

*Full Length Research Paper*

# The effect of value added taxes on the Indian society

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Accepted 13 April, 2011

Value added tax (VAT) is a type of indirect tax that is imposed on goods and services. Sometimes, when the government operates on a budget surplus or wants to increase its revenue in order to finance its budget deficit. A question that arises is whether value added tax has been a boon or misery for a developing country like India. Around 136 countries in Asia have recognized the importance of value added tax. In one of the most large scale reforms of the country's public finances in over the past 50 years, India has finally agreed the launch of its much delayed value added tax from 1st April, 2005 at a rate of 12.5%. The tax rate is fixed by meeting of different state level Finance Minister, in New Delhi, designed to make accounting more transparent, to cut short trade barriers and boost tax revenues. According to Chanakya, "A government should tax its people like a shepherd shears a flock or a bee gets nectar from a flower". The tax is levied not only on products but services that is the source of revenue for the government to plan for development activities in the country. Since, India is a developing country, the main source for revenue is generated through tax levied on the individual on the purchase of goods or services. The government imposes taxes and duty charges on the fellow people for fulfilling the infrastructural, technological, entrepreneurial demand of the country. Whether the imposition of high tax on the society is favorable or unfavorable in the present scenario to meet the technological and infrastructural demand? It has been identified that rural people are charged more tax than urban people due to subsidized rate provided to them in food products, transportation, electricity, water etc. for these facilities they are charged indirectly from their source of income like agricultural and allied activities. The question that arises is: do value added taxes promote prosperity and well being for the common men? VAT is omnipresent in all goods and services provided to the consumer. The paper aims at presenting the importance of value added tax in the Indian society, its impact and the future prospect for product and service industry in India. The data collected is secondary based from the governmental publications and standard for chartered accountants.

**Key words:** Value added taxes levied, socio-economic effects, role of intermediaries, Indian society, calculation of value added taxes.

## INTRODUCTION

Value added tax was first introduced in France in the year 1954 and its scope was expanded to include services in 1978, agriculture in 1983 thus resulting in value added tax becoming one of the most important accounting innovations of the present century. It is presently adopted by over 115 countries all over the world. Value added tax is the abbreviated form for value added tax. For this purpose, value added is to be understood as "the value that a producer (whether a manufacturer, distributor) adds to his raw materials or purchases before selling the new or improved product or service to the user. The tax

was first proposed by Dr. Wilhelm Von Siemens for Germany in 1919. The income tax, excise duty and customs duty constitute the major sources of tax revenue to the central government, the state government substantially depends on sale tax as the main source of revenue. It is implemented on all products related to food and beverages, medicines, transportation, telecommunications, amusement parks, cinema halls, properties owned etc.

Value added tax was first introduced by Maurice Maure, a French Economist and the joint director of the French tax authority in 1954. Though this tax system was first applied in France, it was soon adopted by a number of other European and Asian countries. The Indian economy is moving towards simplified and transparent

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system of indirect taxes by introducing goods and services tax in near future (Peter, 2008).

The indirect taxation, is levied on value from raw materials to the final product, at every stage, value is added to the goods and services. Initiated in France, today value added tax is widely used as a method of taxation in most of the European and Asian countries. Value added tax was first introduced in India in the year 2005. It was levied on all goods and services. Value added tax is a novelty which has claimed the international attention as more countries are adopting it in varying degrees to restructure their systems of taxation. The VAT act allow the set off of tax paid on the inputs in excess of 4% in stock transfer of goods, the same would not be useful in case where goods are transferred from non state, where similar provisions does not occur, the subsequent rates are 4 and 12.5%.

### Definition – Value added tax

Value added tax in simple terms could be defined “as a tax on the value addition at different stages of manufacturing and distribution of goods and services”. It is a form of indirect tax in the nature of a multi-point sales tax with a set off or credit for tax paid on purchases / services. Each transaction of goods sold in the course of business is taxed, thus providing revenue to the government on value addition at each stage.

### Objectives of value added taxes

The primary objective is in the forefront of the evolution of value added tax Law, the State must ensure that barriers to inter-state trade should be eliminated in order to create a unified national market. It will agree that the VAT process must be simple, transparent, and consistent in structure and approach (NCAER, 2009).

### METHOD OF COMPUTING VAT

Value added tax is levied in principle on the value of goods and services produced. Value added tax for a given period is equivalent to all income- wages and salaries, rent, interest and profit generated in the production of the aggregate output. A VAT never differs from a general tax on incomes of firms rather than individuals who ultimately receive income are responsible for paying the tax to the government. There are three methods for computing an individual firm which include the addition, the credit or invoice and subtraction method. The first method-addition presents computing the VAT base is to sum the firm's payments of wages, salaries, interest, rent and profits.

These payments represent the firms contribution to the value of the economy's output in the period or value added. The base multiplied by the tax rate indicates the

amount owed the government in value added taxes Purohit and Vishnu (2009). The second method of subtraction method computes each firms value added as sales less purchases of raw material inputs from other businesses. The third method of credit or invoice computes the tax by applying the tax rate to sales and then subtracting taxes paid on purchase of components. The computation of VAT in European countries are usually computed by the credit method (Figure 1).

The term VAT has been described as some special rate for some goods and services. Various categories of economic activity have been exempted in European countries to simplify the administrative procedure, the banking and the financial institutions offer services to which the value added concept is generally difficult to apply and are exempted from tax which includes governmental and educational services, medicine, transportation, communication products and services.

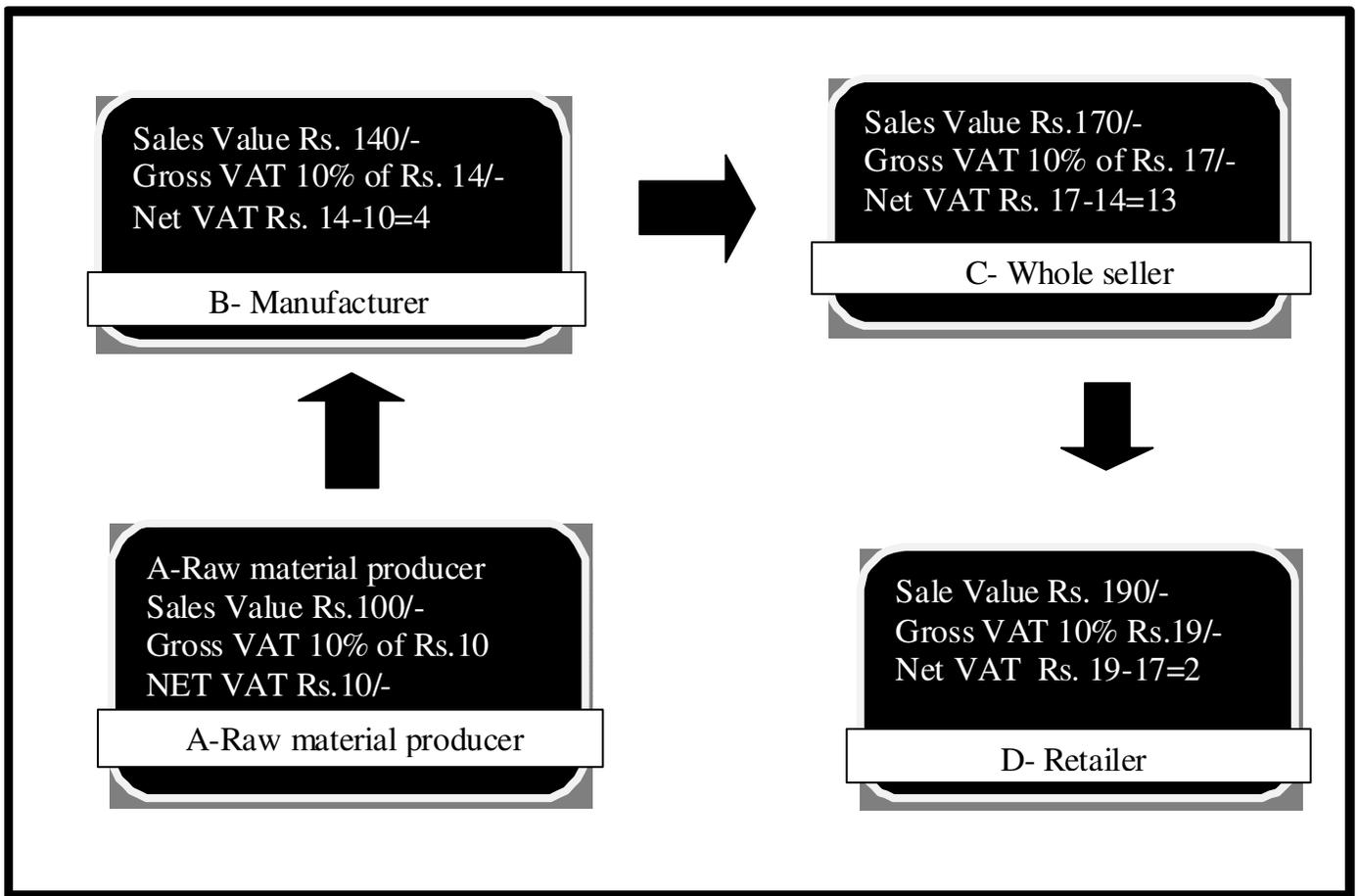
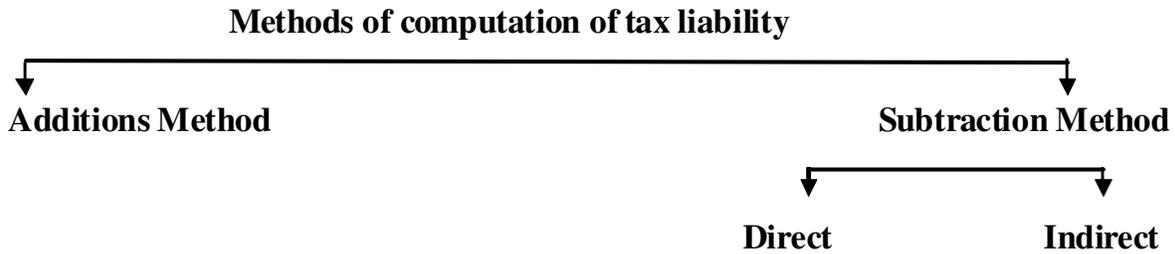
In developing countries, considered necessities of life are taxed at lower rate than the base rate while the luxury items are taxed at higher than basic rates (Rao, 1998).

### Effects on the Indian society

In this diagram the Value added is the value that a producer (whether manufacturer, distributor, advertising agent, farmer etc.) adds to his raw materials, or purchases before selling the new or improved product or service. That is the inputs ( the raw materials, transport, rent, advertising and so on are brought, people are paid wages to work on these inputs and when final goods and services is sold some profit is left. As the term indicates, it is a tax imposed on value addition of the goods in chain of transaction from pro duction, distribution and retail. A full fledged VAT in essence an *ad valorem* tax on domestic final consumption levied at all stages between production and final point of sale. At each stage tax is confined only to value added. So, Vat is a tax not on the total value of the goods being sold but only on the value added to it by seller. The seller is therefore liable to pay tax not on its gross value but on the net value, the gross value minus the value of input. It is a multi stage tax is being collected in instalment. Therefore, VAT may be called as modified multipoint sales tax. In this calculation starts from Rs.10/- from a trader to retailer ends in Rs. 19/- showing a difference of Rs.9 the additional value being extra charged till it reaches the consumers by the retailers.

The importance of value added tax in India and other countries are due to the following accounting standards which include:

1. Simple tax structure and transparency;
2. Neutrality of tax with respect to behaviour of consumer and of producer;
3. Transparency of tax amount in cost of goods and zero rating of tax on exports are easily identifiable.



**Figure 1.** Diagrammatic representation – Calculating VAT. Total VAT collected at four points .Rs 10+4+ 3+2=Rs.19/- Source: A guide on Value Added Tax, Codissia (March 2003), The Coimbatore District Small Industries Association, Coimbatore.

4. Ability to provide same revenue to the Government with lower rates of tax.

Over the last few years, many attempts have been made to implement value added tax in India. Initially, all states were to move to value added tax system by 2000, but administrative problems and concern over the revenue implications of the change delayed the scheduled implementation. It has been postponed many times in the five years and was finally applicable in 2005.

**IMPORTANCE OF VALUE ADDED TAX IN INDIA**

If a well administered system comes in, it will not only close options for traders and business men to evade paying their taxes, but also make sure they will be compelled to keep proper records of sales and purchases. At the macro level, two issues make the production of VAT critical for India. Industry watchers believe that the value added tax system, if enforced

properly, will help in addressing issues like fiscal deposits problems in India and create a high price market for the public Shankar (2005).

### **Summarization of the current advantages of value added taxes**

1. Covering all the states in India,
2. It leads to revenue security for the government,
3. Selection of rates varies state to state due to diversified markets.

### **Disadvantages of the value added taxes at present:**

1. VAT is recognized as an integral activity,
2. VAT is difficult to operate from the position of both administration and business,
3. Leads to business inflation,
4. It has been identified that value added tax favours capital intensive firms that can meet the global challenges.

### **Articles–Spotting VAT status in India**

**1. Times of India, 2010 Mumbai:** This is a piece of news to go nuts about. The prices of dry fruits, including cashew nuts, almonds and dates, will go up by 20% to 25% in the state after the government decided to increase the value added tax on dry fruits by 8.5% from the current 4%. Once this 12.5% value added tax is levied on the nuts, prices will also soar for ayurvedic medicines, for which dry fruits is used as ingredients.

The State's decision came in on March 31, after the presentation of the budget.

**2. Hindustan Times, 2009 New Delhi:** More than 400 petrol dealers here remained closed on Monday in protest against the increase in the value added tax on diesel in the capital; Dealers argued that the increase in Value added tax from 12.5 to 20%, has made diesel costlier by Rs. 3.50 in Delhi, as compared with Haryana leading to a loss of almost 30 to 35% of business for petrol dealers. The worst effected were the 150 odd petrol pumps that are located to the borders of Haryana and Uttar Pradesh.

**3. Express line, 2007, Jammu:** With the VAT Bandh again, the medicine and chemist shops closing down from Monday till Friday. Though no prior notice has been given to the government, the chemists and druggist say that the closure has been forced, since the government is not responding and the State government has not issued any such prior notice so far regarding tax charges.

The articles in the newspaper, show how society is effected with the imposition of value added tax in India. The common people who are the daily earners are the

most sufferers. Sometimes, such impositions anger burst out into the form of strike, hartal and bandh affecting peace and harmony of the society. The common people are the most sufferers as they remain entangled in meeting essential commodities for their living which include rent tax, food tax, education tax, loan tax, medicine tax, entertainment tax, fare tax etc To maintain these standards the people sometimes engage themselves into activities leading to theft, fraud, cheating, and embezzlement in the environment.

### **EFFECTS OF VALUE ADDED TAXES ON SOCIETY**

One of the important components of tax reforms initiated since liberalization, is the introduction of value added tax. VAT is a multidimensional based system of taxation, with tax being imposed on value addition at each stage of transaction in the supply chain (Figure 2). After independence, India embarked on rapid development to eradicate the extreme poverty that has affected the transaction in the supply chain (Figure 2). After independence, India embarked on rapid development to eradicate the extreme poverty that has affected the economy. The state was given an interventionist role for achieving optimum growth and to quickly accomplish an economic transition from an underdeveloped to a developed country. This required the government to collect the surplus funds where available and to mobilize them for rapid development which are included by the name of direct and indirect taxes. In India, income tax, corporation tax, wealth tax are examples of direct taxes whereas, customs, excise and sales taxes are examples of indirect taxes.

Thus, those who are considered to be too poor to pay direct taxes because their incomes are low are also forced to pay taxes. The idea is that at each stage of production and distribution, there is value addition and a part of that should be given to the government for social development.

The rates of taxes charged differ from area to area as per policy. With the upcoming of the Mall system and International services in India like VLCC, Mc Donalds, Sub Food ways etc. charge a hefty amount from the public in the name sake charging as per government order. The medium and lower class people that are not aware of these accounting techniques face difficulties in the ascertainment of rates for a good or service. In order to maintain a better value added tax system in India, it is necessary to maintain a dual process of maintaining invoices, bills by the seller and the purchaser. "VAT is already levied differentially on food and drink; more VAT is charged to drink coffee on the premises than to take it away", writes Sheron, an adviser to the Commons health select committee's inquiry into alcohol earlier this year. "If this policy was applied to alcohol but was reversed – say, for example, reducing the VAT for on-sales from 20 to 12% – it would be possible to increase the rate of duty to

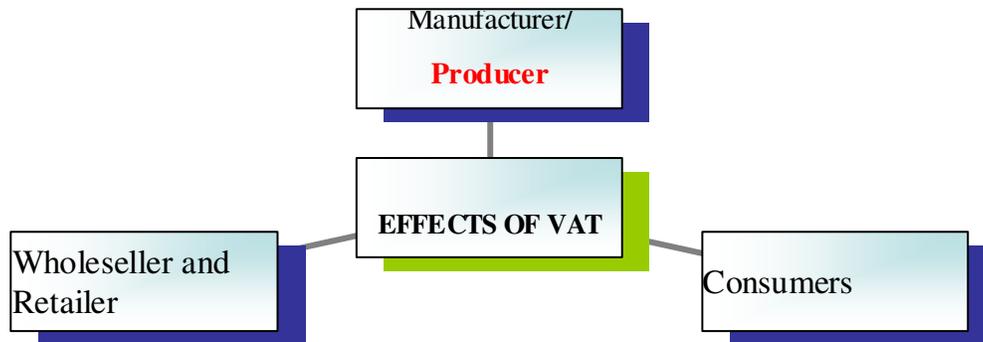


Figure 2. The effect of VAT on the Indian Society.

compensate for this without increasing the price of alcohol in pubs."

### Indian position

India is a federal state. Thus, the powers of taxation are divided between the Centre and State. In India's indirect Tax system, the Central government has the authority to impose excise duties on production or manufacture while the States are assigned the power to levy sales tax. In addition, States are empowered tax on many other goods and services in the form of entry tax, octroi, entertainment tax, electricity duty, motor vehicles tax. In newspapers, we read about the high prices charged on products and services like air fares, food products, petrol, entertainment etc. is affecting people in a positive way leading to contribution for nation and humanity. The quotation of famous personalities which show the impact of value added tax in India Chidambaram to State Governments:

"on behalf of the centre, I promise to fully cooperate with you, compensate you and help in building a computer network system and resolve all problems" (Ramesh Chandra Secretary of the Federal Panel)

"Value added tax will be launched tomorrow (April 1) and there is absolutely no question of deferring it." (World Bank Country director Michael Carter)

"A comprehensive value added tax widens tax net, as it makes tax evasion difficult going by the experience of other countries, value added tax has proved beneficial and leads to remove buoyancy".

These comments by renowned personalities help in understanding the technicalities of the accounting and taxations.

### THREATS UNDER VAT THAT IS RECOGNIZED AS PER INDIAN PERSPECTIVE

The Indian consumer is more burdened with financial

crunch and price inflation. The poor are the most sufferers and their purchasing power is low. They have to earn hard to live a standard life, at ones blood and sweat. Concept of small and working family has emerged in the cities, towns and even in villages where both the partners are working to support themselves and their family. In the rural areas, the men move out to cities in search for employment and the females look after the activities of the household. In such a situation the imposition of heavy tax is feasible or the tax rates should be subsidized to avoid criminal activities such as murder, theft, fraud, embezzlement in the society. Its not only the consumer who are hit hard by the value added tax charges but the intermediaries involved in the chain, from producer to retailers have to pay taxes to the government and meet the legal and accounting standards to present a fair picture of their businesses (Hossain, 2003).

#### From the consumer's end:

1. Incorrect usage of non-VAT memos,
2. Use of fake bills to counter purchases made from unregistered dealers or dealers,
3. Adjustment of inter-state with purchases made local.

#### From the seller's end:

1. Unauthentic bills,
2. Classification of goods for applicability of special additional tax,
3. Classification of goods to identify,
4. Under pricing of goods sold.

The general public is affected by tax rates simultaneously, as rich class people are only able to bear the burden.

### Issues concerning the effects of VAT

The consequences of adopting VAT or any tax change have effects on inflation, income distribution, resource allocation, economic growth and nations balance of payment depends upon the specific forms of tax and the accompanying circumstances. Many believe tax to be a

Cash Memo RESTAURANT		
<b>Bill No: 3412</b>		
Party: Cash		
SN DESCRIPTION	QTY UNIT	PRICE (Rs.)
Masala Dosa	1cm	45.00
Add Vat @12.5%		5.62
Add Sat @ 1.00%		0.45
Less rounded off@		0.07
		.....
		Rs.51

**Figure 3.** Cash memo of a restaurant (Example 1).

regressive tax. The objective is to encourage the economy's potential for and achieve economic growth. VAT as a direct tax tends to increase the nations exports than imports. The VAT is also considered advantageous to the balance of trades.

### VALUE ADDED TAXES CAN BE ACCOUNT BASED

By the method of collection, value added tax can be accounts-based. Under the accounting method of collection, each seller charges value added tax rate on his output and passes the buyer a special invoice that indicates the amount of tax charged. Buyers who are subject to value added tax on their own sale, consider the tax on the purchase invoices as input tax and can deduct the sum from their own value added tax liability. Cash basis accounting is a very simple form of accounting. When a payment is received for the sale of goods or services, a deposit is made, and the revenue is recorded. as of the date of the receipt of funds no matter when the sale had been made "Question: A is a trader selling raw materials to a manufacturer of finished products. He imports his stock in trade, as well as purchase the same in the local markets. If the rate of VAT is assumed to be 12.50% would pay tax as under.\*"

### FINANCIAL IMPACT OF VALUE ADDED TAX ON DIFFERENT SECTORS- DISCUSSION

#### Standard value added tax rate in India

In India, the standard rate is 14%, while the reduced rates are 4, 1 and 0. Presently, there are two basic rates of VAT in India namely 4 and 12.5% effective from 1st April 2005. Apart from this, there is an exempt category and a special rate of 1% for a few selected items. In the exempt category, items of basic necessities and goods of local importance have been put up (Agha and Haughton, 1996). The value added tax is charged differently in the products/manufacturing and service industry.

The examples will provide the clear picture of VAT charges in India.

The value added tax is charged differently in the products/manufacturing and service industry. The examples will provide the clear picture of VAT charges in India. Here, the Figure 3 presents how service industry charges VAT are effecting the ignorant customers and ultimately society. The issue is that common men are unaware of the financial terminologies and calculations. In the case of the product industries the process starts from purchase of raw material, manufacturing and finally selling.

#### **Manufacturer/Producer**

The manufacturer would be required to purchase raw material after paying full tax on the rate applicable on such material. Unlike the present system wherein the manufacturer can purchase the goods at a concessional rate of tax against the declaration form no. which will be required to be issued by the manufacturer (Glen et al., 2006). The input tax suffered by him would be adjusted off from the sale of the finished product. Here, the calculation made by the manufacturer as VAT is calculated by deducting tax credit from tax collected during the payment period.

#### **Wholesaler**

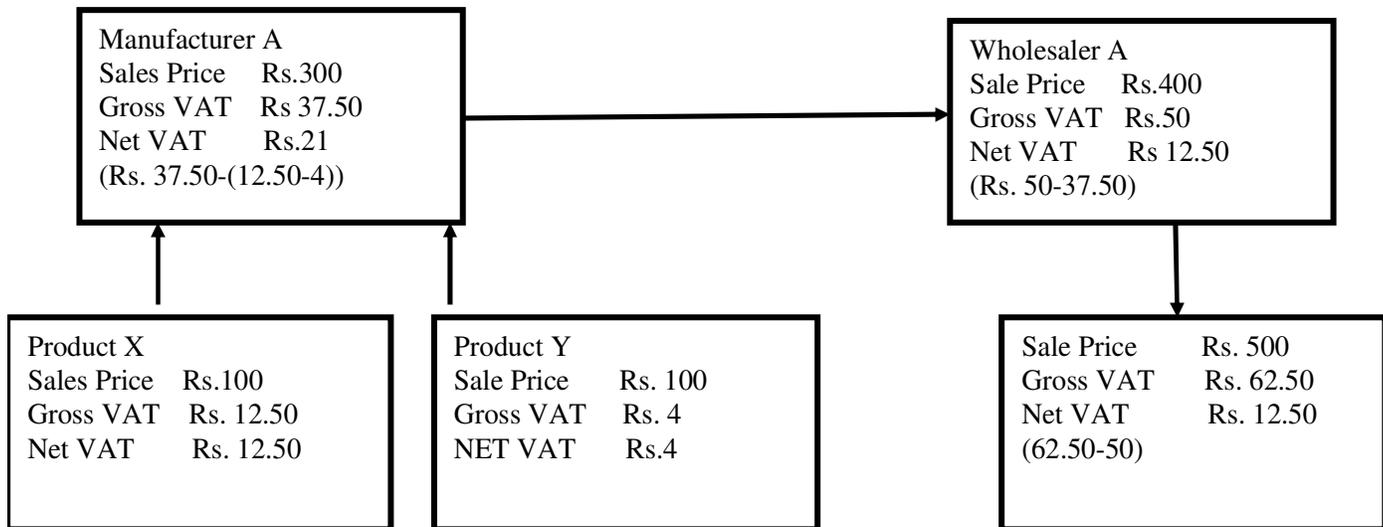
The wholesaler who purchases good in large quantities form the producer or manufacturer has the responsibility in turn to charge VAT rate from the consumer for the price paid. The wholesaler sells the product at a lower price in comparison to the retail price to promote sale of the bulk commodity.

#### **Trader / retailer**

The trader would be required to collect tax on the sales made by him and the tax liability would be set off or adjusted from the purchase or input tax credit of the goods locally purchased by the consumers. The third intermediary in the supply chain has the most effective role of maintaining good relationship with the customers (Ravi, 2005). They directly deal with the regular customers the prices charged by them includes retailer, government and producer share.

#### **Consumers**

The consumers, the ender user are overburdened with the high VAT paid by them due to product or service reaching to them is through the channel of intermediaries.



**Figure 4.** Different stages of VAT-results. Note: The rate of tax is assumed to be 12.5% on the transactions related to goods manufactured by A. Adopted from: Sunil P. Jain (2010), Taxonomy of VAT, Backdrop for State level VAT in India.

The common public is ignorant of the taxation techniques and find it difficult to calculate the selling price of a commodity. It is required that the customers collect invoice at every purchase to maintain an authenticity in the system (Bibi and Jean-Yves, 2004). The government has imposed VAT laws in 2006 for every individual intermediary in the supply chain to pay indirect tax as per fixed in law.

For example, in the furniture industry (product/manufacturing industry) at every purchase by the manufacturer from raw material procurement, cutting, designing and manufacturing tax is charged at each level.

1. Raw material (wood) purchase (VAT charged),
2. Manufacturing of furniture (VAT charged again),
3. Selling price (VAT charged third time).

In the name of government law, to charge rate at every process. The price hike has emerged as a big issue in the Indian society, where people work hard to meet their daily requirements. They are charged thrice for a commodity at 12.5% (Figure 4). In today's scenario, the role of direct purchase and hyper marketing is growing in India.

The scope of direct sales through malls has emerged as a big market, leading to the elimination of intermediaries in the supply chain thus reducing the per value added services charged from the consumers. These markets are the solution to the traditional marketing system in India to overcome the hike in prices in the commodities and services. The traditional supply chain has been replaced by the new system of marketing through super bazaars, sub malls, so that consumers have more choice to buy the varied products. The price charged by them not only included the VAT charge, but also service

charge and showroom costs which add more cost to the product.

These markets have emerged as a super market to the public as the role of direct selling is encouraged leading to mitigation of additional cost and risk in the process of transferring goods from one place to another (Government of India, 2005).

### Stocks

Stock statement are required to be furnished as prescribed for the quarter ending and then monthly from January to March. Set-off of tax paid stocks would be given. Tax paid stocks as on march ending would be the basis for claiming set of under the new value added tax Act (Mahesh, 2001).

### Export

Export would be zero rated. Tax paid on raw material used in manufacture of goods for export would be refunded by the State Government in cash \ adjustment. The exports would become more competitive in the world market as there would be no tax henceforth on raw material used for manufacture of goods for export (Kavita, 2008).

### Conclusion

Value added tax would change the nature of trade in the coming years, but the medium level of trade would face problems as the companies would reduced the tier of marketing. Similarly, small retail dealers would be required to

maintain more accounts or pay composition money which cannot be collected from the customers. The present provision of central sales tax and Value added tax can not go together. After the abolition of central sales tax the direct marketing concept may gain ground and the necessity of having warehouse, go downs etc. in all states may decrease or finish. Value added tax in India has been introduced in modified variants over the past two decades. However, value added tax in its original form is yet to be introduced in India, at Central or State level. After the negative and positive impact on the Indian consumers, Value added tax has been identified as the real goal maker by the Indian government in the coming years to foster growth and prosperity in the country. The change in the standard of livings has increased the purchasing power of the high class society but the medium and the poor class society has to work hard in order to achieve there living and meet extravagances.

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