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Central Value Added Tax (CENVAT)

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PREFACE

This is the second in a series of policy briefs that we have initiated this year. Our attempt in these series is to present to the interested citizen policy issues that are normally the preserve of academics and experts. For this purpose we intend to draw not only on the findings of policy oriented research done at ICRIER but also on relevant high quality research done elsewhere. We know from our own policy experience that purely academic research must be filtered through a screen of practicality and pragmatism for it to be converted into useful policy actions. We hope that these briefs, by making this knowledge and expertise more widely available, will improve the quality of public discussion of complicated policy issues. By empowering the non-specialist eager to learn about and participate in public policy discourse we may also get a fresh perspective on these issues.

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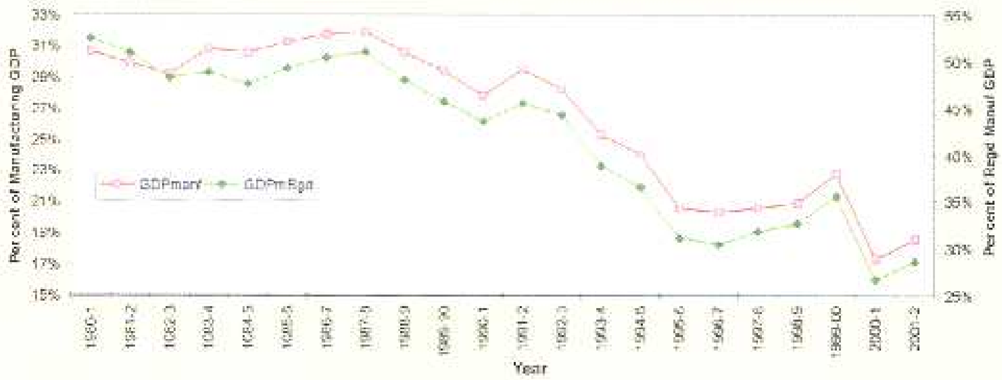
The most significant domestic indirect tax is the Central Excise tax levied on manufactured goods. It was modified during the late eighties by the introduction of selected features of VAT and christened 'MODVAT.' Recently it was converted into a Central VAT and re-christened 'CENVAT.' As a per cent of GDP, Central excise collections fell from an average of 4.5% of GDP between 1980-81 and 1989-90 to an average of 3.2% during 1995-96 to 1999-2000 (figure 1, right scale). This 1.3% point of GDP decline of central excise tax revenues was one cause of the deteriorating fiscal situation.

Figure 1: Excise Revenue Collection Rate (%)

One of the reasons for the decline collection rates is that unlike in many other countries that introduced a VAT system by replacing in one year all their existing indirect taxes by the simple VAT, the process has been excessively drawn out in India. Over 100 countries across the world have a Value Added Tax system of indirect taxes. The process still remains incomplete in India.

MODVAT was introduced in 1986-87 and made applicable to most sectors in 1987-88. From figure 2, we can see that excise revenues as a per cent of GDP from manufacturing (total & registered) was on a clear downtrend during the next nine years. This was primarily due to the piecemeal and somewhat ad hoc extension of MODVAT. The move from a MODVAT to a Central Value Added tax (CENVAT) was made in the Budget of 2000-1 based on a concept note prepared in October 1999 and revised in December 1999.[1] Though the concept of CENVAT was accepted in 2000-1, there was a gap between what was recommended and what emerged in the budget. Though the gap has narrowed since then, we still do not have a complete CENVAT (i.e. a comprehensive and consistent application of VAT principles to Central excise).

Figure 2: Excise Revenue Collection as % of GDP from Manufacturing



Another reason for the decline in collection rate is the progressive increase in the so-called "SSI exemption," and the related "eligibility limit" for availing of this exemption. The SSI exemption was raised to Rs. 30 lakhs in 1993-94 (from Rs 20 lakhs) and to Rs 1 crore in 2000-1, while the eligibility limit for availing of this exemption has risen from 75 lakhs in 1985-86 to Rs. 1.5 crore in 1986-87 to Rs. 2 crore in 1989-90 and finally to Rs. 3 crore in 1995-96. Currently firms with up to Rs 3 crore of total sales can avail of exemption on up to Rs. 1 crore of sales.

[1] The basic approach can be seen in Virmani (1999). Some elements were introduced in the 1999-2000 budget based on notes prepared in March 1998 and December 1998.

The Task force on Indirect taxes has proposed implementation in a time bound manner, by giving detailed recommendations for phasing in of economically sound but politically difficult measures (e.g. reduction of SSI exemption). It has also fleshed out the administrative measures that are essential for effective simplification from the tax payers perspective.

Another potential reason for exercise revenue decline is the rise in manufactured exports (zero rated) as a proportion of manufacturing outputs.

A. ELEMENTS OF CENVAT

To minimise the danger of making mistakes (acting hastily and regretting at leisure) and then making repeated corrections over future budgets, the essential features of such a CENVAT need to be clear. They are as follows:[1]

1. Universal incidence & Set-off

To be called a [central] VAT, the excise tax must be comprehensive and universal, so that every producer pays excise duty on his total output of goods. Excise paid on all excised or excisable inputs used in the production or marketing of the good whether they are "consumable," "design and drawings", or anything else must be deductible from excise paid on the final output. Extension of the system to the wholesale level would facilitate a continuous chain of deduction or set-off. An constitutional change or agreement with the States that allows the central government to bring wholesale trade into the CENVAT net, while promising to return to them the revenues from value added at the wholesale stage would be desirable.

2. Single Basic Rate

The key to a comprehensive VAT type system is a single general or basic ad valorem rate, which is eligible for VAT deduction (or credit). The base rate has been set by the ministry of finance at 16%, even though a 15% rate is somewhat simpler for taxpayers (as is the metric system). This rate falls in the band in which most countries' VAT rates lie. Most of these countries do not, however, have separate state sales taxes. Our state sales taxes are mostly in the range of 8% to 12%, with a few rates (e.g. cars, petrol) as high as 20%. If sales and other domestic taxes were incorporated our domestic indirect tax rates would be in the top bracket and on a few items they are among the highest in the world.

When we extended the MODVAT system during the nineties, we had consciously chosen to provide for full expensing of the excise paid on capital goods rather than set up a system of annual depreciation related deductions. The spreading of the excise deduction on capital goods over two years (i.e. an implicit straight line depreciation over two years) in the 2000-1 budget unnecessarily complicated the system and vitiates the potential benefits from drastic simplification of the administrative system & procedures. It also raised the effective excise tax on capital goods by about 3% at a time when gross domestic investment was declining sharply. The high tax rate on polyester, a hangover from the past, constitutes a serious violation of the uniform basic rate principle (Department of Revenue (1993)). The high excise rates on carbonated beverages also violate the spirit of the CENVAT.

It is however a mistake to think that the CENVAT should have only one rate. The equity and efficiency considerations that justify selective variations from unity are discussed below.

3. Equity

An equitable indirect tax system requires lower effective indirect tax rates for basic human necessities. Food is a very important part of the consumption basket of the poor. With such a large proportion of the population poor and an equal proportion (APL) living under the threat of poverty, food products must be exempted from the CENVAT to ensure that it is equitable. This will (in my view) produce a simpler system than one in which food is subject to half the basic rate (as proposed by the Task force). The new system of deemed credits for value added in agriculture (proposed below) would allow us to retain the basic CENVAT rate on processed agricultural products (e.g. processed food products, cotton textiles), while reducing the currently high effective rate on value added by agro-processing companies. This will also reduce the bias against modernisation of the entire agro-processing sector. When poverty (as per current definition) is eliminated and the country reaches middle-income levels in the next decade (between 2010 and 2020) these exemptions can gradually be phased out.

Ill health is an important cause of people moving from above the poverty line (APL) to below the poverty line (BPL). In principle, therefore medicine/drugs and medical equipment (i.e. disease & injury related) should

[1] See Virmani (2002) for detailed rationale.

be fully exempt. The current system of exemptions for life saving drugs, life saving equipment and special gadgets and equipment for the handicapped could be universalised to cover all scheduled drugs, and drugs & medical equipment required to prevent or treat disease and disability. This is also consistent with the renewed thrust for Knowledge Based industries like biotechnology.

4. Positive Externalities

Lower tax rates can also be justified on selected goods on environmental grounds. Thus natural & biological fertilisers & pest-retarding agents could be exempted from CENVAT, as they act as substitutes for artificial fertilisers & pesticides, which are water polluting sources. Production & supply of Biogas and solar energy should also be completely exempt. There should also be a lower rate of tax on clean fuels such as LNG and LPG, as these fuels are substitutes for polluting kerosene and fuel wood. For this reason there should be no subsidy on Kerosene and the general CENVAT should apply. Government efforts should be focussed on facilitating commercial supply of cooking gas to all urban & semi-urban households and to promote Bio gas in rural areas.

5. Special Excise

A balancing of revenue and equity considerations also suggests a few higher rates for demerit goods like tobacco products (cigarettes, cigars, chewing tobacco or mixed in pan masala) and for final, finished, luxury consumer durable goods like cars. These should be in the form of a 'special excise', which is not eligible for VAT credit. Special excise rates of 5% to 20% (4% to 19%) would be appropriate if the base CENVAT rate is 15% (16%).

Special excise can also be imposed on grounds of environmental pollution. Thus polluting fuels like Motor Spirit and Diesel as well as selected dyes & chemicals that damage water sources could have special excise taxes on top of the general rate of 15% (16%).

6. Import & Export

All imports would also be subject to an identical deductible CENVAT and non-deductible special excise as on domestically produced goods. The 'Additional Duty' (AD also known as Countervailing Duty or CVD) must be renamed CENVAT to make it WTO compatible. The customs department must keep a separate account for this renamed AD/CVD so that it can be distinguished from protective (or basic) customs duty and can appear under a separate account 'CENVAT on Imports.' Exports would be zero-rated and entitled to a refund on all CENVAT paid.

B. SERVICE TAX

Central Service tax reform and extension must be designed to integrate it with the CENVAT by 2006-7, keeping in mind the ultimate objective of a National VAT. The central service tax should therefore be integrated into the CENVAT by the end of the 10th plan. Then all services, particularly modern production services such as transport and communication, under the tax authority of the centre would also be subject to the same basic CENVAT rate. Similarly the tax paid on any services used as input (e.g. "telephone" or "insurance") into the production of excisable services or goods would be deductible (set-off). Any comprehensive Service Tax law must keep these objectives in view.

The second essential feature of the service tax law is that a service must be treated identically no matter who the producer is. Thus once we define what type of education services should be exempt (e.g. primary & secondary) they must be exempt, irrespective of whether they are provided by the government, the co-operative or corporate sector. Thirdly, just as administrative convenience requires that low volume producers be exempted from excise, low volume producers/sellers of services should also be exempt. There seems to be no cogent reason for setting different limits for goods & services. Fourth, as the Service tax administration is a completely new one, it must be built on the best and highest standards of modern tax administration to be found across the globe. In other words it must be technology and data intensive (e.g. web filing & computerised checking) and analytical (accounts, economic flows) rather than manpower intensive and physically intrusive. It can thus serve as precursor for a modern VAT administration.

C. EXEMPTIONS

Exempted manufactured goods as well as wholesale trade must be brought into the net if we are to have a comprehensive CENVAT. This is the only way to ensure that the VAT chain is reasonably complete. There are also some practical and conceptual problems peculiar to developing countries like India, which can be solved as follows.

1. Primary Inputs: Agricultural

In the case of agro-based processing & manufactures, deemed credit must be introduced for all agricultural & allied products (jute, silk, cotton, tea, coffee, cocoa, leather, meat, fish & poultry).[3] Therefore at the first (excisable) stage of agro-processing only the value added is taxed at the basic rate of 15% (16%).[4] Any subsequent processor will get an off-set of 15% (16%) of purchase value. This will allow us to eliminate the multiplicity of CENVAT rates in the textile sector.[5]

2. Job Work & Construction

Job work done by numerous small, dispersed processors (including remaking of jewellery from gold ornaments supplied by customers) creates valuation disputes and complaints of harassment. Such job work (currently fully exempt) will have the option of paying CENVAT on the basis of value added by the jobber (to be specified in the rules or procedures). If this option is chosen the SSI exemption will apply to the added value (not the full value).

Similarly, on site construction activities will be taxed on the basis of value added at the site with the SSI exemption applied to the value added and not the value inclusive of off-site inputs.

3. Government Purchase

All Government (municipal, state, central including strategic) related exemptions, will have to be initially compensated with a higher budgetary allocation on the principle of fiscal neutrality. The excise exemption for armed forces is being misused as for instance by purchase of items for relatives and friends who are not entitled to this facility. This could be partly compensated by higher active duty allowances in border areas like Siachin & Kargil and insurgency areas. All fertiliser related exemptions, will also have to be made fiscally neutral through a higher budgetary subsidy.

4. Small Industry

The SSI exemption should be standard and available to all industries and services subject to CENVAT/excise tax (e.g. matches). The value up to which the exemption applies should be based on a realistic cost-benefit calculation that takes account of the possibility of evasion as well as the need for an unbroken VAT chain. On this basis the optimal SSI exemption Vo probably lies between Rs. 10 lacs and Rs. 30 lacs, for the CENVAT defined here. The current 'incentive' approach has distorted the structure of production and resulted in fragmentation.

The SSI exemption should not be dependent on individual notifications and exceptions. All other industry specific exemptions (e.g. handicraft) as well as those related input use (power use or non-use) should be abolished. The current SSI exemption would have to be modified to ensure that,

- SSI exemption value limit (Vo) will be applied to value added (rather than turnover) in the classes of cases specified (above).
- An excisable input produced in a unit whose output is exempt will be entitled to an SSI exemption on the excisable inputs. The unit need pay CENVAT only on the value of internal production of the excisable good above the exemption limit input (not on total final output).
- The excise law may have to be changed to promote outsourcing by large "branded companies" to SSIs while ensuring that the value added by them through marketing & branding pays due taxes. This can be done by treating the company along with the SSIs from which it out-sources, as a single manufacturing unit but giving a deemed SSI credit of Vo lacs for each SSI (out) source in calculating the "branded company's CENVAT tax liability.
- Alternatively (and at the very least), Village, Khadi & Handloom activities carried out by separate producers should not be treated as a unit for the purpose of SSI exemption, even if marketing and sale is under a unified brand name. That is, each separate producer can avail of the SSI limit. To avoid disputes such organisations would be named under the rules & procedures.

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[3] Processing of Food grain, pulses, vegetables & fruits, milk etc by modern agro processing industry should be fully exempted from CENVAT, because exemptions for traditional processors alone, distorts the system against modernisation, to the detriment of the farmer and the consumer (e.g. spolilage).

[4] The new standard SSI exemption could be made applicable to the Value Added (instead of the entire value of output) at the first stage.

[5] That have been proposed by the Task force on Indirect taxes (chairman Dr. Vijay Kelkar)

D. ADMINISTRATIVE SIMPLIFICATION

These changes allow a drastic simplification of the excise or MODVAT system, which is the great advantage of a VAT or true CENVAT. This simplification is based on a complete transformation of the collection and administration machinery. It has the following related elements:

- An invoice and accounts based system of checking in place of routine physical checking.
- Basic data on the company (and its production units, warehouses, depots etc) would be entered once given an appropriate code number and stored on the computer.[5] It would not have to be entered on every invoice as at present.
- A simplified invoice form that focuses on values of inputs and outputs subject to the single VAT rate, and the source and destination of the inputs and outputs respectively. This is most effective if there is a single uniform base CENVAT rate with all goods treated equally on both the input and output side with respect to this rate. In this case the sale or invoice form would only require the total value of goods sold and the code number of the originating and destination units.
- Monthly, quarterly or annual aggregation of the sales and purchase slips depending on volume of business (i.e. SSI have to do only annual aggregation, and only the largest units have to do monthly aggregation). The aggregation would involve showing total value of purchases and sales by seller & buyer respectively, during the relevant period.
- A comprehensive computerisation of these aggregate returns, which allow cross checking of inputs, outputs value added and CENVAT paid, so as to detect evasion.
- This could be supplemented by industry wide database, which can be used to identify flow of goods and services entirely outside the VAT chain.

E. CONCLUSION

A CENVAT system that is simple, efficient and equitable can play a vital role in improving the competitiveness of Indian industry. Optimal tax theory shows that the demands of efficiency and equity can clash. Such an optimisation, however has enormous demand for data that is not available in practice. The proposed system draws on the broad conclusions of this theory and the limited information available to design a system that balances the three objectives. Recent surveys show that our current indirect tax system seriously handicaps Indian firms vis-à-vis Chinese competitors. The proposed CENVAT system will remove many of these handicaps. A completely level playing field, however, requires the introduction of National VAT that integrates the central and State indirect tax systems.

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[5] A 'CAN' (CENVAT account number) along the lines of PAN (personal account number for income tax) must be introduced. The organisation and issue of this number should however be out sourced.

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