Subtheme Paper

Assignment Systems in Federations

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Abstract

VAT has been introduced in a large number of countries. However, it is no coincidence that it has not been possible to introduce a fully harmonized VAT in any of the federations. The key difference in introducing VAT in a unitary form of government and in a federal country lies in designing a "destination based" subnational VAT. Therefore, the important issue that needs to be addressed in designing a subnational VAT relates to treatment of inter-state trade. To understand the problems of introducing a harmonized VAT in a federation, this paper presents case studies of the structure of VAT in a few select federal countries, such as Brazil, Canada and India. It illustrates the case of the European Union (EU), drawing upon the harmonized features of VAT in its Member States.

1. Introduction

While VAT has been introduced in more than 141 countries, it is probably no accident that a single comprehensive VAT at the national or subnational level has not been adopted in any of the federations. Each one of the federations has different forms: either a federal form of VAT or a system of dual VAT or state VAT.

With a view to analysing the problems in introducing a single comprehensive VAT in federations, this paper presents some case

studies of sales tax and VAT in federal countries and trade blocks, viz., central and state VATS of Brazil, central VAT and provincial sales taxes or VAT of Canada, dual VAT in India, and state-VATs of the EU. These studies illustrate the design of sales tax/VAT adopted by both the national and the subnational governments and offer some insight into the problems.

2. Brazil

Brazil is one of the oldest federations having a comprehensive division of tax powers between different tiers of governments. The overall system of taxes on commodities and services is characterized by a variety of taxes. Besides taxes on income and property, it includes VAT at the federal level as well as at the state level. In addition, it has some cascade type taxes at the municipal level.

2.1 *Federal VAT*

Brazil's system of VAT at the federal level is known as IPI (*Imposto sobre productos industrializados*). It is confined to the manufacturing sector only. It is levied on the value added by the industrial manufacturing sector. That is, the tax is levied on raw materials, intermediary products, packaging materials and finished goods with set-off for the tax paid at the earlier stage of transactions. Set-off is, however, not available on output exempted from IPI. Agricultural and mineral products are also excluded from the scope of IPI, i.e. no credit is available whether used as input or as output. Capital goods, in general, are outside the creditable base but the tax on machinery and equipment produced in Brazil forming part of fixed asserts and used solely in the industrial process is eligible for credit. As in most other countries, exports are zero-rated.

Imports are subjected to IPI but the products exempted from import duty are automatically exempt from IPI. Also, importation of specified machinery and equipment is exempt. Other exemptions under IPI include: (1) output of firms established in Manaus Free Zone—the ZFM (*Zona Franca de Manaus*) and approved by the proper authority, (2) a large number of notified products or

projects, and (3) some specified inputs. The structure of IPI indicates multiplicity of rates with considerable variations across commodities. In general, there are nine rate categories ranging from 4 to 333 per cent. More than half the revenue of IPI is generated from a few commodities. These include vehicles (16.2 per cent), tobacco products (13.2 per cent), beverages (10.1 per cent), chemical products (8.1 per cent), and the products of metal and mechanical industry (7.0 per cent).

2.2 *State VAT*

The system of VAT at the state level is known as ICMS (*Imposto sobre operacoes relatives a circulacao de Mercadorias e services*). It replaced the sales/turnover taxes which prevailed in the sixties. It is levied on the sale of goods at all stages of the production and distribution process including the retail trade, agriculture and cattle raising sectors.

Unlike the multiplicity of rates under IPI, there are only five rate categories under ICMS, viz., 7 per cent on rice, beans, bread, salt, meat and food items; 8.8 per cent on capital goods; 12 per cent on the supply of electricity; 18 per cent standard rate (applicable to most other items); and 25 per cent for luxury consumption items, such as liquor, cigarettes, tobacco, electronic goods, video games, sports, communications, gas and alcohol.

Services are outside the scope of the Brazilian ICMS. Also, a large number of capital goods produced in Brazil are excluded. In addition, there are many exemptions for notified items. These include fertilizers and pesticides, goods for agricultural production, and specified products such as imports of intermediate goods, and the sale of agricultural equipment in the north-eastern states. Exports are zero-rated.

2.3 *Harmonization of Inter-state Transactions*

Brazil has adopted an “origin” principle for taxation on inter-state transactions. Accordingly, ICMS is levied on inter-state transactions by the exporting state. However, the tax levied by the exporting state varies according to destination. While the general rate of tax

on inter-state transactions is 12 per cent, the rate is 7 per cent for goods sent from south-eastern states to the less developed north-eastern or central-western states.

To neutralize the impact of tax on these transactions, the importing state gives set-off for the tax. In effect, by having a higher rate of 12 per cent on exports from the south-eastern states (other than to the north-eastern and central-western states) and the lower rate of 7 per cent on imports into that region and allowing rebate of both these taxes, the ICMS redistributes tax revenue between the states. The rate of tax on inter-state transactions is prescribed by the National Public Finance Council (CONFAZ). In addition, the CONFAZ grants exemptions to some notified products such as vegetables, eggs and domestic fish. Exemptions also include the sale of agricultural equipment to the north-eastern states and agricultural exports. Sales to the ZFM area are zero-rated.

The features of Brazilian VATs described above indicate that there exists a system of a dual VAT: the IPI—a federal VAT on the manufacturing sector—and the ICMS—a state VAT on agriculture and industry. The federal VAT is primarily a tax on selected commodities and restricted to the manufacturing sector with a plethora of exemptions. It is also beset with problems, such as non-neutrality. Besides, there is a tendency on the part of entrepreneurs to undervalue their output to reduce the tax liability. In addition, exemption from IPI is given to machinery produced in the country as against non-exempt imported machinery, which creates distortions in the system. No attempt has been made to harmonize IPI and ICMS; both taxes are independent of each other. In addition to IPI and ICMS on goods, the local taxes on services in general levied by local authorities on a gross sales basis are not integrated with the taxes on goods. The main source of revenue is, however, the state VAT (ICMS).

3. Canada

Canada is another federal country that has implemented a comprehensive VAT at the federal level, known as the goods and services tax (GST). At the level of provinces, there are different

forms of sales taxes. Efforts have been made to harmonize these taxes at the federal and provincial levels.

3.1 *Federal VAT*

At the federal level in Canada, a comprehensive VAT, known as the Goods and Services Tax (GST) has been in force since 1991. It covers almost all goods and services at all stages of production-distribution process. The tax is levied at the rate of 6 per cent (changed recently to 5 per cent) on sale price, allowing input tax credit for all purchases in the course of business. Thus, the total amount of tax on goods and services is equal to the final selling price multiplied by the nominal rate of the GST.

While having comprehensive coverage, GST provides for some exemptions and rebates for specified goods and services. Sales made by small dealers with an annual taxable turnover of less than $30,000 (Canadian) and occasional sales by private individuals (such as the private sale of a used car) are exempt. Residential rents (other than temporary accommodation), majority of the health and dental services, domestic financial services (such as interest on loans, charges for accounts, credit card fees and commission on transactions in stocks or other securities), day care services, and education services are also exempt. The resale of old houses is exempt but sales of new homes are fully or partially taxable.

As in most countries, exports are zero-rated. Some other items that fall in this category include basic groceries (excluding snack foods, non-food beverages, prepared foods and restaurant meals), prescription drugs, medical devices, and international flights. All purchases made by provincial and territory governments are zero-rated either through mutual agreement or through treaties. Zero-rated items also include most agricultural and fish products. Sales by farmers are zero-rated. These include seeds and fertilizers bought in large quantities. Individuals and organizations having diplomatic immunity also fall in the category of those eligible to buy goods under zero-rating.

Visitors to Canada making purchases for taking goods out of the country are given full refund of GST, provided the amount paid

exceeds a certain threshold. They can also claim refund of tax payable on accommodation. There is no rebate for tax on restaurant meals, gasoline, alcoholic beverages, tobacco and services purchased while in Canada.

Some specified institutions such as municipalities, academic institutions (including universities), schools and hospitals (known as MASH sector) that do not engage in sales but provide services, pay GST on their purchases. Such institutions, however, receive a partial rebate on taxes paid by them. Municipalities receive a rebate of 57.14 per cent of the tax paid while universities and public colleges receive 66 per cent rebate. The rebate for schools is 68 per cent and for public hospitals 83 per cent. Government registered charities and non-profit organizations are also entitled to a 50 per cent rebate of all taxes paid on their purchases. The rebate is provided directly to these institutions when they file a specific rebate application at the Canada Customs and Revenue Agency which verifies the amount and sends the rebate amount directly to them.

3.2 *Provincial Sales Tax/Vat*

In addition to the imposition of GST by federal government, all provinces except Alberta levy a provincial tax on the sale of tangible personal property. The different forms of sales tax in the provinces are as follows: first, a retail sales tax, known as provincial sales tax (PST), is levied by five provinces, viz., British Columbia, Ontario, Manitoba, Prince Edward Island, and Saskatchewan. The PST levied by these five governments differs considerably in terms of coverage and varies between 7 and 10 per cent. Second, Quebec levies VAT at the provincial level. It applies zero-rating of QST on inter-provincial sales and exports. Third, harmonized sales tax (HST) is levied in four provinces, viz., Newfoundland, Nova Scotia, Prince Edward Island, and New Brunswick. The HST is a VAT imposed by the federal government and composed of the 6 per cent GST and the 8 per cent provincial tax, and applies to the same base of goods and services that are taxable under GST.

In the Canadian system, there is no effective tax on inter-provincial transactions. In the provinces that have a retail sales tax,

the tax is not imposed on inter-provincial transactions. In the other provinces, such transactions are zero-rated under VAT.

The coverage of GST as well as HST is comprehensive. Both the forms cover most goods and services. However, the provinces levying provincial sales tax (PST) provide for some exemptions that have been notified by the concerned provinces. Most provinces exempt prepared meals as well as a few specified consumer and producers' goods.

Most services are exempt under PST. However, over the years, many provinces have taxed services such as car repairs, hotel/motel accommodation, etc. Insurance premiums are taxable in Quebec and Newfoundland, where there are different rates for different schemes. Telephone and other communication services also fall in the category of taxable services. Similarly, computer software, labour services, laundry and dry-cleaning are taxable in most provinces. Many provinces provide for separate sales tax on specified goods and services such as alcoholic beverages, restaurant meals and telephone services.

3.3 *Federal Efforts at Harmonization*

The federal government attempted to harmonize these taxes. With the dialogue extending for over six years, it was only in April 1996 that the federal government entered into an agreement with four provinces (viz., Newfoundland, Nova Scotia, Prince Edward Island, and New Brunswick) to introduce a harmonized sales tax (HST), which is a combination of the GST and the provincial sales tax being levied in each of these provinces. HST became effective from 1 April 1997 and now is being levied at the rate of 13 per cent (GST 5 per cent and provincial VAT at 8 per cent).

The HST is legislated and administered by the federal government. The provinces receive their share (8 per cent) from the federal government. The share is allocated primarily on the basis of consumption although some other variables also get into the distribution-formula. In addition, the provinces receive adjustment assistance to compensate for the loss of revenue due to reduction in the tax rate. The grant of $961 million was payable over a period of four

years. To enlarge the scope of harmonization, the federal government is attempting to persuade the other provinces to enter into the system of HST.

Quebec levies a VAT known as Quebec Sales Tax (QST). It collects GST as well as the QST (which has been converted into a value added tax at the provincial level). However, Quebec remits the yield of GST to the federal government after deducting the charges for collection.

The model of dual taxation, i.e. GST (the federal VAT) levied by the federal government and the provincial retail sales tax (PST) imposed by the provinces is followed in Ontario, Manitoba, British Columbia, and Prince Edward Island. Prince Edward levies PST on the GST inclusive base and Ontario, Manitoba, Saskatchewan and British Columbia impose PST on the price exclusive of GST.

None of the provinces levy tax on inter-state sales. Their retail sales tax/VAT jurisdiction is confined to sales within their own borders. For example, if the Ontario vendor delivered the products to a vendor in Quebec, he would not charge Ontario tax. However, if Quebec buyer actually took delivery of the goods in Ontario, he would have to pay the tax. Thus, a sale delivered outside the province is free of provincial sales tax/VAT of the province of origin.

4. European Union

The VAT structure of the European Union (EU) could also be considered an illustration of VAT under a federal system, wherein VAT is levied by all the member states (MSs). The EU has ensured that the domestic trade taxes levied by the member states would be rational by insisting that any country which wishes to be part of the Union should adopt a VAT and must refrain from levying any effective tax on intra-Community transactions. Prior to the abolition of internal fiscal frontiers within the Union (1 January 1993), this object was achieved by zero-rating exports of goods from the member state of origin and taxing their importation in the member states of destination. As from the abolition of fiscal internal frontiers, the concept of zero-rated exports of goods was replaced by zero-rated intra-Community supplies of goods and the

concept of taxed importation of goods was replaced by taxed intra-Community acquisitions of goods. From 1 January 1993, the concept of zero-rated export was restricted to the movement of goods from one member state to non-EU countries, and the concept of taxed importation of goods was restricted to imports into the EU from non-EU countries.

Coverage of VAT in the EU includes both goods and services. The basis of assessment was substantially harmonized through the implementation of the Sixth Directive. Further, a degree of rate harmonization was achieved by the Union stipulating that there shall be a minimum standard rate of 15 per cent, with one or two reduced rates on a few specified items, with a minimum of 5 per cent following the removal of border controls. The standard rate ranges from 15 to 25 per cent. The Finance and Economic Ministers of the Member States reached agreement to this effect in 1992.

Thus the EU has succeeded in preserving the common market with a harmonized VAT. In order to achieve this, it proposed two systems. The first relates to the origin principle, that requires a clearing house mechanism, and the second relates to the traditional destination principle.

4.1 *Origin Principle*

The European Commission's initial idea of harmonizing VAT in the EU was based on the origin principle necessitating the establishment of a clearing house. The Commission's idea was that supplies of goods transported from one member state to another would be taxed in the member state from which the goods were supplied (member state of origin) and the customer in the member state of destination would be entitled to a tax credit. To make the system work, the exporting state would remit the VAT collected on exports to the administration of the importing state. Only net balances would have to be settled, through a mechanism of a central clearing house. It was thought that each member state would calculate its total VAT sales and purchases for intra-Community trade for the month by aggregating all VAT charged and claimed by registered traders on sales and purchases to EU member states. The net

position would be calculated vis-à-vis the EU and not against each individual state. So each country would create a monthly statement showing its total VAT input and output figures for intra-Community trade. The statement would establish a claim or payment. Under this system, clearing would be a perpetually on-going process.

While the benefits of the clearing house mechanism were clearly recognized, the members of the EU anticipated problems relating to the accuracy of likely claims involving large flows of money. The Commission proposed to tackle this through the mechanism of standardized audit trails, improved control and cooperation between member states. Subsequently, the Commission proposed clearing on the basis of estimates of consumption in member states.

However, considering the different levels of commitment towards making the clearing house work, the member states were not ready politically or administratively to implement the system of the clearing house mechanism.

4.2 *Destination Principle*

The EU subsequently adopted a transitional regime to deal with the treatment of intra-Community transactions in goods. In conjunction with this, a VAT information exchange system (VIES) was set up to monitor intra-Community trade of goods. Under the "transitional regime" the taxable event in cross-border transactions takes place in the country of destination. For example, a manufacturing firm producing finished goods, located say in France, "imports" raw material worth EUR 500 from the United Kingdom where this transaction is subject to 17.5 per cent VAT. When the transaction involves the movement of goods from United Kingdom to France, the transaction is taxed at the zero rate in the United Kingdom provided the sale is made to a registered trader in France. With a view to ensuring that non-registered traders do not benefit from this zero rate, the registration number of the French customer would have to be mentioned on the invoice of the UK supplier. Thus, the supplier who sends goods to other EU countries will need to obtain the VAT registration number of its foreign customer and quote it with its own VAR number on the sales invoice.

Consequently, the "exports" to France would effectively be free of UK tax, but the French customer has to account for French VAT on the intra-Community acquisition (19.6 per cent of EUR 500). The French customer pays the same amount of VAT on goods purchased from suppliers in other member states as he would have to pay to French suppliers.

In addition when the UK supplier dispatches goods, there is no paperwork to present to customs officials because for VAT purposes fiscal frontiers have been abolished. Apart from spot checks for drugs, anti-terrorism measures, etc., there would be no delays in the transportation of goods from one member state to another.

Similarly, the French dealer is not required to clear the goods into France; neither is the French dealer required to pay French VAT to French customs officials at the time the goods enter the country. When the goods arrive at the dealer's premises in France, the French dealer accounts for French "acquisition" VAT on his VAT return. If the French dealer has acquired these goods for resale, that dealer is entitled to deduct the acquisition VAT on the same VAT return. The same procedure applies in reverse if the goods are moving from France to the United Kingdom. In this regime, taxation of intra-Community transactions in goods takes place in the consuming state.

This scheme was originally scheduled to apply only from 1993 through 1996. However, there has been no consensus among the member states about changing to the new regime. Hence, the transitional regime still continues.

5. India

India has adopted a system of dual VAT: central VAT (CenVat) at the federal level, and state VAT at the state level. In addition to the central VAT, which is the basic excise duties, some other taxes are also levied. These include Special Excise Duty on a few items at the rate of 8 per cent, which is levied over and above CenVAT (basic excise duty); Additional duties of excise on textile and textile articles; additional duties of excise (as goods of special importance) on sugar, tobacco products and textile articles; and cess at varying rates under different enactments.

5.1 *Federal VAT*

The central government levies VAT (known as CenVAT) on all goods manufactured, payable at the time of clearance of such goods from the manufacturing unit (factory). The general rate of CenVAT is 16 per cent. A few commodities are subject to 8 or 16 per cent special excise. There are some total or partial exemptions, which are general as well conditional in nature. Set-off is given for the tax paid. For capital goods, however, only 50 per cent of the duty paid on the goods can be availed of in a financial year; the remaining credit can be claimed in the next financial year, provided the goods are still in use (except for spares and components, refractories, moulds and dies). A manufacturer who manufactures only tax-exempt final products is not allowed to take this credit. However, a manufacturer producing both dutiable and exempted final products in the same factory is eligible to avail of its benefits. This is subject to certain conditions, viz., maintenance of separate records in respect of inputs used to manufacture exempted products, or payment of 8 per cent of the total price (excluding taxes) of the exempted final products or on reversal of the credit availed in the case of a few specified items. Similarly, credit can be availed on capital goods, if not used exclusively for the manufacture of exempted final products. The coverage of CenVAT, however, does not encompass light diesel oil, high-speed diesel and motor spirit (gasoline), as also matches.

5.2 *State VAT*

The most important of state taxes is state VAT. All states except Uttar Pradesh now levy VAT on the sale of goods on all transactions. Uttar Pradesh levies a first-point sales tax. The system of state VAT in all the states and sales tax in Uttar Pradesh follows a two-rate structure: 4 per cent and a standard rate of 12.5 per cent with some exceptions. Gold, silver, precious and semi-precious stones have a VAT rate of 1 per cent and liquor has a higher rate of 20 per cent. On essential commodities (such as branded bread, bulk drugs, writing paper); goods considered important in inter-state trade (such as iron & steel, hide & skins); industrial and agricultural

basic inputs (such as printing ink, coir, beedi leaves, fibres, seeds); and capital goods a 4 per cent VAT is applicable. Commodities exempted from tax include natural and unprocessed products (generally in the unorganized sector such as betel leaves, earthen pots, etc.); items which are legally barred from taxation on sale (such as newspapers, national flag, etc.); and items which have social implications (such as books, periodicals, slates, slate-pencils, etc.). The coverage of VAT, however, does not encompass petrol and petroleum products.

6. International Experience in Harmonizing Taxation of Inter-state Trade

Taking into account the different models of VAT prevailing in federations, this section presents international experiences and also academic proposals in relation to harmonization of taxation of interstate transactions.

6.1 *Canadian Models*

Canada presents some interesting models of subnational VAT as well as a "joint-tax" administered by the federal government. Especially, there are three different models of harmonization of subnational VAT: Quebec levies a VAT (known as Quebec Sales Tax—QST); four of the provinces (viz., Newfoundland, Nova Scotia, Prince Edward Island, and new Brunswick) levy a harmonized sales tax (HST)—a combination of federal GST and provincial VAT; and rest of the provinces levy a retail sales tax. HST is legislated and administered by the federal government. The provinces receive their share (8 per cent) from the federal government. The share is calculated on the basis of a formula, which is based mainly on consumption, although some other variables are also taken into consideration. While the federal government collects HST comprising both the taxes (GST + provincial VAT), Quebec collects GST as well as the QST (which has been converted into a value added tax at the provincial level). However, Quebec remits the yield of the GST to the federal government after deducting the charges for collection. None of the provinces levy tax on inter-provincial sales. Their retail sales

tax/VAT jurisdiction is confined to sales within their own borders. Four provinces having HST are treated as one block, where all inter-provincial transactions are also treated as intra-provincial transactions. As regards transactions taking place between an HST province and provinces outside the HST system, they are zero-rated under the provincial component of HST. Distribution of the net collections between the HST provinces is on the basis of consumption statistics, ensuring the destination principle. Quebec, which levies a provincial VAT, know as QST, applies zero-rating on inter-provincial sales and exports. Thus, the Canadian federation has succeeded in fashioning a system where inter-provincial transactions are not taxed.

6.2 *Harmonization in EU*

The EU levies VAT at the "state" level. It has attempted harmonization of VAT and abolition of fiscal frontiers with effect from 1 January 1993. Under the "transitional regime" the taxable event in cross-border transactions was changed from the country of origin to the country of destination. Accordingly, all movement of goods to member states are zero-rated and taxed in the country where the goods are consumed. However, to ensure that the transactions take place between registered dealers, a system of VIES has been operational. In this scheme, the importing manufacturing firm uses inputs as if they are just bought in that country. In addition, when the supplier of an exporting member state dispatches the goods, there is no paper work to present to the customs officials at the frontier. Apart from spot checks for drugs, anti-terrorism measures, etc., there would be no delays at the frontier. Similarly, the importing dealer is not required to pay VAT at the time goods enter into the country. When the goods arrive at the business premises, the importing dealer will account for "acquisition" VAT on the VAT return. When the dealer sells goods further, the dealer would recover the "acquisition" VAT from the purchaser.

6.3 *Brazilian Model*

The overall system of state VAT in the Brazilian federation, known as ICMS is levied on interregional as well as intra-regional sales.

The former transaction is taxed by the exporting state. While the general rate of tax on interregional transaction is 12 per cent, the differential interregional rate is 7 per cent for goods sent from south-east to the north-east or north-west regions. That is, the rate of tax on inter-state transactions varies according to destination. In effect, by having a higher rate of 12 per cent on exports from the south-east subnational governments and lower rate of 7 per cent on imports into that region and allowing rebate of both these taxes, the ICMS redistributes tax revenue among the regions.

To neutralize the impact of tax on these transactions, the importing state gives a set-off for the tax. The National Public Finance Council (CONFAZ) prescribes the rate of tax on interregional transactions. In addition, the CONFAZ grants exemptions to some notified products sold to the north-east, and to agricultural exports.

6.4 *The Little Boat Model*

Apart from the above-mentioned models of taxation of inter-state transactions prevalent in different federations, Varsano (2000) has proposed a new model based on dual VAT. It is a destination-based consumption type of dual VAT without zero-rating of inter-state exports, called the "little boat model". In the terminology of a riverboat, it suggests that tax levied by the state of origin from where goods are exported may not cross the border (say, a river, as many a time it happens to be). To avoid double taxation in the next transaction and to make the system destination-based, it assumes a dual VAT: a federal VAT levied in all the provinces and a state VAT levied in each province. It further asserts that for the purpose of the federal part, the state borders are irrelevant because it is levied all over the country. But the tax jurisdiction of state VAT ends when the commodity moves out of the state. Hence, the exporters and importers, who are federal taxpayers, transport the state tax across the border embodied in the federal tax. That is, the federal government collects both the state VAT and the federal VAT and provides the corresponding credit to the importer. The result is that the subnational VAT reaches the other bank of the river free from previous tax collections and ready to follow its course as a tax of the state of destination.

This simple procedure is able to take care automatically and practically at no cost of transactions between registered dealers subject to the normal tax regime, which is the bulk of inter-state trade. In the case where the importer is an identifiable household (distance selling)—a non-registered trader, or a small registered trader not assessed according to value added—a different scheme must be used. The state tax is also paid to the national government—but separately, so that total tax collection of this kind may be known, which shares the proceeds to the states in proportion to their respective own VAT revenues.

The "little boat model" requires that registered traders distinguish four components of their total sales: (i) intra-state sales, including those to unidentifiable residents of other jurisdictions (cross-border shopping), to which the federal and the state rates apply; (ii) inter-state sales to registered taxpayers, except small traders subject to special simplified tax regimes, in which case the state tax is zero-rated and the federal tax is assessed at a rate equal to the sum of the federal and the state rates; (iii) inter-state sales to unregistered traders, small traders excepted from the previous case, and identifiable households domiciled in other jurisdictions (distance-selling), to which the federal and the state rates are applied, but the state tax is paid to the national government (explicit CVAT); and (iv) exports to other countries, which are zero-rated.

No special rules are necessary regarding purchases: taxes paid to the national government are credited against federal liabilities; and those paid to the subnational units against state dues. Note that, by contrast with current arrangements, no tax that had been collected by a state is credited against another.

At the end of each VAT assessment period, each registered trader is liable for three pieces of information on tax: (i) the net state tax liability (difference between its state liabilities, except the explicit CVAT, and state credits); (ii) the net federal tax liability (difference between its federal liabilities and credits); and (iii) the explicit CVAT paid to the national government, which distributes the proceeds to the states.

6.5 *The Indian Model*

Taxation of inter-state trade in the Indian state VAT is origin based. Currently, the inter-state tax is levied at the rate of 3 per cent (against 12.5 per cent on intrastate transactions) when sale takes place between the registered dealers of different subnational governments having support of a C Form issued by the importing State. In the absence of a C Form the transaction is treated as a sale made to an unregistered dealer in another subnational government and the tax rate applicable for the commodity in the exporting state is levied. The effort has also been made to have verification of the information about the C Form and the status of the registered dealer through the TINXSYS (Tax Exchange Information System).

In spite of the low rate of CST (central sales tax) on registered dealers, the levy of CST on the basis of "origin" goes against the principle of a unified market. It conflicts with the principle of inter-jurisdictional equity. Available information indicates that a major portion of revenue from the CST goes to high-income (or industrially developed) subnational governments. CST on inputs levied at earlier stage cascades and results in higher prices. The producing subnational governments use this measure to "export" their tax to the consumers in other subnational governments. Such a tax also encourages consumers to buy locally produced goods at the expense of the national economy. The consuming subnational governments surrender a considerable degree of autonomy in exercising their power to levy high rates of VAT. This is because the rate of CST besides the rate of VAT of the importing state, which is levied in addition to the CST, becomes excessive for the consumers of the importing state. Also, the incidence of CST on exports (for dealers entering in to export transactions) cannot be reliably quantified, much less relieved under such a system. Hence, the existing CST encumbers exports. In view of the adverse economic implications of the origin based CST, it has now been decided that the CST will be tapered off gradually. It has already been reduced from 4 per cent to 3 per cent this year.

Further, as already announced by the central government, it is expected that it will be further reduced to 2 per cent next year,

to 1 per cent the following year and to zero per cent by 1 April 2010.

Notwithstanding the effort of the central government in reducing the rate of CST to zero per cent, the treatment of inter-state taxation by the constituent units of federations discussed above indicates that, except for India, all other federations take care to ensure that there is no effective taxation of inter-state sales so that there is no cascading and escalation of costs. The principle of destination is fulfilled and there is no barrier to interregional trade.

From the experience of different federal structures discussed above, three alternative solutions to the problem of inter-state taxation can be considered: the first is zero-rating of inter-state sales, the second is some kind of clearing house mechanism as envisaged by the EU and the third is the destination based pre-paid VAT, to be discussed below.

One advantage of the clearing-house mechanism is that the rate of taxes for all transactions, intra-state as well as inter-state, will be the same for any given state. Thus, there will be no need to differentiate between inter-state transactions and other transactions. As such the possibility of evasion is much reduced (if the rates of taxes in the different states are close to one another, the advantage of exporting goods to unregistered entities will also be reduced considerably). The major characteristic of the clearing-house mechanism concerns the fact that effectively the tax collected by the exporting states would have to be transferred to the importing states. In order to do this, the exporting states would have to transfer, month by month, the amounts of tax they have collected on inter-state transactions to the national pool and the national pool will have to distribute these amounts to all the states according to their respective imports. If the rates of tax vary among the states, this job would require elaborate account keeping because the national pool office will have to keep records of commodity exports to each of the states. The job would be made somewhat simpler if inter-state transactions are differentiated and taxed with one single rate. In such a case only total state export and import figures would have to be recorded. This itself would be a stupendous job. This may not be possible in many countries, given the present state of

information coverage and state computerization. Besides the importing state will have to give a set off as soon as the import takes place and will get it back only after a delay of a month or so. It is also important that the states exporting goods must fulfil their commitment to transfer the tax amounts promptly to the national pool.

One way of handling this is to adopt the EU system and to have an information exchange system. In addition, the states could introduce the powerful instrument of what is known as "prepaid VAT". This is a destination-based system with no effective tax burden on inter-state transactions. In this system, when dealer "A" imports commodities, say in Delhi (importing state) from dealer B in Maharashtra (exporting state), "A" (Delhi dealer) will immediately pay Delhi VAT on its imports, and instantaneously claim a set-off from VAT liability. Hence, it will not cause any additional burden on Dealer A—the importing dealer. As a next step, "A" will transmit the proof of this payment (e.g. a copy of the tax deposit receipt or authenticate challan form showing payment of tax, that could be prescribed by state VAT procedures) to the dealer "B" in Maharashtra (exporting state). On receipt of this document, "B" can claim a set-off of the input taxes already paid under the Maharashtra VAT. That is, the exports would be zero-rated in Maharashtra. With this modus operandi of the operations of "prepaid VAT", the importing dealer "A" would instantaneously claim a set-off from the tax payable to the government on the sales. There would neither be any cascading of the tax paid by the importer nor would there be any additional cost to the dealer. This will be a national tax and will not stick to the price of the commodity. It will, therefore have no price effect. In the spirit of the VAT, which is a self-complied tax, "prepaid VAT" will also be self-regulatory. The state administration would not be required to have check-posts or any other mechanism to control such payments. The dealer in the importing state (who is a taxable person for VAT purposes) would have a strong incentive to pre-pay the tax, which would instantaneously be creditable against his output tax in the state of destination. Unregistered dealers or consumers would have the choice of paying the local tax or the destination tax. On similar lines, the dealer in the exporting state would have an interest in

obtaining the proof of payment needed for claiming a refund of input tax, failing which he would be required to pay state VAT on his turnover. The whole mechanism would be guided by the self-interest of both the parties.

7. Conclusion

As in most federations, India also faces the problem of harmonizing tax on inter-state trade in the context of introducing the VAT. The examples of Canada and the EU suggest that there should not be tax on the basis of "origin". The case study of Brazil suggests that if the tax is levied on the basis of "origin" the set-off needs to be given in the importing state, which in addition to making the tax destination-based, serves as an "equalizing mechanism" in a federal structure. The other models available in the tax literature suggest that the central and state VATs could corroborate each other in carrying the tax of the originating state to the destination state. However, under the Indian system of CenVAT, the power to tax extends to the manufacturing sector only. Hence, the coordination of CenVAT and state VAT for carrying the tax burden to the exporting state is not feasible. However, the model of pre-paid destination VAT seems to be useful. Thus, India should have a common market by repealing the CST Act and replacing it by a "prepaid VAT". This would enable India to have rational procedures and facilitate removal of check-post. It would also help Indian taxpayers to reduce the costs of doing business and be competitive internationally.