besides reduction in the number of rates, the tax has been progressively converted from a specific into ad valorem levy in respect of majority of commodities. The facility of providing credits on input taxes under the MODVAT too has been progressively extended to a larger number of commodities, with the budget 2000 taking a quantum leap by introducing CENVAT.
Another important change since 1991 is the introduction of a selective tax on services. The constitution does not assign this tax base specifically either to the centre or states. However, the central government by invoking residuary powers has introduced a tax on services since 1994-95. (After 92nd Amendment service tax has been brought under Union list of seventh schedule) Beginning with three services (telephones, non-life insurance and stock brokerage), the base of the tax has been broadened to cover a large number of services such as transporters, car rentals, air travel agents, architects, interior designers, management consultants, chartered accountants, cost accountants, company secretaries, credit rating agencies, market research agencies, underwriters, private security/detectives, real estate agencies and mechanized slaughter houses. In budget 2004-05, 13 more services were brought under the net taking the total to 71.

Over the last few years, many attempts have been made to implement VAT in India. Initially, all states were to move to a VAT by 2000, but administrative problems and concern over the revenue implications of the change delayed the scheduled implementation. Most states, however, began to implement some of the agreed preliminary measures, such as the uniformity of “floor rates” on particular classes of goods. Yet political compulsions impeded any further advancement in this direction and the schedule for implementation of VAT has been repeatedly postponed for five times since 1999, the year when all the state governments for the first time agreed that they would introduce a VAT system to replace the sales tax structure.

IV.

It can be argued that a major difficulty in evolving a destination based retail stage VAT at the state level arises from the apprehensions expressed by a number of states about possible revenue losses in the process of transition to VAT.
Thus the first hurdle is to compute the revenue loss incurred by the states on basis of an agreed formula and then devise a plan for compensation to the states. In fact one major reason for revenue loss is the fact that in order to stabilize VAT, elimination of CST will become inevitable as the two cannot remain in tandem. Discussions between the states on replacing their sales taxes by VATs in fact centered to a considerable extent on the issue of what to do with the CST in order to deal with the inter state trade. Bagchi (1996) suggested the CST be reduced to 2 percent, with the exporting state keeping half the revenue and the remainder being pooled and distributed “on an equitable basis” basically to finance a full rebate of the exporter’s tax by the importing states. In 1997 a committee of state finance secretaries also recommended reduction of CST by 2 percent, with half the revenues going to the exporting state and the other half pooled and shared on the basis of consumption (Poddar 1999).

The CST is a major source of revenue for the states, thus the problems arising out of eventual phasing out of the CST will be difficult to resolve. State governments are demanding the right to retain and in fact widen the tax net by levying a range of taxes, including entry tax. This would defeat the fundamental objective of imposing VAT, namely, unifying and harmonizing the complex tax structure in the country. Thus the compensation issue is directly related to the reluctance of the states to pursue tax rationalization sincerely. ‘Revenue’ after all is what matters the most to the government. As Keen and Smith (2000) have emphasized that the fate of any possible redesigns of central-state or interstate taxation is likely to turn on who gains and who loses, and by how much. It won’t be wrong to suggest that as a rule when fiscal circumstances permit some compensatory transfers to be made to losers, as was done in Canada, the level of acceptance of the rational tax system rises.

As a part of revenue compensation package the states were given the power to tax AED goods (textiles, tobacco and sugar) in 2002-03 budget. Earlier, the states merely received 1.5% of the Central tax revenues distributed to them as suggested by Eleventh Finance Commission, for giving up their right to levy sales tax on the three commodities. There was no sales tax on sugar, tobacco and textile products. Instead, the Centre levied an
additional excise duty (AED) on these items ‘in lieu of sales tax’, the proceeds of which were meant to be passed on to the States. What the 2003-04 Budget did was to ‘empower’ States to levy sales tax/value-added tax (VAT) of up to four per cent on these products, even while the Centre will continue to impose the AED. Both the levies thus now co-exist. The AED cannot go because states are given an additional 1.5 per cent of the Centre's shareable tax revenues, which is their entitlement from the levy as per the 11th Finance Commission's award.

Service tax has also been used to address the compensation issue. In India, the states do not have the power to levy tax on services. The states can levy sales taxation of only goods. Taxation of services before 92nd Amendment Act, 2003 (passed on 7th January 2004) was not assigned to either the centre or the state, but the former levied taxes on selected services based on its power to levy taxes on residual items under ‘entry 97’ of the Union List, which relates to taxes not mentioned in either the State or Concurrent Lists. After 92nd amendment service tax has been brought explicitly under Union list of seventh schedule. The central government has tried to use service tax to convince the states to gradually eliminate the taxation on inter-state sales (CST) so that a levy of destination based VAT becomes a reality. Thus 92nd Amendment seeks to allow States to ‘collect' and 'appropriate' taxes on services. Though power to 'levy' these taxes, will remain with the Centre yet the act has given sufficient powers to the State governments to collect the proceeds. In the Budget 2003-04 the general service tax rate was increased from 5 percent to 8 percent in order to allow the states to appropriate 3 percent of the overall 8 percent service tax and leave the rest to the center. Budget 2004-05 increased service tax to 10 percent. Thus now the overall position is that, even after States are empowered to collect and appropriate revenues from three out of the overall ten per cent service tax rate, they will still be entitled to 29.5 per cent of the Centre's balance seven per cent collections under this head. For 2003-04, the Centre budgeted total revenues of Rs 8,000 crore from service tax, of which Rs 2,360 crore or 29.5 per cent was devolved to the States as per the 11th Finance Commission's formula.
It is due to such efforts in the past coupled with determination of the UPA government and assurance for adequate compensation for revenue loss due to VAT (if any) and deferring the phasing out of central sales tax, that a consensus among the states seems to be emerging with all agreeing to implement a state level VAT. In order to compensate states for any loss of revenue while switching over to the new tax regime a three tier package has been offered, that include 100% compensation for revenue loss in the first year, 75% in the second and 50% in the third.

But the things cannot be taken for granted as the quantification of the loss on transition to VAT will be contentious issue. It has been asserted that the loss on transition to VAT may not be as high as is expected to be projected by the states. It is to be noted that compensation of loss to states on transition to VAT will be on agreed basis and agreement has yet remained quite elusive.

Keeping in view the need for developing viable VAT model for Indian states on one hand and uncertainty on account of past experiences of repeated postponements of deadlines for implementing VAT, on the other, certain measures have been suggested by various experts. M.G. Rao states “Simplification and rationalization of the state taxes into VAT has to be calibrated carefully. Rate rationalization, systematic provision of tax credit on inputs and those paid on previous stages, removal of competing tax incentives and concessions, zero rating the tax on inter-state sales – all these have to be done in phases. There is also an urgent need to create a proper management and information system and to computerize tax returns”. [M. Govinda Rao (2000)] Here it would be important to point out that implementation of VAT in Indonesia and Thailand is a success story. It can be attributed to careful planning and the employment of a simple system of record keeping, tax rates and tax administration leading to high compliance levels.
The greatest challenge in India is to design a sales tax system that will provide autonomy to the subnational levels to fix tax rate in a common geographical space, without compromising efficiency or creating enforcement problems. In fact, political compulsions have led the government to propose an imperfect model of VAT that is a unique hotch-potch. The VAT system rolled across India by the white paper on State level VAT is not a true VAT. The rate structure as recommended by the empowered committee of state finance ministers is complex. Though the white paper claims that CST will be phased out, no exact time period has been mentioned. 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.

On January 18th 2005 all national dailies quoted Mr P. Chidambaram as saying, “It is our dream to move on to GST (Goods and Services Tax) in future….it will be a National VAT and the State level VAT would be integrated into it.” Given the political realities and constitutional problems, this wishful thinking is likely to remain a dream for ever. This dream overlooks the fact India is a federal country with strong regional governments (the fact that regional governments shares power at the center makes them more powerful).

While devising a proper and feasible model of VAT for India it should be kept in mind that one of the major lessons of the Canadian experience is simply that there is no need to have single VAT system for whole country. Respecting the regional differences different provinces can be allowed to adopt different variants of VAT. Canada has allowed five different systems to operate in its ten provinces. This probably answers the often raised question as to whether by amending the constitution a Central VAT (the centre levying the VAT and sharing it with states) or a Subnational VAT (VAT being completely in state hands) shall be followed.
Thus it is important not to try to formulate a universal and precise conceptual design leading to elimination of the likelihood of evolution of a tax policy that will be able to put up with the regional differences thereby allowing different systems to coexist within same nation. The better part is that it is functioning well in a federal country like Canada. This however does not mean that the system will necessarily work in India too. In fact differences in political culture, may lead to certain difficulties in permissibility of such solutions in India. This significant issue, therefore, calls for further study and investigation in Indian context.

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