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INTRODUCTION TO VALUE ADDED TAX

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Abstract

Value Added Tax is the most recent innovation in the field of taxation. Value Added Tax system is designed to address various problems associated with the conventional sales tax system. It is a tax that has developed as an alternative for the traditional sales tax. VAT is a modern and transparent tax. It is less distorted and more revenue productive. That is why this tax has become a popular topic for tax reform and has been spreading all over the world since the late 1960s.

Objectives

1. To trace the history and development process of VAT.
2. To find the reasons for increasing popularity of VAT.

Introduction

Value Added Tax is the most recent innovation in the field of taxation. Actually, VAT is considered one of the most important tax reforms of the second half of the twentieth century. It is a scientific tax system, which was first introduced

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in 1954 in France. VAT is a family member of indirect tax. Indirect tax is primarily so called because the real burden of tax under this type can be shifted forward to the consumers or in other words, it is not borne directly by the person who pays it. As long as the burden of the tax can be shifted forward, it is indirect. To obtain the exact definition of VAT, the following section gives its practical and precise meaning as implicit in the definition of various experts and institutions.

Meaning of VAT

Different experts and institutions have attempted to give the meaning of VAT according to their own interpretations. Here some of their definitions may be studied. In the words of Ishwar Bhattarai & Girija Koirala.

VAT is a general consumption tax assessed on the value added to goods and services. It is a general tax that applies, in principle, to all commercial activities involving the production and distribution of goods and the provision of services. It is a consumption tax because it is borne ultimately by the final consumer. It is not a charge on companies. It is charged as a percentage of price, which means that the actual tax burden is visible at each stage in the production and distribution chain. It is an indirect tax, in that the tax is collected from someone other than the person who actually bears the cost of the tax (namely

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the seller rather than the consumer). As VAT is intended as a tax on consumption, exports (which are, by definition, consumed abroad) are usually not subject to VAT or VAT is refunded.

According to economy watch website,

Value Added Tax, popularly known as 'VAT', is a special type of indirect tax in which a sum of money is levied at a particular stage in the sale of a product or service. (Source: www.economywatch.com/business-and-economy/vat.html)

According to Wikipedia Website

Value added tax (VAT), or goods and services tax (GST), is tax on exchanges. It is levied on the added value that results from each exchange. It differs from a sales tax because a sales tax is levied on the total value of the exchange. For this reason, a VAT is neutral with respect to the number of passages that there are between the producer and the final consumer. A VAT is an indirect tax, in that the tax is collected from someone who does not bear the entire cost of the tax.

To avoid double taxation on final consumption, exports (which by definition, are consumed abroad) are usually not subject to VAT and VAT charged under such circumstances is

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usually refundable. (Source: en.wikipedia.org/wiki/Value_added_tax)

From the above definitions, it is obvious that VAT is an indirect tax which is the newest and significant experiment done on the modern tax system.

The value added tax system is designed to address various problems associated with the conventional sales tax system. It is a tax that has developed as an alternative for the traditional sales tax. That's why it is also called improvised version of sales tax. In sales tax, there is no provision for input tax credit, which means that the end consumer may pay tax on an input that has already been taxed previously. This is known as cascading and leads to increases consumer tax and price levels, which increases the rate of evasion and can be detrimental to economic growth. In contrast, the VAT that has been levied in the previous level can be deducted while paying taxes on the later levels. It has a special system where a person trying to deceive tax will be caught on either one of the subsequent levels. Therefore, the trend of tax evasion is highly discouraged.

Types of VAT

Value added tax can be distinguished in three types:-

- (1) Consumption type
- (2) Income type

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(3) Gross product

The essential distinction between these three variants is their treatment of capital goods that is, items such as machinery, buildings, equipment, furniture and vehicles or any asset that will not be used up entirely within the tax year of purchase.

1. **Gross Product Variant:** Under this variant deductions are allowed for raw material and components purchases however no deduction/set off is allowed for purchase of Capital goods. Under this variant tax paid on Capital Input such as purchase of Plant, Machinery and equipments etc. are not eligible for set off and hence is not deductible from the tax collected on sales

To illustrate the gross product value-added tax base, Let us assume that a firm has only the following three transactions in the course of its taxable year:

- a) Gross receipts (Sales) of Business Rs. 1,25,000/-
- b) Purchase of a machine (Capital Goods) Rs. 10,000/-
- c) Purchase of materials and supplies
(Non-Capital Goods) Rs. 25,000/-

For this firm, the gross product value-added tax base will be Rs. 1,00,000/- (Rs. 1,25,000/- in gross receipts less Rs. 25,000/- in purchases on current account).

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No deduction is permitted for the Rs. 10,000/- machine since this is a purchase of a capital asset

2. Income Type Variant: The net income-type, with national income its closest counterpart in the national income accounts. Under this type of tax, the cost of a capital asset again is not deducted when it is purchased. The income-type tax base does, however, permit the firm to deduct the amount of depreciation that occurs in a given year on its capital assets. Under the usual definition of the income-type value-added tax base, depreciation is allowed on all capital assets, whether old or new. Depreciation could, however, be limited only to capital assets purchased after the adoption of the tax. If, to the previous three transactions of the firm, an item for depreciation of its purchased machine is added-say Rs. 2000/- (Depreciation rate is assumed to be 12%) for the year then the income-type value-added tax base would be Rs. 98,000/-.

(Rs. 1,25,000/- gross receipts from sales less Rs. 25,000/- for purchases of materials and supplies, less Rs. 2,000/- for depreciation of the machine during the year).

3. Consumption Type Variant: The consumption-type, Corresponding most nearly to the personal consumption account in national income statistics.

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The consumption-type of value-added tax provides the most nearly neutral treatment of capital assets. Under this tax base, a firm that purchases a capital asset may deduct, in the year of purchase, the full value of this purchase. In contrast to the income-type value added tax base, where depreciation is deducted year by year, the consumption value-added approach permits no adjustment for depreciation since to do so-after allowing deduction of full value in the year of purchase-would amount to deducting the price of the capital good twice.

The name consumption-type value-added tax is appropriate because the value-added represented by the capital equipment is not subject to tax until later years, as the equipment is being consumed in the process of production.

In effect, the immediate tax rebate granted to users of capital equipment imposes the tax only once-on gross proceeds of the sales of the goods and services produced by the capital equipment. Funds are not tied up for tax purposes as under the income variant of this tax

The consumption variant, then, is equivalent to instantaneous depreciation of these capital acquisitions.

Using the same illustration, the tax base for the firm in question under the consumption type value-added tax would be Rs 90,000/-. This is arrived at by taking the Rs.

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1,25,000/- in gross receipts from sales and subtracting purchases on both current account (Rs. 25,000 for materials and supplies) and capital account (Rs. 10,000 for the machine).

In this way, the variants of VAT differ in its treatment of capital goods. Among these three types of VAT, the consumption variant is the most superior form of VAT and is universally practiced.

Methods of Computation of VAT

There are three basic methods by which VAT can be calculate. They are: A. Tax Credit Method, B. Subtraction Method and C. Addition Method. The first two methods are frequently used while the third method, Addition Method, is rarely used.

- (1) **Addition Method:** This method is based on the identification of value-added which can be estimated by summation of all the elements of value-added (i.e. wages, profits, rend and interest). This method is also known as income approach method.
- (2) **Subtraction Method:** The subtraction method estimates value-added by means of the difference between the value

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of the outputs and inputs {(i.e. $T = t(\text{output} - \text{input})$ }. This is also known as product approach and has further variants in the way subtraction is attempted namely (a) direct subtraction method, (b) intermediate subtraction method and (c) indirect subtraction method, Direct subtraction method is equivalent to a business transfer tax whereby tax is levied on the difference between the aggregate tax-exclusive value of sales and aggregate tax-exclusive value of purchases. Intermediate subtraction method is based on deduction of the aggregate tax-inclusive values of purchases from the aggregate tax-inclusive value of sales and taxing the difference between them.

- (3) **Tax-Credit Method:** The indirect subtraction method entails deducting of tax on inputs from tax on sales for each tax period, {i.e., $t(\text{output}) - t(\text{input})$ }. This method is also known as tax credit method or invoice method. In practice most countries use this method and employ net-consumption VAT.

Since business is required to state the tax on invoices under the tax credit method, it facilitates border tax adjustments. This implies that the amount of tax that levied on export can be refunded to exporters. Similarly, this method is effective under the destination principle where exports are zero-

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rated and the tax credit chain is not broken. It also provides the facility of cross checking.

This method is particularly useful if it is desired to reduce the rate of value added tax at certain stage in the process of production and distribution. Since this mechanism puts an equal burden of taxation on both imports and domestic products, it is further preferred. The tax credit method, thus, is desirable for several reasons and has been adopted by many countries of the world.

Punjab & Haryana has adopted the tax credit method.

History and Development of VAT

Tax is collected by government to meet the need of budget. Among the various types of tax, the sales tax is one of the major sources. VAT is the most scientific system of sales tax. In the early days, the tax from the consumption and production is collected as sales tax. But now, it is almost completely replaced by the VAT. The concept of VAT was introduced in 1919 by Dr. Wilhem Von Sieman in Germany. This concept was brought to replace the "Usnatzsterller" (multi stage sales tax) due to its undesirable effects, particularly cascading and vertical integration of the latter tax (MST) for the first time. The Germany knew the administrative complication of the VAT system. So, it has the fear to implement. Therefore, the rate of unsatzsteuer is

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reduced instead of the implementation of VAT. In 1921, the America was implementing the corporate income tax. Pro. Thomas S Admas suggested the tax for the United State of America to replace the existing tax system. Until early 50s the development of VAT remained limited only in the theory.

France was the first implementer of VAT in 1954 covering only in the industrial sector. The VAT was limited to only up to whole level. But these countries limited the VAT only on import and manufacturing stage.

In late 60s, VAT started to become popular. Countries like Denmark and Brazil adopted this system of tax in 1967. France, the first implementer of VAT, extended it to the retail level for the first time. And Germany also adopted VAT in the same year. In 1969, the countries like Netherlands and Sweden also adopted VAT in their countries. In 1970, 1971 and 1973, Luxembourg, Belgium and Ireland introduced the VAT respectively.

In Asia, Vietnam was the first country to introduce this most scientific tax system. The country adopted VAT in 1973. The trend being VAT popular was increasing all over the world. In 1977, 1984, 1985, 1986, South Korea, China, Indonesia and Taiwan introduced VAT respectively. Similarly, VAT was introduced by Philippine in 1988, Japan in 1989, Thailand in 1992 and Singapore in 1994.

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In SAARC region, Pakistan was the first adaptor of VAT. It implemented VAT in 1990. India introduced VAT first as modified value added tax (MOD VAT) in 1996. But actually in India, VAT replaced sales tax on 1 April 2005 Haryana was the first state to introduced VAT from 1 April 2003. The Empowered Committee, constituted by Government of India, provided the basic framework for uniform VAT laws in the states but due to the federal nature of Indian constitution, States do have a liberty to set their own valuations for the VAT levied in their own territory. India introduced the full VAT in some prescribed regions of the country on April 1, 2005. Around 130 countries have introduced VAT system across the world. The list below shows the chronology in which VAT was implemented in different countries.

Implementation of VAT in different countries in the chronological order.

Year	Countries that have started adopting VAT
1954	France
1960	Ivory Coast
1961	Senegal
1967	Brazil, Denmark
1968	Germany, Uruguay
1969	Netherlands, Sweden

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1970	Ecuador, Luxemburg, Norway
1971	Belgium
1972	Ireland
1973	Austria, Bolivia, Italy, United Kingdom, Vietnam
1974	Argentina, Chile, Colombia, Costa Rica, Nicaragua
1976	Honduras, Israel, Peru
1977	South Korea, Panama
1980	Mexico
1982	Haiti
1983	Dominican Republic, Guatemala
1984	People Republic of China
1985	Indonesia, Turkey
1986	Morocco, New Zealand, Nigeria, Portugal, Spain, Taiwan
1987	Grenada, Greece
1988	Hungary, The Philippines, Tunisia
1989	Japan, Malawi
1990	Iceland, Kenya, Pakistan, Trinidad and Tobago
1991	Bangladesh, Benin, Canada, Jamaica, Mali, Algeria, South Africa, Armenia,
	Azerbaijan, Cyprus, EL Salvador, Estonia, Fiji, Kazakhstan
1992	Tajikistan, Belorussia, Kyrgyzstan, Russia, Thailand, Turkmenistan, Ukraine,

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	Uzbekistan, Moldova
1993	Burkina Faso, Czech Republic, Paraguay, Poland, Romania, Georgia, Slovak
	Republic, Venezuela
1994	Bulgaria, Finland, Lithuania, Singapore, Western Samoa, Madagascar, Niger
1995	Gabon, Ghana, Switzerland, Zambia, Malta, Latvia, Liechtenstein, Mauritania
1996	Albania, Belize, Guinea, Uganda
1997	Barbados, Congo, Nepal
1998	Croatia, Mongolia, Sri Lanka, Tanzania, Vanuatu, Surinam, French Polynesia
1999	Cambodia, Cameron, Mozambique, Netherlands, Papua New Guinea,
	Slovenia, New Jersey
2000	Australia, Chad, Macedonia, Namibia, Sudan
2001	Botswana, Rwanda
2002	Lebanon
2005	India*

Source: The VAT Project Office (Revenue Administration Support), IRD, IRD/DANIDA, 2001:3-4)

*India has implemented Modified VAT since 1986. This system is not exactly a VAT system. The system was introduced to refund excise duty paid on inputs.

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Reasons for the increasing popularity of VAT

VAT is definitely a new and modern tax as compared with other traditional tax systems. Actually, VAT is thought of being the most important tax reform in the 21st century. Of all the indirect taxes that evolved in the past, VAT is by far the best tax system. By contrast, other tax system had never risen into prominence in such a short span of period.

Ever since its introduction in France around 1954, VAT has gradually and promisingly won the heart of people and is currently implemented in about one hundred and thirty countries.

Several other countries, which so far have not adopted VAT are trying to make necessary changes in their fiscal policies and laws to assimilate and accommodate this scientific tax system into their economic setup.

Although VAT is out and out a new system as compared to other traditional tax system, its popularity is growing fast. It is a precondition that any European countries must have already adopted VAT to become a member of EEC. This precondition plays a vital role in the popularization of VAT. In addition to them, there are some factors that are attributed to its growing popularity.

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1. VAT is neutral with respect to the choice of method of production and distribution. Since the tax is levied only on the value. It is efficient too. An efficient tax system is one that does not cause any distortions in production and consumption. In other words, such a tax system does not bring any unintended and undesirable effects in the methods of production and distribution or in consumption. Added at each stage in the system, tax liability remains the same regardless of the system of production and distribution. Total tax paid on a given commodity depends on the rate of tax and on the total value added (i.e. the final price) of the commodity but not on the number of states through which it has passed. Since VAT does not interfere with the optimal allocation of means of production, it is considered neutral. All other forms of sales tax are distorted since they bring unnecessary and intended changes in the method of production and distribution. VAT is, thus, superior to other forms of sales tax on the ground of efficiency since this tax is neutral with respect of method of production and distribution.

Likewise, VAT is neutral with respect to consumer's choice too. VAT does not affect the relative price. Consequently, there is no need for the consumer to shift from one commodity to the other as responsive to tax.

Thus VAT does not affect the preference of the consumer. It also avoids probable distortions of the optimum allocation of

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resources. All other form of sales taxes is not neutral in respect to consumer's choice.

2. Another feature of an ideal tax system is equity. VAT is more equitable in the sense that it falls equally on all goods that gather a different proportion of value added at various stages.

VAT is also attractive from the point of view of foreign trade considerations. Exports are commonly relieved from taxation in order to maintain the competitive power of domestic manufacturers in the international market. This promotes exports and increase global competitiveness. That is why, the tax levied on exports is refunded to exporters. It is possible to refund the exact amount of tax levied on exports under VAT. It is difficult to refund the exact amount of tax levied on exports under other form of sales tax system except the retail tax.

Another reason for the growing popularity of VAT is that this tax avoids the problem of cascading. Under VAT system especially when the invoice method is adopted, the exact amount of tax can be shifted forward to the consumer.

3. One of the desirable features of a good tax system is the revenue productivity. VAT is popular from the revenue point of view. VAT is well known in the world for its effective revenue

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generation. It is important instrument for the mobilization of recourses. There is tremendous scope for increasing the revenue from VAT. it offers greater revenue potentiality as compared to other forms of sales taxes. VAT is an improved version of sales tax, which has the virtue of mobilizing substantial amount of revenue. Hence, VAT has become an important source of revenue on many developing as well as developed countries. It yields more than 20 percent of tax revenue.

4. Furthermore, VAT is favorable from the administrative point of view also. VAT is favored on the ground that, as the base of this tax is broad, a relatively low rate can produce the required revenue. Low rate reduce the possibility of tax evasion. Since the tax burden is distributed among a large number of taxpayers under the VAT system, it does not put a heavy burden on a taxpayer and hence avoids the chance of considerable tax evasion. The built-in control nature of VAT makes tax evasion more difficult. VAT is thus, better in this respect than other forms of sales taxes.

In summary, VAT is a modern and transparent tax. It is less distorted and more revenue productive. That is why this tax has become a popular topic for tax reform and has been spreading all over the world since the late 1960s. The attractiveness for VAT across the nation has proved that it is

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preferred not merely for raising revenue but also its avoiding multiple distortions as created by other forms of sales tax. In the process of economic liberalization and globalization. VAT makes the tax system flexible and the bracket widen. All this indicates that the VAT is the tax system of the present day.