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An Essay on the History and Impact of VAT in India

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ABSTRACT

This paper is intended to give an account of the emergence of Value Added Tax (VAT) in the world economy and then its subsequent adoption in various countries. It also documents the emergence of the concept of the VAT (including the theory of Input Tax Credit)and the history of the indirect tax system in India. The study also explores the impact of VAT on the economy in terms of economic growth, revenue generation, consumption, and income distribution. Through a thorough literature review, this essay provides a theoretical basis for the grounds on which VAT was implemented and then eventually replaced by Goods and Services Tax (GST) in India. The objective of the study is to contribute to the literature on VAT in India, while laying a basis for rationalizing the entire indirect tax structure.

Keywords: *VAT; Input Tax Credit; Goods and Services Tax (GST); Consumption tax.*

1.0 Introduction

Historically, the role of a government in an organized society has been to nurture individual freedom and to foster the economy. Governments can accomplish these objectives only by incurring expenses for various types of activities, such as national defence, infrastructure, education, medical and public health, social security, and numerous others. These expenditures are made from revenues acquired through taxes. The government would fail if there was no revenue from taxes.

This study explores the evolution of VAT in the world economy, starting with the emergence of the concept in Germany and following its spread throughout the world. VAT, which operates on the idea of input tax credit, facilitates the elimination of double taxation, and reduces the problem of tax evasion by increasing accountability. This paper traces the history of the Indian tax system until the implementation of VAT.

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It also explains in detail the constitutional powers of taxation in post-independence India. Most of the state governments fiercely opposed VAT, since they feared a loss of autonomy in setting tax rates, and consequently the loss of a large share of tax revenues. The VAT Act in India finally overcame all these hurdles and was passed in April 2003, and all the states had finalised its adoption by 2008.

However, India shifted to a comprehensive GST system of taxation from 1st July 2017. GST is an improvement on VAT because it subdues the cascading effects of service taxes by integrating them with the tax on goods. It is more efficient than VAT and reduces the taxpayer's burden by taxing goods and services in different tiers in a particular way. However, this does not take away from our purpose of research since a sequential study of the indirect taxes helps in analysing and improving the existing and the future arrangement of taxes. Identifying and documenting the flaws and merits of the previous tax arrangement i.e., VAT in this case, would help in designing a better overall indirect tax system and it would also go a long way in contributing to the existing literature on the Indian tax set-up.

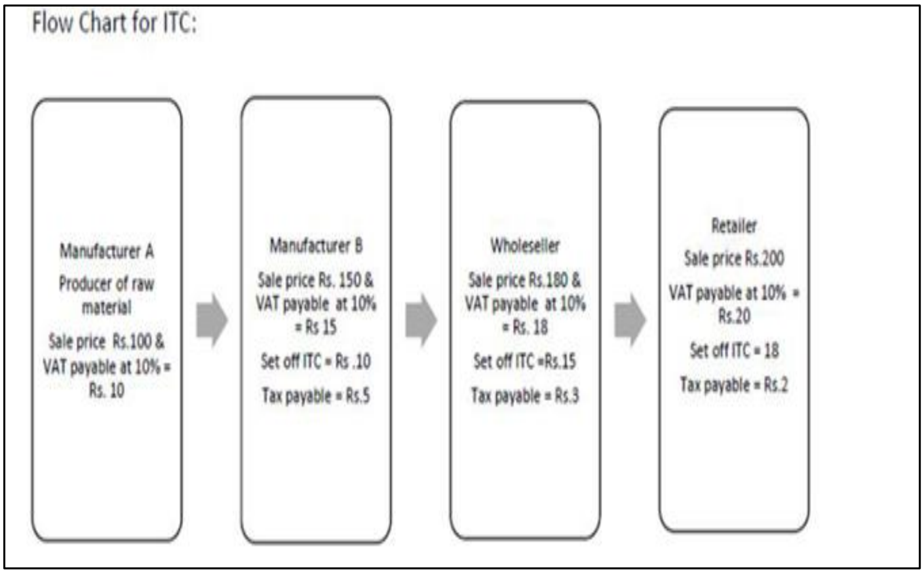
2.0 History of VAT

VAT is a consumption tax of which the final burden is borne by the consumer. It can be defined as a tax on the value added of a commodity at every point of its production and is levied on the difference between the selling price of a good and the cost of producing that product. The main principle of VAT lies in the concept of Input Tax Credit (ITC), which involves providing setoffs at each stage for the tax paid at the previous stage. Prior to the initiation of the VAT, the problem of multiple taxation plagued the tax structure. In other words, during the process of production of a commodity, first the inputs are taxed, and then, after the commodity is produced, the output is taxed again without providing any deduction for the previous tax paid. This system of double taxation, with its cascading effect that has an adverse effect on production and distribution within the economy, is overcome successfully by VAT through the incorporation of the idea of input tax credit. The flowchart in Figure 1 helps to understand the modus operandi of ITC, hence VAT.

The producer of raw material (Manufacturer A) sells his output at ₹ 100 and the amount of VAT payable by him is ₹ 10 (at 10%). In the second stage of production, where the sale price is ₹ 150 and the amount of VAT payable is ₹ 15, Manufacturer B only pays ₹ 5 as tax since ₹ 10 has already been paid by the raw material manufacturer. Therefore, the input tax credit in this case is ₹ 10. The wholesaler and the retailer thus pay ₹ 3 and ₹ 2 as VAT due to subsequent deductions of the tax paid in the previous stages.

The concept of VAT was the brainchild of German businessman Wilhelm Von Siemens in the 1920s. Von Siemens identified the flaws of the prevalent turnover taxes and proposed a new tax system that did not have a cascading effect.[1] Interest in VAT was subsequently reinvigorated in the early 1950s by the Shoup Mission to Japan. This Mission was led by Carl S. Shoup and aimed to amend the tax system in Japan in the aftermath of the Second World War, based on the idea of comprehensive income taxation. Adhering to its goal of promoting a progressive system of taxes, the Mission recommended the indirect taxation of certain luxury items (Beyer 1994) and advocated VAT as the main source of revenue for local governments. However, agricultural co-operatives, firms, and businessmen, as well as the Japanese media, rallied against the bill and developed a hostile attitude towards VAT. They were concerned about various issues such as mass unemployment, complications in the VAT design and a disproportionate burden of the tax. VAT became so unpopular that it ended up being withdrawn before it had been implemented.

Figure 1: Flowchart of VAT operation



Source: Implementation of Value Added Tax in India – Lessons for transition to Goods and Services Tax – A Study Report, Comptroller and Auditor General of India (2010)

Eventually, Maurice Laurè, the joint director of the French tax authorities (also known as the father of VAT), developed the idea of VAT into a perfectly operating system and enforced it in France in 1954. There were multiple exemptions and reduced rates on several items to either reduce the burden on necessities or motivate the consumption of certain goods. The exempted goods mostly comprised food products (Whittington & Sullivan 1996). By the late 1960s, though, VAT had failed to achieve the desired level of success, with not more than 10 countries having implemented it around the world. However, the European Union's requirement that countries which aimed to secure a place in the union adopt VAT (Charlet & Owens 2010) meant that, by 1989, a total of 48 nations, including many countries of Western Europe, had implemented the new system of taxation. Since then, there has been a rapid rise in the number of countries adopting VAT. After intense deliberations and political debate, India finally replaced its sales tax with VAT on 1st April, 2005.

United States remains a major exception to VAT implementation. Like other countries, it initially showed an interest in VAT that developed from the need for a general sales tax to overcome the cascading effect of general turnover taxes. T.S. Adams was one of the pioneers of this idea. However, the US government decided that VAT had a penalizing effect on consumption without having any direct benefits for either the national debt or government services. Instead of replacing any tax, they believed that VAT would only supplement the existing tax system, thus increasing the number of taxes that consumers had to pay. Another major reason why it was never enforced in the United States is the apprehension that the adoption of VAT would lead to losing states' fiscal autonomy in fixing tax rates. These concerns are very typical of any country that has contemplated the adoption of VAT, but, unlike other economies, the United States has never overcome them.

In addition to being neutral and transparent, VAT is considered one of the government's most potent instruments for generating revenue and for giving incentives for increases in productivity and industrialization. Countries like Sweden and Norway have replaced their retail sales tax with VAT. Since VAT does away with the cascading effects of the other indirect taxes, it has gradually emerged as the preferred alternative for international trade. VAT also minimizes distortions in the economy by favouring labour over capital and smaller production units over vertical integration. Also, it is designed in such a way that it does not dampen the competitiveness of domestic firms. This is because in general, exports are exempted from VAT, with the corresponding input tax being deductible, and imports are subject to VAT, thus discouraging them. One of the main benefits of the VAT system of taxation is that it requires successive taxpayers to disclose invoices to be able to claim setoffs, which enables the government to keep a check on successive transactions between taxpayers. This policy also encourages compliance and reduces the scope for fraud. By doing away with the multiplicity of taxes and rates, VAT also ensures efficient resource allocation within the economy. In other words. VAT promotes stability, simplicity, and efficiency in the tax structure of an economy (Khan & Shadab 2013; Sebastian 2012; Nellor 1987).

Apart from this, the structural adjustment policies by the International Monetary Fund and the World Bank recommended creating a tax system that avoids economic distortion and helps in the process of fiscal consolidation. This implied lowering and eliminating of tariff rates, thus ensuring an ad valorem basis in excise tax rates. For developing countries, who struggle to collect a sizeable amount of direct taxes, implementing VAT was the way forward.

3.0 History of Indirect Taxation in India

The concept of indirect taxation in India can be traced back thousands of years to Kautilya's Arthashashtra (3rd century BCE), according to which all state activities depend first on the Treasury, and therefore a King should devote his best attention to it. During the British rule, the Indian tax structure was hegemonized by custom duties, as most of India's raw materials were exported and then later imported again as finished products. These imported products were then subject to taxes. In addition, the British government levied excise duties on some items to meet their war-time financial requirements. The basis of the tax policy in post-British-era India was the division of tax powers between the Centre and the State as per the Constitution of India.

Article 246 of the Indian Constitution assigned the power to levy the different taxes in the Concurrent List, with the Centre and the states having divided jurisdiction. The State governments were entrusted with VAT and the Central Sales Taxes apart from Octroi, Entertainment tax etc. The model of taxation of goods and services that India had followed since independence was plagued by a multiplicity of tax rates and exemptions and the tax system lacked transparency. The tax base was narrow and the cascading and distortionary taxes on the production of goods led to the severe misallocation of resources and hampered the growth of the economy. To overcome these drawbacks of the tax structure, ad valorem taxes were initiated. After a lot of deliberation, the Government decided to introduce Modified VAT (MODVAT) in 1986. MODVAT was superseded with Central VAT (CENVAT) in 2000– 01.

Initially, many of the states were uncertain about the viability and future of VAT and were reluctant to implement it for various political and economic reasons. The implementation of a uniform rate throughout India was not considered at all desirable by the states, as it would take away their power to set tax rates and they feared losing a major portion of their revenue (Bagchi, 2005). Besides this, consumers were concerned about the impacts of these taxes on the prices of commodities, while small businessmen anticipated high compliance costs and harassment from the relevant tax authorities. The Empowered Committee of State Finance Ministers unanimously agreed that all 28 States and Union Territories of India would adopt the VAT from April 2003. The states had to be reassured with compensation packages for the initial three years. After being postponed several times, the VAT Act, 2003, finally came into effect from 1stApril, 2005, for 21 states of India. Haryana was the first state to implement VAT in April, 2003. The other states that enacted it in the same year were Andhra Pradesh, Jammu and Kashmir, Maharashtra, Delhi, Uttarakhand, West Bengal, Himachal Pradesh, Bihar, Punjab, Orissa, Karnataka and Kerala. Several more states, namely Jharkhand, Chhattisgarh, Madhya Pradesh, Rajasthan and Gujarat, enforced it in 2006. Tamil Nadu and Uttar Pradesh were the last ones to implement the VAT Act, in 2007 and 2008 respectively.

The VAT structure followed in India is consumption-based and was implemented as a destination-based tax. Consumption as a base for tax not only has the advantages of neutrality and easy administration, but also limits the tax burden to final consumption goods, thus excluding capital goods. An important point to note here is that some Indian states had had experience with VAT in one form or another prior to the universal implementation of VAT. For instance, in 1995 Andhra Pradesh introduced a VAT rate of 4 percent on inputs for resellers by eradicating surcharges and turnover taxes. Kerala also levied VAT on resellers of some commodities without discounting the tax already paid on inputs. Madhya Pradesh enforced VAT in 1997, but the tax on resellers did not follow the actual VAT rules, as there were no setoffs given to make the tax structure neutral and transparent. Maharashtra, on the other hand, endeavoured to introduce a proper form of VAT in the same year as Andhra Pradesh, not only revoking the turnover tax but also providing input credit for any tax paid above 4 percent. However, for various non-economic reasons, it later had to abolish VAT and replace it with first point sales tax.

Further, despite being a vast improvement on the existing commodity taxes all over the world, VAT has its share of problems. According to Keen (2009), one of the most important concerns with VAT was what would happen if some taxpayers or items were to end up excluded from VAT, either purposefully or due to noncompliance. In such cases, the sequence of the tax and credit operation would crash, and it would be difficult to design that breakdown. Sharma & Sarker (2015) also analysed the shortcomings of VAT in Nepal and concluded that it is not very easy to maintain an audit trail in the presence of a huge informal sector. Moreover, there is a very high probability that fraudulent invoices will be generated to claim the input tax credit, especially in a less developed country like Nepal. Also, the imperfection of the markets and the weakness of government regulations leave abundant scope for tax evasion even in the VAT system. India being a developing country, is not immune to this scenario too.

Owing to the pitfalls of VAT, India, have since replaced VAT with GST. GST was introduced to integrate goods and service taxes within the indirect tax structure, unlike VAT, which did not cover tax on services. This solved some of the existing problems of VAT by increasing revenue generation for the states by giving them additional power to levy tax on services.

4.0 Impact of VAT

Taxation is one of the major channels through which a country's government can affect the income distribution of the economy. If implemented in a wise manner, it can lead to the efficient mobilization of revenue for the government, which is one of the main purposes of taxation. Further, if drafted appropriately, consumption taxes are more efficient and redistributive than income taxes, and hence Pareto superior to them (Bankman & Weisbach 2006).

4.1 VAT and economic growth

A rise in VAT is typically associated with a fall in the aggregate consumption, thus leading to a decline in the overall economic growth. This is the precise reason why lowering the VAT rate can sometimes be an important policy prescription when the economy is under recession and is in severe need of an increase in consumption. The effect of VAT on growth is contingent upon its impacts on consumption and investment.

Simionescu & Albu (2016) have estimated the effects of the imposition of VAT on the economic growth of five Central European countries, namely Hungary, Bulgaria, Czech Republic, Poland and Romania, over the time period 1995–2015 and have shown that VAT affected the five countries' economic growth positively during the time period considered. Miki (2011), on the other hand, pointed out that the effect of VAT on growth is dynamic. Economic growth rises as soon as the increase in taxes is announced, and this last until it is implemented. The growth rate falls drastically as soon as the increased rates of VAT are implemented, then rises again gradually after a certain period. Another study (Jalata 2014) analysed that VAT enhanced the growth rate of the country by approximately 2.53 to 21.9 percent relative to the previous sales tax system during 2003-2012.

Furthermore, the effect of VAT on the prevailing price level in the economy was explored by Ruebling (1973). He posited that VAT is not inflationary unless the increase in prices is sustained for a long period of time. He also considered VAT to be beneficial to a country's balance of trade position, as imposing VAT on a country's imports discourages imports and increases exports, other factors remaining unchanged. Besides this, he found that the effect of VAT on the income distribution in the United States is contingent upon the use of the revenues generated by the VAT system, apart from the rates of taxation and the items that were exempted from tax. In other words, the dissemination of real income because of the change in tax policy can be ascertained based on whether the revenues were used to eliminate other forms of taxation or to boost government expenditure.

4.2 VAT and government revenue

The main purposes of a reform in indirect tax policy are to maximize government revenue and to increase the efficiency and transparency of revenue collection. However, economists and policy makers are divided as to whether VAT is superior in terms of revenue mobilization, especially for developing or under-developed countries.

- Implementation of VAT is usually associated with an increase in the ratio of government tax revenue to gross domestic product, also known as the tax ratio. Nellor (1987) examined the notion for 11 European countries that enforced the VAT reform between 1967 and 1973. He found weak empirical evidence that the growth rate of the tax ratio had risen after the introduction of VAT. In another related study, Ebrill, Keen, Bodin & Summers (2001), also found empirical evidence that VAT leads to an efficient rise in revenues and is connected to higher tax ratios, keeping the per capita GDP and the trade openness of the economy fixed. They analysed the pre- and post-VAT tax systems of Sub-Saharan Africa, Asia and the Pacific, the EU (plus Norway and Switzerland), Central Europe and the Baltic States, Russia and a few other countries of the Soviet Union, North Africa and the Middle East and established that, in most of the developing countries, a basic VAT that has an exorbitant registration threshold is easier to execute than the other taxes that VAT would be replacing. They also compared and contrasted VAT with a uniform tariff on all imported goods for a small economy and showed that the efficiency benefits of shifting to a VAT would be outweighed only if the difference in the cost of collection is high enough. Keen & Lockwood (2006) extend the analysis for a panel of OECD countries and investigate the assertion that VAT is a "money machine". The weak form of the hypothesis can be defined as the situation where countries with a VAT in place raise more revenue than those that have not implemented it. The strong form of the hypothesis states that the implementation of VAT is a source of an increase in the size of the government. The evidence in the study supports both the strong and the weak forms of the hypothesis.

4.3 VAT rates, base, and issues of compliance

The actual realization of the benefits of VAT hinges on issues like the harmonization of the rate structure through a decrease in both the number of rate categories and the ambiguity associated with it, the broadening of the tax base, and the reduction of tax evasion by lowering the cost of compliance. However, countries differ in the type of VAT that they choose to put into effect, for various economic and political reasons.

Agha & Haughton (1996) study the determinants of VAT compliance across 17 OECD countries by constructing an index for VAT compliance. They found that a higher VAT rate has a negative correlation with tax compliance and higher the administrative spending on taxes and the smaller the country (in terms of population), the higher is the degree of tax compliance. However, every country has its own distinctive characteristic and income distribution, and therefore, generalization of the results needs to be interpreted very carefully.

Apart from studies on the compliance of VAT, the economic rationale behind the existing limited VAT base in the United Kingdom has been explored by Davis & Kay (1985). They proposed and provided substantive empirical evidence of an alternative of more effective direct measures where the VAT base is extended by removing all the exemptions and taxing zero-rated items at the standard rate, in combination with increases in both the income tax thresholds and the social security expenditures. A package of taxes and social expenditure designed in this way, would promote a better administration of all taxes in the economy, while reducing the costs and distortions at the same time.

4.4 Studies of VAT in the Indian context

Several authors have studied VAT in India, but their focus has been mainly on the revenue efficiency, revenue productivity and causes of the snags in the tax's implementation in the various Indian states.

Discussions on the adoption of VAT in India were initiated in the 1990s, by which time it had been implemented by many countries. However, before it could be enforced, there was a need to assess the drawbacks of VAT in the context of a federal economy such as India. Purohit (1993) analysed the existing commodity tax structure of India and the problems with and options for VAT implementation in the federal setup. The study demonstrates that the prevalent structure of commodity taxes in India lacks integration and there was a severe need of consolidating the multiple systems along with a tax on services into the existing structure of commodity taxes.

Another related study posited that the fractured VAT system which was being introduced was not the best option available for tax reforms in the country (Mukhopadhyay, 2003). He suggested that, rather than enforcing a distorted VAT which would not achieve the desired purpose, a far better alternative for the government would be a mix of reformed CENVAT, a retail sales tax with uniform rates across all states, minimizing exemptions, and the elimination of CST. However, few studies supported the implementation of VAT despite its drawbacks. Das Gupta (2005) emphasized that VAT in India is not transparent: it still excludes a tax on services, and there are no deductions on some universal intermediaries like petroleum products. However, putting aside its drawbacks, VAT rejuvenates the tax administration and reduces compliance costs. It also broadens the tax base and leads to a reformation of the costs of production, thus increasing the efficiency of resource utilization. Above all, the mechanism and discussion of VAT implementation in India have resulted in the strengthening of the organization of co-operative federalism. This is precisely why VAT deserves some patronage, regardless of some of its problems in the context of a developing country.

4.5 VAT on consumption and distribution

When designing the new sequence of indirect taxes in India, the implications for revenue generation and the efficiency of the revenue collection procedure were kept in mind. However, the impact of indirect taxes on the income distribution or consumption possibilities is a relatively unexplored area.

Ghosh (2020) investigates the effect of Value Added Tax (VAT) on the consumption of necessary food and fuel items and on the poverty of Indian households. The study uses household level data from the 61st and the 68th rounds of the National Sample Survey Office’s (NSSO) surveys, as well as state-level variations in VAT rates and revenues to estimate the impact of an increase in the VAT rate on the consumption (measured by both quantity and expenditure) of necessary food and fuel items, as well as on the poverty gap and the headcount ratio among households in India. Using censored regression analysis, the paper documents that the introduction of VAT leads to a significant decline in the consumption quantity of items such as wheat, pulses, and petrol, but not of items such as rice, kerosene, diesel and Liquefied Petroleum Gas (LPG). The results also show that consumption quantity and expenditure respond less to an increase in VAT for households above the median expenditure than for those below. The study also provides an empirical investigation of the relationship between a state’s

VAT revenue in a year as a share of its Gross State Domestic Product (GSDP) and the poverty gap and headcount ratio of poverty of a household. The results show that poverty is unresponsive to changes in VAT revenue in both the full sample of households and the different social groups. However, VAT is effective in reducing poverty in the poorer states of India, especially in rural regions. Developmental social expenditure reduces poverty significantly across all specifications.

5.0 Concluding Remarks

This study provides a brief introduction to the concept of VAT, its emergence in the world economy, and the economic rationale behind its implementation, with a special focus on India. We have also traced the history of the indirect tax structure in India that led to the adoption of VAT throughout the country. The paper aims to establish a theoretical basis for the grounds on which VAT was implemented and then eventually replaced by GST in India the analysis being imperative to designing a good indirect tax structure. Keeping in mind that India has taken a leap forward in revolutionizing its indirect structure by implementing GST, we have tried to elucidate and summarize the merits and demerits of the VAT (high compliance costs, complicated and expensive tax structure and regressive to an extent among others), to contribute to the sparsely available literature on indirect taxes, especially in the Indian context.

Endnote

1. The cascading effect refers to the tax-on-tax effect that occurs when a good is taxed at every stage of production.

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