



## **Indirect Tax Structure Prior to the Introduction of GST: Challenges and the Need for a Unified Tax Structure**

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### **ABSTRACT**

*An indirect tax is one whose burden can be shifted from the original payer to the ultimate consumer of the commodity or service taxed. Indirect taxes (also called hidden taxes) are convenient to collect but lack equity attribute. They do not allow considerations for the personal circumstances of taxpayers as do direct taxes. The distribution of indirect tax burden is often, though not always, regressive and even the poorest of the poor are made to contribute to public exchequer. This paper examines the indirect tax structure of India prior to the introduction of Goods and Service Tax (GST) to enable an understanding and appreciation of the need for GST in India. It analyses the various indirect taxes such as import duties, excise levies, and sales taxes. It also shows how VAT, which is a multi-stage tax levied on all stages of production and distribution of a commodity, suffers from certain limitations. Despite the self-policing nature of VAT, opportunities do exist under it for evasion and fraud. The need to overcome various challenges and limitations of this indirect tax structure has led to the adoption of a unified tax regime, i.e. GST.*

**Keywords:** *Indirect taxes; Excise duty; Customs duty; Value added tax (VAT); Goods and Services tax (GST); Tax equity.*

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### **1.0 Introduction**

Taxes are imposed so that a government may perform its traditional functions (defence, and maintenance of law and order), undertake welfare and developmental activities, and make provision for public goods to satisfy collective needs of the people. It has also to pay for its own administration. It needs financial resources for these purposes and taxation is one method of transferring money from private to public hands. Taxation is necessary because what the government gives it must first take away.

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### 1.1 Meaning and bases of taxation

A tax is a compulsory payment made to general government without any direct *quid pro quo*. General government includes central, state, and local governments. Tax payments are compulsory and the benefits provided by government to taxpayers are neither direct nor proportional to such payments. Since social security contributions paid to government in most developed countries are compulsory, they are treated as tax revenues. Every tax is made up of two elements: a base, i.e. the object to be taxed and a rate structure, indicating how the base is to be taxed.

The distinction between tax and non-tax revenues of the government is not watertight. There are some borderline cases which pertain to certain fees and charges levied in connection with a specific service or activity. Sometimes, it is difficult to distinguish between a fee and a tax. For example, vehicle licence fee is generally regarded as a tax.

The definition of a tax given above is subject to modifications in view of the differing practices of tax authorities in different countries. The Organisation for Economic Co-operation and Development considers the following fees and charges as non-tax revenues: court fees, driving licence fees, harbour fees, passport fees, radio and television licence fees where public authorities provide the service (OECD, 1996). Fines and penalties relating to tax offences are treated as tax revenues whereas fines relating to non-tax offences (e.g. traffic violations) are included in non-tax revenues.

Ultimately, all taxes are imposed by politicians helped by bureaucrats. Tax policy pertains to (a) level of taxation, i.e. tax-GDP ratio, (b) composition of tax revenue, and (c) use of tax incentives. Tax policy is an important determinant of the investment climate in a country. Rates of direct taxes determine the incentives to work, save and invest, while the level and structure of indirect taxes influence the aggregate demand and thus the scale of operations on the one hand and relative prices of different goods and services on the other.

The base of a tax is the legal description of the object which is taxed. Tax bases, or what Richard Musgrave calls *tax handles*, are numerous but the common ones are listed in Table 1. Broadening the tax base means application of a tax to a larger portion of the object already being taxed. Erosion of the tax base means narrowing of the tax base through special exemptions and concessions. A good tax base is one which can easily be measured and monitored. Thus, a realised capital gain is a good base for taxation as compared to an accrued capital gain.

It is the availability of tax bases that determines the nature of tax system in a country. Furthermore, it is the nature of the tax base that determines the final resting place of the burden of a tax. To quote Richard Musgrave, "Apart from the level and

distribution of income, the availability of 'tax handles' is related to the economic structure of the country. Thus, the administration of an income tax is much more difficult where employment is in small establishments. Profits taxation is not feasible until accounting practices attain minimal standards, and it is difficult if firms are small and unstable. Product taxes cannot be imposed at the retail level if retail establishments are small and impermanent. Effective land taxation is difficult where food is home-consumed, the agricultural sector is largely non-monetised, and land surveys are inadequate in providing proper valuations. On the other hand, taxation is simplified in a highly open economy where imports and exports pass through major ports and thus can be readily established by tax authorities." (Musgrave and Musgrave, 1989, p. 595)

**Table 1: Common Bases for Taxation**

| <b>Tax/duty</b>       | <b>Base</b>  |
|-----------------------|--|
| Excise duty           | Value (in case of ad valorem duty)/quantity (in case of specific duty).            |
| Sales tax             | Sales of business.   |
| Customs duty          | Crossing of goods over national frontiers.   |
| Inter-state sales tax | Crossing of goods over boundaries of states within a country.                      |
| Octroi/terminal taxes | Crossing of goods over boundaries of local areas within a state.                   |
| Income tax            | Income earned by corporate and non-corporate assesseees during an accounting year. |
| Gift tax              | Value of gifts made by an assessee during an accounting year.                      |

A closed economy will have no customs revenue and an agricultural economy with small business establishments cannot operate corporation tax. The relative importance of various tax bases differs in different countries and it may change in a country over a period of time. In this context, Harley Hinrichs in his book *General Theory of Tax Structure Change during Economic Development* has mentioned the following five stages through which tax structure has changed historically as economies have developed (Hinrichs, 1966).

- **First stage:** A traditional society relies primarily on traditional direct taxes like taxes on land, livestock, water rights etc.
- **Second stage:** Society breaks away from old ways and indirect taxes become more important, especially external indirect taxes (i.e. taxes on foreign trade).
- **Third stage:** Traditional direct taxes decline relative to national income and governmental revenues.

- **Fourth stage:** Domestic commodity production increases and internal indirect taxes (excise duties and sales taxes) grow rapidly to replace customs duties.
- **Fifth stage:** Economy gains maturity and modern direct taxes like personal income and corporate profit taxes become dominant.

### 1.2 Determinants of tax yield

Amount of money collected from a tax or a tax system is called tax yield. If the cost of collecting a tax is deducted from the gross tax yield, the resultant amount is net tax yield. Tax yield is determined by coverage of the tax, exemptions/concessions, rate structure, tax compliance, penal provisions, and administrative efficiency. There can be other factors also, specific to particular taxes. For example, the yield from excise duties also depends upon industrial progress and the general health of the economy. Similarly, revenue from customs duties is affected by factors like import policy, availability of foreign exchange, and international trade climate.

### 1.3 Objectives of tax policy

Tax policy has a number of functions to perform and objectives to satisfy. Apart from its traditional functions (defence, and maintenance of law and order), a modern government undertakes welfare and developmental activities and makes provision for public goods to satisfy collective needs of the people. It has also to pay for its own administration. It needs financial resources for these purposes and taxation is one method of transferring money from private to public hands. Taxation is necessary because what the government gives it must first take away.

Taxation is a potent instrument to shape and influence the socio-economic policies of a country. It is, of course, difficult to formulate a set of universally acceptable goals of tax policy because (a) different countries are in different stages of economic development, (b) objectives of economic policy differ in these countries, (c) priorities of economic policy are different, and (d) objectives and priorities of economic policy continually change with the changing economic, social, and political milieu.

Though the concept of an ideal tax system for a country is linked with the peculiar characteristics of its economy yet tax policy is usually assigned the following four functions in the stated order in a typical developing economy: resource mobilisation, resource allocation, distributive justice, and stabilisation.

- a) **Resource mobilisation:** There are several ways through which resources can be acquired for public use. A government may resort to the following alternatives or a judicious mix of all of them.
  - Through deficit financing<sup>1</sup>, it can purchase a part of goods and services available in

the economy. Since such a policy usually leads to price rise, it is called *inflation tax* the effects of which are very disorderly in the sense that burden of inflation falls inequitably on different classes.

- A government can raise resources by charging for the goods and services it provides. This is possible where it operates like a commercial enterprise but not in the case of many other services like defence, and law and order.
- A government may raise loans internally as well as externally. However, public borrowings involve problems of debt management, debt servicing and increase in government's liabilities besides burdening future generations.
- A government can, and usually does, impose taxes to finance public expenditure.

The first and foremost objective of tax policy in a country is to raise resources for public authorities for administration and development. Taxes are the main instrument for transferring resources from private to public use. By designing an appropriate tax structure, resources can be raised from those who are holding them idly or squandering them on luxury consumption. According to Gobin (1980) pp. 272-73, "the revenue criterion is usually the dominant consideration, since governments in LDCs have become increasingly aware of the active role which budgetary measures can play not only in initiating and promoting growth but also in maintaining political power. Not only are higher revenue levels needed, but also tax yields should be increased at a faster rate than income, if infrastructural investments and social welfare expenditures are to be financed without generating unacceptable inflationary pressures and/or increasing reliance on foreign assistance."

The revenue performance, i.e. resource mobilisation function of a tax system may be judged in terms of the responsiveness of tax yield to changes in macroeconomic aggregates like national income. Two widely-accepted measures of revenue performance are buoyancy and elasticity of tax revenue.

- b) **Resource allocation:** Scarcity of real resources in developing countries calls for their optimum utilisation. Since the composition of investment is an important determinant of growth rate of the economy, public policy must discourage the flow of resources to *low priority* areas so that they could be diverted to *vital* sectors of the economy. By imposing high tax rates on luxuries and other low priority items (such as motor cars, air conditioners, and jewellery), the government can discourage the consumption and production of such items, ensuring in the process release of resources for high priority sectors. Conversely, production of necessities of life and employment-oriented industries can be encouraged by offering tax concessions or even subsidies.

- c) **Distributive justice:** Distributive justice or economic justice is an important function of tax policy. Economic justice relates largely to distribution of tax burden and benefits of public expenditure. It is a component of the broader concept of social justice which encompasses, besides distributive justice, such questions as treatment of women and children, and racial and religious tolerance in a society. Tax policy is a democratic method to influence the distribution of income and wealth on desired lines. The main ingredients of this policy can be (a) progressive direct taxation of income, wealth, and property transactions, (b) taxation of commodities (customs duty, excise levy, and sales tax) purchased largely by high-income groups, and (c) subsidies (negative taxation) on goods purchased by low-income groups.
- d) **Stabilisation:** Initial developmental efforts are generally marked by inflationary tendencies in an economy. Inflation, if uncontrolled, may thwart all development plans and bring misery to the poor. A reasonable degree of price stability should be a primary concern of a government's economic policies.

The overall level of economic activity in an economy depends upon aggregate demand, relative to capacity output. At times, the level of aggregate demand may be insufficient to secure full employment of labour and other factors of production. At other times, aggregate demand may exceed available output at full employment level. Government intervention in both the cases becomes essential to correct such disequilibria in the economy. Monetary and fiscal policies are important instruments available to the government to ensure smooth functioning of the economy. Reduction in taxes during deflation would leave greater disposable incomes with the people, giving a boost to aggregate demand. The reverse is true in times of inflation.

The evaluation of a tax system with reference to the foregoing objectives is a difficult task because various other policies (like public expenditure policy) may be geared to achieve the same objectives. To what extent the redistributive objective has been served and what was the relative role of tax policy in it, is a difficult question to answer. Moreover, the various objectives of tax policy may not always work harmoniously. Rather, they are often in conflict with each other if not mutually exclusive. Since the tax system of a country grows out of the interaction between political judgement and economic rationale, the process of compromises and trade-offs is influenced by political expediency and economic logic, the former, in most cases, having the upper hand. In fact, political requirements and economic thinking change with time, giving new directions to tax policy. As Bird (1970, p. 23) has observed, "Tax reform is, therefore, a never-ending process, not something that can be brought about once and for all and then forgotten."

## **2.0 Direct versus indirect taxes**

The distinction between direct and indirect taxes is nebulous. The definitions of these two types of taxes have been a subject of long-drawn debate in public finance literature. A direct tax is one the ultimate burden of which falls on the person on whom it is levied. In other words, it is a tax that cannot be shifted from the original payer to someone else. It is contrasted with indirect tax which can readily be shifted to ultimate consumers of the commodity or service taxed. John Stuart Mill, the celebrated British economist of the 19th century, distinguished between direct and indirect taxes as follows. "A direct tax is one which is demanded from the very person who, it is intended or desired, should pay it. Indirect taxes are those which are demanded from one person in the expectation and intention that he shall indemnify himself at the expense of another." (Collected Works of John Stuart Mill, 1965, p. 825)

Income tax, property tax, and payroll tax are generally considered direct taxes, although many economists believe that it is possible to pass on these taxes under certain circumstances. Corporate income tax, a supposedly direct tax, is known to be shifted to consumers in many countries<sup>2</sup>. Direct taxes, though administratively inconvenient, are preferred because they (a) can be related to ability-to-pay, (b) satisfy the principle of certainty, and (c) create civic consciousness. An indirect tax is one which can be shifted from the original payer to the ultimate consumer of the commodity or service taxed. Import duties, excise levies, and sales taxes are generally regarded as indirect taxes. Thus, an excise duty on cigarettes levied on producers is usually passed on to the consumers in the form of higher prices.

Indirect taxes (also called hidden taxes) are convenient to collect but lack equity attribute. They do not allow considerations for the personal circumstances of taxpayers as do direct taxes. It is not possible to grant exemptions or allow deductions or to have a progressive rate schedule. Indirect taxes are borne in relation to the consumption expenditure which constitutes a higher percentage of income for lower income groups than for persons in higher income brackets. It is true that incidence of indirect taxes depends on (a) the selection of commodities for taxation and (b) the rate of tax on them. It is desirable that luxuries and comforts are chosen for heavy taxation with necessities of life either exempted or moderately taxed. However, in poor countries the demand for luxury items is limited apart from being price elastic. Conversely, the demand for necessities is vast and price inelastic, obliging tax authorities to extend the tax net to daily needs. This has a tendency to fuel inflation.

In short, it is almost universally accepted that indirect taxes are inferior to direct taxes in terms of equity attribute. The distribution of indirect tax burden is often, though

not always, regressive and even the poorest of the poor are made to contribute to public exchequer. The chief advantage of indirect taxes is that they are convenient to collect.

The demarcation between direct and indirect taxes is ambiguous because of conflicting empirical evidence of tax incidence studies. Direct taxes can be shifted under certain circumstances while taxes on commodities may stick on the producers finally<sup>3</sup>.

### **2.1 Specific versus *ad valorem* taxes**

This classification is relevant in the case of taxes/duties on commodities (customs, excise duties and sales taxes). A specific or volumetric duty represents a fixed amount of tax on a unit of the physical quantity of the product. Customs duties, excise levies, and sales taxes on commodities may take specific or *ad valorem* form. Specific duty is generally preferred for commodities the classifications and sub-classifications of which are not numerous, i.e. the commodity is a standardised one, e.g. sugar. A specific duty is easy to apply besides having the political and psychological advantages of obscuring the actual ratio of the tax to the selling price. It is, however, price-neutral in the sense that price changes, if any, in the commodity do not affect the revenue yield. Specific duty is quality-neutral also unless differential rates are prescribed with reference to the quality of the product.

There can be many variants of the specific form of duty. If a flat amount per unit of a commodity is levied irrespective of the price range, it is a simple specific duty. It may be simple specific with initial exemption. However, if the flat amount per unit changes with the price range of the commodity, it becomes a graduated specific duty. A custom duty, an excise levy, or a sales tax may be imposed either on *ad valorem* (according to value) basis or on specific basis. An *ad valorem* duty is imposed as a fixed percentage of the price of the product taxed. This form of duty is preferred when a commodity has many classifications and sub-classifications, e.g. textiles. An *ad valorem* duty is responsive to price changes and thus ensures an undiminished proportion of taxes in national income. The main problem in applying *ad valorem* rate is the determination of the tax base, i.e. valuation of production.

An *ad valorem* duty may be a simple one, a duty collected as a fixed proportion of the price irrespective of the price range. As a variant of this, the commodity in question may be completely exempted till the price reaches a pre-determined maximum level. When different duty rates apply to different price brackets of a commodity, it becomes a graduated or bracketed *ad valorem* duty. So long as the price remains within a single bracket, the rate of the duty remains the same. Generally, commodities in higher price brackets bear a higher duty rate and vice versa.

Sometimes, both specific and *ad valorem* duties are levied on a single item. This



pattern is called specific-cum ad valorem duty or compound duty.

### 3.0 Canons of Taxation

Given the level of taxation in a country, fiscal experts can design a tax system which best promotes the objectives of economic policy with due regard to social justice. Principles (or maxims) of taxation lay down general guidelines for designing or evaluating a tax or a tax system. How should taxes be imposed? Adam Smith, the famous eighteenth century British economist, was the first to set forth such maxims for this purpose in his book *Wealth of Nations* published in 1776 (Chapter 2, Part 2). The four normative requirements of a good tax system laid down by him, irrespective of the circumstances of different countries are as follows.

a) **Equity:** According to Adam Smith, “The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities, i.e. in proportion to the revenue which they respectively enjoy under the protection of the state.” Thus, equity consideration is of overriding importance for any tax system and for any particular tax. Equity level determines how the tax burden is distributed among the taxpayers.

Though highly desirable, the concept of tax equity is nebulous and value-laden, defying measurement. It is identified with such general notions as fairness, justice, and impartiality which in turn again defy quantitative measurement. There are two approaches to tax equity in the literature:

- Benefit principle of taxation.
- Ability-to-pay principle of taxation.

It is noteworthy that these two principles which are understood distinctly by modern economists were mixed up by Adam Smith in his above quoted passage.

b) **Certainty:** This Smithian dictum relates to the time, manner, and the amount of tax payment. Adam Smith observed, “the tax which each individual is bound to pay ought to be certain, and not arbitrary.” Uncertainty may subject taxpayers to the arbitrary decisions of the authorities, demoralise the honest taxpayers, and breed social evils like bribery. Certainty about tax liability helps a taxpayer to effect necessary co-ordination between his income and expenditure with a view to discharge his tax obligation with planning. The canon of certainty requires that tax laws are well-defined and do not contain provisions which the government cannot, or will not, enforce effectively. Frequent changes in tax laws should also be avoided.

c) **Convenience:** The canon of convenience relates to the procedure adopted for collecting taxes. According to Adam Smith, “Every tax ought to be levied at the time, or in the manner, it is most likely to be convenient for the contributor to pay it.” For

instance, land revenue should be collected at the time of harvest and in the village itself. Similarly, provisions should exist in tax laws for postponement or remittance of the levy in case of poor harvest. Following the principle of convenience, many municipalities allow payment of property tax in instalments. Deduction of income tax at source and payment of taxes through banks are other examples of convenient compliance for the benefit of taxpayers. Deduction at source increases the speed of cash flows into public treasury and also reduces the possibility of tax evasion. The principle of convenience is further promoted if tax laws are simple and comprehensible by ordinary taxpayers.

d) **Economy:** Every tax involves some revenue yield and a corresponding cost of collection. The main items comprising the latter are wages of the officials and costs of materials. Adam Smith noted, “every tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible over and above what it brings into the public treasury of the state.” Cost of collection when expressed as a proportion of tax revenue is called cost-yield ratio. It is indicative of the overall efficiency of tax administration. Thus, the lower the cost of collection, the more productive is the tax and vice versa.

Unusually high cost-yield ratios prove drag on public exchequer. Cost-yield ratios may be used to evaluate administration of competing taxes. Administrative costs are generally high in developing economies which are in the process of evolving tax system and tax administration. Widespread illiteracy and lack of accounting practices make assessment procedures extremely difficult in these countries.

In addition to the above four canons of taxation given by Adam Smith, there are other canons that have also been propounded in literature.

e) **Neutrality:** Relative prices determined by competitive market forces tend to ensure the most efficient allocation of resources in an economy. Taxes cause distortions in relative prices and therefore reduce productive efficiency. According to the neutrality rule, taxes should not interfere with consumers’ choices and if they do, it would entail a sub-optimal allocation of resources.

However, arguments in favour of neutrality are abstract and based on rather unrealistic assumptions, e.g. perfectly competitive markets. To quote, “While the elimination of undue tax-induced distortions should be a major concern of tax policy, it is utopic to imagine a tax system which does not exert some distortionary effects. Only a lump-sum tax, i.e., a levy absolutely equal for all taxpayers, would be perfectly neutral, but such a tax obviously cannot be the mainstay of a tax system.... Furthermore, the assumption that the unimpeded functioning of markets always results in an optimal allocation of resources does not quite conform to reality.”(Sylvain, 1988, p.23)

It is difficult to devise a fiscal system which exerts no influence on the economic

behaviour of consumers and producers. The spirit of neutrality principle requires least interference by taxes in the working of a competitive market. For example, a sales tax on the generality of goods will cause lesser distortion than excise duty on a few specified commodities. Similarly, granting tax concessions to encourage enterprise in areas where producers would not otherwise go, runs counter to the principle of neutrality. This reasoning is valid if only private costs and private benefits are taken into account. However, when the term efficient use of resources is discussed in the broader context of social costs and social benefits, the picture may be different.

f) **Buoyancy and elasticity:** Another requirement of a good tax system is the relatively high degree of responsiveness of tax yield to changes in national income. High degree of responsiveness of tax yield to changes in national income is a desirable characteristic of any tax system. If a government depends on tax revenue to finance a large part of its expenditure then it is necessary to ensure that an increasing proportion of national income flows into the public treasury as taxes. In other words, the requirement is to increase the incremental tax ratio. Computation of tax buoyancy and elasticity becomes relevant in this context.

The foregoing requirements of a good tax system are desirable when examined individually. However, serious problems arise when a mix of these principles is evaluated. Quite often these desirable elements are in conflict with each other and pose serious difficulties in formulating tax policy. For example, simplicity in tax laws may leave too much unexplained, giving ample discretion to tax officials. The simplicity argument may also run counter to the principle of equity if tax laws fail to take account of the varying circumstances of taxpayers. Similarly, there is an inherent conflict between canons of economy and equity. Equity demands, *inter alia*, the right to appeal but the provision for appellate tribunals increases the cost of tax administration.

In view of the inconsistency among several goals, it is difficult to achieve all of them simultaneously. Therefore, society has to trade-off some goals for others. Which objective should be pursued at the expense of which other and to what degree is a question difficult to answer. The solution must be sought with reference to a country's currently accepted goals of social and economic policies and the government's concern for them. It is also possible that principles of taxation are overlooked not because of conflict between them, but because of overriding political considerations. The virtual exemption of agricultural incomes from income tax in India, a clear violation of the principle of horizontal equity, is a case in point.

### 3.1 Operating costs of a tax

These are made up of administrative costs plus compliance costs of a tax.

a) **Administrative costs:** These are costs incurred by public authorities in administering a tax.

These costs (also called expense ratio) include wages of tax officials and expenditures on stores and supplies for running tax administration. They are interpreted in terms of cost-yield ratio which means cost of collection expressed as a proportion of tax revenue. A lower cost-yield ratio is considered indicative of the efficiency of tax administration. Unusually high cost-yield ratio is a drag on the public exchequer. Thus, cost-yield ratios may be used to evaluate administration of competing taxes.

The concept of cost-yield ratio suffers from various limitations and therefore needs to be used carefully as an index of tax efficiency. The ratio depends upon the nature of a tax. Generally, cost of collecting direct taxes is high as compared to indirect taxes. The ratio is also affected by the nature of tax administration. If separate administration is used for each tax, the scope for scale economies is greatly reduced. Conversely, if a single administration deals with a variety of taxes of similar nature (e.g. all direct taxes), cost-yield ratio may fall due to scale economies.

Cost-yield ratio is also influenced by the nature of an economy. The ratio is generally high in developing countries which are in the process of evolving their tax systems. Widespread illiteracy and lack of accounting practices make assessment procedures extremely difficult in these countries.

Equity considerations may demand a tax system which is poor in terms of cost-effectiveness. Thus, there may be a conflict between cost-effectiveness and equity. Pointing out another limitation, G.K. Shaw has observed, "The cost-yield ratio provides a purely static insight into the efficiency of a given tax which may be misleading in terms of the potential dynamic evolution of the tax. Thus, for example, a tax in its infancy may have high costs associated with the establishment of the appropriate administration and collection machinery and yet its future prognosis may be favourable if it is progressively based or confronts income elastic demand conditions." (Shaw, 1981, p. 153)

It is noteworthy that reduction in cost of collection which leads to ineffective enforcement and hence tax evasion, is false economy. Similarly, employment of incompetent and/or inadequate staff can result in harassment of taxpayers and multiplying appeals and hence increased cost of compliance. Properly understood, the principle of economy requires lowest possible costs consistent with effective administration and existing level of facilities to taxpayers. While interpreting cost-yield ratio, account should also be taken of compliance costs which may differ from tax to tax.

**b) Compliance costs:** Compliance costs refer to costs incurred by taxpayers or third parties in complying with a tax, over and above the tax payment made to public authorities. The third party compliance costs are those incurred by firms in discharging their legal responsibility as tax collectors, e.g. deducting income tax from salaries and

passing it on to the tax authorities.

The following three types of compliance costs may be distinguished:

- Money Costs: These include payment for legal advice, fees to accountants or to valuers for valuation of property (for purposes of death duties, wealth tax etc.), cost of postage, telephone calls, travelling, books, and in some cases litigation.
- Time Costs: These include time taken to consult tax advisers, complete tax returns, and to travel to tax offices.
- Psychic Costs: These refer to the worries and anxieties associated with tax payment.

#### 4.0 Indirect Tax Structure prior to introduction of GST

##### 4.1 Excise duties

Excise duties are imposed by a government on commodities produced or manufactured domestically. They are also known as production taxes. They are collected from the producers of excisable goods. The Indian Fiscal Commission, 1921-22, enunciated the following five *golden rules of excise taxation*, which with necessary modifications, seem to be relevant to this day.

- 1) Excise duties should ordinarily be confined to industries which are concentrated in large factories or small areas.
- 2) They may properly be imposed for the purpose of checking the consumption of injurious articles and especially on luxuries coming under this category.
- 3) Otherwise they should be imposed for revenue purpose only.
- 4) While permissible on commodities of general consumption, they should not press too heavily on poorer classes.
- 5) When an industry requires protection, any further necessary taxation on its products may, if the other conditions are fulfilled, take the form of excise duty *plus* an additional import duty. The latter should fully countervail the former and may be pitched at a higher price<sup>4</sup>.

There are various procedures to assess and collect excise duties which are as follows:

- a) **Physical control system:** This procedure, based on personal verification of production by excise officers, is the chief procedure to realise excise duties. Under the physical control method, excise control is exercised by the officers of the excise department who are posted at the factory to keep watch over the operations in the various departments of the factory to prevent illegal disposal of the manufactured articles. The physical control procedure is based on personal verification of production, storage, and clearance of excisable goods.

b) ***Self-Removal Procedure (SRP)***: Under this liberal system, an assessee is allowed to take clearances on his own assessment of the duty liability without prior permission of physical checks by excise officers. An assessee is, however, required to get his classification list approved by the excise authorities before effecting any removal. In the classification list the assessee details the description of the goods produced so that they may be categorised in terms of the rate of duty applicable to them. In case of *ad valorem* duties, the assessee is further required to submit a price list showing the prices charged along with discounts and deductions, if any. In essence, the SRP is a record-based system of duty collection relying on mutual trust and belief. Unfortunately, evasion of excise duty can take place under this scheme. Excise evasion under this liberal scheme is generally resorted to by following such malpractices as incorrect accounting of goods, undervaluation of goods, and flouting the conditions subject to which any goods may be exempted from duty.

c) ***Compounded levy scheme***: This is another procedure for the benefit of small-scale sector and for administrative convenience. Levying of excise duties on small-scale sector has always remained a major problem of the excise system. In many cases, small-scale sector accounts for a significant portion of the output of an industry and it becomes necessary to subject it to excise taxation. However, the procedures adopted for collection of excise from big firms have often been found expensive and time-consuming when applied to small firms. This has necessitated the adoption of special procedures suitable for small-scale sector.

Under the compounded levy scheme, a lump sum payment is made on the basis of some installations, e.g. the number of looms in case of textile units. Once the compounded levy has been paid, the producer becomes free from all excise formalities except to maintain a record of looms in operation. This system affords considerable advantages to the small producers insofar as they are saved from the cumbersome normal excise procedures and also by the fact that the fiscal burden under compounded levy is generally lower than the burden under normal procedures.

***Statutory versus effective rates***: Rates of excise duty approved by a government are termed as statutory or tariff rates. However, the government enjoys the power to exempt, by notification, any excisable goods from the whole or any part of duty leviable on such goods. In exercise of this power, the government determines and notifies from time to time the effective rates of duty. The rationale for granting such powers to the executive is that during the period intervening two consecutive budgets, necessary adjustments might be made to regulate exports, consumption, and prices of different commodities. However, the delegation of this power to the executive leads to frequent changes in excise rates, creating an unsettling atmosphere for trade and industry and problems for

the administration.

Excises on inputs: One major problem of the excise system is the taxation of inputs (raw materials, components, and other intermediates) and the resulting cascading effect on the prices of final products. The disadvantages of input excises are well-known. Excises on inputs enhance costs and profits and therefore increase the prices of goods much more than the amount of excise collected. The cost of production increases because producers and middlemen require larger amounts of working capital to maintain the necessary stocks of inputs. Prices of finished products tend to reflect taxes imposed on inputs used. If the middlemen apply fixed percentage mark ups to purchase prices as their profit and if the purchase prices include taxes, the mark ups will be applicable to the tax component of the purchase price as well. In other words, increase in the price of the manufactures is in excess of the excise revenue accruing from input taxes.

Still further, excises on inputs may promote vertical integration in an industry, a trend which is harmful to the growth of small-scale sector. Lastly, input excises impose an inequitable burden on different economic classes by not discriminating between essential and non-essential uses of a product. For example, an excise on aluminium hits indiscriminately the use of the product for decoration purpose as well as for making utensils (generally used by the poor).

Notwithstanding the various disadvantages of input excises, governments in many countries impose duties on inputs due to administrative convenience. Many items of inputs are the end-product of one manufacturer but merely a component for another (e.g. tyres and tubes) and are also used as replacement items. Exemption of such items will be discrimination in favour of replacement consumption and certain commodities (say motor cars) may be sold with avoidable components and accessories stripped off. Moreover, provisions can be made in tax laws to minimise the cascading effects of input excises.

Exemptions and Concessions: Exemptions and concessions are an integral part of the excise system. Excise preferences and reliefs are given to promote a wide spectrum of socio-economic objectives. If used judiciously, such tax preferences can become an effective tool of economic change on desired lines. The rationale for providing excise preferences is as follows:

- Exemptions and concessions are necessary to ensure progressivity in the structure of commodity taxation.
- Excise preferences are justified to induce entrepreneurs to undertake activities which they would otherwise shirk, e.g. adopting labour-intensive techniques of production. Concessions are designed to promote enterprises deemed *vital* by society though it is controversial as to which activities are *vital* and require governmental support.
- Exemptions/concessions provide the desired flexibility to the tax system to deal with

changing market situation. They are used as a corrective mechanism to stabilise demand, production, and profits of different industries. Due to continuous diversification of the economy and inflation, markets for various commodities have not remained stable in India after Independence. Because of the changing market conditions, the levels of profit in different industries have also been fluctuating and on balance have shown a rising trend. Excise rates, it may be argued, should be modified upward to mop up excess profits and downward to boost sluggish demand for idle-capacity industries.

- Exemptions may be granted on administrative considerations. For example, exemption of smaller of the small industries is also due to administrative problems. Agricultural products are also exempt owing to the same reason.

The desirability of excise preferences is to be viewed against problems created by them, which are as follows:

- Excise concessions narrow the tax base and therefore shrink governmental revenues.
- Excise concessions interfere with the designing of the excise system and lead to complexities in the excise law which in turn may lead to tax evasion and litigation.
- They also obscure the evaluation of excise system, particularly from equity angle.
- Excise concession to a particular industry may lead to a chain reaction, i.e. similar demands by other industries, causing unsettling effects on producers, consumers, and the administration. Exemptions/concessions are often the result of persistent representations and pressure tactics by industry and trade than any economic justification.
- It is not always possible to segregate the effects of duty reduction on production, costs, prices, and consumption because duty concessions operate in conjunction with other non-tax policy measures to affect the production process.

#### **4.2 Service tax**

Service sector is very wide in its range. It includes, *inter alia*, health care, education, social security, leasing, entertainment, credit rating agencies, telecommunications, transport, publicity and advertising, insurance, banking, legal and financial services. From equity point of view, services should be taxed in the same way as goods. Taxation of goods and exclusion of services distorts the relative prices of goods vis-à-vis services, encouraging artificially the demand for services. In the process, the allocation of resources is also distorted. If tax is imposed on goods and not on services, a relatively high rate of tax would be required on goods to generate a given amount of revenue. If tax is imposed both on goods and services, a moderate tax rate can



yield the given revenue. Administratively, taxation of both goods and services is desirable because it would reduce disputes pertaining to distinction between goods and services.

Like goods, services can also be classified into two broad categories: essential services (e.g. health and education) and luxury services (e.g. entertainment and tourism). The rationale for exemption/lenient tax treatment of essential services is the same as for essential goods. Similarly, luxury services should be taxed at a high rate like luxury goods.

### 4.3 Customs duties

These are duties on the import and export of goods levied by a national government and payable to it when the goods cross the customs boundaries of the nation. Hence, they are also called border taxes. The term *customs duty* as an English expression originated in England during a period of disagreement between the king and the parliament over the king's right to collect it. King's supporters claimed that the sovereign had been vested with the authority to impose this levy by a long established custom. Hence, it is suggested that the term customs duty was derived. The right was claimed on the ground that customs duties were a reasonable return to the king for the protection and security he was supposed to provide on land and sea.

Customs duties are probably the most ancient form of taxation. They are as old as international trade itself. Just as domestic production flows provide the base for excise taxation so also international trade flows are the basis for customs duties. These duties are levied either on *ad valorem* basis (i.e. as a percentage of the value of goods imported or exported) or on specific basis (i.e. as a stated amount per unit of weight, volume etc.). Customs duties can be classified into two categories: import duties, and export duties.

Customs duties are of the following types:

a) **Import duties:** Goods imported into a country are chargeable to a duty. The duty may be a percentage of the value of the goods (i.e. *ad valorem* rate) or at a specific rate. Import duties are usually levied with *ad valorem* rates and their base is determined by the domestic value of the imported goods calculated at the official exchange rate.

Apart from the revenue function, import duties provide a protective barrier for domestic industries. There are two main purposes of import duties: (a) to raise revenue for the government (revenue tariff) and (b) to discourage imports in order to protect a nation's domestic industry (protective tariff) or to correct disequilibrium (deficit) in its balance of payments. Other measures to protect indigenous industries from foreign competition are import licensing, import quotas, and outright import ban.

b) **Countervailing duties:** These are duties in addition to the normal import duties levied

on goods imported into a country. The rate of countervailing duty is generally equal to the excise duty imposed on like items produced domestically. The argument is that normal import duty represents the desirable degree of protection to internally produced goods which are not subject to excise duty. When excise duty is levied or the rate of an existing one is increased, a corresponding enhancement in import duty is required to preserve the accepted degree of protection.

c) **Export duties:** Export duties are imposed on export values expressed in domestic currency. Export duties can become an important source of revenue when a country enjoys monopoly or near-monopoly in certain products in the international market. Thus, when there is considerable disparity between the domestic and international prices of certain goods, levy of export duties is justified to mop up a part of the profits of exporters. Export duty on an item is levied after considering such factors as domestic production, likely exportable surpluses, demand for the item in the foreign markets, changes in exchange rates, and prices prevailing in the international market.

d) **Cesses on exports:** Certain cesses are leviable on specified articles of export. These cesses are collected as duties of customs and handed over to the agencies in-charge of the administration of the commodity concerned. For example, in India cesses are imposed on exports of coffee, coir, lac, mica, tobacco (unmanufactured), oil cakes and meal, marine products, cashew kernels, black pepper, cardamom, iron ore, animal feed and turmeric.

#### **4.4 Sales tax**

Sales tax is normally an *ad valorem* levy imposed on the seller with reference to the transaction of sale. On the basis of the stage of collection, sales tax is classified into (a) multi-point sales tax, and (b) single-point sales tax. As a *multi-point levy*, sales tax may be applied at two or more stages of production and distribution and becomes akin to a turnover tax applicable at each transaction of purchase and sale. Multi-stage sales tax is politically expedient. A given amount of revenue can be raised at a lower rate of taxation which also reduces the temptation for tax evasion. The chief demerit of multi-point sales tax is its encouragement to vertical integration of production and distribution processes. Producers of finished products prefer to produce their own materials and components, and this tendency harms the interest of independent suppliers, particularly small ones. Furthermore, multi-point sales tax discriminates against those goods, and their consumers, which have to pass through numerous transactions. In view of these disadvantages, John Due has opined, "On administrative as well as economic and equity grounds the objections to the multi-stage form are so great as to suggest its complete rejection, regardless of circumstances." (Due, 1959)

A *single-point sales tax* applies to one stage, either at the manufacturing, or the wholesale, or the retail level. At the manufacturing level, sales tax applies to the sale by manufacturer of finished product and is similar to excise duty. At the wholesale level, the tax applies to the last wholesale transaction, i.e. purchase by retailer. The retail sales tax applies to the final sale which means sale to the consumer. The main advantage of single-point sales tax is that it does not discriminate against non-integrated firms as does multi-point sales tax. It, thus, discourages vertical integration and promotes horizontal integration. As regards the stage of its imposition, the retail stage is considered the most satisfactory due to the following reasons.

- Sales tax at the retail stage is collected when final sale to the consumer takes place. Thus, it avoids what economists call the cascading or pyramiding effect of a tax. The contention is that middlemen apply fixed percentage mark ups to purchase prices and if the purchase price include taxes (as is the case if sales tax is imposed at manufacturer's, or wholesaler's level), the mark ups will be applicable to the tax component of the purchase prices as well, a situation which must be avoided in the interest of the consumers.
- A given revenue can be realised by applying a lower tax rate at the retail stage as compared to other stages because the margins of all middlemen are included at the final stage of sale, meaning thereby the enlargement of the tax base at the retail stage.
- The desired change in the ratio of tax to consumer expenditure can be achieved more effectively in case of retail-stage sales tax. This will be difficult at 'other stages' because the margins of dealers on various goods, besides being applied to the tax component of the purchase prices, may differ significantly.
- Sales tax at the retail stage can be shown separately from the price and thus made known to the purchaser, increasing tax consciousness among the taxpayers.
- Expected changes in the rates of retail sales tax do not lead to changes in inventory position of the firms. Anticipated changes in the rates of sales tax at 'other stages' may influence inventory decisions of the firms causing dislocation in trade circles.

However, retail-stage sales tax has its own problems, the chief being the large number of taxpayers in the form of small shopkeepers and scattered retail outlets. In developing countries, the problem of tax administration is more acute in view of widespread illiteracy, lack of monetisation, and poor accounting practices. From administrative viewpoint, this form of taxation is costlier and cumbersome, offering ample scope for tax evasion and corruption.

Sales tax at manufacturing or wholesale stage is administratively preferable because the number of taxpayers is small and readily identifiable. However, the problem

of 'cascading' will reappear. In fact, the farther we move from the retail level, the more serious the problem of 'cascading' becomes. In short, the problem boils down to a trade-off between economic rationale and administrative efficiency. The relative weightage to competing objectives depends on political judgement and the economic circumstances under which the sales tax system has to operate.

#### **4.5 Value Added Tax (VAT)**

Value-Added Tax (VAT), a fiscal innovation of early 1950s, has claimed worldwide attention as more and more countries are adopting it in varying degrees to reform their systems of commodity taxation. The origin of value added tax (VAT) can be traced as far back as the writings of Von Siemens, who proposed it in 1918 as a substitute for the then newly established German turnover tax. VAT was first introduced in France in 1954. With the imposition of *Taxe sur la Valeur Ajoutée*, France became the first European country to implement VAT on an extensive scale. Initially it was not a complete system of VAT, since it applied only to transactions entered into by manufacturers and wholesalers. Later on, it was supplemented by a separate tax on services (*taxe sur les prestations de services*). In addition, there were special excises (*taxes uniques*) which were levied on services and distribution in lieu of (*taxe sur les prestations de services*).

Development of VAT in other countries has been gradual. Until the sixties it was not adopted by many countries, over the years the tax has come to occupy an important place in the fiscal armoury of nearly all industrialised countries and in a large number of Latin American, Asian and African countries. As many as 50 countries have switched over to VAT during last decade. This has brought the total number of countries who have adopted VAT as their major form of consumption tax to more than 115. Thus, the augmentation of interest in VAT has been the most remarkable event in the evolution of commodity taxes in the present century.

Pursuant to the Treaty of Rome (March 25, 1957), the European Economic Community (EEC) was set up with the primary objective 'to establish, within the framework of an economic union, a common market providing for healthy competition and having characteristics similar to those of an internal market.' From July 1, 1968, all customs duties and quotas in the trade between EEC member countries were abolished to move towards a common market with equality of competition as a condition. Following the principle of destination, exports to member countries became entirely tax-free, and imports from countries within the community began to be treated in the same way as domestic production destined for home consumption.

To follow the above policy, two arrangements had to be made. First, although tax

on export of goods as such was abolished, the possibility of taxation of these goods during various stages of their production and distribution still existed. The rules of the new arrangement demanded calculation and refund of tax burden on goods as and when they were classified as exports. Second, imports into the country, which had escaped taxation by claiming refund in the exporting country, needed to be taxed in a way which avoided discrimination between them and domestically produced goods which had already faced taxation at different stages. Therefore, it was necessary to replace with a common system the differing systems of indirect taxes which had distorted competitive conditions between the member states.

With the above purpose in view, the Commission of the EEC had set up a Committee under the chairmanship of Professor Fritz Neumark which submitted its findings entitled *Report of the Fiscal and Financial Committee of EEC* in 1962. The Neumark Report visualised ultimate acceptance by all EEC countries of all-stage value added tax similar in terms of tax rates, exemptions etc.

Agreeing with the recommendations of the Neumark Report, the Council of Ministers of the six original EEC countries issued two directives dated April 11, 1967 which required the common market states to abolish the existing gross turnover tax systems and to introduce a comprehensive system of value added taxation by January 1, 1970. Value added tax, an offshoot of economic union, therefore emerged as an instrument of tax harmonisation in the EEC countries. It was a fiscal necessity in the absence of which the success of common market experiment would have been seriously hampered. In certain cases its adoption was almost a precondition for entry in the common market, e.g. United Kingdom which replaced purchase tax and selective employment tax by VAT with effect from April 1, 1973. Commenting on the changeover, it was remarked, "Although Conservative Ministers argued the case for VAT on its merits and held that they would have introduced it anyway, an essential background factor was Britain's impending membership to the EEC, which required the adoption of VAT as the Community's form of turnover taxation." (Sandford, 1981, p. 5) Though VAT grew as an offshoot of economic union of EEC countries, it has been adopted voluntarily in many countries as a measure to rationalise commodity taxation.

To understand the meaning of value added tax, it is necessary first to explain the term *value added* as used in economics. Under the simple commodity production system of the olden days, goods were produced locally and in most cases, for local consumption. Normally, the producer him-self was the seller of his products. In contrast, modern system of production is highly complex involving acute division of labour, large-scale production, and a wide market for the output. The final product as handed down to the consumer does not represent the efforts of one production unit but a host of independent

manufacturers, big and small. Firms buy raw materials, components, capital goods from each other and sell their products through a chain of dealers, wholesalers, and retailers. The value of the final product as it reaches the customer represents the reward of the services of various factors of production rendered at different stages in the chain of production and distribution. The final value is the sum total of values added at different stages. The value added at a particular stage is measured through two alternative approaches: (a) subtraction method and (b) additive method.

Both these approaches are based on the identity that total sale proceeds of a firm from its output during a given period are equal to the cost of inputs, wages, rent, interest, depreciation, and profits. Under the subtraction method, value added is measured by deducting value of inputs from the value of output (O-I). If the cost of inputs is deducted from total proceeds, the remainder represents the sum of factor incomes plus depreciation. Alternatively, additive method adds together various types of factor incomes generated, and depreciation. In practice, subtraction method is considered more workable and therefore widely relied upon.

VAT is a multi-point tax with set off for tax paid on purchases. It is collected in instalments at each transaction in the production-distribution system. It does not have cascading effect due to the system of deduction or credit mechanism. It is a tax on consumption. The final and total burden of the tax is fully and exclusively borne by the domestic consumer of goods and services. It being a tax on domestic, consumption, no VAT is charged on goods exported. It is an alternative mechanism of collection of tax. Value added tax is, therefore, a multi-stage sales tax levied as a proportion of the value added, that is, sales minus purchases, which is equivalent to wages plus profits.

Value added tax is levied on the sellers of goods and services based on value added by their respective units. The base for VAT is determined by value added at a particular stage of production or distribution. In other words, inputs of a firm are not taxed. At each point, the firm is reimbursed the tax which it has already paid at the time of purchasing the inputs. Thus, there is no cascading effect. Meaning of VAT becomes clearer when it is juxtaposed against conventional turnover tax (excise duty, sales tax) which falls on the total value of the product at each stage of production chain and is called a cascade type tax.

As already noted, subtraction method is popular one to measure value added and hence to compute VAT. There are two ways to compute VAT according to subtraction method. Under the first method, called the sales less purchases or accounts procedure, the rate of tax is multiplied by the difference of output and inputs,  $t(O - I)$ . Under the second method, called the tax credit or invoice procedure, the product of the rate of tax and input is deducted from the product of the rate of tax and output,  $t(O) - t(I)$ <sup>5</sup>. The

latter is more common in practice being the system applied throughout EEC countries. The VAT liability of a seller under it is equal to the tax arising from its total sales minus a credit for the tax paid by it on its purchases. The seller charges full tax from his buyer but pays to the government the difference between the tax charged and the one already paid on his (seller's) inputs.

The VAT required to be shown on any given invoice is not the seller's VAT liability with respect to that sale but which he can collect from buyer. In fact, the VAT liability is determined only at the end of the taxable period when he takes into account all of his purchases from other taxpayers. It is important to note that the ultimate burden of VAT rests on the consumer. In this connection the Indian Indirect Taxation Enquiry Committee, 1978, observed, "Since the value of a product increases as it goes through successive stages of processing or production, the tax passed on to the successive buyers keeps increasing. The final buyer, i.e. the consumer, cannot pass the tax: nor can he claim tax credit, since he is not a taxable person under VAT. The intention is that the full tax on the product, though collected in instalments from producers at different stages, should be borne by the final buyer." (Government of India, 1978, p. 283).

One distinct advantage of the invoice method is its self-enforcing characteristic because tax credit for a firm is subject to the proof of its having paid the tax to its supplier. This feature of the VAT is particularly emphasised in countries where tax compliance is rather poor.

*Treatment of Depreciation under VAT:* There are three ways to treat the cost of capital goods whose use in the production process is spread over time.

- 1) Since value added is defined as output minus input, it is necessary to clarify whether input includes depreciation of capital goods. One interpretation is that it does, i.e. depreciation (also called capital consumption) is excluded from the value added so that value added reflects the sum of wages, interest, rent, and profits. This is called the *income variant approach* under which the base for taxation is *net value added* by each producer. The *net value added* is defined as gross receipts minus purchases of intermediate goods and depreciation. This corresponds to the concept of net national product in national accounting.
- 2) The second approach is to exclude the cost of capital goods from value added instead of granting allowance for depreciation over the life of capital goods, and is called the *consumption variant approach*. Value added is now defined as gross receipts minus purchase of inter-mediate products and capital expenditure on machinery etc. Since producers are allowed to deduct their capital expenditures, the base for taxation is restricted to the value of production of consumer goods only.
- 3) Lastly, it is possible that the cost of capital goods is not allowed to be excluded when

they are initially purchased and no allowance is made for depreciation when they are used in production. Value added equals gross receipts minus the cost of purchasing intermediate goods. In other words, it is the sum of wages, rent, interest, profits, and depreciation. This may be called the *gross product variant* and is the most comprehensive form of VAT. It corresponds to gross national product concept of social accounting.

The consumption variant approach permits a firm to deduct purchases of capital goods (i.e. gross investment) while income variant concept allows it to deduct depreciation only. In this sense, the base for VAT is bigger under the income variant than under the consumption variant by the amount of net investment (gross investment minus depreciation). In brief,

Income variant = Gross receipts – Costs of intermediate goods – Depreciation

Consumption variant = Gross receipts – Costs of intermediate goods – Costs of capital goods

Gross product variant = Gross receipts – Cost of intermediate goods

*Benefits and Limitations of VAT:* VAT is a multi-stage tax levied on all stages of production and distribution of a commodity. It is collected in instalments on the basis of value added at each stage of production and distribution of a commodity. It is a comprehensive levy covering almost all production and distribution in its fold. It is different from excise duties which, in many cases, are selective in nature.

Under VAT, each input is taxed only once. Since an input is taxed only once, VAT avoids cascading which is the chief disadvantage of the traditional system of excise and sales taxation. Excise duties, and multi-point sales taxes levied on gross output tax the same input repeatedly as goods pass along different stages of production<sup>6</sup>. This type of taxation encourages vertical integration of industries, a tendency harmful to the growth of small-scale sector.

Since the cumulative effect of input taxation is absent under VAT, the cost of production increases by the amount of tax itself. Thus, by preventing unnecessary cost escalation, VAT promotes competitiveness of domestic Industries in the world market and thereby generates favourable effects on exports. Among the various limitations of VAT, the following are more common. VAT is levied on ad valorem basis and does not admit of physical output as the basis for tax liability determination. Excise duties may be imposed on ad valorem or specific or ad valorem-cum-specific basis, or even in the form of a compounded levy.

Ideally, VAT should be imposed at a uniform rate at all stages of production and distribution so that tax credit claims can be made easily. Excise duties, as also sales taxes, are imposed at different rates depending upon the nature of the commodity taxed.



VAT is more suitable under a unitary form of government, i.e. under a single tax authority for commodity taxation. In a federation where different tiers of government enjoy overlapping commodity taxation powers, VAT is difficult to operate due to tax rivalry and lack of coordination among federal and provincial governments.

In its ideal form VAT should be imposed at a uniform rate or at the maximum 2-3 rates. The higher the number of rates, the more complicated the operation of VAT. To quote, "Experience has shown that the introduction of several rates complicates the administration of VAT considerably. The complication arises from the fact that the taxpayer is forced to maintain separate records in order to match inputs and parts of outputs that may be taxed at different rates. The difficulties are said to be particularly felt by multi-product firms. The easiest form of VAT to administer would be one with a single rate. For various socio-economic reasons, however, governments which have adopted VAT have found it necessary to introduce more than one rate, but the number of rates has to be strictly limited." (Government of India, 1978, p. 289)

The present system of excise taxation discriminates between necessities, comforts, and luxuries in a big way. Many necessities are either exempt or bear a very low rate of tax. Contrarily, luxuries are subject to a high rate of taxation. The underlying philosophy of this approach is that direct taxes in themselves cannot lessen economic inequalities and some degree of progression and differentiation has to be there to achieve the objective. Value added tax tends to be regressive in view of uniformity or limited number of rates. One way to ensure progressivity under VAT is to impose special excise duties on a select band of final commodities (luxuries) without extending the advantage of tax credit. At the other end, zero-rating or exemption may be applied in the case of necessities<sup>7</sup>. However, such provisions will complicate the commodity tax system of a country.

The proponents of VAT claim that evasion under it is difficult and minimal. The tax credit method ensures cross-checking of the records of taxpayers through invoices. Buyer firms insist on supplier firms to furnish invoices which help the former to claim tax credit. Since tax liability of a single taxpayer under VAT is only a fraction of the total amount of tax, the incentive for evasion is relatively weak. Even a successful evasion would mean less revenue loss as compared to the one suffered under a system of turnover tax on gross value (excise duty or sales tax).

Despite the self-policing nature of VAT, opportunities do exist under it for evasion and fraud. In fact, VAT provides opportunities for fraud (fictitious claims for refunds) which are not available under other forms of commodity taxation. The methods commonly applied to defraud tax authorities under VAT include, *inter alia*, the following.

- 1) Use of fake invoices to claim tax credit.
- 2) Tax credit claims on purchases for personal use.
- 3) Over-reporting of sales of zero-rated goods.
- 4) Secret deals between buyers and sellers as regards issuance of receipts.
- 5) Formation of fake companies which sell receipts to traders to enable them to claim tax credit on inputs.

Thus, VAT is as susceptible to evasion and fraud as any other tax. An efficient tax machinery capable of cross-checking a large number of invoices through an elaborate computer system is a pre-requisite for the successful implementation of VAT.

Administration of VAT: A comprehensive VAT requires an elaborate system of book-keeping, involving numerous computations, at each level of production and, therefore, may prove very cumbersome for the taxpayers. It calls for additional and efficient administrative efforts to check and cross-check the paperwork done by the taxpayers. VAT requires both a collection and a refund mechanism. Apparently, both collection and compliance costs have a tendency to increase.

The problem of administration is more serious in developing countries where accounting practices are less developed, partly due to low literacy rate. It is much simpler for firms to file returns of gross turnover than the value added returns which require, inter alia, accounts of taxes paid on inputs. This problem is further compounded because of the preponderance of small-scale producers and sellers in less developed economies. These constraints deprive VAT of its theoretical advantage of automatic cross-checking to discourage evasion. Lack of proper recording of transactions and the unmanageable number of small taxpayers engage the administration in a futile exercise of hide and seek. This problem can partly be solved by extending the VAT system to wholesale stage only and exempting sectors dominated by small-scale production. For further simplification, VAT may be restricted to the manufacturing stage. Exclusion of retail and wholesale stages would significantly reduce burden on administration without, at the same time, interfering in the working of the tax since they come at the end of the production chain.

In fact, VAT is an approach not a fixed procedure to be applied indiscriminately from one type of tax system to another. It must be moulded to fit into the specific objectives of a country's tax system.

The effects of VAT are felt all over the economy. This is because the tax influences several variables such as savings, investment, employment, distribution, prices and efficiency of resources. Some of these variables are directly affected by VAT whereas the effect on others is indirect. The effect of VAT on prices is tremendous and direct. The effect, however, depends upon whether VAT is a new levy, that is, intended

to mobilise additional resources or simply a replacement for existing tax to recover the lost revenue from other taxes reduced or replaced by VAT.

If VAT is adopted as a replacement for prevailing commodity taxes, then the effects of reduction in prices due to the abolition of the existing taxes must be considered. At the same time, price increase should also be taken into account due to the introduction of VAT. This could imply a complex mixture of changes in factor prices and producer prices at manufacturing and wholesale levels. However, in general, a VAT causes increase in price of commodities depending upon the elasticity of demand and supply of the commodity concerned. Normally, it is fully shifted forward because traders would wish to maintain their level of profit by shifting VAT ahead. All traders will initially bear tax and compliance costs but would like to recoup them in due course, sometimes even to take advantage of the situation to charge prices somewhat higher than wanted by VAT.

The shifting would, however, depend upon the supply and demand conditions of the commodity in question. The degree of shifting would cause increase in prices. This would result in a fall in aggregate demand, if money supply is not raised. In that case, the dealers would be forced to absorb VAT or pass on its burden back to factor owners in the form of low returns to them. Hence, whether VAT would be inflationary depends not only on the possible offsetting changes in other taxes and on accommodating money supply but also on the reaction of wages, transfer payments, liquidity and psychological effects. To overcome the limitations of the existing indirect tax structure, goods and service tax (GST) has been proposed to be implemented. It will mark a breakthrough in the indirect tax structure as it will be a nationwide tax that would be levied on goods and services. It is expected to bring a plethora of benefits for various stakeholders in the economy.

## Endnotes

1. Deficit financing is a kind of forced saving. When all types of government receipts fall short of its stipulated total expenditure, then the only alternative left with it is to print more currency. The net effect of deficit financing is to increase money supply in the economy. When money supply increases, it puts pressure on the supply of goods and services. Since supply cannot be increased so easily, prices have a tendency to rise. Price rise is accompanied by its own adverse effects because the burden of price rise falls inequitably on different classes. Deficit financing is a kind of inflation tax which drives the people into involuntary savings.
2. For United States, see M. Krzyzaniak and R.A. Musgrave, *The Shifting of the Corporation Income Tax* (Baltimore: John Hopkins University Press, 1963); For India, see G. S. Laumas,

'The Shifting of Corporation Income Tax: A Study with Reference to Indian Corporations', *Public Finance*, Volume 21, No. 4, 1966, pp. 462-73.

3. For a detailed discussion on the distinction between direct and indirect taxes, see 1. Ursula K. Hicks, "The Terminology of Tax analysis," in *Readings in the Economics of Taxation*. The American Economic Association (London: George Allen and Unwin Ltd., 1959), pp. 214-16; 2. D. Walker, "Direct versus Indirect Taxes," in *Public Finance* edited by D. W. Houghton (England: Penguin Books Ltd., 1972), pp. 349-75.
4. Government of India, *Report of the Indian Fiscal Commission* (Chairman: Ibrahim Rahimatoola), 1921-22, p. 87
5. Let output be Rs. 500, input Rs. 400, and VAT 10 per cent. Then,  $t(0-I) = 1/10 (500-400) =$  Rs. 10, and  $t(0) - t(I) = 1/10 (500) - 1/10 (400) =$  Rs. 10.
6. It can be argued that double taxation of commodities can be avoided if excise duties are restricted to only final consumer goods. To compensate for the loss of revenue, rates of duty on final goods may be appropriately raised upwards. Several difficulties arise in adopting this approach. For one, certain goods are capable of being used as intermediate goods and also as final consumer goods as, for example, tyres and tubes. If tyres and tubes are exempted from tax, there is discrimination in favour of consumers who use them as replacement items. If these goods are subject to taxation, there is possibility of their being taxed again at the retail sales tax level, causing cascading effect. Therefore, it is not always possible to replace input taxation by tax on final output. Taxation of inputs is unavoidable and in a sense part and parcel of the indirect tax system. However, the harmful effects of this necessary evil can be lessened if appropriate methods are devised to allow refund wherever it is deemed necessary to do so. Value added tax is one such device whose scope (i.e., at what stage or how many stages) may be altered depending upon local conditions. Furthermore, it is administratively easier to tax inputs rather than final goods produced with those inputs. It is convenient to tax aluminium than articles made of aluminium or cotton yarn than cotton fabrics.
7. The difference between zero-rating and exemptions is of crucial importance and has been explained by Sandford in the following words, "The difference between zero-rating and exemption is important and perhaps needs explanation. A trader selling zero-rated goods is normally a 'registered' trader, part of the VAT system, recovering from Customs and Excise the whole of the input tax paid on his purchases. An exempt trader (whether by virtue of the products in which he deals or because his taxable turnover is below the threshold) is outside the system; he is not a registered trader. If his purchases are subject to VAT he will have to pay tax on them and cannot recover it from Customs and Excise, though he is at liberty to raise his prices to recoup the rise in his costs. While it is almost invariably an advantage to be zero-rated, it is not necessarily an advantage to be exempt rather than standard-rated. A trader selling almost entirely to the general public will usually gain by being exempt, but he may find exemption a disadvantage if he is selling to registered traders in competition with registered traders. His potential customers in that case will prefer to buy from other registered traders because then they can offset input tax against their output tax, which they cannot do if

they are merely paying an increased price that does not technically contain VAT. For this reason provision exists for a trader (who would otherwise have been exempt because his turnover was below the threshold) to seek voluntary registration” (C.T. Sandford et. al. *Costs and Benefits of VAT* (London: Heinemann Educational Books, 1981), p. 6.

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