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Implications of VAT for India : First the pains, then the gains

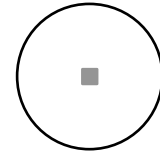
By P. Viswanath, Consultant, Avalon Consulting, Chennai

For the past one-year there have been heated debates on the introduction of a value-added tax (VAT) in the sales tax area. After two postponements, the Union Budget has now mentioned that the states would move to a value added tax system in the sales tax area from April 2003. However, it is unlikely to boost the economy as a whole in the short term. For the next 2-3 years we expect that VAT in the proposed form would benefit the Indian economy only through better accounting of economic activity and not by fuelling growth. But once reforms in the tax area are completed (especially the Central Sales Tax-CST reforms), the true advantages of VAT can be reaped. There would be large-scale logistics revamping and depot realignments. As per Avalon Consulting estimates, this would save the Indian economy to the tune of Rs.12000 Crores. – 17000 crores (0.5%-1% of the GDP).

Sales tax in India has had a unique problem of being levied by the 29 state governments. State governments have often used sales tax concessions as incentives to attract industries. The conduct of business was being distorted by tax considerations. There have also been multiple levies of taxes like entry tax, octroi and turnover tax. This has led to a cascading effect on the prices of goods. Another problem was the prevalence of a large number of tax slabs. In some states there were as many as 20 slabs. Over years many committees have studied the pitfalls of our system and suggested remedies. One of the most often suggested was the introduction of a Value Added Tax (VAT) system in the sales tax area.

Road Map to VAT

The introduction of a value added tax system required reforms in two areas: Harmonization of the state tax laws and CST reforms. Indian state tax laws lacked uniformity in definitions and interpretation of various terms under the tax laws, classification of goods and their tax rates and also on administration aspects. In the last 3 years some states have started this harmonization process. However a lot more needs to be done. The second area was of CST reforms and stabilizing it at 1% level. However there was inertia in this because CST contributes close to Rs. 15000 crores each year. The success of any new system depends largely on the CST reforms and hence the government has finally reduced the CST to 2% from 2003 onwards and plans to abolish it by 2006. The much-awaited transition to VAT system will happen in April 2003, and this will bring in new management challenges and impact the economy.



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Economic Impact of VAT

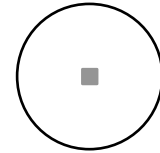
In our opinion, the real benefit of VAT would not surface in the short run. This is mainly due to the fixation of the tax rate at the revenue neutral tax rates of 10% or 12.5%. The Centre has also guaranteed the states to compensate for the short fall in revenue to the extent of 100%, 75% and 50% in the first 3 years of implementing VAT. This ensures that the state revenues would not be affected severely. Some products could actually become costlier depending on the tax rate that they suffered earlier. Sugar, tobacco and textiles could become dearer as the states have been empowered to tax them. Services would also become dearer as the states have been given the powers to levy tax on them and the service tax has been increased to 8%. Further 10 additional services are proposed to be brought under the service tax net. But the advantage is that cascading affect of taxes would be removed. The pressure to get registered would increase, as the sellers would want to utilize their tax credit. This would increase the tax registrations. Transactions that were not recorded would come to light. Hence the improvement in the short term would be more because of better accounting of economic activity.

This situation would improve in the long term as CST reforms are completed by 2006. The Government has set the ball rolling by reducing the CST to 2%. There are indications that the multiple rates of tax would merge into a single rate of VAT and provision of VAT credit would be extended to services also. Increased tax base and better compliance would ensure that the tax revenues do not decrease. This would result in lower prices and hence accelerate the economy.

Business Impact of VAT

In the near future at least, one can see both VAT credit eligible and uneligible taxes prevailing. This is mainly due to the CST being origin based and credit not being given in the state of consumption. This will encourage business to adopt local purchases to avail of maximum VAT credit. There would be increased negotiations for price reductions with out of state customers or opening of new depots to pass on VAT credit. This will lead to geographic reallocations of ancillary unit/input manufacturers, opening of new depots and higher compliance costs. Hence in the short term we could see more depots and stronger preference for regional suppliers: an effect, which vat is designed to abolish! for the next 3 years at least this practice would continue and would eventually stop when the CST is brought down to 1% or completely abolished.

But business would have great benefits once this is done and with the likely introduction of a uniform consignment tax. With these reforms logistics advantage would determine the movement and storage of goods and not tax distortions.



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Companies would then have to realign their supply chain by considering the market size/share targeted, the desired service levels and primary and secondary freight costs. Places like Vijayawada, Nagpur, and Hubli/ Dharwad would emerge as distribution hubs in the country. We project that this reorientation of supply chain would result in savings of Rs. 12000 to Rs. 17000 Crores. to the economy-a mammoth 0.5% - 1% of the GDP.

Currently the manufacturing GDP of our country stands at USD 150 Bio. Taking a 30% value addition in this sector the manufacturing revenues of our country would stand at USD 500 Bio: Rs. 22,50,000 Crores. The interstate (depot related) trade has a share of around 50% of the total trade. On various assignments, Avalon Consulting has found that the depot operating costs would be in the range of 0.5% to 1%. By realigning the logistics and after depot revamping, companies would be able to save to the tune of 1-1.5% of their revenues. This works out to a total saving of Rs. 12000-Rs.17000 Crores. Hence in the long term VAT could help grow the economy and help in achieving the 8% GDP growth, now being talked about.

The Take Away

India has for long debated on the issue of introduction VAT. Finally it has crystallized and industry, states are all set to move in to the new era by April 2003. However there have been serious doubts on the readiness of states for this transition. A recent World Bank study has found that none of the states are actually fully prepared for a VAT system. This raises doubts on the benefits that India would get by this tax regime. As pointed out earlier the benefits of a VAT system are huge. Hence India should accelerate its implementation schedule. Otherwise the true benefit of this system would start only after 2006 when the CST reforms are expected to be completed. Hence the Governments should work backward from that time and prepare for the new regime. Almost all the state governments have started having training sessions for the stakeholders including their officials and corporates. But the size of the effort may not be enough.

The Central Government has done its bit by reducing the CST to 2% and emphasizing that CST reforms would be completed by 2006. Its now time that corporates started their preparations to realize the savings through logistics realignments and depot revamping. It is only then that the Indian economy would get the required boost.