State level reforms

2.57 The need for fiscal adjustment have not only been recognized by States, they have also been taking a number of pro-active steps including enactment of their FRBMAs, and introduction of monthly cash flow systems aimed at improving their financial positions. Even prior to the TFC recommending enactment of FRBMA as a prerequisite for States to claim the benefits under the Debt Waiver and Relief Facility, a few States had already enacted their FRBMAs. TFC's Debt Consolidation and Waiver Facility (DCRF) has a two-stage benefit scheme as incentives to the States: first, a general scheme of debt relief applicable to all States, which provides for consolidation of Central loans (from Ministry of Finance) contracted by States till March 31, 2004 and outstanding as on March 31, 2005 for a fresh term of 20 years at an interest rate of 7.5 per cent, prospectively, from the year in which they enact FRBMAs; and second, a Debt Write-off scheme (after consolidation of Central loans-Ministry of Finance) linked to fiscal performance, subject to the following conditions:

i) Enactment of FRBMA (required, in any case for debt consolidation),

ii) Reduction of revenue deficit every year starting from 2004-05, when compared to the average of the preceding three years (i.e., 2001-02, 2002-03 & 2003-04). In the process, if revenue deficit is eliminated completely by 2008-09, the State gets full benefit of the waiver,

iii) Reduction in revenue deficit should be equal to at least the interest rate relief on account of consolidation, and

iv) Containing fiscal deficit/GSDP ratio at the 2004-05 level in all the subsequent years.

2.58 Under debt write-off scheme, repayments falling due during the period 2005-06 to 2009-10 on the consolidation of the Central loans would become eligible for write-off. The quantum of write-off will be linked to the absolute amount by which revenue deficit is reduced in each successive year, during the award period. TFC has estimated that the debt relief during its award period (2005-10) for all States would be Rs. 21,276 crore in interest payments and Rs. 11,929 crore in repayments of consolidated Central loans. If all the States eliminate revenue deficit in 2008-09, the amount of debt waiver that would be available to the States is expected to be Rs. 33,205 crore. To traverse on a credible path of eliminating revenue deficit to zero by 2008-09 and to bring down the fiscal deficit to 3 per cent of GSDP and achieve other targets of TFC, States are required to draw up their own "Fiscal Correction Paths". So far, 23 States have enacted their FRBMAs and 21 States had drawn up their fiscal correction paths. Debt consolidation has been done for 19 States namely, Andhra Pradesh, Assam, Bihar, Chhatisgarh, Gujarat, Haryana, Himachal Pradesh, Karnataka, Kerala, Madhya Pradesh, Maharashtra, Manipur, Orissa, Punjab, Rajasthan, Tamil Nadu, Tripura, Uttarakhand and Uttar Pradesh. Central loans in respect of these States have also been consolidated. Out of 19 States, 6 States namely, Assam, Bihar, Kerala, Maharashtra, Tripura and Uttarakhand were not found eligible for debt waiver in 2005-06. In case of 13 States, amount of debt waiver is estimated at Rs. 3,856 crore.

Value Added Tax (VAT)

2.59 Introduction of State Level VAT is the most significant tax reform measure at State level. The State level VAT implemented has replaced the existing State Sales Tax. The decision to implement State level VAT was taken in the meeting of the Empowered Committee (EC) of State Finance Ministers held on June 18, 2004, where a broad consensus was arrived at to introduce VAT from April 1, 2005. Accordingly, VAT has been introduced by 30 States/UTs so far. Tamil Nadu has implemented VAT from January 1, 2007. The union territory of Puducherry has communicated its decision to implement VAT from April 1, 2007. Uttar Pradesh has not yet taken any decision in this regard. Since Sales Tax/VAT is a State subject, the Central Government has played the role of a facilitator. A compensation formula has also been finalised in consultation with the States, for providing compensation, during 2005-06, 2006-07 and 2007-08, for any losses on account of introduction of VAT and compensation is being released according to this formula. Technical and financial support has also been provided to the States for VAT computerization, publicity and awareness and other related aspects.

2.60 The Empowered Committee, through its deliberations over the years, finalized a design of VAT to be adopted by the States, which seeks to retain the essential features of VAT, while at the same time, providing a measure of flexibility to the States, to enable them to meet their local requirements. Some salient features of the VAT design finalized by the Empowered Committee are as follows:

(a) The rates of VAT on various commodities shall be uniform for all the States/UTs. There are 2 basic rates of 4 per cent and 12.5 per cent, besides an exempt category and a special rate of 1 per cent for a few selected items. The items of basic necessities have been put in the zero rate bracket or the exempted schedule. Gold, silver and precious stones have been put in the 1 per cent schedule. There is also a category with 20 per cent floor rate of tax, but the commodities listed in this schedule are not eligible for input tax rebate/set off. This category covers items like motor spirit (petrol), diesel, aviation turbine fuel, and liquor.

(b) There is provision for eliminating the multiplicity of taxes. In fact, all the State taxes on purchase or sale of goods (excluding Entry Tax in lieu of Octroi) are required to be subsumed in VAT or made VATable.

(c) Provision has been made for allowing "Input Tax Credit (ITC)", which is the basic feature of VAT. However, since the VAT being implemented is intra-State VAT only and does not cover inter-State sale transactions, ITC will not be available on inter-State purchases.

(d) Exports will be zero-rated, with credit given for all taxes on inputs/ purchases related to such exports.

(e) There are provisions to make the system more business-friendly. For instance, there is provision for self-assessment by the dealers. Similarly, there is provision of a threshold limit for registration of dealers in terms of annual turnover of Rs. 5 lakh. Dealers with turnover lower than this threshold limit are not required to obtain registration under VAT and are exempt from payment of VAT. There is also provision for composition of tax liability up to annual turnover limit of Rs. 50 lakh.

(f) Regarding the industrial incentives, the States have been allowed to continue with the existing incentives, without breaking the VAT chain. However, no fresh sales tax/VAT based incentives are permitted.

VAT implementation–experience so far:

2.61 The experience of implementing VAT has been very encouraging. The new system has been received well by all the

stakeholders, and the transition has been quite smooth with the Empowered Committee constantly reviewing the progress of implementation. The revenue performance of VAT-implementing States/UTs has been very encouraging. During 2005-06, the tax revenue of the 25 VAT implementing States/ UTs registered year-on-year increase in VAT revenues of 13.8 per cent, higher than the average annual rate of growth in the last five years. In the first seven months of 2006-07 (April-October), the 30 VAT State/UTs have collectively registered revenue growth rate of 26.1 per cent over the corresponding period of the previous year. The Central Government had announced a compensation package under which the States are compensated for any revenue loss on account of VAT introduction at the rate of 100 per cent of revenue loss during 2005-06; 75 per cent during 2006-07, and 50 per cent during 2007-08. The initial Budget provision for the year 2005-06 was Rs. 5,000 crore, which was reduced to Rs. 2,500 crore at the RE stage. For the year 2006-07, a provision of Rs. 2,990 crore (BE) was initially made, and an additional provision of Rs. 1,000 crore has been made through First Supplementary. In all, 8 States requested for VAT compensation for a total amount of Rs 6,765.6 crore in 2005-06. In 2006-07 so far, claims for a total of Rs. 514.3 crore have been received from 5 States.

CST Reforms

2.62 It is generally agreed that the CST, being an origin-based non-rebatable tax, is inconsistent with the concept of VAT and needs to be phased out. One critical issue involved in phasing out of CST is that of compensating the States for revenue losses on account of such a phase out. During 2005-06, the total revenue collection from CST for all States was around Rs. 18,000 crore. Since phasing out of CST will entail a revenue loss, States are insisting on a mechanism to compensate them on a permanent basis. The EC has been deliberating on the issue. The matter was also discussed in the meetings of State Finance Ministers. The EC had submitted a proposal to the Department of Revenue containing their recommendations on the modalities for phasing out of CST and for compensation of revenue loss on this account. The proposal of the EC was examined and, thereafter, the views and suggestions of the Government on the same have been communicated to the EC. Further deliberations on the issue are going on in the EC.