Reforming the State Tax System: Transition to VAT

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1. Introduction

The relevance of Value Added Tax to the Indian context has been under discussion ever since it was proposed by the Indirect Taxation Enquiry Commission in 1977 under the Chairmanship of Shri L. K. Jha. In 1986, this idea was put into practice in a cautious and tentative manner through the introduction of MODVAT covering select commodities as a partial replacement to existing excise duties. Gradually, the scope of the tax was expanded – by 1994, commodities in 77 out of 91 chapters were covered by this tax. The Jha Committee report focused mainly on the taxes of the central government. Subsequently, the Report of the Tax Reforms Commission and more importantly, the report on the Reform of Domestic Trade Taxes in India: Issues and Options (1994) presented a detailed case for replacing the sales tax regimes in the Indian States with a comprehensive VAT. Necessarily, the latter also addressed the issue of CST reforms as a part of the broader reform agenda. In the years following, the discussion on a shift to VAT from an assorted system of sub-national level sales taxation remained on the national agenda without making concrete progress.

The first major breakthrough in this direction came in the form of an agreement between the Union Finance Minister and the State Chief Ministers on November 16, 1999

- to introduce floor rates within the existing sales tax regimes,
- to eliminate the tax based industrial incentives for new and expanding industries,
- to replace the existing system of sales tax with a VAT at the State level, phase out CST.

Compliance with the first two items was to be ensured by January 1, 2000, with April 1, 2000, being the proposed date for introducing VAT. The first item found easy acceptance with most States complying to the agreed floor rates. There were a number of discussions on the second item, which resulted in the formulation of detailed criteria for identifying "pipeline projects" which would be the last set of units provided with access to the incentive schemes. The target date for introduction of VAT however, has been rescheduled many times since, with the new target set for April 1, 2005. During this period, the Empowered Committee of State Finance Ministers, constituted to coordinate and monitor the transition to the new tax regime, has, through sustained deliberations over a period of over three and half years, arrived at a consensus on a design of VAT to be implemented from April 1, 2005. An important feature of the proposed VAT regime is that it seeks to simply replace the existing form of sales tax with a value added tax based on input tax credit mechanism without changes in the scope of the tax– an intra-State VAT on goods. This paper begins with an assessment of this design of VAT[3] (Section 2). The proposed design and

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[2] This report was prepared by consultants for the Asian Development Bank. The views expressed in this report are the views of the authors and do not necessarily reflect the views or policies of the Asian Development Bank (ADB), or its Board of Governors, or the governments they represent. ADB does not guarantee the accuracy of the data included in this paper and accepts no responsibility for any consequence of their use.

[3] The proposal for a reform of existing forms of sales tax into a VAT regime is based on the idea that VAT, especially through the input tax credit method provides a transparent and neutral method of taxation. Further, by creating a trail of invoices, this method of taxation is argued to aid improved compliance with tax, since it permits easier administration. The literature does discuss a number of issues relating the efficiency and welfare effects of VAT with the following important conclusions:

- If VAT is to be introduced as a revenue neutral measure accompanying a reduction in import tariffs, then, in the presence of an informal sector, there is possibility of a reduction in welfare. It could discourage the expansion of the formal sector, which in effect constitutes the base of the tax. Since VAT in India does not come in to replace import tariffs, the discussion is not immediately applicable. It is however useful to point out that the incidence of tax in the form of income tax, tends be much higher than the VAT/sales tax and the rationale for remaining in the informal sector therefore will be driven more by the income tax structure and administration than by the VAT/sales tax structure and administration. If this is a correct or reasonable representation of the economy, then the efficiency gains from a shift to a neutral and transparent tax within the formal sector could be the more

coverage of VAT leaves out two important components – two components critical for defining a comprehensive VAT at the sub-national level in India

- Taxation of services
- Taxation of inter-State trade

The section 3 discusses the issues and options in the case of taxation of services, while section 4 provides an assessment of an intra-state VAT with continuation of CST in its present form on inter-state trade, and section 5 discusses the options for reform of taxation of inter-state trade. Section 6 explores the reasons for opposition to the new tax and in the process highlights the role of appropriate publicity and effective dissemination of information.

2. Proposed State Level VAT: An Assessment

To begin with it would be useful to summarise the key features of the proposed design of VAT.

1. VAT is proposed as a tax on the sale of goods to replace the present sales tax, along with all related taxes such as turnover tax, additional tax and surcharges. Entry taxes levied in order to protect the sales tax revenue from diversion of trade would have to be integrated into the VAT. However, entry taxes levied as a replacement for Octroi would continue to remain as separate taxes.
2. Input tax credit form of VAT is to be implemented: provides for credit of any input/purchase taxes paid against taxes collected on sales. The input tax credit on capital goods is to be spread over a maximum of 36 months in equal monthly instalments.[4] A negative list of goods excluded from the domain of input tax credit is to be prescribed
3. Tax credit will also be available against CST paid on inter-State sale. In the case of exports too, full credit is available. In the case of consignment and branch transfer, the State would retain tax of up to four per cent on the inputs and the rest would be available as credit.
4. The dealers can adjust these credits against the payment of local tax. Any balance credit can be transferred to the next tax period and credit availed of. In other words, the design

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important dimension to contend with, in discussions on the merits of introducing VAT. Further, as pointed out by Kanbur and Keen, the decision to enter the formal sector as against remaining in the informal sector would be guided by an assessment of the costs and the benefits. “Only those firms for whom the benefits of formalization outweigh these costs will choose to come under the formal sector umbrella.” (http://www.arts.cornell.edu/poverty/kanbur/ISPEIntro.pdf). Interestingly, Auriol and Warlters argue that such government-imposed costs of entry to the formal sector create barriers to entry and hence market power and rents for firms in the formal sector. These rents can then be taxed. Thus regulations that may on the face of it seem inefficient may be consistent in the short run with a revenue raising strategy. (http://www.arts.cornell.edu/poverty/kanbur/ISPEIntro.pdf)

- Under conditions of imperfect competition, the entire tax burden need not be passed on to the consumer. In such cases, a turnover tax model may be both revenue superior and welfare superior to a VAT with input tax credit (Dasgupta, 2004). While this could in principle be correct, the calibration of the turnover taxes would depend on the structure of the market. Further such a tax regime would perpetuate tax exportation both across jurisdictions within the country and across international borders. The former would undermine the potential for creation of a common market and the efficiency gains from the same, while the latter would undermine the competitiveness of the domestic industry both vis a vis exports and imports.
- Ebrill et al(2001) raise doubts about the revenue potential of VAT, by presenting results that imply that the VAT is indeed associated with a higher ratio of general government revenue and grants to GDP; weaker evidence that it is associated with a higher ratio of general government tax revenue alone; and no evidence that it is associated with a higher (or lower) ratio of central government tax revenue. While this could be read as a cause for concern, to the extent that the tax can correct for distortions induced by the cascading form of existing sales tax system, with no revenue loss, it should constitute an improvement over the present regime.

[4] The view of the Empowered Committee has evolved over the years – initial discussions excluded capital goods from the purview of tax credit; subsequent decisions limited tax credit for capital goods to manufacturing alone. In terms of the time frame for providing credit for capital goods, the decision has evolved from a stand of uniform provision of credit spread over 36 equal monthly instalments, to one where the above represents a ceiling. The states can now choose the time frame for setoff of tax credit on capital goods.

does not provide for an instant refund provision in the event of credit exceeding the tax due in any period.[5]

5. Following up on the work done for the floor rates regime, 550 major commodities have been classified into three broad categories – those to be exempt from tax, those to be taxed at 4 per cent and those to be taxed at 12.5 per cent.[6] These rates are to remain uniform across all States. Petrol and diesel are to remain out of the VAT system, while alcohol is to be taxed at a floor rate of 20 per cent. For gold and bullion a special VAT rate of 1 per cent has been agreed upon.
6. To facilitate incorporation of "declared goods" within the VAT regime, an amendment to the CST Act has been proposed whereby the States can tax these goods at a maximum rate of four per cent but at multiple points. Similarly, in the case of sugar, textiles and tobacco, it has been proposed that the Centre continue to levy and collect the additional excise duty. Over and above this, the States would have the scope to levy a VAT at 4 per cent on sugar and textiles.A higher rate on tobacco was debated. The White Paper however, proposes that AED goods remain out of the purview of VAT for the first year after switchover, since these states are not experienced in administering the tax and adding new goods would place greater revenue at risk.
7. Very small dealers are to remain outside the tax net. The White Paper proposes a ceiling of Rs. 5 lakh on the threshold for exemption. States are however free to choose an exemption threshold less than Rs. 5 lakh. [7]
8. Simplified scheme for dealers below a certain threshold – they can pay a turnover tax on their entire turnover as an alternative to adopting the entire system of VAT. While it was initially proposed that the turnover limit for this option too be fixed uniformly across all States, subsequent deliberations have resulted in some flexibility to the states on this front. States now can fix the turnover limit for this alternative to suit local conditions. A ceiling is however proposed – no state can choose a threshold above Rs 50 lakh, for mandatory VAT registration.
9. It is desired that the draft Acts too achieve some degree of convergence in terms of definitions, charging sections and procedures. Empowered Committee specifies a list of 22 points for convergence.

The draft bills of most states are receiving the presidential assent conditional on a commitment to honor the consensus design and make any required changes in the Act before it is notified.

The above design would put into place a fairly broad based intra-State tax on goods, and alongside eliminate cascading that results from the taxation of inputs. This would be a major improvement over the present state of affairs in more ways than one. Apart from the reduction in the cascading effect of taxes, this system would bring all the States to a two rate regime from present one of multiple rates.[8] Further, by replacing a number of the related levies such as entry tax, turnover tax, luxury tax, additional tax and surcharges, it would make the system more transparent and potentially easier to comply with. There are however a few weak points in the proposed design. This section seeks to highlight some of these weaknesses and the implications of the same.

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[5] The refund becomes due at the end of a financial year, except in the case of exporters, who can get refund in three months. These provisions however come into force only after the initial two years. In the first two years, there is no provision for refund of excess credit in the case of local sales/inter-state sales.

[6] The initial discussions on the rate structure proposed a three rate VAT, following up on the scheme of floor rates that were implemented in 1999. Further, the highest rate category was to be associated with a Revenue Neutral Rate, which would vary from state to state and would ensure that each individual state received the same revenue as in the pre-VAT regime. Problems in identifying the RNR, and further, difficulties envisaged in implementing the identified RNR – many states found the computed rates too high – on the one hand and the central government's assurances of compensation on the other, led the discussion towards uniform rates of tax across all states in the country.

[7] Extending the concept of uniformity, the discussions on the threshold for exemption initially proposed a uniform threshold of Rs 5 lakh.

[8] For example, West Bengal currently has more than 15 rate categories along with a variety of levies. Karnataka has more than 5 rates.

To begin with the rate structure, the proposed design suggests two primary rates, of 4 percent and 12.5 percent. A large number of commodities have been meticulously classified into exempt goods, and those to be taxed under these two rates. It was proposed that all essential consumption items as well as all industrial inputs would be classified under the four percent category, while the rest of the commodities would be subject to a 12.5 percent rate of tax. While this would constitute a major improvement over the present state of affairs, the above classification would imply a revenue loss for the States. The logic is as follows: the rationale for placing all industrial inputs in the four percent category rests in the uneasiness of the tax departments to provide timely refunds, when they become due. In a VAT regime, transactions involving inter-state trade and even more so, exports, would require refunds. In the case of the former, since the rate of tax on inter-state sales is presently four percent, it is felt that keeping the rate of tax on inputs too at four percent would limit the refund claims on the department – thus minimising the dependence of the dealers on the departments. The flaw in the argument is that it is difficult to segregate and successfully list out all industrial outputs and place them in the four percent category. This would mean that some industries would continue to clamour for and articulate a case for reclassifying some more commodities into the four per cent category. The other problem is that any particular good, even if it is primarily used as an input to industry, could have some demand from exempt dealers or from final consumers. Demand for cement for instance, could be from industry – as an input – or from final consumers. By classifying cement at four percent, the department loses tax on the sale for final consumption as well. To the extent the rate structure chosen is a function of the above set of arguments, a more efficient solution to the problem would have been corrections in the mechanism of refund. This would permit more commodities to be moved to the higher rate category, which in turn would facilitate reduction in the rate of tax associated with this category, if so desired. It is therefore, desirable as well as more efficient to have very few commodities of essential consumption alone at the low rate of tax and place all the rest at the higher rate. The Report of the Twelfth Finance Commission too argues that “a very small number of commodities under well enunciated principles, should be put under the proposed lower rate category of 4 per cent.” (pg. 78)

Another issue related to the decision on the rate structures relates to the agreement for imposing uniform rates of tax across all States and union territories in the country. In the existing sales tax system, considerable variation in the rate structure is in evidence. This is a reflection of the autonomy of the States in determining a package of taxes and services best suited to the preferences and needs of the citizens of their jurisdiction. In other words, this was a reflection of the federal nature of the polity at the State level with elements of competitive federalism in play. This process however, opens the door for tax competition among the States leading to trade diversion and consequently a race to the bottom, thereby eroding the tax base of the States. The agreement to introduce floor rates on groups of commodities was a step towards curbing this process. By reducing the scope for tax competition and resultant trade diversion, an agreement on adherence to floor rates would thus protect the revenue of the States and enable a simpler job of tax administration. The Empowered Committee’s decision to implement uniform rates of tax however, takes this process of elimination of tax competition to its logical conclusion. This process effectively removes an instrument of decision making from the hands of the States' policy makers, thus undermining the autonomy of the States. If a State chooses to provide a higher level of service to its citizens, who are willing to pay for the same in the form of higher taxes, the State may have very few lucrative and effective handles to undertake the same. This dimension is particularly surprising since earlier discussions and decisions of the Empowered Committee incorporated only floor rates and not uniform rates of tax even in the context of a switchover to VAT. The Report of the Twelfth Finance Commission too presents a case for having a floor rate of 12 per cent for the higher rate category, instead of a uniform rate.

To understand the problems in adopting a uniform structure of taxation, it is illustrative to consider the implications of having uniform thresholds for exempt dealers as also for dealers having the option for paying a turnover tax. The initial agreements in the Empowered Committee had specified Rs 5 lakh as the threshold for exempt dealers and Rs 25 lakh for dealers choosing

to pay tax on a composition scheme through a turnover tax. Clearly, in a less developed, low income State like Orissa, a very large number of the dealers would be covered by the two categories spelt out above, leaving very few dealers within the VAT net. In other words, for a majority of the tax-payers in the system, the introduction of VAT would mean an increase in the coverage of the turnover tax. On the other hand, in States such as Maharashtra and Gujarat, there may be incentive to set the thresholds even higher at least in the case of the composition scheme. Thus, it appears that each State should have the option to choose rates of tax and the thresholds for operating the tax, based on the profile of the dealers and the level of services the State seeks to provide. Recent discussions within the Empowered Committee have recognised this problem and incorporated the option for flexibility in choosing the levels for these two thresholds.

An offshoot of this agreement for uniform rates of tax is the enhanced demand and need for compensation for the relatively higher taxed States, since their current revenue requirements may not be met through a VAT at the proposed rates. However, once there is agreement on compensation from the Union Government in the event of any shortfall in revenue, it generates a perverse incentive not to collect taxes efficiently while compensation is feasible.[9] Here it should be mentioned that a VAT regime with destination based treatment of inter-state trade does not require homogeneity in tax rates, for it to be efficient and neutral. It is possible to design and operate VAT regimes with different rates across State borders, as is the case in Canada. Further, it is not clear whether there exists any mechanism by which compliance to this agreement can be enforced. For instance, once the three year period of compensation from the Union government is over, individual states preferring a lower rate of tax could opt for a lower rate, thereby disrupting the carefully worked out consensus.[10] Since compliance has to be largely voluntary on the part of the States, it is important that the design should provide some flexibility to the States instead of attempting to achieve complete or even a very high degree of convergence.

Another aspect of the requirement of homogeneity is in the formulation of the Act – in the definitions, the charging sections, and the procedures and rules. It is often argued by the business community, often rightly so, that operations especially across State borders, can be greatly facilitated if the broad forms and procedures are same across States. This is a more legitimate demand for uniformity or convergence, more than the proposed convergence in the rate structure. However, tax departments are usually reluctant to entertain this possibility which potentially entails dispensing with the existing set of rules, forms and procedures – which have "stood the test of time"! In other words, there is a serious resistance to change on this front. Instead of using the opportunity provided by the introduction of a new tax to clean up the tax system and get rid of cumbersome and archaic provisions, the departments often seek to make minimal changes in the Act so as to comply with the requirements of VAT. What ever level of convergence can be achieved on this front would be very useful and welcome. [11]

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[9] This perverse incentive is curbed to an extent by the provision to disallow any refunds in the first two years of introduction of VAT. While this provision was introduced to protect the revenues of the states in the initial years of introduction of VAT, this was the period when the revenue risk was relatively small, given the assurance of compensation from the Government of India. Now since the liability of refund would rest largely with the state government, there is need to monitor at least the refund cases more carefully.

[10] To the extent that the enhanced revenues in the new regime would facilitate additional expenditures by the state governments, it is possible that there would develop some interest groups within the government, which work towards retaining the higher rates and the related higher levels of revenue. To this extent, the agreement could become sustainable beyond the initial three years.

[11] To give a few examples, the VAT Act of Maharashtra (2003) requires the dealer to print a copy of the registration certificate on the reverse of the VAT invoice, a carry over from the present sales tax system. Further, the Act does not define the tax due from a dealer as the difference between the taxes collected on sales and the taxes paid on purchases – it defines the tax due as the tax collected on sales. A separate chapter provides for some input tax credit, where the extent of credit is to be specified in the rules and could potentially be less than 100 per cent. This once again, is a signature of the present sales tax Act. Similarly, the Tamil Nadu bill carries forward its fascination for graded taxes and penalties, by proposing a system of graded penalties for default/evasion of tax, the amount of penalty being related to the extent of divergence of the returned tax from the assessed tax. Further, the Tamil Nadu Act retains the right of the Government to provide special treatment to certain commodities/areas/groups of dealers, once again a feature of the existing tax regume.

One other feature of the design, which could make compliance as well as the administration of the tax difficult, is the proposed treatment of credit for taxes paid on capital goods. The credit, as mentioned above, would be provided in pre-determined number of installments. There are two problems with this approach. First, consider any major manufacturer – it is possible that she acquires some piece of equipment every few months, if not every month. The nature of this provision implies that both the dealer as well as the tax department has to keep track of the credit in case of each and every piece of equipment separately over the proposed period over which credit is to be availed – a very tedious compliance requirement. This would hold good even if the credit is spread over thee installments instead of thirty six. Since most Acts have some claw back provisions, if the dealer closes shop before the payment of tax, it is not necessary to have such a cumbersome treatment of credit on capital goods. A straight upfront credit with options only for carry forward in the short run, can address the potential revenue loss concerns of the departments. This is all the more important since the revenue attributed to the taxation of capital goods in most States is not more than 5 per cent of the total sales tax revenue. Second, by differentiating the treatment of capital goods from that of other purchases, these Acts bring back the need to define inputs/purchases and capital goods, with the possibility of disputes at the margin.[12] One of the advantages of a VAT is it allows the system to function without need for definitions like capital goods – it allows for a setoff of all taxes paid on purchases against all taxes collected on sales. By bringing back the definitions of capital goods, some of these advantages are lost.

In the case of declared goods, this concept has outlived its utility and hence should be abolished. This concept had relevance when there were serious shortages and there was apprehension that the States would use the access to this easily taxable base to collect large amounts of taxes from what were considered essential goods and critical inputs for the manufacturing sector such as iron and steel. The provision therefore was to limit the tax on "declared goods" to a maximum of four percent and at one point. However, in the new environment of VAT, since all taxes paid on inputs are rebatable against taxes collected on subsequent sales, there is no ground to retain this provision. It should therefore, be abolished. In keeping with the discussion above, these commodities should be subject to the standard VAT rate of 12.5 percent and not the concessional rate of 4 percent.[13]

In the case of goods subject to additional excise duty – sugar, textiles and tobacco – the long term aim should be for the tax rental arrangement between the Centre and the States to be ended so that these commodities can be integrated into the VAT regime. It is irrational to propose a tax by the Union Government within the CenVAT system, an additional excise duty on behalf of the States as a part of the tax rental arrangement and over and above this, a VAT at four percent to be levied and collected by the States. Once again, the States should consider subjecting these commodities to VAT at the standard rate of 12.5 percent. This would strengthen the tax base and facilitate consideration of a lower floor rate for the standard rate of tax in the country.

The above would make the intra-state VAT on goods relatively more efficient, revenue enhancing and sustainable. By allowing for some flexibility and autonomy to the States in the determination of the rates structures and the thresholds in keeping with the profile of the dealers and the preferences of the citizens of the State, the States can be made more self-reliant. This is important given the entire discussion on the proposal for compensation of loss of revenue by the Centre. It is worthwhile recognising that the average level of incidence of tax in widely different

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[12] Some states have sought to list goods to be treated as capital goods in a schedule (Tamil Nadu), while others have sought a convergence with the Income Tax Act (Maharashtra) or propose a cost floor (Karnataka). Andhra Pradesh proposes to merge the treatment of capital goods with other purchases and provide a uniform treatment, thereby getting around the problems mentioned above.

[13] The recommendations of the Twelfth Finance Commission on the treatment of sugar, textiles and tobacco too match the discussion in this paper. The report suggests the tax rental arrangement in regard to these goods should be formally revoked. Similarly, in the case of "declared gods", the report questions the relevance of a ceiling of 4 per cent and proposes that the entire mechanism of "declared goods" should be re-examined.

across States in India. While Kerala, TamilNadu and Karnataka register a tax to GSDP ratio greater than 10 per cent, West Bengal and Punjab operate with only six to seven per cent. By advocating a uniform rate of tax, the former are likely to be constrained in the provision of services. This could either translate into a disagreement on the rate structure in the long run or manifest in the form of demand for more sustained compensation schemes to be financed by the Union Government.

3. Issues and Options for taxation of Services:

Taxation of services in India, so far, has been within the domain of the Union Government. Unlike the case of other tax powers, the Constitution of India, did not recognise, the power to tax services as a separate and distinct tax handle. By exercising its residuary powers, Government of India introduced a Services Tax in 1994. This tax was levied on select services, the list of which has been extended and expanded over time. Currently, this tax covers 58 services, with another 15 being added in the Budget of 2004-05. While the tax was and continues to be a standalone tax, attempts have been made to integrate it with CenVAT. The last budget provided for credit of both CenVAT and Service Tax on purchases/inputs and capital goods against CenVAT on production of goods or Service Tax collected on the supply of services. However, since CenVAT is essentially a manufacturer's VAT, the rules allow for agents other than those paying the tax, to issue VAT invoices – first and second stage dealers in the case of goods and input service distributors in the case of services. Since the value added by these agents is exempt from the tax, these agents represent a weak link in the chain of invoices.

With the proposal to switch over to VAT at the State level, there is a demand from the States for the expanded tax base in the form of taxes on services, so as to compensate for the potential loss from the restructuring of the of the State level taxes. Since services are considered the fastest growing sector in the economy, the States articulate the need to have access to tax this segment so as to ensure reasonable buoyancy in their tax collections. This approach however is not yet in terms of an integrated and comprehensive base for VAT.

Ideally, for deriving the full benefits of a VAT, the tax should cover all goods and services. Any exemptions, whether they be in the form of exemptions of select goods or the entire set of services, bring back cascading into the system, diluting the gains from introduction of VAT. To the extent that the production of goods requires the use of some services, where the suppliers of the services, in turn would have used some goods for the supply of the service, the tax on these goods does cascade through the system. This could potentially distort decision making between production of goods and provision of services. Further, there are a number of services, which are often intimately related with the sale of goods or vice versa. In such cases, the value attributable to the sale of goods cannot be easily separated from the value of the services provided. This opens up the possibility of under-valuation of the goods part of such transactions. Servicing of cars in garages as well as similar other repair activities are examples of the same. Hire purchase schemes too potentially face the problem of distinction with hiring in schemes. The other major activity, which suffers from this problem, is construction activity. Most States have sought to get around this problem in the case of construction by determining some benchmark shares for goods and services in the transactions. Such processes once again would distort the decision making process, but have been adopted for want of a better mechanism of taxation. With a comprehensive VAT on goods and services, the treatment of all these transactions does not have to be separately addressed.

This constitutes the background for the 88th Amendment to the Constitution of India. This Amendment assigns the sole power of taxation of services to the Union Government, with a provision that on some select services, the Union Government can levy the tax and allow the States to collect and retain the same. Following up on this amendment, a draft Service Tax Bill was introduced and is being circulated among the States. This legislation classifies and lists services into four categories –

- exempt services,
- services currently being taxed by the Centre with the receipts being collected and retained by the Union Government,
- services to be taxed by the Union Government with receipts being collected and retained by the States and finally,
- services reserved for taxation by the Union Government in the future.

While the objections from the States to the draft bill comes from the perception that the Union Government has retained for itself the power to tax services which are considered most lucrative and on which it is easy to collect taxes, there are two more fundamental problems with this approach. First, as discussed above, selective taxation of services hinders the process of reforms of domestic trade taxes, through a transition to a comprehensive VAT. The implications of such an approach are well documented and discussed. The Expert Committee for Taxation of Services headed by Dr. M. Govinda Rao too recommended that both the Union Government and the States should have the power to tax all services (with a small negative list of services, which might be exempt or taxed by the Union Government alone). It further recommended that these taxes on services should be integrated into a comprehensive VAT at both levels of government.

It is only upon the introduction of such a comprehensive VAT that States can be convinced to integrate the other standalone taxes on services such as electricity duty and passenger and goods tax into the VAT base. The former is an important input for the production of most goods and services and hence any taxes on the electricity generation and distribution could potentially introduce significant levels of cascading into the tax system.

Second, the tax rental kind of approach for taxation of services by the States undermines the autonomy of the States to vary the levels of taxes in line with the paying capacity and preferences of the citizens in its jurisdiction. The rationale for such an approach is drawn from the idea that for ensuring a unified domestic market, which is conducive to the efficient functioning of the economic agents, it is useful to have uniform laws, rates of tax and procedures across the country. As discussed above, while there is merit in looking for uniformity in the charging section and the definitions and even in the procedures, the basic principles of federalism are violated if there is a demand for uniformity in the rate structures as well.[14]

Once it is agreed upon that services should become a part of the tax base for VAT in the states, treatment of services within the regime needs to be discussed. The principle for the taxation here can be stated as follows:

> *The place of origin would define the location or jurisdiction for taxation, with the qualification that for services having an inter-state dimension, if the supplier is registered in both the jurisdiction, the transaction can be taxed as per destination state for a registered dealer of the destination state.*[15]

Services like goods, may be provided locally and consumed locally, or may involve some inter-state dimension. In the case of localised services, the place or origin, supply of services as well as consumption of service would converge into the same jurisdiction. In the case of non-localised services, services which have an inter-state dimension – these services could be delivered over a space of two states. Passenger and goods transport as well as

[14] The report of the Twelfth Finance Commission refrains from taking a view on the proposed form of taxation of services. It restricts its attention to the revenue consequences of the proposed Service Tax Act and restricts its comments to prescribing that the revenue of the states prior to the new legislation should be protected.

[15] For suppliers registered in all jurisdictions, the registered dealer purchasers could supply the service provider with a C-form at the beginning of the transaction period. The supplier can use the VAT ID or create fresh internal ID in the event of frequent transactions with these dealers. All transactions by these dealers can then be billed and taxed at the jurisdiction of registration of the concerned purchasing dealer. Detailed information of these transactions can be provided to the relevant tax departments as well for improved surveillance and associated improvements in tax compliance.

telecommunication services are important examples of the latter. Hence the origin of the services would be a location different from the destination. The principle suggests that the transaction can be taxed as per the destination for a dealer registered in the destination jurisdiction, provided the service provider is registered in both the jurisdictions. Let us consider the implications of the above for the three specific services mentioned above.

Goods transport:

Case 1: Supplier of the service is registered in State A while purchaser is registered in State B.

I. If goods owned by purchaser are to be transported from State A to State B, the tax would have to be paid in state A. This would be similar to a case where a non-registered person or a final consumer requires transport of goods from one state to another.

II. If goods are purchased from a registered dealer in State A and the seller of the goods contracts the transport of goods also, the supply of service would be to a registered dealer within the state and would be taxed in State A. The value of transport services too would become a part of the price of goods when sold and in the process of zero-rating this inter-state sale, the cost of transport too gets zero-rated. The buyer in State B can acquire the goods with no taxes attached.

Case 2: Supplier is registered in both jurisdictions. The transaction can be billed in the destination provided buyer is registered dealer in the destination. The transaction would be zero-rated in the state of origin and taxed in the destination.

Passenger transport:

Cases 1 and 2 would work in the same manner as above. In addition to the above, it is possible to imagine, passengers undertaking a journey from a place in State A, to another in State B, further on to a third destination in State C, and finally returning to place of origin in State A. By the above principle, each leg of this journey would be taxed in a different State.[16] Given the qualifier spelt out in the principle, if the same journey were undertaken by the employees of a business enterprise registered in State A, and if the service provider is registered in all the three states, it would be possible to zero-rate the transactions in States B and C and bill and tax them from State A, provided the journey begins and ends in State A. This would facilitate the mechanism for tax credit for the concerned enterprise.

Telecommunications

This sector involves two kinds of services, landlines and mobile phones. Applying the same principle, telephone calls of the land line variety would be billed and taxed at the origin for local as well as STD/ISD calls. In the case of mobile phones too the same principle applies, as long as the caller is in the jurisdiction of registration or purchase. When roaming is invoked, the call would be local to some other jurisdiction and the tax should accrue there. This can be collected on behalf of the other service provider by the primary service provider and remitted back. Difficulties arise in the case of "toll free numbers" and "collect calls". Here while the call originates in one jurisdiction, the charges for it are borne within another jurisdiction. If the origin principle is to be applied, the service provider would have to collect taxes as per originating state and remit the same. This would hugely complicate matters and not permit setoff as well. A simplification could be to collect no tax on such transactions, since they would account as business expenses, taxes on which need to be credited to the enterprise. A distorting alternative would be to tax the call charges on destination principle in this event.

[16] This is distinct from suggesting that the revenue from a journey passing through multiple states should be allocated to all the states involved in proportion to the distance covered in that state. the latter approach would apply if the tax concerned is visualised as a tax on the use of infrastructure in the state. VAT however, does not follow this principle. It is meant to be a tax on consumption of services and goods and the consumption of this service can only be identified either with the originating jurisdiction or the destination.

Kelkar Committee Report on the Implementation of the Fiscal Responsibility and Budget Management Act (2004) suggests a comprehensive VAT at both levels of government, with the Centre collecting a tax at twelve per cent and the States at eight per cent. This, it is argued, would limit the gross burden of tax to twenty per cent on all goods and services. This end result, it is recognised, would be contingent on the negotiation of a "grand bargain" between the Centre and the States. The Centre has to agree to extend the power of taxation of all services to the States and the States need to relax their power on taxation of sale of goods to allow the Centre to extend its goods tax beyond the stage of manufacturing. This is a model discussed in the Report on the Reform of Domestic Trade Taxes in India as well.

If there are negotiations to bring about this "grand bargain" between the Centre and the States, there are a few other items that need to be brought on to the table. First, while a desirable end, the above proposal too attempts to restrict the autonomy of the States by specifying a uniform rate of eight percent. Second, if as proposed, there would be two taxes on identical or almost similar tax bases, it is possible to argue that there are benefits from having a single administration instead of two. This would reduce the cost of compliance on the part of the tax payer. The question then would be – who would administer the tax and how? What happens to the tax administration of the other level of government?

4. Intra-State VAT with CST: An Assessment:

In its present form, the treatment of interstate transactions between registered dealers distinguishes between inter-state sales and consignment/branch transfers. The former are subject to a tax at a maximum rate of 4 per cent, while the latter are exempt from the tax. This tax is levied by the Government of India, and is collected and retained by the State of origin. As is well recognised in the literature, this form of taxation leads to tax exportation beyond the extent of the tax on the inter-state sale, since this system allows the originating State to tax its inputs too at a rate of upto four per cent. For any rate of tax on inputs, higher than four percent, the manufacturer in any State would prefer to purchase through inter-state transactions thereby reducing the incidence of the tax. This very process had placed a ceiling on the rate of tax on inputs used by a manufacturer. For rates lower than or equal to four per cent however, there was a "level playing field" between local purchases and inter-state purchases. This therefore meant that the taxes on purchases as well as the tax on the inter-state sale were exported out of the State. In the case of consignment transfers, the incidence was limited to the former.[17]

It is important to assess how this scenario changes with a changeover from the present cascading type of first point sales tax to an intra-state VAT with set off of input taxes against CST as well. The proposal for treatment of inter-state transactions in the new scheme of things is as follows: the States would offer set-off of input taxes against CST collected. In the case of consignment transfers, the set-off would be for input taxes over and above four per cent. Once again the latter is designed to prevent or minimise the incentive to take recourse to inter-state transactions for purchase of inputs. While this change over should make every individual State an attractive investment proposition when assessed in isolation, when put together, it has the potential of inducing greater concentration of industry in a few States. The logic is as follows: since full tax credit is available for local purchases, whereas CST (or input taxes on purchases in the case of consignment transfers) sticks to the value of the good on inter-state purchases, there

[17] Since this distinction between inter-State sales and consignment transfers created a significant difference between the incidence of the tax, it is argued that the companies opted to set up branches all States and/or appoint commission agents so as to avoid the tax. There was one proposal to bring consignment transfers too within the ambit of CST – a bill was passed in the parliament – however, the recognition that this would harm genuine branch transfers and be affected by issues relating transfer pricing put a hold on the notification of the bill. Taking recourse to corrective action within the parameters of the State sales tax itself, this "perverse incentive" was sought to be neutralised by raising the tax on inputs used for goods manufactured for consignment transfers. Maharashtra provides one such example.

is incentive to minimise the number of inter-state transactions before the good reaches the consumer. Further, an illustration suggests that locating the manufacturing activity in the State with the largest value of sales too yields some tax saving which could translate in either lower prices or higher profits for the manufacturers. (See Appendix 1) This would suggest that manufacturing activity would get concentrated in the States which have higher levels of income.

In order to understand the impact on the economy of this change over to this proposed system of it is useful to compare this scenario with that under the present system. The present scenario can be represented by Case I in the Appendix table. Given that there is not much difference in the tax rates between local purchases and inter-state purchases in the present system, the distortions in the economy induced by the tax system are largely limited to those induced by the existence of cascading tax system. The location of industries was less likely to be affected by this system – even the tax-based industrial incentives tended to become uniform across States as a result of competition among States.[18]

In other words, the change over to an intra-state VAT with CST provisions remaining in place (even with reduced rates of tax) would, at the very minimum, disturb the existing structure of business transactions in the economy. While there is agreement in principle, that the present system of taxation of inter-state trade has to be replaced with a system which works on a destination basis, the contours of the new system as also the time frame for the reform process are yet to be defined. The agenda presently is defined only so far as reduction in the rate of CST to two per cent, at the time of switch over to the intra-state VAT. This would be an unhappy state of affairs for two reasons – one, with a change over to VAT, it is expected that economic agents would have to restructure their business strategies to optimise in the new environment. If the path of reforms and the time frame are not setout in advance – since it is not being planned as a one shot process – economic agents would face a new and uncertain environment which does not permit long term planning. Second, given that some of the measures would involve costs in terms of revenue loss for the different levels of government, evaluating the costs and planning a suitable course of action is critical to the success of the reforms process. To give an example, a change over from a first point tax to a value added tax is associated with some losses and some gains. It is often argued that the losses are from firm sources – revenue that is easy to collect – while the gains are from dispersed sources, requiring more effort by the tax department. To guard against potential loss of revenue in the short run, it is considered advisable to introduce VAT with slightly higher rates of tax. In the Indian context, however, the increase in rates of tax through the floor rates regime was implemented independent of the introduction of VAT. This meant two kinds of problems – the potential for repeating the same is limited, and the revenue that needs to be protected was enhanced. In other words, the revenue augmenting measures of tax reforms need to be packaged with those that imply a cost on the exchequer.

The objective therefore, should be to provide a stable business environment, then the trajectory and time frame of reforms need to be announced in advance. This would allow agents to plan for the future and allow for minimisation of any short term irrational decisions.

5. Options for Treatment of inter-state trade:

There are a number of options discussed in the literature, some of which require the union government to play an overarching or important role, and other which don't. Since the former set of options are not within the domain of the feasible at the moment in India, this discussion is limited to the options which do not depend on a distinct role for central taxes. Within the latter category, the main options can be spelt out as follows

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[18] Vertical integration is one way to avoid the tax in a cascading system of taxes. This process also helps CST by allowing branch transfers across State borders. By this very process, the likely distortions to the choice of location are expected to be limited.

1. Zero-rating with detailed and timely documentation: a simple zero-rating mechanism requires that the exporting state zero-rate a transaction and the taxation begins afresh in the importing state. Since this system can be very prone to evasion, since there would be incentive to pass off all local sales as inter-state sales, unless there is a suitable safeguard in the form of a reliable and timely information system. This can work in the form of transaction wise revalidation of transactions by both the buyer and the seller, through electronic c-forms. Given the dependence on the electronic media and in the absence of the same on the department officials, there could be high compliance costs at least in the initial years of introduction of the tax. Further, there is need to monitor this system closely to ensure that the revalidation from the importer is received in time or else the tax would become due on the part of the exporter.

2. Zero-rating with pre-payment: This model too works on the principle of zero-rating with the difference that the exporter in the exporting state can zero-rate his transaction provided the importer in the importing state has accounted for the transaction and paid a tax on the same. This could either mean that the transaction is accounted for in the next tax period and the tax due is paid or that the importer agrees to pay a tax on every individual transaction at the time of placing the order and/or receipt of the goods. While this mechanism provides greater security to the revenues of the exporting and importing state, the cost of such a security is borne by either the exporter or the importer in the form of higher interest burden. if however this system could be designed in such a manner that the exporter gets conditional zero-rating which could be reversed if the importer in the importing state does not remit the tax due within a defined period, the compliance costs can be reduced. The only difference between this system and the earlier one would then be one where the importer pays the tax on receipt of goods in the latter and on sale of goods received in the former. In this sense, the latter system may provide greater degree of neutrality between local purchases and inter-state purchases.

3. Pair-wise clearing house: since both the above systems require the exporting state to provide an exporting dealer with the option of zero-rating, it is possible to imagine the possibility of systems of tax evasion being devised, since the difference between 12.5 per cent and 0 per cent, the gain from masking local sales as inter-state sales, is rather large. The other options therefore focus on this aspect and propose mechanisms to eliminate this incentive. The present option proposes that local as well as inter-state sales are subject to tax at the same rate and the revenue is collected by the exporting state. The details of inter-state sales are provided by the exporter as a part of the return and the corresponding revenue receipts are passed by the exporting state to the importing state. The importing state continues the chain of tax and credit subsequently. In other words, this is a system where a clearing house works for each pair of states. Clearly, there would be some mistrust, in timely transfer of resources between states and therefore there is need for a dispute settlement mechanism before such a system can be proposed and implemented. In addition to the need for a dispute settlement mechanism which would be critically dependent on the availability of reliable data, there is some cost of transactions for the states themselves, since each individual state now would have to deal with every other state and keep track of transactions there from. In practice however, it is the large manufacturing states that would need to keep track of resources that to be transferred to all other states. For the poorer states, the transactions may not span all other states, especially all the other less developed/consuming states.

4. Complete Clearing house: the taking into account the benefits from the above, the final option is to create a centralized clearing house, which receives receipts as well as claims from all the states and balances the two. Quite obviously, this system too would require a detailed and reliable information system. Further, in the absence of an autonomous system of administering the system, there are apprehensions about the destination principle being violated. This is evident from the discussions about the applicability of the clearing house in the Indian case, where the alternative formulae were proposed for distributing the receipts, one such option being half being retained by the exporting state and the balance being transferred to the importing state on the basis of

some formula. It should however be recognized that while the scope and technological feasibility of monitoring individual transactions was non-existent when these proposals were put forth, given the present environment, clearing house too can be a option provided the administration of the same can be kept within an autonomous body outside the control of the union government. This is essential to belie the apprehensions of the states, that the resources so pooled could get reallocated on the basis of some alternative criteria, if the control rests with the union government.

Key to the implementation of any of these systems is the existence of an efficient information system, capturing information on inter-state trade. While information is ideally desirable transaction-wise, this needs to be achieved without imposing significant transaction costs on the dealers. The present mechanism for collecting this information runs through C-forms, which has the following problems: one, the high level of interaction between the dealer and the department required in this system leads to potential harassment/corruption. Two, since consignment transfers are not subject to a tax, the documentation of these transactions is not considered reliable. The new system therefore has to correct for these two problems.

Empowered Committee of State Finance Ministers and the Union Finance Ministry, have come together to institute an information system and the contract for implementing it has been assigned to ICICI Infotech. While the system being proposed, sets out to capture already available data with the sales tax departments of the states, wherein the data is obtained on an annual basis from the dealers in the form of C-form, the model presumably retains the option for capturing data at shorter intervals like a quarter as also the progress to continuous monitoring through electronic C-forms. In other words, there would come into existence a mechanism through which the transactions can be monitored. Once such a system is instituted, it may be important to mandate that the exporters and importers are responsible for entry of information on to this network as well, where the department would look for a consonance of information between returns and this information base. The effectiveness of the mechanism and the machinery and the database so generated would depend on the design of the system for replacing the present Central Sales Tax.

Report on the Reform of Domestic Trade Taxes in India (1994) provides a detailed discussion of the pros and cons of three out of the four systems discussed above and concludes that the pre-payment system is superior, in the sense of safeguarding revenue and suggests the adoption of some variant of the clearing house until such a time a pre-payment system is put in place. (It does not discuss the pair-wise clearing house system) The Report of the Group of Officials and Experts on Taxation of Inter-state Sales (1996) concludes on the other hand that a variant of the Clearing House Mechanism provides a better solution, with the distribution of the resources pooled being undertaken on the basis of estimated consumption figures. Some examples presented below suggest that by distributing the amounts on the basis of shares in consumption, there remains a bias in favour of the States with higher share in production/consumption.

Of the options outlined above, therefore there is a need to assess the relative merits and problems and identify the most suitable model. Table – below provides a summary for comparison of the same. A look at the table suggests that, while there is no one clear winner, if the states are to choose a model that safeguards their interests the best, then given an inherent mistrust on inter-dependence of revenue, the last two options get a lower preference. Of the remaining two, a suitably designed pre-payment system may be the best pick, since it provides a presumptive protection to the revenues of the state. If appropriately defined and administered, it can provide an acceptable model for the dealers as well. This would require the importing dealer to account for the transaction when the goods are received and pay the tax in the subsequent return. The exporting dealer gets his refund in the same tax period, while filing her return. The returns of both these dealers would have to provide transaction wise details of imports and exports, so that the transactions can be matched. It can be mandated that the details of all such transactions should also be entered at the dealer's initiative into the tax information system. The dealers can also be given the option of pre-entering the data, i.e., prior to the filing of the return, and print the corresponding waybills, and other related documents for inter-state trade.

Box: Clearing House with Distribution based on Consumption Figures
Some Illustrations

Dealer in State A sells intermediate goods to dealer in State B, who then manufactures a consumption goods and sells part in the local market and part to consumers in State A. It is assumed that there is a ten per cent tax on both local sales and inter-State sales. The collections on inter-state sales are transferred to a central pool, and distributed among the States on the basis of their share in total consumption. The importing State provides full setoff of taxes paid on inter-state purchases as well. In Case 1, where both the States have similar levels of production and consumption, their shares in total taxes too are the same. However, when the shares in production are altered (cases 2 and 3), even with the levels of consumption remaining the same, the shares in taxes are biased in favour of the net producing State. In other words, this mechanism fails to achieve the destination principle.

	State A		State B
Case 1			
Value added	100		100
Value of sales	100		200
Consumption	100		100
Local sales tax collected	=10-10=0		=10-10=0
Inter-state sales tax collected	10		10
Total tax due	=0+20/2=10		=0+20/2=10
Case 2			
Value added	50		150
Value of sales	50		200
Consumption	100		100
Local sales tax collected	=10-10=0		=10-5=5
Inter-state sales tax collected	5		10
Total tax due	=0+15/2=7.5		=5+15/2=12.5
Case 3			
Value added	150		50
Value of sales	150		200
Consumption	100		100
Local sales tax collected	=10-10=0		=10-15=-5
Inter-state sales tax collected	15		10
Total tax due	=0+25/2=12.5		=-5+25/2=7.5

Table : Reform of CST: Comparison of Alternatives				
	Pure Zero rating	Pre-payment system	Pair wise clearing	Clearing House
Comparison with local sales	High benefits from evasion	High benefits from evasion	No benefits	No benefits
Comparison with local purchases	Inter-state purchase cheaper	No difference	No difference	No difference
Dependence on other states for revenue	None	None	On all inter-state transactions	On all inter-state transactions
Dependence on transaction wise information	Complete	Complete	Complete	Alternative redistribution mechanism may be devised
Compliance costs	Report individual transactions independent of return (for both buyer and seller)	Report individual transactions independent of return (for both buyer and seller)	Not required	Not required
Possible Mechanism for fraud	Exporter can set up a fake dealer in the importing state and record the receipt of transactions. The importer can then disappear. If the department is not vigilant, then this can be a source of major revenue loss. If the department is vigilant, these transactions cannot be sustained over long periods.	Provisions have to allow for the importer to reallocate the pre-paid tax, in the event of the goods being lost/ damaged in transit or the value of the goods being lower than when the tax was paid. If this provision is made, there are issues of valuation and verification of the receipt of goods to authenticate the transactions, without which there can emerge the scope for tax evasion.	Exporting state and exporting dealer have no incentive to document inter-state sales. exporting dealer can record the transaction as a local sale to an unregistered person, when a transaction involves inter-state sales. This reduces the transaction costs for the seller and buyer can pass of these goods without paying tax in the importing state. The exporting state can afford to ignore such transactions since there is a revenue gain from ignoring them. In other words, this system may require a strong set of check posts too, to monitor inflow of goods.	Same as in the pair-wise clearing case.

The treatment of services, especially services of an inter-state nature depends on the mechanism chosen for monitoring inter-state trade. The treatment of such services within a zero-rating mechanism is already spelt out in the section on services. Given that the pre-payment system is a variant of the zero-rating system, choice of the pre-payment system as the system for tracking inter-state transactions would not require major changes in that mechanism. Consider the case of travel across state borders. In the earlier case, it was already proposed that for registered entities, for purchase of tickets for travel across multiple jurisdictions, they could opt to pay the tax of the jurisdiction of registration. This is in essence the working of a pre-payment tax in the case of these services. The same holds for the other examples discussed. All transactions of purchase by registered entities, of services spanning more than one tax jurisdiction can be accounted for as imports into the jurisdiction of registration and therefore taxed in that jurisdiction alone.

As discussed earlier, the existing system of taxation of inter-state trade wherein sales to registered dealers are subject to a tax but branch transfers are not, provides some incentives for cloaking the former as latter. With the introduction of a VAT, and a destination based system for inter-state trade, since, sales to registered dealers would be effectively zero-rated, there would be very little incentive left for undertaking consignment or branch transfers to avoid taxes. In other words, a large part of what was hitherto classified as branch transfers should now be accounted for as inter-state sales. Thus, the second problem discussed above would be less serious in a VAT system with a destination based treatment of inter-state transactions.

6. Basis for Resistance:

Critical to the successful implementation of State level VAT from April 1, 2005 is an understanding of the problems that dogged the implementation till now. The timeframe for implementation of the tax has been altered a number of times so far, partly for reasons of inadequate level of preparedness of the States and partly, because of the resistance faced by the tax from the dealers. The former is an issue internal to the tax departments and steps to address the same can be taken provided the States get a clear picture on the design and criteria for compensation from the Centre in the event of loss of revenue. The latter requires to be addressed in some detail to ensure that the concerns of the dealer community can be addressed and the environment made suitable to greater reliance on voluntary compliance. This section seeks to identify the concerns of the latter.

The factors contributing to the opposition to VAT can be summarised as follows.

1. Homogeneity in the rate structure is expected to result in an increase in the rates applicable on a number of commodities in many of the States. The floor rates regime worked with three rate categories, other than the exempt category – 4, 8 and twelve percent. With a reduction in the number of rate slabs to two, a number of the eight per cent goods now moved to the 12.5 per cent rate, which was considered high. The existence of a four percent rate category induces people to lobby for a reclassification of some or all of these commodities in this lower rate slab. One response to this problem is to reduce the number of commodities in the four percent and the exempt categories drastically, by limiting these rates to few essential commodities alone. This would raise the scope of the higher rate slab and thereby allow the associated tax rate to be reduced to more acceptable levels.

2. A number of the factors responsible for the resistance to the tax are related to perceptions regarding the administration of the new tax

    a) Uncertainty regarding the refund mechanism where the need arises: most of the VAT Acts do not provide for suitable mechanism for refund of the tax even in the case of exporters. Since the governments would be collecting taxes on the inputs, whenever manufacturers or other dealers propose to send the goods out of the jurisdiction, the excess VAT credit, it is proposed should be adjusted against taxes collected on local sales, then carried forward for use in subsequent periods. For tax payers involved in major inter-state operations, like say automobile manufacturers, the taxes collected on local demand may consistently be inadequate for covering the credit on input taxes. If some provisions for timely

refund are not structured in, the business community perceives significant costs from holding such tax credits. It is therefore imperative to design an appropriate refund mechanism. However, as is evident from the evolution of the tax system in the states that have implemented the new regime so far, there are continued efforts to increase the number of commodities taxable at 4 per cent, with a fair degree of success in states like Delhi.

b) Over-cautious departments have tried to bend over double, in their efforts to protect revenue, by introducing features like the entry tax. Alongside a switch over to a VAT regime, it is expected that the tax system would be made more user-friendly encouraging voluntary compliance. Departments however, do need to find mechanisms for safeguarding their own revenues. This can be done either by relying on more efficiently operated databases, with greater and timely sharing of information across States, or through the legislative provisions like the entry tax introduced in the draft VAT Act for Delhi, where the transporters too were made liable to the tax system. The latter tends to make compliance more difficult and administration more tedious as well. The alternative of putting in place a tax information exchange system, which can help monitor inter-state transactions can address concerns such as this one.

c) Ineffectiveness of the departments in convincing the dealers that the inter-face of the department with the dealers would undergo a sharp decline, with self-assessment and selective audit provisions. This meant that the dealers who were hitherto not a part of the tax system were reluctant to be brought in.

d) In addition to the above, the departments tended to highlight the stiff penal provisions. In the context of the assertions that tax evasion in the new regime would be easily identifiable, these molded an opinion that the new tax would be difficult to comply with and can potentially open the grounds for greater harassment by the tax departments. The need of the hour therefore, is to establish to both the tax departments as well as the dealers that the only mechanism for administering the tax is through greater reliance on voluntary compliance. This would require a well structured publicity campaign as well.

e) There are some genuine concerns of dealers who would have to change their way of doing business in the new scenario – agents who operated through trade margins earlier would now have to record all transactions as sales. For such agents, the departments need to make special efforts to facilitate the transition to the new tax, by providing information and training if required.

In addition to specific concerns, there is an overarching concern of the dealers regarding inadequate emphasis on awareness and training of the dealers for the new regime. The dealers have a valid criticism if the departments fail to provide the Act and Rules prior to the switch over to the new regime. This has been made more difficult for both the dealers and the departments, since the tax design is continuously evolving, even after the so called introduction of the new tax.

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Appendix: Table: Impact of VAT with CST: Some Examples

		Case I		Case II		Case II	
		Value	Tax	Value	Tax	Value	Tax
Dealer 1		State A		State A		State C	
Purchases	100		=4	100	=4	100	=4
Sells	200	208	=8 - 4 = 4	200	=8 - 4 = 4	200	=8 - 4 = 4
Dealer 2		State B		State A		State C	
Purchases	200	208		200	=8	200	
Sells	400	424.32	=408 * 0.04=16.32	400	=16 - 8 = 8	400	=16 - 8= 8
Dealer 3		State C		State A		State C	
Purchases	400	424.32		400	=16	400	
Sells	800	882.02	=(0.5*0.04+0.5*0.1)*824.32 = 57.7024	800	=((1/8)*0.1+(7/8)*0.04)*800 = 22	800	=((4/8)*0.1+(4/8)*0.04)*800 =40
Taxes in Consumption							
State A	100		18.72		38		10.4
State B	300		48.47		31.2		31.2
State C	400		57.70		41.6		56
Value at sale							
State A		117.88		110		114.4	
State B		353.63		343.2		343.2	
State C		453.38		457.6		440	

Notes: Dealers 1 and 2 produce intermediate goods while dealer 3 produces goods for final consumption. The demand for the final consumption good is distributed in value terms as Rs.100 from State 1, Rs. 300 from State 2 and Rs. 400 from State 2, when there are no tax in the system. It is assumed that all sales of intermediate goods are taxed at 4 per cent which is also the rate applicable on inter-State sales. Local sale for final consumption is taxed at 10 per cent. Case 1 refers to the situation where dealer 1 is located in State A, Dealer 2 in State B and Dealer 3 in State C. This would be similar to the present first point sales tax system, with inputs being taxed at the same rate as CST sales. Case II is one where all the dealers are located in State A and Case III, when they are located in State C