



VISION: Journal of Indian Taxation  
Vol. 1(1), Jan-Jun 2014, pp. 98-123  
DOI: 10.17492/vision.v1i1.2416  
www.journalpressindia.com/vjit  
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## India's Transition from State Level Sales Tax to Value Added Tax (VAT)

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### ABSTRACT

*An outstanding development in the sphere of State finances since Independence has been the precipitous growth in the relative revenue significance of sales tax levied under entry 54 of List II in the Seventh Schedule of the Constitution. It has grown considerably in depth and coverage, and forms the mainstay of States' tax revenue. Prior to tax reforms initiated in early 1990s, sales tax was characterised by a multiplicity of tax rates and exemptions, lack of uniformity across States, large number of exemptions and concessions, and differing procedures for tax collection. In mid-1990s, most states had agreed to phase out the incentive-related exemptions and implement floor rates of sales tax. As part of the nation-wide efforts to redesign commodity taxation and the implementation of CENVAT at the level of the Centre, many States have modified their sales tax regimes to launch a state level VAT under the scheme prepared by the Empowered Committee for this purpose. This paper explains and examines various problems associated with sales tax and its switch over to Value Added Tax (VAT) in recent years.*

**Keywords:** Sales tax, Value-added tax, Inter-State sales

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### 1.0 Introduction

In India, sales tax in its modern form was levied for the first time by the Government of Central Provinces (now Madhya Pradesh) in 1938. Since then, the levy has proved an outstanding development in the sphere of State finances. It has grown considerably in depth and coverage, and forms the mainstay of States' tax revenue. It is levied not only on consumer goods but also on raw materials and capital goods.

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### 1.1 Different Forms of 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.

**Multi-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. Thus, it discriminates against non-integrated firms. 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." (John F. Due, 1959)

**Single-point Sales Tax:** 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.

1. 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.

2. 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.
3. 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.
4. 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.
5. 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.

## **2.0 Constitution of India and the Provisions for the Regulation of Taxation of Inter-State Sales**

The problems relating to taxation of inter-State sales were considered by the Drafting Committee of the Constituent Assembly. It proposed incorporation of provisions in the Constitution restricting the powers of the State Governments in respect of the levy of sales tax in the course of foreign trade, inter-State trade, and on essential commodities. In spite of opposition from some States, these provisions were finally incorporated in the Constitution as Article 286 (described below).

Under entry 54 of List II (State List) in the Seventh Schedule of the Constitution, the States were given the power to levy “a tax on sales or purchases of goods other than newspapers”. This provision was quite similar to entry 48 of List II in the Seventh Schedule of the Government of India Act, 1935. However, under the Constitution, the States’ power to levy sales tax was subject to a number of restrictions. These restrictions on the sale or purchase of goods as mentioned in Article 286 of the Constitution were the following.

1. No law of a State shall impose a tax on the sale or purchase of goods where such sale or purchase takes place: (a) outside the State, or (b) in the course of import of goods into, or export of goods out of, the territory of India.
2. Except in so far as the Parliament may by law otherwise provide, no law of a State shall impose a tax on the sale or purchase of any goods where such sale or purchase takes place in the course of inter-State trade or commerce.
3. No law made by the legislature of a State imposing a tax on the sale or purchase of any such goods as have been declared by Parliament by law to be essential for the life of the community, shall have effect unless it has been reserved for the consideration of the President and has received his assent.

In simple words, the States were prevented from taxing the following transactions: 1. Sales or purchases in the course of foreign trade. 2. Sales of goods delivered in another State for consumption purpose. 3. Sales in the course of inter-State trade and commerce. Furthermore, the power of States to levy the tax on commodities declared to be ‘essential’ by the Parliament was made subject to the prior approval of the President.

## **2.1 Consequences of Constitutional Restrictions on Sales Tax**

The first restriction resulted in considerable loss of revenue to States, which were levying sales tax on exports. The main losers in this category were Bombay, Bihar, Madhya Pradesh, Orissa, and Assam. Nevertheless, this was the least controversial provision of Article 286.

The second and third restrictions, the benefits of which applied equally to registered dealers, unregistered dealers, and consumers, led to large scale evasion and avoidance of tax and hence loss of revenue to the States in general. As the Taxation Enquiry Commission, 1953-54, observed, "Traders in one State started to sell direct to unregistered dealers and consumers in another. Similarly, consumers of valuable commodities tried to get these from dealers in another State rather than buy the articles from their local dealers. The practice grew for sales of goods within a State itself to be shown in the books of accounts as having been made to fictitious dealers outside the State and the goods having then been resold by those dealers to consumers within the State. For valuable commodities like motor vehicles, jewellery, watches, etc. this practice became very common. On transactions that could be shown to be in the course of inter-State trade, the 'exporting' State was prohibited under Article 286 from levying the sales tax; and if the goods delivered as a result of these transactions were shown to be received by individual consumers or unregistered dealers neither could any tax be levied on them by the 'importing' State. Thus, many of these transactions escaped sales tax altogether." (Government of India, Ministry of Finance, 1953-54)

The loss of revenue was more for States with single-point system as compared to States having multi-point sales taxation. This was so because the restriction was not applicable to sales in the State prior to the last point of sale for export to another State.

The constitutional restrictions led to uneconomic diversion of trade and production centres. The problems which the constitutional provisions sought to solve got further compounded *albeit* with a different nature. To quote, "The constitutional restrictions on sales taxation greatly increased the scope for evasion. While the problem before the Constitution had been multiple taxation (by different States) on the same act of inter-State sale, the problem after the Constitution was that inter-State sales frequently escaped taxation altogether." (Walter Mahler, 1970)

## **2.2 Essential Goods Act, 1952**

As already noted, in addition to the above restrictions, Article 286 also prevented the States from levying tax on sales or purchases of goods declared by the Parliament to be essential for the life of the community, except with the previous assent of the President. For this purpose, the Parliament enacted the Essential Goods (Declaration and Regulation of Tax on Sale or Purchase) Act, 1952, and various commodities were declared as essential including cereals and pulses, fresh and dried fruits, fresh milk, meat, fish, salt, hides and skins, iron and steel, coal, fertilisers, petroleum products, and books.

In spite of its desirable objectives, the enactment of the Essential Goods Act, 1952, led to various problems and criticism from some State Governments. Since the legislation was not retrospective, the States which had been levying sales tax on 'essential goods' prior to the passage of the Essential Goods Act, continued to levy the tax. However, those States which sought to levy the tax after the passage of the Act had to obtain the consent of the President. This evoked sharp resentment among the State Governments.

The resentment among the States was further fuelled by the fact that the Central Government itself was levying relatively high rates of excise/customs duties on some of the so-called 'essential goods'.

## **2.3 Constitution (Sixth Amendment) Act, 1956**

In view of the problems arising from constitutional restrictions on the taxation of inter-State sales, the Constitution was amended by the Sixth Amendment Act of 1956. Under this Amendment, the Parliament was empowered to impose 'taxes on the sale or purchase of goods other than newspapers, where such sale or purchase takes place in the course of inter-State trade or commerce'. This new provision in the Constitution was made by inserting entry 92A in List I (Union List) in the Seventh Schedule. Simultaneously, entry 54 in List II (State List) was made subject to the provisions of the new entry 92A of List I. Also, Article 269 of the Constitution was amended which added a new clause (1)(g) which permitted taxes on the sale or purchase of goods in the course of inter-State trade to be levied and collected by the Government of India but assigned to the States. [1] Again, clauses (2) and (3) of Article 286 of the unamended Constitution were substituted by new clauses to

make it read as follows.

(1) No law of a State shall impose or authorise the imposition of a tax on the sale or purchase of goods where such sale or purchase takes place (a) outside the State, or (b) in the course of import of goods into or export of goods out of the territory of India.

(2) Parliament may by law formulate principles for determining when a sale or purchase of goods takes place in any of the ways mentioned in clause (1).

(3) Any law of a State shall in so far as it imposes or authorises the imposition of a tax on the sale or purchase of goods declared by Parliament by law to be of special importance in inter-State trade or commerce, be subject to such restrictions and conditions in regard to the system of levy, rates and other incidents of the tax as Parliament may by law specify.

The new Article 286(2) gave Parliament the powers to define a sale outside a State. The new Article 286(3) is different from the old 286(3) in the following respect: In the old provision, Parliament had the authority to restrict State taxation of commodities declared by Parliament to be 'essential for the life of the community'. In the new provision, Parliament is empowered to restrict State taxation of goods declared to be of special importance in inter-State trade only. [2]

### **3.0 Central Sales Tax (CST) Act, 1956**

Consequent upon the Constitution (Sixth Amendment) Act, 1956, the Central Sales Tax (CST) Act was passed in 1956. The following three main objectives of the CST Act were stated in the Preamble: 1. To formulate principles for determining when a sale or purchase of goods takes place in the course of inter-State trade or in the course of import into or export from India. 2. To provide for the levy, collection, and distribution of taxes on sale of goods in the course of inter-State trade or commerce. 3. To declare certain goods to be of special importance in inter-State trade and specify the restrictions to which State laws imposing taxes on the sale and purchase of such goods of special importance shall be subject.

### 3.1 Main Provisions of CST Act

The regulations contained in the CST Act provide, *inter alia*, for a degree of uniformity by prescribing a maximum rate of sales tax on certain goods considered important for the whole country. According to Section 3 of the CST Act, a sale or purchase of goods is deemed to take place in the course of inter-State trade if it (a) occasions the movement of goods from one State to another, or (b) is effected by a transfer of documents of title to the goods during their movement from one State to another.

Section 14 of the Act declares certain goods to be of special importance in inter-State trade and commerce. These are: coal, cereals, cotton, cotton yarn, cotton fabrics, crude oil, hides and skins, iron and steel, jute, oilseeds, pulses, rayon and artificial silk fabrics, sugar, tobacco, woollen fabrics. The list of 'declared goods' originally covered by the Act in 1956 was expanded twice, once in 1957 to include textiles, sugar, and tobacco, and again in 1976 to include cereals (like wheat, paddy, rice etc.), crude oil, and pulses.

Section 15 of the Act lays down the rate structure. The rates are different depending upon the classes of goods and the status of the person to whom the goods are sold. Thus, goods are either 'declared goods' (goods of special importance) or 'non-declared goods' while a person may be a registered or a non-registered dealer. Based on these classifications, the rates of sales tax are prescribed by the Central Government though the tax is administered (i.e. assessed, collected and appropriated) by the State Governments by virtue of the powers delegated to them by the Central Government under Article 258(1) of Constitution.

The maximum prescribed rate of sales tax on 'declared goods' inside a State is 2 per cent of the sale price and is not leviable at more than one stage. [3] Thus, although sales tax on intrastate sales is levied by the States, taxation of intrastate sales of 'declared goods' (goods of special importance) is subject to certain restrictions in terms of the nature of the levy (not to be levied at more than one stage) and the rate of tax (not more than 2 per cent).

In the case of inter-State sale of such goods to registered dealers, the rate of tax is the same as applicable to the sale of such goods inside the exporting State. In respect of sale of 'declared goods' to non-registered dealers (including consumers) the CST is chargeable at twice the rate applicable to the same goods



inside the State, i.e. 8 per cent. Where 'non-declared' goods are sold in the course of inter-State trade to a registered dealer, the ceiling rate is 4 per cent [4] or the rate applicable to internal sales of the concerned goods, whichever is lower. [5] However, on inter-State sale of non-declared goods to non-registered dealers, the rate of CST is 10 per cent or the rate applicable to the sale of such goods inside the exporting State, whichever is higher. [6]

The Act further specifies that when a sales tax has been levied inside a State on any declared goods and such goods are sold in the course of inter-State trade, the tax so levied shall be refunded. Provision also exists that goods which are generally and unconditionally exempt from the sales tax within a State will also be exempt from CST in the course of inter-State trade.

### **3.2 Working of CST Act**

It is clear as to why some kind of Central control is necessary on sales tax for larger national interest. Had Punjab, and Haryana been free to levy sales tax on foodgrains at will, the people of food deficit States would have suffered. Similarly, uncontrolled imposition of sales tax by West Bengal, and Bihar on iron and steel, and coal would have impeded the growth of engineering industry in Gujarat and Maharashtra.

CST Act authorises a State to tax residents of other States. Lest this power should be misused to export undue tax burden to the other States, the original scheme devised in 1956 kept the rate of CST low at 1 per cent ensuring some reasonable revenue for the exporting States. However, over the years the rate of CST has been raised by stages to 4 per cent. This trend has benefited industrially advanced States (like Maharashtra, Gujarat, Tamil Nadu, and West Bengal) at the cost of industrially backward States. Since manufactures are the main items of inter-State trade, the developed States are able to export a part of their taxation to other States. In effect, it amounts to transfer of financial resources from poorer States to well off States, much against the declared objective of regional balanced development and equitable distribution of resources among the States. Moreover, the high rate of CST hinders the free flow of trade and commerce within the country.

It may be suggested that the rate of CST should be reduced to the original level of 1 per cent to safeguard the interests of poorer States. Furthermore, the

Central Government should declare some more inputs as goods of special importance in inter-State trade to restrict the power of the States to tax such goods. However, these suggestions have met with stiff resistance from most State Governments. At the New Delhi Conference of Chief Ministers held on September 16-17, 1980, there was a unanimous opinion that the rate of CST should not be brought down from 4 per cent to 1 per cent. However, it was agreed to constitute a panel of Chief Ministers to consider, *inter alia*, additions to the list of 'declared goods'. The Conference also expressed unanimity over the need for uniform sales tax laws in the country because various variants of the sales tax pose problems for the collecting authorities as well as for the taxpayers. The Chief Ministers' Conference decided to request the Law Commission to undertake, on a high priority basis, the drafting of a model sales tax law for consideration by the States.

#### **4.0 Additional Duties of Excise (Goods of Special Importance) Act, 1957**

Another landmark in the evolution of sales tax in India was the year 1956 when, following a voluntary agreement between the Centre and the States at a meeting of the National Development Council (NDC) held in December, 1956, it was decided to replace sales tax on textiles, tobacco, and sugar by additional duties of excise and to distribute revenues derived therefrom among the States. The agreement provided also that the share accruing to each State shall not in any case be less than the revenue realised from the levy of sales tax on these goods for the financial year 1956-57 in that State. The Council's decision was implemented through the Additional Duties of Excise (Goods of Special Importance) Act, 1957, the First Schedule of which prescribed the rates of additional duties of excise and the Second Schedule the scheme of distribution of the net proceeds among the States.

The Act does not debar States from the levy of sales tax on the specified commodities, but it does provide that if in any year any State levies and collects a tax on the sale or purchase of such commodities, no sum shall be paid to that State in that year by way of share out of the net proceeds of the additional duties of excise, unless the Central Government by special order decides otherwise. The commodities covered under the scheme (textiles, tobacco, and sugar) were

declared goods of special importance in inter-State trade so that no State could find it worthwhile to opt out of the voluntary agreement not to impose sales tax on these goods. [7] The revenue derived from additional duties of excise, levied and collected by the Centre, is distributed among the States in accordance with the formula prescribed by the Finance Commission. The Fourth Finance Commission described it as a *tax rental arrangement*. [8]

#### **4.1 Rationale of the Scheme**

The scheme of additional duties of excise in lieu of sales tax has the following advantages: 1. It minimises tax evasion by levying the tax at first point and saving industry, trade, and consumers from administrative complexities involved in the collection and payment of sales tax. 2. It helps in maintaining uniformity in the prices of widely consumed goods throughout the country. 3. Such an arrangement contributes to the development of an integrated market by facilitating movement of goods across State borders. 4. Rationalisation of commodity taxation at the national level becomes easy. 5. Cost of collection is reduced.

***Views of the State Governments:*** The scheme of additional duties of excise in lieu of sales tax has been in force for the last 40 years. While the business community has demanded extension of this scheme to other commodities, the States have generally remained disinclined in this regard. The distrust between the Centre and the States regarding the operation of this scheme by the Central Government is an irritant in Centre-State relations. States have argued that (a) sales tax is the only elastic source of revenue available to them and in view of its regional applicability it is also the only effective instrument for shaping their economic policies, (b) replacement of it by Central levy will encroach on their constitutional rights leading to erosion of their financial autonomy, (c) if taxes are levied and collected by a State itself then it is more conscious of its responsibilities towards the taxpayers. Subventions from the Centre may lead to reckless spending causing fiscal indiscipline.

As regards the working of the existing scheme, the dissatisfaction of State Governments is borne out of their belief that revenue potential of additional duties of excise has not been fully exploited by the Centre. Their complaint is that the growth of revenue from additional excise duties on textiles, sugar, and

tobacco lags behind the growth in revenue from basic excise duties on the same commodities. The States complain that once sales tax on the three commodities was replaced by additional excise duties, the Centre did not feel the need for consultation with the States for reviewing the working of the scheme. They claim that the growth rate of their sales tax revenue is much higher than the growth rate of the yield from additional excise duties.

#### **4.2 Decisions of the National Development Council (NDC)**

Following complaints from the States, the whole issue was reconsidered by the NDC in its meeting held on December 28, 1970. The Council decided to continue the scheme with the following conditions: (a) that the incidence of additional duties would be stepped up to 10.8 per cent of the value of clearances within a period of two or three years, (b) that a ratio of 2:1 between basic and additional excise duties would be achieved and maintained, (c) that specific duties would be converted into *ad valorem* duties except in regard to unmanufactured tobacco. It was also agreed that a Standing Review Committee consisting of representatives of the Central and State Governments with the Economic Adviser, Planning Commission, as convenor, would be set up and the same would meet at least once a year to review the working of the new arrangement and make such recommendations as may be necessary for its further improvement.

As a follow up action, specific duties were replaced by *ad valorem* rates and significant enhancements were made in additional excise duties in the Central budgets for the three consecutive years 1971-72 to 1973-74. The Standing Review Committee met for the first time in February 1981 and appointed a sub-committee which recommended that the incidence of 10.8 per cent should be achieved in three stages: 8.5 per cent by 1984-85; 9.75 per cent by 1987-88; and 10.8 per cent by 1989-90. The Ninth Finance Commission was informed by the Union Finance Ministry that the incidence achieved by the end of 1988-89 was 10.7 per cent. The Commission hoped that the committed level of 10.8 per cent would be actually achieved by the end of 1989-90. In a significant move, the Commission recommended that during its award period (1990-95), if in any year the incidence of additional excise duties falls short of the level of 10.8 per cent of the value of clearances, the shortfall should be made good by the

Centre by providing an equivalent amount by way of grants-in-aid to be distributed among the States in the same manner as recommended for sharing the proceeds of additional excise duties. (Second Report of the Ninth Finance Commission, 1989) As regards the ratio between basic excises and additional excises, the Centre fulfilled its obligations by achieving the stipulated 2:1 ratio by 1981-82.

#### **4.3 Expert Committee on Replacement of Sales Tax by Additional Excise Duty, 1983**

As already noted, sales tax on textiles, tobacco, and sugar was replaced by additional duties of excise in 1957. The scheme of additional excise duties was proposed to be extended to some more commodities in 1980. At a conference of the Chief Ministers convened by the Centre on September 16-17 of that year, it was resolved to bring *vanaspati*, and life-saving drugs under additional excise duties in lieu of sales tax. It was also decided to constitute a committee of Chief Ministers to consider what other items could be added to the list for additional excise duties. However, the Non-Congress (I) States viz. Kerala, Tamil Nadu, Tripura, and West Bengal did not agree with the resolution passed at the Chief Ministers Conference.

The matter was further examined at another conference of Chief Ministers held in February 1981, which recommended the appointment of an expert committee by the Central Government to look into this matter. The expert committee under the Chairmanship of Mr. Kamlapati Tripathi submitted its report (Government of India, Ministry of Finance, 1983) in January 1983. It recommended the replacement of sales tax by additional excise duty on *vanaspati*, drugs and medicines, cement, paper and paper board, and petroleum products. The recommendations were considered in a conference of Chief Ministers held on November 2, 1983. However, the six Chief Ministers of the non-Congress (I) States, viz. Andhra Pradesh, Jammu and Kashmir, Karnataka, Tamil Nadu, Tripura, and West Bengal opposed the Centre's initiative to implement the recommendations. The recommendations of the Tripathi Committee were further discussed at a conference of Chief Ministers held in New Delhi on February 9-10, 1989. Unfortunately, no progress could be made in this regard and the matter is still hanging fire.

The opposition of non-Congress (I) States was based on the belief that implementation of the scheme would erode their revenue position. However, a close perusal of the recommendations of the Tripathi Committee suggests that it evolved elaborate formulae for protecting the financial interests of the States. In the case of three commodities, namely paper and paper board, *vanaspati*, and drugs and medicines, it suggested that the annual growth rate of the amount to be collected by way of additional excise duty in lieu of sales tax should be related to the future annual growth rate of sales tax revenue of all the States. For petroleum products and cement, which are substantially subject to administered prices, the Committee recommended and worked out linkages between the amount to be collected by way of additional excise duty from year to year and value of consumption on which normal sales tax would be leviable.

In spite of these safeguards, the apprehension of some States that their resource position would be adversely affected reflects their lack of confidence in the Centre in implementing the scheme sincerely. Thus, an important tax reform has become a casualty of the distrust between the Central and the State Governments. The scheme of additional excise duties in lieu of sales tax has merits of its own. In view of the safeguards provided by the Tripathi Committee and the Ninth Finance Commission, the scheme should not only be retained but extended to other commodities as well.

It is pertinent to mention here that during the first two decades of Independence (1947-67), the Congress party ruled, with some exceptions, both at the Centre and in the States. This political homogeneity facilitated taxation agreements between the two tiers of the Government, e.g. the agreement reached in 1957 regarding substitution of sales tax by excise duties on sugar, textiles, and tobacco. Since 1967, the politics of confrontation pursued by different political parties ruling at the Centre and in the States has hindered the process of rationalisation and harmonisation of commodity taxation. In fact, reform of commodity taxation is closely interwoven with the political process. Unfortunately, the political response to economic logic so far has neither been adequate nor helpful.

## **5.0 Constitution (Forty-sixth Amendment) Act, 1982 and Consignment Tax**

Consequent upon the Sixth Amendment of the Constitution, the Central Sales Tax (CST) Act was passed in 1956. Section 14 of the Act declares certain goods to be of special importance in inter-State trade while section 15 of the Act lays down the rate structure.

However, the CST Act left out of its ambit the consignments (or despatches or stock-transfers) from a company to its branch located in a different State. Since no sale is involved, it is called in-house transaction by a company. The loophole has come in handy for unscrupulous parties to evade sales tax by showing virtual sales as consignments from one State to another. By this method, the payment of CST is avoided. Only local sales tax becomes payable. Therefore, through the Constitution (Forty-sixth Amendment) Act, 1982, the Parliament was empowered to levy 'taxes on the consignment of goods (whether the consignment is to the person making it or to any other person), where such consignment takes place in the course of inter-State trade or commerce.' This was done by inserting entry 92B in List I of the Seventh Schedule and simultaneously amending Article 269 by inserting sub-clause 269(1)(h). Consignment tax is a levy on inter-State transfer of goods.

Ever since, the States have been pressing the Centre to levy the tax, the net proceeds of which are entirely assignable to States under Article 269. The proposed tax is intended to check avoidance of CST. The Commission on Centre-State Relations, 1988, also impressed upon the Government to "bring in suitable legislation in this regard without further loss of time." (Government of India, 1988)

### **5.1 Issues Related to Consignment Tax**

Though the necessary legislation is still to be enacted, industrial and commercial circles have expressed grave concern about the deleterious effects of the impending levy. Trade circles maintain that consignments become necessary in view of seasonal fluctuations in the demand for goods as well as frequent transport bottlenecks. Commercial practices like 'branch transfer' or 'transfer on consignment basis' also help manufacturer-supplier to reduce avoidable costs of

holding high levels of inventory.

What will be the impact of consignment tax on prices? What should be the rate of tax? Who shall have the exemption powers? How will it affect the location of industries? How will the proceeds of this tax be shared among the States? These are some of the issues to be sorted out.

The impact of the consignment tax on prices will depend on the rate of the new levy and the commodities covered under its ambit. Since the new levy will be in addition to CST leviable at 4 per cent, it is bound to push up prices. To minimise the inflationary potential, the rate of the new levy may preferably be fixed at a low level of 1 per cent. It may be recalled that in 1956 when the CST Act was passed the rate was fixed at 1 per cent. However, over the years the rate of CST has been raised by stages to the present level of 4 per cent. Thus, the rate of proposed consignment tax should be low and pegged to that level through constitutional provisions to avoid frequent hikes as in the case of CST.

Furthermore, to lessen the adverse impact on prices, it is necessary to grant exemptions to items of mass consumption. To achieve this, it would be desirable that the power to grant exemptions from the proposed levy be concurrently enjoyed by the Centre and the States. The concurrent power of exemption would enable the Centre to ensure uniformity of taxation of goods of national importance, particularly those which are subject to the scheme of administered prices.

The levy of consignment tax may encourage lopsided industrial development of the country. Producers in States which are self-sufficient with respect to raw materials and the market for goods manufactured out of them will remain unaffected by the consignment tax. Conversely, the entrepreneurs in States which import raw materials from other States and also market their manufactures in other States will be doubly taxed, once on the raw materials and then on the manufactured goods. Under such circumstances, prospective entrepreneurs would be tempted to opt for self-sufficient States to enjoy price advantage on the final product, negating in the process the national policy of regional balanced development.

As regards the sharing of tax proceeds, it is apparent that producer-States like Maharashtra, and Gujarat would like the proceeds to accrue to the respective States in full. Contrarily, the backward States would prefer to see a higher



proportion of the proceeds distributed among the States through the Finance Commission. At a conference of the Chief Ministers held in February 1989, it was agreed that 50 per cent of the proceeds of the consignment tax would be retained by the collecting States and the remaining 50 per cent would flow into a divisible pool from which the amount would be distributed among the States in accordance with the formula devised by the Finance Commission. At the same Conference, the Government announced its decision to introduce a Bill in this regard in the monsoon session of Parliament of that year. Since then nothing has been heard about this legislation.

Sales tax system has already played havoc with internal freedom of industry and trade. Enjoying their constitutional right, different State Governments levy sales tax on a wide range of commodities at different rates with different procedures and rules for its collection. In a scenario like this, the introduction of consignment tax will further confound the existing confusion about commodity taxation at the State level. The imposition of consignment tax would discourage free movement of goods from one State to another. Restricting movement of goods across State borders through tax practices runs counter to the needs of a growing and diversifying economy. Moreover, in view of the current experiment with MODVAT at the Central level to save industry of the cumulative effects of excise duty, the introduction of consignment tax would hinder the process of rationalisation of commodity taxation. Ideally, imposition of consignment tax should be avoided. In case it is unavoidable, a cautious approach is necessary keeping in view the national interest.

## **6.0 Present Nature of Sales Tax**

Under the Constitution, the right to levy sales tax belongs to the State Governments. Each State is, therefore, empowered to collect tax on the sale of goods within its territory according to the rules framed by it. Thus, different State Governments levy sales tax on a wide range of commodities at different rates with diverse procedures and rules for its collection. The Central Government also enters the field in so far as it prescribes the ceiling rate of sales tax on goods in inter-State trade. In the case of three important commodities, viz. textiles, sugar, and tobacco, additional duties of excise are imposed in lieu of sales tax, the

proceeds of which are distributed among the States.

Different States have adopted different variants of the sales tax due to a number of reasons including administrative convenience, ad hoc measures to increase tax revenues, and to attract enterprise in their respective areas. Sales tax in a State may take the form of a single point, double-point and/or multi-point levy. However, single-point is the main type of sales tax imposed on most commodities in all States. In most States a significant part of sales tax revenue originates from first-point levy, i.e. at the manufacturer's level. Some States also levy surcharges on sales tax as an ad hoc measures to augment their resources.

The rate structure of sales tax is further complicated in view of different lists of exemptions/concessions, numerous nominal rate categories, and different administrative procedures in each of the States. These variations have caused disparities in the effective rate of sales tax on similar commodities in different States. Agricultural commodities like cereals and pulses are either exempt or bear low rate of sales tax ranging from 2 to 3 per cent. For most commodities, the rate of single-point levy varies between 4 to 8 per cent. However, in the case of luxury items like motor cars, refrigerators, and VCRs, the rate may go up to even 15 per cent in some States. The rate of multi-point levy hovers around 4 per cent.

### **6.1 Problems Created by Sales Tax**

Perhaps no other tax impinges on so large a number of interests as sales tax. Firstly, it hurts the consumers who ultimately bear its burden. Next, there are the dealers from whom it is collected, and in many cases the producers also come in its ambit in case it is levied at the manufacturer's level. Then there are the State Governments, always anxious to extend its scope and retain their hold on it. Furthermore, the Central Government decides the rate of sales tax on goods of special importance in inter-State trade. Consequently, the operation of sales tax creates a host of problems which may be summarised as follows.

1. Sales tax is a levy on commodities which, in most cases, are also subject to excise duties. As excise duty and sales tax are levied by different layers of Government, it becomes difficult to determine judiciously the impact of these levies on production, investment, and the consumers. No attempt to rationalise commodity tax system can succeed if the Centre and 25 States act independently without co-ordination among themselves.

2. A closely related problem is the taxation of inputs and capital goods, by the Central and State Governments, through excise duties and sales tax respectively. Apart from generating cascading effect, sales taxation of inputs benefits the comparatively richer States at the cost of poorer States. To quote, “The (sales) taxation of inputs also means that its burden falls on consumers outside the State. While procedures exist for refund of excise duties on a product when it is exported outside the country, the sales tax paid on inputs is not rebated. In consequence, the more developed States which have attained high levels of agricultural or industrial production are able to derive additional resources, by taxing consumers in other States, while the resource mobilisation capacity of the less developed States, which have to depend on most of their needs being met by imports from other States, is weakened.” (Government of India, Ministry of Finance, 1977) This reverse flow of funds is further strengthened by the frequent hikes in the rate of Central sales tax.

Originally at 1 per cent, the Central sales tax rate has steadily increased to 4 per cent, thereby imposing undue burden on the importing States and defeating, in the process, the very objective of Central Sales Tax Act of 1956.

To tackle the problem of cascading effect associated with the taxation of intermediate goods, recent reforms at the Central level provide instant credit of excise duty paid on inputs under the MODVAT scheme. Although State laws do provide relief through exemptions in regards to sales tax when inputs are sold to manufacturers, such concessions are limited and lack uniformity. This lacuna in the sales tax system has hindered reform of indirect tax system in India.

3. In order to attract trade and industry to their respective areas, some States have been indulging in a kind of ‘rate war’ (competitive reductions in sales tax rates). It is true that some States lack infrastructural facilities and to compensate for that sales tax concessions come handy to attract industries, but this shortcut erodes the resource-base of the States, so vital for the development of infrastructure which alone guarantees their speedy development on permanent footing.

Differential rates of sales tax on the same set of commodities in different States often lead to uneconomic diversion of trade as well as production centres. It is not uncommon for people of one State making purchases in other States to avoid or reduce sales tax liability. Apparently, purchases from lower tax States to those where rates are higher are beneficial so long as the cost of transporting

goods is lower than the tax differential. Purchase of truck chassis in Daman (a Union Territory levying a low rate of 3 per cent) by the residents of a far off State of Jammu and Kashmir is a popular case in point.

Similarly, rate differentials may cause flight of capital and enterprise from high to low tax rate States thereby distorting natural selection of production centres based on geographical advantages, leading to unnecessary transportation of raw materials and finished goods and hence cost escalations. Such a misallocation of resources undermines economic efficiency and thereby retards developmental efforts.

4. Sales tax has another disadvantage in that it discourages horizontal integration and on the contrary encourages vertical integration in industries. Firms try to produce their own components in order to avoid sales tax. This tendency harms the growth of ancillary units which are mainly in the small-scale sector.

5. Different types of sales tax (multi-point, double-point, and single point) with varying procedures and rules in different States cause difficulties for the traders, particularly small ones, leading to harassment, corruption, and litigation.

## **6.2 Alternative Remedies**

To deal with the foregoing weaknesses of the sales tax system, experts have put forward various suggestions.

***Sales Tax as Central Levy:*** It is argued that through a constitutional amendment, the levy of sales tax can also be made a Central subject and thereafter a rationalised system of indirect taxation of domestic production and consumption can be administered by the Centre. This is a drastic suggestion which has not found favour with statesmen.

***Complete Substitution of Sales Tax by Excise Duty:*** It is suggested, particularly by the business community, that in place of sales tax corresponding enhancements should be made in Central excises the proceeds of which could be earmarked for distribution among the States. This will facilitate rationalisation of commodity taxation and also reduce the cost of collection apart from saving the business community from harassment from the differing sales tax practices of the various States.

Is a complete substitution of sales tax by excise duties possible? Unfortunately not. Like sales tax, excise duties cannot become universal in scope

because of administrative reasons. For instance, the Centre has the legal power to impose excises on agricultural products but it has refrained from doing so. Similarly, small and tiny units of the industrial sector are left out because of administrative reasons. However, what is small for excise duty may be large for the purpose of sales tax.

Since excise duties are of all-India nature, they cannot take into account regional variations in the levels of income and patterns of consumption. However, different rates of sales tax in individual States permit consideration of regional factors. Moreover, if sales tax is levied at the retail stage, the value base of the tax is large and even low rates of tax can yield sufficient revenues. The cumulative effect is also absent.

***Partial Substitution of Sales Tax by Excise Duty:*** The approach towards substitution of sales tax by excise duties has to be selective. Some arrangements already exist in this regard in the form of additional duties of excise in lieu of sales tax on three important commodities namely textiles, tobacco, and sugar. The extension of this arrangement to certain other commodities as recommended by Tripathi Committee has already been discussed above.

***Minimum Rate Agreement among States:*** As already noted, some States have been indulging in a sort of 'rate-war' to attract trade and industry to their respective regions. To avoid this unhealthy competition, the Chief Ministers agreed, at their conference in New Delhi on February 9-10, 1989, that all the States would adopt the minimum floor level rates as recommended by the Committee of Sales Tax Commissioners in its report of 1984 in respect of 29 identified items. The follow up action is yet to take place. Even at the regional level, the response is not encouraging. The Chief Secretaries of northern States (Punjab, Haryana, Himachal Pradesh, Rajasthan, Delhi, and Uttar Pradesh) had recommended in May 1994 that there should not only be a uniform rate of sales tax but the slabs of this tax be reduced in these States. The recommendation is still to be implemented. The lack of concern on the part of States to harmonise their sales tax systems is apparent.

***Single-Point VAT:*** To deal with the cascading effects of a traditional turnover tax, some experts have suggested a single-point VAT at the Central level to replace both excise duties and sales taxes. Since sales tax is the most important source of tax revenue for the States, such a drastic suggestion, which

will leave the States at the mercy of the Centre, is difficult to implement. Replacement of existing system of excises, sales taxation, and octroi by a comprehensive VAT would require amendment of the Constitution by a two-thirds majority in Parliament and its approval by more than half of the States. A comprehensive VAT at the national level has to be ruled out on economic as well as political considerations.

Switch over to VAT has to be an independent exercise by the Central Government and 25 State Governments. In this connection the Tax Reforms Committee, 1991, observed, "As regards sales tax, the Committee is of the view that this tax could be converted into a form of State VAT within the manufacturing sector. There may be no need for levying sales tax at more than two rates since the distributional and other non-revenue objectives could be left to be performed by the Central taxes which apply uniformly throughout the country." (Government of India, Ministry of Finance, 1992) Even this dual VAT system is difficult to achieve because it is highly unlikely that the 25 States will move in tandem to ensure smooth transition to a uniform system of VAT in place of their differing practices of sales tax. Thus, the problem of co-ordination is not only between the Centre and the States but also among the States themselves.

The introduction and extension of MODVAT scheme at the Central level is a step in the right direction to reform excise taxation. Unfortunately, similar reforms have not been introduced at the level of States. The State Finance Ministers' Conference held in New Delhi on May 27, 1994 failed to arrive at a consensus on the replacement of indirect taxes at the State level by a value added tax. The matter was deferred indefinitely by appointing a ten-member Committee of State Finance Ministers to go into this and related questions.

## **7.0 Implementation of VAT**

At a conference of Chief Ministers and Finance Ministers of the States in New Delhi on November 16, 1999, States and Union Territories decided to put an end to all sales tax-based incentives to industry and enforce floor rates of sales tax with effect from January 1, 2000. They also decided to move over to the simple, transparent and efficient regime of Value Added Tax (VAT) with effect from April 1, 2001.

The agreement to impose a set of minimum rates (floor rates) of sales tax on all commodities will ensure sales tax uniformity throughout the country. Four general floor rates of zero per cent, 4 per cent, 8 per cent and 12 per cent and two special floor rates of 1 per cent and 20 per cent were agreed upon.

Essential commodities such as foodgrains, raw meat, eggs, milk and plain water will be subject to the zero rate. There will be a minimum sales tax rate of 4 per cent on commodities such as edible oils, vanaspati, processed vegetables, kerosene, bicycles, chemicals and fertilisers. Products like electricals, tyres and tubes, butter and ghee, blades and razors, drugs and medicines, cooking gas, tea and coffee, biscuits and computers will attract a floor rate of 8 per cent. Television sets, VCRs, air-conditioners, diesel, paints, telephone equipment and carpets will attract the highest floor rate of 12 per cent.

The 1 per cent special floor rate will apply to bullion, gold and silver while the 20 per cent special floor rate will cover petrol, liquor, rectified spirit and narcotics.

It was also decided at the Conference that a standing committee of State Finance Ministers will be constituted to oversee the preparations for the switch over to VAT and to review the progress of the implementation of sales tax floor rates in the interim.

The decision to implement these sweeping tax reforms came about after the Union Finance Minister gave an assurance to make good any consequential revenue loss the States may suffer.

The prolonged tax war among the States had strained the finances of several States. The race among the States to lure industries by offering competitive concessions in sales tax is expected to come to an end. If implemented sincerely, these tax reforms at the level of States will go a long way in creating conducive climate for the growth of country's economy, industry and trade.

However, some fiscal experts feel that the floor rates of sales tax fixed are too high and hence unrealistic. Since the floor rates are already high, there is hardly any scope for individual States to determine effective rates above the floor level depending on expectations of growth of industry and trade in each state. Moreover, the high floor rates are contrary to the post-liberalisation policy of low tax rates to ensure better tax compliance. It is also being felt in some quarters that

uniformity in tax rates is not necessarily a desirable objective to pursue. In many federations (e.g. USA), state governments compete with each other to attract industry and trade to their respective areas.

### **7.1 Empowered Committee of State Finance Ministers, 2001**

At a Conference of Chief Ministers and Finance Ministers of various States held on July 5, 2001 in New Delhi, the report of the Empowered Committee of State Finance Ministers on VAT, headed by West Bengal Finance Minister Asim Kumar Dasgupta, was accepted and adopted for the introduction of VAT with effect from April 1, 2002. The VAT design recommended by the Committee had the following elements.

1. The VAT system will eliminate the cascading burden of taxation by setting off the tax paid on inputs against that on output.
2. It will reduce distortions in the economy caused by double taxation.
3. It will end market fragmentation with a uniform regime of taxation followed in all the States.
4. There will be one category of tax-exempted commodities for all the States.
5. There will be two VAT rates: a uniform 4 per cent for all States on goods of basic necessities and a uniform floor rate of 10 per cent for other commodities (except a few items such as bullion and liquor).
6. A uniform set of procedures for VAT assessment will also be followed by all the States, including the use of Permanent Account Number (PAN) as a common business identifier.
7. The States which do not implement 100 per cent uniform floor rates of sales tax by July-end 2001 should be penalised by discontinuing Central Government assistance.
8. The Centre has undertaken to make good any revenue loss to States on their switch over to VAT. A committee of State Finance Secretaries would evolve clear and measurable criteria for judging revenue loss, if any, due to the introduction of VAT. It will also recommend the manner and quantum of compensation.

As many as 12 States have agreed to implement VAT by April 1, 2002.

However, the road to the Indian common market seems to be dotted with hurdles. Many fear that VAT, as worked out by the Empowered Committee of



the State Finance Ministers, would make the Indian market place chaotic and confusing. There are many issues which must be resolved to smoothen the transition to the modern and efficient system of VAT.

1. The uniform floor rate of 10 per cent does not ensure that States would not charge various higher rates on the same commodity. There should be a cap rate of tax.
2. It is not sure whether the classification of goods into the zero rate VAT and the 4 per cent VAT would be done on a scientific basis.
3. It is not clear what treatment would be given to inter-State trade. The biggest concern of industry and trade is the non-eligibility for set-off of CST paid on inputs sourced from across the State border.
4. The fate of exemptions/concessions being enjoyed by various industries under the sales tax system is uncertain when switch over to VAT takes place. By its very nature, VAT cannot be successfully implemented if there are too many exemptions and concessions.
5. A few States have not yet fully implemented even the uniform floor rates of sales tax.
6. From the Government side also, the promised amendment to the Central Sales Tax Act is still to be carried out. Moreover, it is not clear whether changes in CST would coincide with the transition to VAT or not. To reduce distortions, the business circles would like the CST (levied at 4 per cent) to be abolished in one go rather than phased out.

The benefits of VAT at the State level can be achieved fully only when all the States comply with the recommendations of the Empowered Committee. If all the States move towards a uniform VAT system, it would be an example of cooperative federalism. The introduction of VAT in place of the existing sales tax system would make the common market dream a reality.

## **7.2 Agreement of January 23, 2002**

At the Conference of State Finance Ministers held on January 23, 2002 a final decision was taken that all States and Union Territories would introduce VAT from April 2003. This position was reiterated by all States at the Conference of State Chief Ministers held on October 18, 2002. Empowered Committee of State Finance Ministers endorsed the suggestion that every State Legislation on VAT

should have a minimum set of common features. Accordingly, a model VAT Bill was circulated to all the States. Introduction of VAT is expected to increase revenue buoyancy, as the coverage expands to value addition at all stages of production and distribution chain.

Again, at a meeting of the Finance Ministers of all States/Union Territories on January 17, 2003, States and Union Territories again reiterated their firm commitment to introduce VAT from April 1, 2003. It was decided that the VAT legislations of all States and UTs would have common provisions in respect of all important matters and that a simple VAT legislation with maximum convergence would be implemented. It was also agreed that along with the introduction of VAT, the origin based Central Sales Tax would be phased out. It was also agreed that the Additional Duties of Excise (Goods of Special Importance) Act would be suitably amended to empower States to levy sales tax/VAT on sugar, textiles and tobacco with a ceiling rate of 4 per cent. This would be done without affecting the existing levy of Additional Duties of Excise on these items by the Union Government

In view of the apprehensions expressed by a large number of States about possible revenue losses in the initial years of introduction of VAT, an assurance was given to the States that the Government of India would compensate the States to the extent of 100 per cent of revenue loss in the first year (2002-03), 75 per cent of the loss in the second year (2003-04) and 50 per cent of the loss in the third year (2005-06).

The Empowered Committee of State Finance Ministers agreed upon the following sequence of steps to ensure introduction of VAT in place of retail sales tax system in States.

1. Passing of VAT legislation and framing of rules and regulations.
2. Computerisation of dealers who will fall within the ambit of VAT.
3. Training of tax officials, traders and consumer associations.
4. Publicity for consumers.
5. Implementation of VAT, assigning VAT identification numbers to tax payers.
6. Implementing transitional measures for introduction of VAT.

### **7.3 Task Force on Indirect Taxes, 2002**

The Task Force on Indirect Taxes (Chairman: Vijay Kelkar), unanimously

acknowledged that VAT is a major reform in the indirect tax system of India. For a smooth and speedy implementation of VAT at the level of Centre and States, it made the following recommendations.

1. A publicity awareness programme should be started jointly by the Central and State Governments and the former should extend financial support for this, if required. Since State VAT is expected to be implemented from 1.4.2003 it is also necessary that the publicity awareness programme should be implemented at the earliest.
2. An attempt should be made towards uniformity of all State legislations, procedures and documentation relating to VAT.
3. The issue of compensation, if it arises, must be primarily tackled through mutually acceptable mechanism of additional resource mobilization through service tax and not through budgetary support.
4. With the introduction of VAT, all other local taxes be discontinued.
5. Whereas additional duty of excise may continue for textiles up to 2005, it may continue even thereafter for cigarettes which should not be subjected to VAT.
6. The VAT scheme should provide for grant of credit of duty by the importing State for the duty paid in the exporting State, in the course of inter-State movement of goods.

For the stability and continuity of VAT, the possibility of a VAT Council or a permanent suitable alternative, vested with adequate powers to take steps against discriminatory taxes and practices and eliminate barriers to free flow of trade and commerce across the country, should be explored

#### **7.4 Agreement of June 2004**

At a meeting of the State Finance Ministers with the Union Finance Minister on June 18, 2004, it was decided that all States will introduce a uniform VAT from April 1, 2005. The proposed VAT will replace the taxes levied by different States like sales tax and octroi. Coinciding with the introduction of VAT, the Central Government will bring down the Central Sales Tax (CST) rate from 4 per cent to 2 per cent. The CST will be phased out in 2006-07. It was also decided that traders with an annual turnover up to Rs. 5 lakh will be exempt from VAT. This decision was aimed at ending traders' opposition to VAT. It may be

recalled that States have missed at least five deadlines for the introduction of VAT, mainly due to resistance from trading community.

### **7.5 Salient Features of the State-level VAT Design**

VAT is essentially a federal or central tax, while in India it is aimed at replacing State as well as Central sales taxes. Its effective implementation depends almost entirely on the co-operation of the State Governments. In an ideal situation, VAT is supposed to be a tax to end all taxes. Many countries that have adopted VAT do not levy excise duty, entry tax or luxury tax. However, State Governments in India are demanding the right to retain and, in fact, widen the tax net by levying a range of taxes, including entry tax. This would defeat the basic purpose of the imposition of VAT, namely unifying and harmonizing the complex commodity tax structure in the country.

A VAT regime is theoretically meant for a unified market in which the VAT levied can always be set off against taxes already paid, irrespective of the state-wise location of the manufacturing or trading entities. In India, these inter-state adjustments are proving to be difficult to implement in view of the existing constitutional provisions regarding distribution of taxation powers between the Centre and the States. It needs, however, to be emphasised that the States must think in terms of economic development of the country as a whole and encourage the free flow of trade and commerce in the economy. A national approach is necessary to harmonise and rationalise the existing system of commodity taxation.

In view of the above constraints and also to provide some flexibility to the States, the Empowered Committee, through its deliberations over the years, finalised a design of VAT to be adopted by the States. The model design seeks to retain the essential features of VAT, while at the same time, providing a measure of flexibility to the States, to enable them to meet their local requirements. The main features of the VAT design finalised by the Empowered Committee are the following:

1. Rates of VAT on various commodities shall be uniform for all the States/UTs. There are 2 basic rates of 4 per cent and 12.5 per cent, besides an exempt category and a special rate of 1 per cent for a few selected items. The items of basic necessities have been put in the zero-rate bracket or the

exempted schedule. Gold, silver and precious stones have been put in the 1 per cent schedule. There is also a category with 20 per cent floor rate of tax, but the commodities listed in this schedule are not eligible for input tax rebate/set off. This category covers items like motor spirit (petrol), diesel, aviation turbine fuel, and liquor.

2. Model VAT design makes provision for eliminating the multiplicity of taxes. In fact, all the State taxes on purchase or sale of goods (excluding entry tax in lieu of octroi) are required to be subsumed in VAT.
3. Provision has been made for allowing input tax credit, which is the basic feature of VAT. However, since the VAT being implemented is intra-State VAT only and does not cover inter-State sale transactions, input tax credit will not be available on inter-State purchases.
4. There are provisions to make the system more business-friendly. For instance, there is provision for self-assessment by the dealers. Similarly, there is provision of a threshold limit for registration of dealers in terms of annual turnover of Rs. 5 lakh. Dealers with turnover lower than this threshold limit are not required to obtain registration under VAT and are exempt from payment of VAT. There is also provision for composition of tax liability up to annual turnover limit of Rs. 50 lakh.
5. Regarding the industrial incentives, the States have been allowed to continue with the existing incentives, without breaking the VAT chain. However, no fresh sales tax/VAT-based incentives are permitted.
6. Exports will be zero-rated, with credit given for all taxes on inputs/purchases related to such exports.

### **7.6 Progress of VAT Implementation**

According to *Economic Survey, 2006-07*, "VAT has been introduced by 30 States/UTs so far. Tamil Nadu has implemented VAT from January 1, 2007. The union territory of Puducherry has communicated its decision to implement VAT from April 1, 2007. Uttar Pradesh has not yet taken any decision in this regard. Since Sales Tax/VAT is a State subject, the Central Government has played the role of a facilitator. A compensation formula has also been finalised in consultation with the States, for providing compensation, during 2005-06, 2006-07 and 2007-08, for any losses on account of introduction of VAT and

compensation is being released according to this formula. Technical and financial support has also been provided to the States for VAT computerisation, publicity and awareness and other related aspects. (Government of India, *Economic Survey*, 2006-07)

## 8.0 Conclusion

Broadly speaking, the experience of implementing VAT has been quite encouraging. The new system has been received well by all the stakeholders, and the transition has been quite smooth with the Empowered Committee constantly reviewing the progress of implementation. The EC has advised the States to constantly interact with trade and industry to remove their apprehensions, if any, and to ensure that the benefits of VAT due to input tax credit and reduction in tax rates (wherever applicable) are passed on to the consumers. The EC is also persuading the remaining States/UTs to implement VAT at the earliest.

### End Notes

1. Under Article 258(1), the Union has the power to delegate to any State Government any of its executive functions (including the power to assess and collect sales tax on inter-State trade). Thus, the power to levy and collect sales tax on inter-State trade belongs to the Centre [Article 269(1)(g)] though it has delegated the power to collect it to the States.
2. Clause (3) of Article 286 was further amended by the Constitution (Forty-sixth Amendment) Act, 1982. In its present form it is as follows.  
Any law of a State shall in so far as it imposes, or authorises the imposition of  
(a) a tax on the sale or purchase of goods declared by Parliament by law to be of special importance in inter-State trade or commerce; or  
(b) a tax on the sale or purchase of goods, being a tax of the nature referred to in sub-clause (b), sub-clause (c) or sub-clause (d) of clause (29-A) of Article 366, be subject to such restrictions and conditions in regard to the system of levy, rates and other incidents of the tax as Parliament may by law specify.
3. In 1956, when the Central Sales Tax Act was passed the rate was fixed at 1 per cent. Subsequently, it was raised to 2 per cent, 3 per cent, and 4 per cent in 1958, 1966, and 1975 respectively. It was reduced to 3 per cent and 2 per cent in 2007 and 2008 respectively.
4. Originally, the rate was fixed at 1 per cent in 1956. It was raised to 2 per cent, 3 per cent, and 4 per cent in 1963, 1966, and 1975 respectively.
5. It means the States are free to fix the rate of sales tax on the internal sales of non-declared goods but there is a ceiling rate of 4 per cent on the sale of such goods in inter-State trade.

For example, if the rate of sales tax on internal sale is 6 per cent, it will be 4 per cent for inter-State trade, being lower of the two.

6. In other words, the rate of CST is a minimum of 10 per cent. For example, if general sales tax is charged at the rate of 5 per cent on the sale of colour television in a State, the rate of CST on the same will be 10 per cent, being higher of the two rates. In 1956, the minimum rate was fixed at 7 per cent but was raised to 10 per cent by the Central Sales Tax (Amendment) Act, 1963.
7. Internal as well as inter-State sales tax on goods of special importance is governed by the Central Sales Tax Act, 1956. The present rate of CST is 4 per cent.
8. India's federal system of government creates a dual polity based on divided governmental functions and taxation powers. Taxation laws of the Central Government extend to the whole of the country while those of State Governments are applicable within their respective jurisdictions. A tax belonging to the States may be imposed with a varying base and/or rate in different States. Even the procedures and rules for its collection may differ from State to State. The lack of uniformity in the imposition of State tax laws can cause difficulties for traders and consumers and thus hinder inter-State trade. To overcome these problems, arrangements could be made to transfer from the States, the legal right to levy the tax, to the Centre with the proviso that revenue collected will be assigned to the States. This is known as 'tax rental arrangement'.

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