VAT: A Valuable Strategy to Combat Tax Hazards

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Traditional indirect taxation policy plays a vital and commendable role in mobilising fund through tax revenue collections although it triggers the cascading effect of tax i.e. tax on tax leading to rise in the prices of products and services. The Value Added Tax (VAT) aims to radically reform the prevailing system of sales tax laws that was mingled with the horrible effects of double taxation. VAT is the most diversified and simple as well as transparent indirect tax system with in-built capacity to raise more tax revenues without distorting the existing tax structure and is yet able to widen the tax base. VAT system has the unique feature of preventing the scope of tax avoidance. VAT is more taxpayer-friendly than the existing sales tax system and the traders/common people need not have any fear about VAT as it is simple to administer and is less hazardous to adopt and adapt. It does not exert any undue pressure of shouldering additional tax burden. For the socio-economic growth and prosperity of an economy, introduction of VAT is a boon and not a baneful act.

The public hue and cry against the introduction of VAT has become a threat to many State Governments implementing VAT. The traders and the businessmen are projecting VAT as the root cause of rise in prices of goods and services. As a result of this, the public sentiments have been aggravating blatantly to exert pressure on the administration to stop implementation of VAT for the common interests of the general public and thus generating bottleneck in the economy. It has become a matter of great problem since VAT is not what the traders/people are trying to establish and evince.

Concept and Genesis of VAT

The term 'value added' refers to increase in value of goods and services at each stage of production/ transfer of goods or commodities/ services. Thus VAT (Value Added Tax) basically means the tax likely to be levied on the value added by an organisation at each stage of its rendering services or producing goods. It is a simple transparent tax collected on sale/transfer of goods/services and has the unflinching capacity to augment the economic development of a society through better tax mobilisation. The praxis of Value Added Tax is that it is a tax on the final consumption of goods/services and is ultimately borne by the customer although it is collected at every stage of production/distribution and a tax credit is granted at each stage for tax paid earlier in the chain of transfer/sale of goods and services till it reaches the ultimate customer. It is anti-inflationary and is armoured against price rising. However, small producers/ dealers up to certain limit are outside the ambit of VAT for which the State Governments may face some amount of revenue loss. To tackle the situation as well as to inspire the State Governments to implement VAT so as to keep pace with the WTO and GATT regime, the Central Government has agreed to compensate cent per cent of the loss of revenue during 2005-06, 75 per cent of the revenue loss during 2006-07 and 50 per cent of the revenue loss during 2007-08.

The concept of VAT first emerged in 1921 when F. Von Siemans proposed it as a substitute for the then newly introduced German

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Turnover Tax. France is the pioneering European Economic Country to adopt and usher VAT for the first time in 1954 whereby VAT made its debut followed by UK, USA and then to scores of other countries with every enthusiasm to operate as one of the major instrument to generate additional tax revenue. Along the lines of international experiences of introducing VAT as one of the most fabulous tool of fiscal policy measure in garnering revenues for socio-economic developments by various developed countries of the world, many of the East and East Asian countries like Indonesia, Thailand, Philippines, Malaysia, Sri Lanka, etc. have introduced VAT in their tax reform programmes with a major drive to replace sales tax and other taxes. VAT will replace the existing system of inspection by a system of built-in self-assessment by the dealers and auditing. The tax structure will become simple and more transparent and will lead to voluntary tax compliance and will also augment revenue growth.

Rationale of Introducing VAT

In the existing sales tax structure, there are problems of double taxation of commodities and multiplicity of taxes, resulting in a cascading effect of tax burden. For instance, in the existing structure, before a commodity is produced, inputs are first taxed, and then after the commodity is produced with input tax load, output is taxed again. This causes an unfair double taxation with cascading effects. In the VAT, a set-off is given for input tax as well as tax paid on previous purchases. In the prevailing sales tax structure, there is a multiplicity of taxes in several States, and such taxes include turnover tax, surcharge on sales tax, additional surcharge, etc. With introduction of VAT, these other taxes will be abolished. In addition, Central sales tax is also going to be abolished in a phased manner. As a result, overall tax burden will be rationalised, and prices in general will tend to fall.

Introduction of VAT has some sparkling advantages. It provides a set-off for input tax as well as tax paid on previous purchases. Other taxes, such as turnover tax, surcharge, additional surcharge, etc. will be abolished and overall tax burden will be rationalized. The general prices of products will fall because of non-cascading effect of taxation.

In India the need for fiscal reforms in indirect taxes became highly imperative and somehow inevitable because of the irrationality and distortions in the overall tax structure of it as also the poor tax revenue mobilisations. Fiscal reforms in the major Asian countries during the eighties have been quite spectacular and successful. The introduction of various tax rates as well as the incapacity and failure on the part of the tax administration to raise adequate tax revenues and to look after the every details of voluminous tax legislations to control tax evasion, had made it a real compulsion to adopt tax reforms as an emerging need.

The Indirect Taxation Committee so formed in July 1976 under the chairmanship of L. K. Jha extensively reviewed the Indian Indirect Tax structures where it was found that there were multiplicity in tax rates, exemptions and tax base was narrow thus making the tax system less effective and less robust in regard to tax mobilization. To overcome the impasse, the Committee recommended both long-term as well as short-term measures for reforming the indirect tax system and advocated to introduce *ad valorem* tax as far possible to boost the economy on to its growth trajectory with less of departure from the cherished path of success and growth so as to compete with the global standards and prosperity. As a refinement of *ad valorem* tax, the Government latter introduced MODVAT with effect from March 1, 1986. A large number of foreign countries, both developed and developing, have successfully taken recourse to fiscal reforms with utmost fervour and zeal to introduce VAT as one of the magnificent vehicle for raising revenue for their economies.

Features of VAT

VAT is a multi-point tax without any troubles of double taxation effect. It is chargeable at every point of sale/transfer of goods and services. The mechanism of VAT is quite simple and easy to understand. It has no cascading effect on the multiplicity of taxpayers' liability to pay tax on the same aspect again and thus it effectively surpasses the pyramiding of tax incidence as is inherent in the conventional sales tax procedures and therefore, it is often called as Improved Sales Tax. Under VAT there is no tax on tax since only value added at any stage of production or distribution of goods is made subject matter of tax and an allowance is offered for the previously taxed material cost and other overhead charges so incurred.

With offsetting of tax on inputs against that on output, VAT does away with tax on tax. Claiming input tax credit under VAT ensures proper invoicing. These features of VAT encourage voluntary disclosure of complete information on business turnover. Every business transactions carried on by individuals, partnerships, companies etc. will come within the purview of VAT. It will not cover small businesses with a turnover below a certain limit that will be decided by

each state. Medium size business can opt for VAT or a composite system of tax on turnover.

The VAT rates scheduled to be applied are— the zero rate, 1%, 4% and a general rate of 12.5%. These rates will be uniform in all states across the country. The same set of goods will be charged at the same rates in all states. Most essential commodities are exempt from VAT or fall in the category of 4%. Most business purchases will carry a VAT charge. VAT paid as input tax can be adjusted against VAT on output. This will include VAT paid on purchases of raw materials or goods purchased for resale. The original copy of the VAT invoice is required to be produced to claim the input tax credit. VAT observes tax neutrality and tax equity i.e. equal treatment for equal. VAT is equally applicable in every sort of transaction leading to value added whether by a small trader or by a big wholesaler and thus VAT is a rational tax system.

VAT Methodology

The VAT methodology is simple and easy to understand. Let us assume that A is the primary producer/manufacturer who sells his products to B who is a secondary producer /manufacturer who again sells or transfers his finished products to C who is a dealer/wholesaler and he sells goods to D, the final consumer. Now if A sells goods to B for Rs.3000 on which VAT liability arises Rs.300 (say VAT rate is 10% at each stage of sale/transfer of goods). B has to pay Rs. 3,300 to A who will pay the VAT to the government exchequer. Now suppose, B incurs some amount of expenses in the form of wages, additional raw materials and other manufacturing expenses for completion of production and sells his goods to C, say for Rs.5,000. On this sale, VAT liability will be Rs.500 for which C will pay Rs. 5,500 to B. But B's actual VAT liability will be only Rs. 200 since out of gross VAT liability

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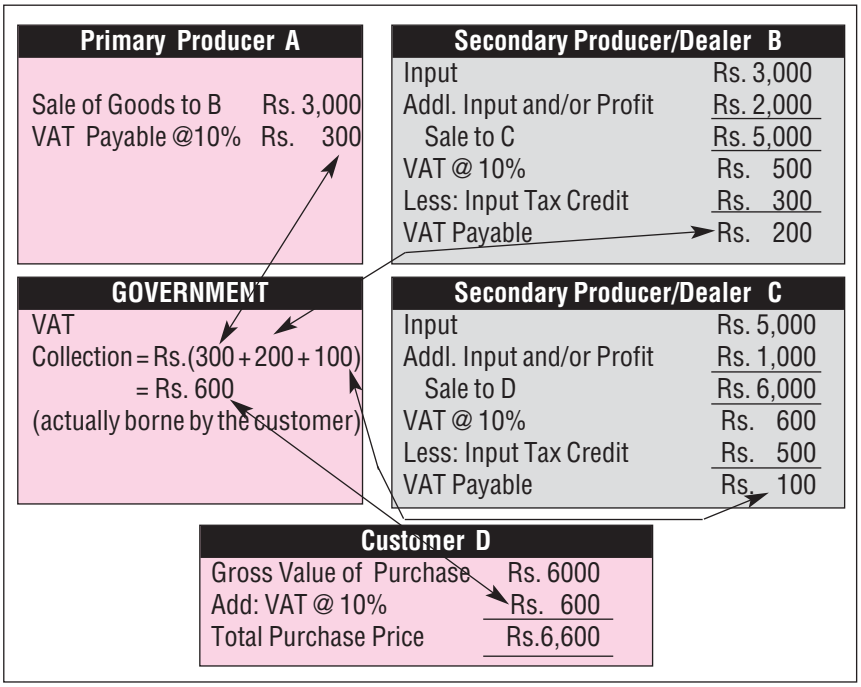
of Rs. 500 he will get an input tax credit of Rs. 300 previously borne by him while purchasing from A. Hence, B will pay VAT of Rs. 200 only to the government. Similarly, in case of sale by C to D for Rs. 6,000, C's net VAT liability will be Rs.100 only because out of gross VAT liability of Rs.600 he will get input tax credit of Rs. 500 paid by him earlier to B and for the ultimate consumption by customer D, the VAT liability of D will be Rs.600 i.e. 10% on Rs. 6,000 — the value of goods purchased by him for ultimate consumption. Thus the total VAT of Rs.600 so generated in the instant case will be borne by the consumer D although collected at Rs. 300, Rs. 200 and Rs.100 respectively at different points of transfers/sales of Rs.3000, Rs.5000 and Rs.6000 without any cascading effect of tax causing price rise.

Value addition in the hands of A = Rs.3,000, VAT is Rs. 300; value addition in the hands of B = Rs. 2,000 (Rs. 5,000 – Rs. 3,000), VAT is Rs. 200; value addition in the hands of C = Rs. 1,000 (Rs. 6000 – Rs. 5,000), VAT is Rs. 100.

From the following diagrams, it is evident that because of the inbuilt shiftability of VAT, the ultimate VAT liability is borne by the customer although collected at different stages of production or distribution process. It also proves that the VAT liability does not multiply despite its several collections at different levels and also supports the view that VAT methodology does not act as a cost multiplier. It provides a unique opportunity to entail the tax burden on the ultimate consumers. Over and above this, it may be reiterated here that VAT is a tax which is levied in an equitable manner at each point of production or distribution process of a firm with a spillover mission to ensure legitimate tax revenue collection without enhancing the tax liability and without increasing the cost.



Advantages of VAT

Introduction of VAT has some sparkling advantages. It provides a set-off for input tax as well as tax paid on previous purchases. Other taxes, such as turnover tax, surcharge, additional surcharge, etc. will be abolished and overall tax burden will be rationalized. The general prices of products will fall because of non-cascading effect of taxation. There will be self-assessment by producers/dealers and transparency will be attracted leading to higher revenue mobilisation. The advantages of VAT may be highlighted as follows:

(1) VAT has magnificent benefits besides its splendid performance of amassing tax revenues to finance the fund necessary for socio-economic growth of an economy. It has unleashed the scope of its wide adaptability around the globe.

(2) Uniform rates of VAT will boost trade activities in an enthusiastic manner and will create a favourable atmosphere for expansion and growth of the economy.

(3) As VAT is mostly based on 100% self-assessment, it will reduce the taxpayers' hazards to visit tax offices frequently and will thus lead to attract better tax compliance leading to less of tax evasion and tax avoidance. It will also pave the way to achieve better tax administration and tax management.

(4) VAT has the unique system of providing tax credit, which is taxpayer-friendly, and favours better tax compliance. The system of input tax credit will promote production efficiency of investment surplus. Investment decisions will be less disrupted and therefore investment proposals will not be based on tax differentials, tax holidays.

(5) With zero rating of exports, the rate of VAT on export goods will be zero and yet credit will be given on tax paid on inputs. This will foster export promotion and will help the economy amass foreign exchange wealth, improve the balance of payment and will ultimately boost competitive strength of the economy.

(6) VAT is not amenable to price rise as there is no tax on tax in the system. Price escalation due to tax burden can be easily avoided and it will make the pricing more competitive with the foreign counterparts. The matter is relevant particularly in the present era of globalisation and economic liberalisation where competition is acute and overwhelming. The VAT will therefore help common people, traders, industrialists and also the Government. It is indeed a move towards more efficiency, equal competition and fairness in the taxation system. It is taxpayer-friendly since it is mostly self-assessment tax and has the necessary impetus to streamline the indirect tax system for the betterment of the society. It will help achieve legitimate tax mobilization and will still offer overall cost effectiveness.

Demerits of VAT

Despite several advantages that VAT possesses, it has some shortcomings too. Like other indirect taxes, VAT is a destination-tax ultimately borne by the final customers. VAT requires a sound and systematic base and a profound tax administration to function properly. A good and well-diversified and integrated tax administration is highly needed to adopt VAT otherwise it may jeopardise the basic objective of VAT to accentuate on more tax revenue mobilisation. The harmonization of Input Tax Credit which is the essence of VAT system requires a well formulated and compact networking based on computer access facility on a large scale all around the country and abroad which is not readily available in India for the lack of available infrastructures at its disposal in different hinterlands of various states.

Conclusion

VAT is a progressive tax system to ensure and to observe tax equity and tax neutrality as well as to usher economic solvency of a society. It is highly conducive to provide necessary impetus to stumble along the path of socio-economic growth trajectory by replacing existing distortionary and multiple-rated indirect tax structure comprising central excise duties and individual state sales taxes with cascading effect to raise prices of products/services. To foil the shortcomings of the present indirect tax laws it is highly judicious to introduce VAT in place of several sales tax, excise duties and other related taxes. The traders and the general people need not be worried about VAT since it is not against the interests of the general public and is not injurious to the socio-economic status of them. The philosophy of VAT and its noble intention to raise public fund without causing any extra hardship on the taxpayers should be highlighted in an unambiguous manner to mend the minds of the common people for their whole-hearted acceptance of VAT. It has to be introduced on a holistic approach to keep pace with the changing global scenario especially under the WTO and GATT regime to tame fierce international competitions. Over and above this, the traders' lobby should be complimented with due exposures favouring VAT and its glaring effectiveness to avoid double taxation and its corollary to check price rise which is a must in the present era of globalisation and economic liberalisation. The common people should also be motivated and adequately geared up to adopt and adapt VAT for the greater interest of the society. ■