Public Finance Sessions

Dr J V M Sarma

Public Finance

VAT & GST

Dr J V M Sarma

Commodity taxes - Problems

- Regressive and iniquitous
- Inter-jurisdictional conflicts
- Complex rate structures
- High compliance costs
- Leakages due to single stage taxes.
- Tax pyramiding /cascading

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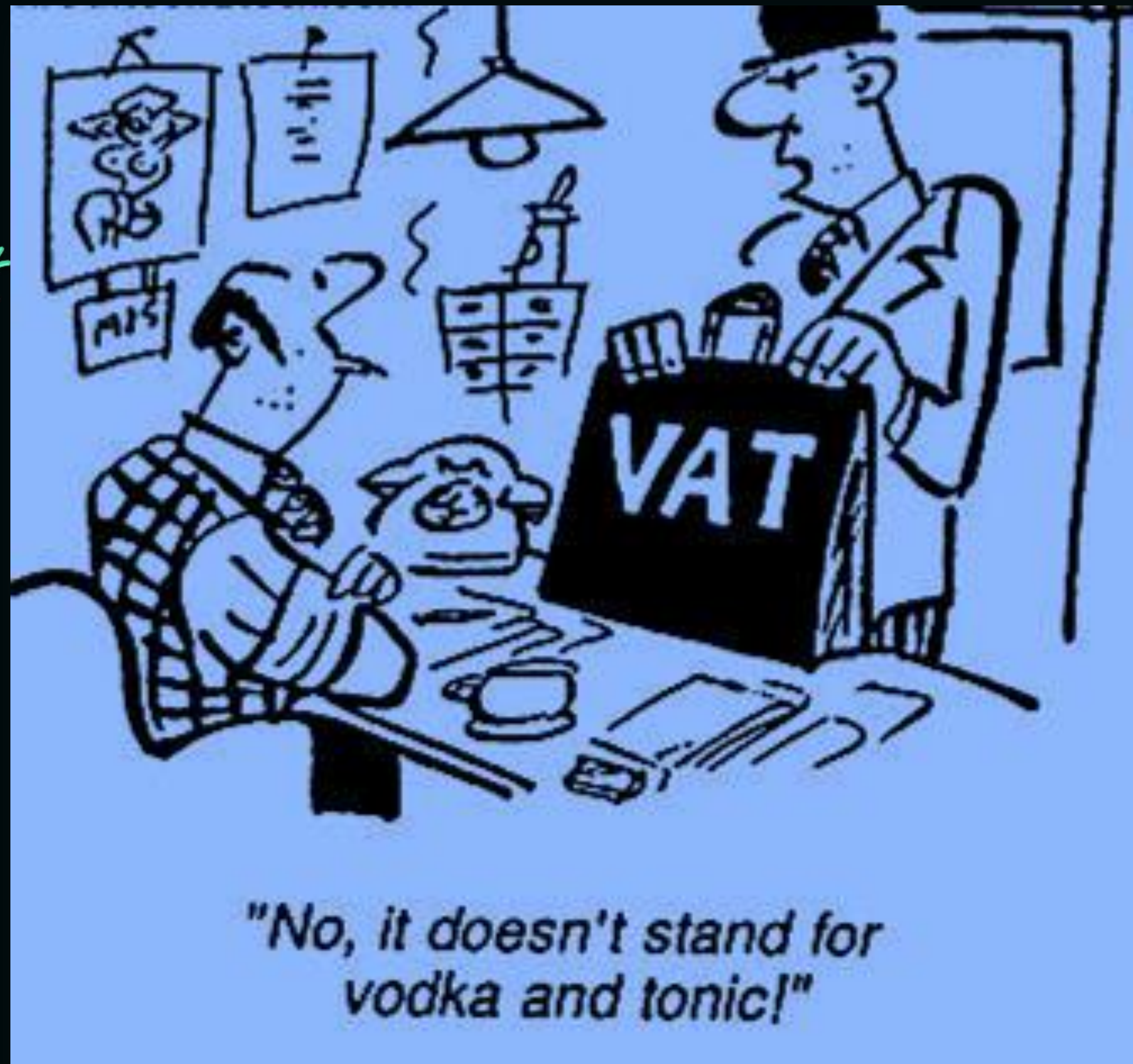
Tax pyramiding/ cascading

	rate	margin	value with margin	tax	Value
Original value					100.00
Customs duties – Imports	15%		100.00	15.00	115.00
Union excise – Manufacturing	15%	10%	126.50	18.98	145.48
Sales tax levied on price	10%	10%	160.02	16.00	176.02
Local taxes / cesses	5%	10%	193.63	8.80	202.43
Original price					100.00
Total tax without pyramidding					45.00
Total actual tax component					58.78
Final price including taxes					202.43

The Sessio

- Rationale for
- VAT design ch
- Methods of V
- Techniques of
- The Indian exp
- Design and imp

The Concept



The Concept

- VAT is a form of indirect tax levied on the value added at various stages of production and distribution
  - It is like a sales tax at the retail point, collected at different stages of transactions.

The Rationale

- Replaces unsatisfactory taxes
  - Tot, Single stage sales tax
- Invoice-based tax credit system self-enforcing
- No cascading and pyramiding
- Higher revenue potential
- However, very complex, difficult to administer

Critique of VAT

- Major Attributes:
  - Neutrality,
  - Transparency,
  - Certainty
- Weaknesses:
  - Regressivity,
  - Price impact,
  - Administrative and compliance costs

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Origins and History

Origins and Spread

- Wilhelm Von Siemens, 1920
- Thomas S Adams, 1923
- French man Maurice Lauré, 1954
    - taxe sur la valeur ajoutée

Highly popular

- French West Africa 1960s & Brazil 1965
- 147 countries, 70% population
- EC and OECD countries.

In Europe, - 17 countries:

- Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Netherlands, Norway, Portugal, Spain, Sweden, Turkey, and UK.

In Latin America – 14 countries:

- Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Ecuador, Guatemala, Honduras, Mexico, Nicargua, Panama

Others

- Africa - 2: Madagascar and Niger
- Asia -2 Republic of Korea and Taiwan
- Caribbean - 2 Dominican Republic and Haiti
- Middle East - 1 Israel
- Oceania - New Zealand.

VAT designing

Choices involved

- Types of VAT: Consumption, Income, Gross product
- Origin or Destination principle
- Method of computation: Subtraction or Invoice method
- Techniques of freeing from VAT: Exemption or Zero-rating
- Single rate or Multiple rate VAT
- Tax-inclusive or Tax-Exclusive.

Types of VAT

- Gross product VAT
  - All goods including capital goods are taxable
- Income VAT
  - Taxes only the final goods
  - Excludes the depreciation part of the capital goods
- Consumption VAT
  - Neither capital goods nor depreciation enters the tax net.
  - More popular.

Computation methods

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Subtraction method

- The tax liability at any stage is equal to the tax rate multiplied by the value added
  - (measured as the difference between the values of outputs and inputs).
- Difficult to follow in a multiple tax rate regime.
  - eg, Apportioning of the output produced with the same input.

VAT by Subtraction method

	Farmer (wheat)	Miller (flour)	Baker (bread)	Retailer (bread)
Purchases(VAT-exclusive)	0	100	200	250
Sales	100	200	250	300
Subtraction method				
Value added	100	100	50	50
VAT rate	10%	10%	10%	10%
VAT liability	10	10	5	5
Total VAT				30

Invoice or Tax credit method

- The tax paid at the earlier stage is given back as a credit
- Self-enforcing
- And so more popular.

VAT by tax credit method

	Farmer (wheat)	Miller (flour)	Baker (bread)	Retailer (bread)
Purchases (VAT-exclusive)	0	100	200	250
Sales	100	200	250	300
Tax credit – invoice method.				
VAT rate	10%	10%	10%	10%
VAT on sales	10	20	25	30
VAT paid on purchases	0	10	20	25
VAT liability	10	10	5	5
				30

Techniques of freeing from VAT

Exemption method

- An exempt stage is completely eliminated from the production-distribution chain:
- not required to collect the tax on output sold to its consumers,
- not entitled to claim for the credit of the tax the firm has already paid on its input purchase.
- illustration

Zero-ratng

- firm charges no VAT on its consumers—
- but claims for refunds of the VAT previously paid on its input purchase.
- zero rating does not break the link between the zero-rated stage with others in the whole production-distribution chain.
- illustration

The Indian experience

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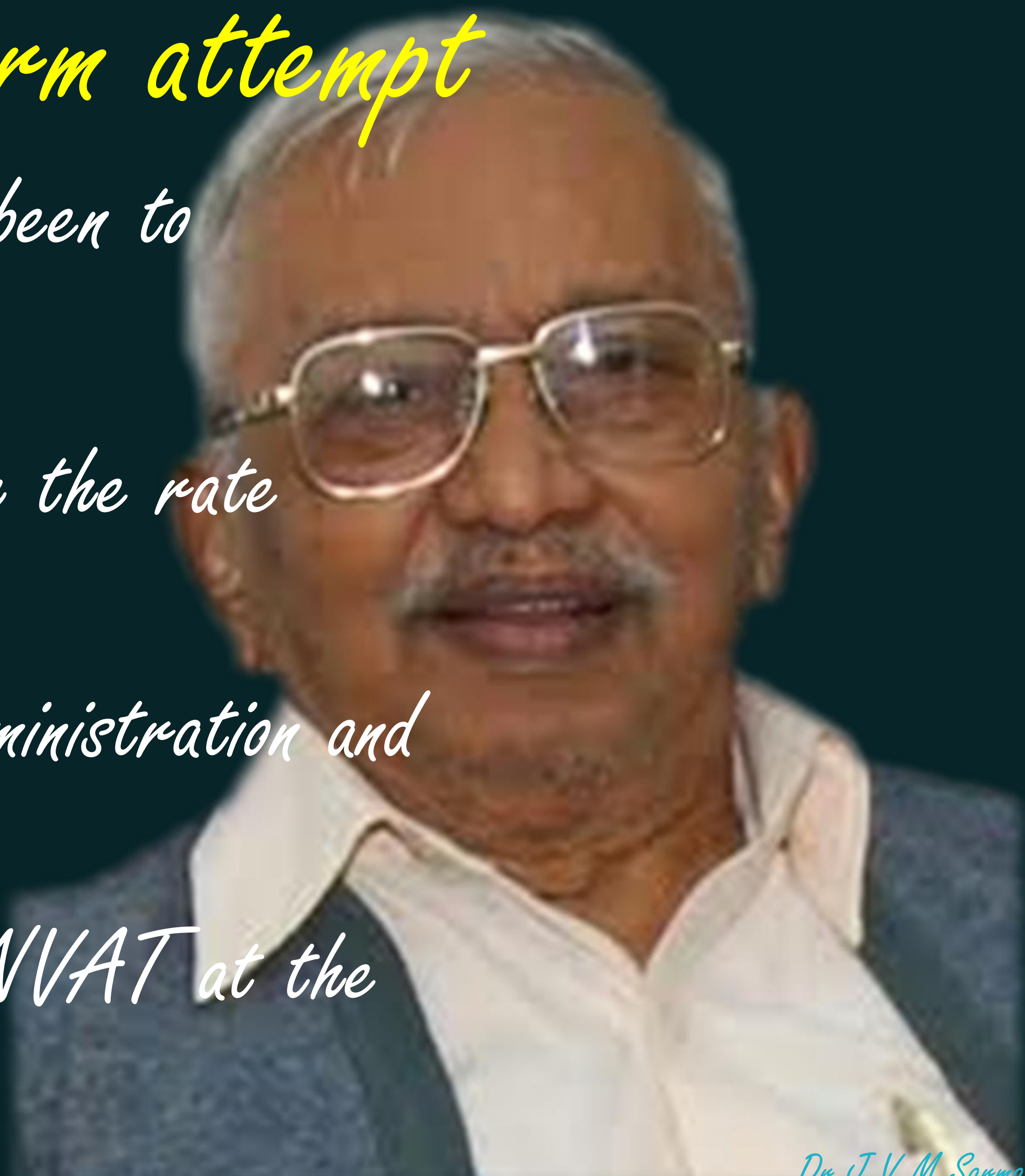
1991 tax reform attempt

- The attempts have been to
  - broaden the base,
  - lower and simplify the rate structure, and
  - streamline the administration and enforcement
- MODVAT and CENVAT at the Centre.



VAT Options for India

- Extreme Choices – A Central VAT vs State VAT
- Dual or Joint VAT.

Central VAT

- Merits: Brings about harmonization and uniformity
- Demerits:
  - Surrendering of States' tax powers,
  - loss of efficiency,
  - administrative burden.

State VAT

- Merits: Promotes fiscal responsibility
- Demerits:
  - Reduction in the Centre's reveneues.
  - Low coordination of State level taxes.
  - Administrative burden on States.

Dual or Joint VAT

- Concurrent VAT (Poddar's Variant)
- MODVAT at the Centre and Retail VAT at the States: The TRC variant
- Independent VATs (NIPFP variant)

Concurrent VAT: Illustration

State VAT levied on price including Central VAT					
Central VAT @		10%			
State VAT @		5%			
Dealer	Sales	Central VAT	Sale price after Central VAT	State VAT	Sales inclusive of both VATs
Manufacturer	100	10	110.0	5.5	115.5
Wholesaler	160	6	166.0	2.8	168.8
Retailer	200	4	204.0	1.9	205.9
Total tax	200	20	204.0	10.2	205.9
Effective tax rate		10%		5%	

VAT in the States:
The Challenges Ahead

- There is need for reform of the domestic trade taxes
- Attempts not always in the right direction.

Committee of States' Finance Ministers

- laid down steps to transform the prevailing State sales tax systems into a consumption type VAT at the retail stage

Rationalization in tax rates

- four floor rates, namely, 0, 4, 8 and 12 per cent for general commodities and two special floor rates of 1 and 20 per cent on high value and conspicuous items
- sales tax incentives for industrialization should be done away with
- provision for relieving the tax paid on inputs and capital goods
- by further rate rationalization, elimination of the tax on inter-State sales tax.

Recent reforms fall into two categories

- extending the tax beyond the first point of sale with a set off on the tax already paid selectively on specified finished consumer goods
- extending the tax on all finished consumer goods up to the wholesale or semi-wholesale stages identified by specified turnover base

Not exactly VAT

- at best, the initial moves towards VAT
- VAT only on trade margins,
- Selective coverage - further complicate
- services outside the purview
- Refunds subject to complex procedures.

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GST- thepromise

- Increase revenue
- Provide harmonised national market
- Make Manufacturing competitive

A Possible Solution – A flawless GST

- A single goods and service tax (GST) applied to all firms. State and Central GST across the same base – harmonised and distinct
- All major Central And State Taxes subsumed
- VAT credits running across all kinds of firms in the economy.
- Level Playing field between goods and services . Presently not so.

A flawless GST (cont'd)

- Only limited exemptions
- Nuetral to nature of activity of the firm – resource allocation is tax independent
- Single rate would eliminate political lobbying about rates and eliminate classification disputes

Why progress towards a 'flawless' GST?

- Revenue growth
- Lowered costs
  - Low compliance cost
  - Low collection cost
  - Reduced loss/Distortion

13 Finance Commission Reccom

- Model GST
  - Single Rate
  - Subsume all Central Taxes, Cesses and Surcharges
    - Subsume all State taxes , cesses and surcharges including stamp duty, excise, taxes on vehicles, luxury tax, entertainment tax, entry tax
  - Special Provision HSD, MS ATF etc- additional levy
  - Limited exemptions- unprocessed food items; public services excluding railways, health and education
  - Rs 50,000 crore for compensation to state governments

The GST bill

- 115 Constitutional Amendment : March 2011
- GoI and SGs- concurrent power to tax intra state sales of goods and services
- Parliament- exclusive power to tax inter state sale of goods and services
- Goods and Services Tax Council –structure the GST to create a harmonised national market for goods and services

The GST bill(contd)

- Exempts Petroleum motor spirit, Kerosene , HSD
- ATF, Liquor
- empowers states to tax intra state sales of these items
- Empowers GoI to levy excises on these items as well as tobacco and tobacco products

The GST Council

Will make recommendations on

- Taxes, levies and surcharges to be subsumed into GST
- Exemptions
- Thresholds
- Rates

The Way forward- Short term

- Phase Out CST and pay compensation to state governments
- Allow States to levy service tax
- Merge CENVAT with Service Tax and build a Central GST

"That must stand for Very Annoying Tax!"

Hoping for better

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Thank you!