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Challenges of Value Added Tax Compliance for Economic Growth of Madhya Pradesh, India

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Abstract:

Taxes is one major source of government revenue, across the globe, however, every national government have not been able to effectively exploit this great opportunity of revenue generation. It is because of number reasons including the system of taxation; tax legislation; tax administration and policy issues; over reliance on other sources of revenue such as foreign aid and grants. Many instances corrupt practices in the system affect taxation especially as it relates to the system of tax collection and behaviour of citizens towards tax payment; and ease of tax payment. This paper examined the effect of Tax compliance on economic growth and development in state of Madhya Pradesh. Various reasons for non-compliance of tax are discussed with reference to Value added tax to find out shortcomings in the tax structure. It is aimed to characterize and explain the pattern of tax non-compliance in order to find out ways to improve it for economic growth of the State.

Keywords: Compliance, revenue, social capital, transparent, value added.

1. Introduction

Tax revenue is an important instrument for economic growth and development in many developing economies like India since the internal revenue generated through taxes go a long way in providing funds for the provision of public goods. Tax compliance is one of the most vexing problems for policy makers in developing and transition economies like India. High tax compliance is necessary for efficiency and equity as well as for the development of social capital (Slemrod, 1998) and this issue is independent of the overall tax “take” from GDP. Tax evasion inseparably bound up with the instruments of fiscal control that the government attempts to use in carrying out its economic policy unlike other illegal activities (Cowell 1990). High tax compliance not only improves the government’s revenue, it is a broader issue for the development of a civil order (Knack and Keefer, 1997). Tax compliance is likely to be higher, when the services provided by the government are viewed as widely desired and the decisions determining the services provided are transparent and fair. It is enhanced when individuals view the paying of taxes as a fair fiscal exchange. The level of compliance depends on the manner by which the public budget is determined. It needs widely supported political mechanism where when the public good is voted on, rather than imposed (Jackson 1993). The reasons for high tax compliance include social norms and morals with rules (Elster, 1989) and collective actions (Naylor, 1989).

2. Tax Compliance: Theoretical Consideration

Tax is a major player in every society of the world where the tax system provides an opportunity for government to collect additional revenue needed in discharging its pressing obligations. (Azubike 2009). Taxation system in a national economy offers itself as one of the most effective means of mobilizing a nation’s internal resources and help in creating an environment conducive to the promotion of economic growth. Tax is a compulsory levy imposed on a subject or upon his property by the government to provide security, social amenities and create conditions for the economic wellbeing of the society (Appah, 2004; Appah and Oyandonghan, 2011). Taxation is defined as the compulsory transfer or payment (or occasionally of goods and services) from private individuals, institutions or groups to the government. (Anyanwu (1997). It has been stated that tax is imposed to regulate the production of certain goods and services, protection of industries, control business and curb inflation, reduce income inequalities etc. Taxes are primarily levied to raise revenue to meet government expenditure and to redistribute wealth and management of the economy (Ola, 2001; Jhingan, 2004; Bhartia, 2009). As per Nzotta (2007) the four key issues to be understood for taxation to play its functions in the society are

- Tax is a compulsory contribution made by the citizens to the government and for the general common use.
- A tax imposes a general obligation on the tax payer.

- There is a presumption that the contribution to the public revenue made by the tax payer may not be equivalent to the benefits received.
- A tax is not imposed on a citizen by the government because it has rendered specific services to him or his family.

It is evident that a good tax structure plays a multiple role in the process of economic development of a country where India is not an exception (Appah, 2010a). These roles include: the level of taxation affects the level of public savings and thus the volume of resources available for capital formation; both the level and the structure of taxation affect the level private saving. (Musgrave and Musgrave 2006)

The tax control framework and its components of governance, communication, risk identification, controls and monitoring are the key areas you need to focus on when trying to enhance the management of tax in the modern business and tax environment(fig.1). The tax structure in India is presented in fig.2.



Figure 1: Tax Control Framework
Source: <http://www.pwc.co.uk/>

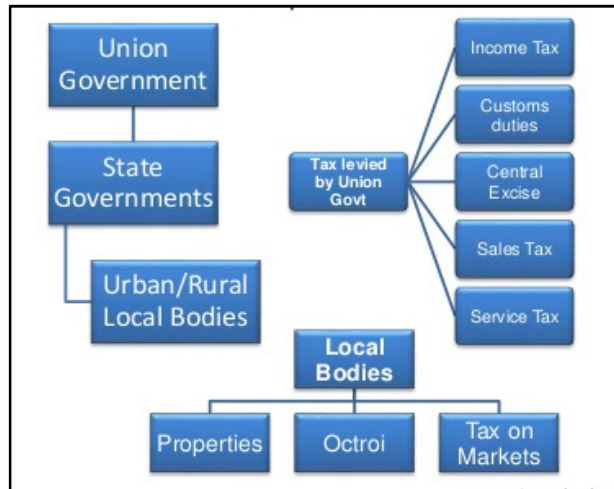


Figure 2: Tax Structure in India.
Source: www.slideshare.net

To influence the efficiency of resource utilization a system of tax incentives and penalties may be designed. In addition to this, the distribution of the tax burdens plays a large part in promoting an equitable distribution of the fruit of economic development. The tax treatment of investment from abroad may affect the volume of capital inflow and rate of reinvestment of earnings there from; and the pattern of taxation on imports relative to that of domestic producers affects the foreign trade balance. As per Nwezeaku (2005) the scope of these functions depends, inter alia, on the political and economic orientation of the people, their needs and aspirations as well as their willingness to pay tax.

3. Compliance and Compliance Cost

Tax system can collect revenue effectively when the taxpayers cooperate and act in expected manner. The principles of simplicity, convenience of payment and certainty are must to have maximum tax compliance and minimum tax gap. Tax compliance, in simple terms, means compliance with tax reporting requirement and taxpayers’ willingness to comply with tax laws, declare the correct income, claim the correct deductions, relief and rebates and pay all taxes on time. It has been defined as taxpayers’ ability and willingness to comply with tax laws which are determined by ethics, legal environment and other situational factors at a particular time and place (Palil 2011). Tax compliance requires a degree of honesty, adequate tax knowledge and capability to use this knowledge, timeliness, accuracy, and adequate records in order to complete the tax returns and associated tax documentation(Singh and Bhupalan, 2001).

The tax structure has to be designed in such a way which minimizes non-compliance and gap between the taxes that one owed and taxes that are voluntarily paid. Simplicity implies ease of understanding rules and cost effective correct compliance of taxes by the tax payers. Certainty generally comes from clear and understandable administrative guidelines readily and timely available to tax payers so that desirable level of tax compliance takes place. For tax compliance the taxpayer has to perform many activities generally people comply with the tax laws.

People comply with tax laws	Taxpayers are required by law
For social acceptance	To register for tax,
For business formalisation	To keep and maintain sufficient records
To avoid tax penalties	To carry out tax assessments,
To get tax clearance certificate.	To pay taxes (as due)
	To file all tax returns in time

Table 1: Tax Compliance

Tax compliance can be administered or voluntary. In the system of voluntary tax compliance, the taxpayer calculates his tax liability himself, pays the tax and informs the Tax authority. This Requires elaborate set of rules that allow objective computation of tax liability as Tax Administrator does not look into the tax liability of every taxpayer and the system need to have credible deterrent to disincentives tax evasion.

Role of Tax Administrator is to create a system that would facilitate tax compliance by having easy to calculate tax with less confusions and simplified procedures for reporting. The tax administration needs strategic efficiency, efficiency of taxpayer services ability to guide taxpayer's ability of creating a Credible Deterrence catching tax evaders and punishing them. As a result, the tax payers have to incur the cost for tax compliance.

Under the system of administered tax compliance, the Tax Administrator calculates the tax liability of the taxpayer and informs him, according to which the taxpayer pays the tax. This Requires less elaborate rules as Tax Administrator look into the tax liability of each & every taxpayer and the Need for deterrence is limited. Tax administration needs Ability to efficiently assess the tax payable by taxpayer, Expedient action and communication, High skills in law, accounting. As a result, the tax administration has to bear the cost. In both the cases imposition of taxes by the tax authority create burden on tax payers consisting of the elements of the tax themselves and the costs expended in complying (or sometimes not complying) with their tax obligations usually referred to as compliance cost. Compliance with tax laws does not occur without effort: it must be created, cultivated, monitored, and enforced in all countries. In economic terms, of course, effort is just another word for cost, and tax compliance costs.

4. Compliance Cost

For meeting tax liability, the tax payers have to bear some cost. For a business, the compliance costs include the cost of collecting, remitting and accounting for tax on the products or profits of the business, together with the cost of acquiring the knowledge to enable this work to be done, including knowledge of their legal obligations and penalties, and the associated overhead costs, including costs of storing records as required by the tax authorities. Compliance costs tend to increase with the number of taxes that an entrepreneur is subject to, the complexity of the tax rules, the frequency of submitting tax returns, and the number of levels of government involved in levying and collecting tax (Yesegat 2009). When the tax laws are simple and can be understood easily, compliance cost comes out to be lesser and voluntary tax compliance improves. Complex tax system compels the taxpayer to take help of experts to comply with their tax obligation and spent more.

Previous studies have identified the following as determinants of tax compliance and its cost

- tax rates;
- tax audits
- perception on government spending;
- role of tax authority and tax administration;
- simplicity of tax returns;
- probability of detection;
- awareness on offenses and penalty; and
- personal financial constraint,

5. Components of Compliance Cost

Tax compliance require time spent for preparation and filing of tax, money and involves the problems faced by tax payers while complying with the tax obligations. Compliance costs of taxation include three major components:

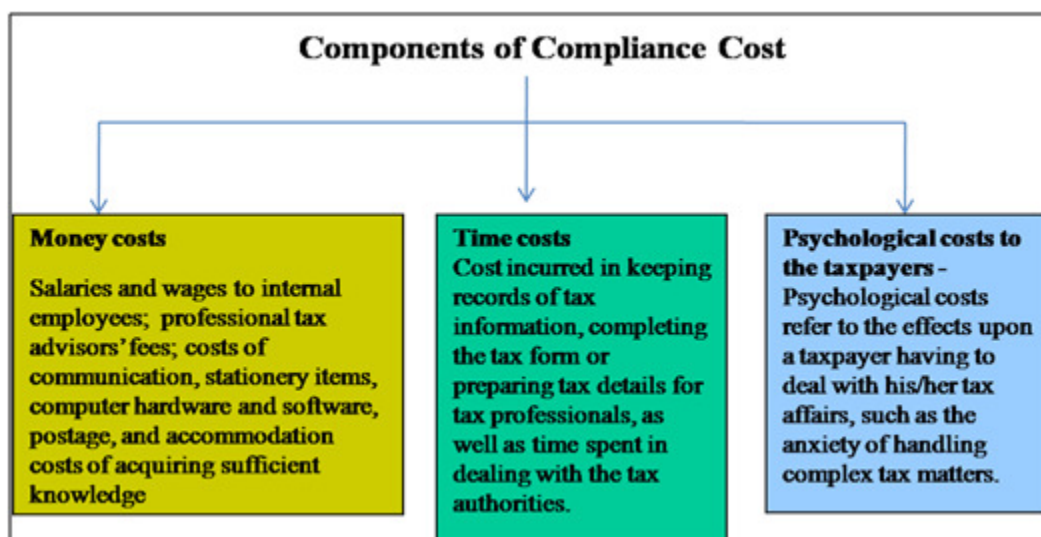


Figure 3: Components of Compliance Cost.

6. Compliance cost of Value Added Tax (VAT)

VAT regime has been introduced in India in April 2005 with the idea of promoting tax compliance, especially voluntary compliance. VAT provides for self-assessment mechanism in tax calculation and payment. It has replaced cascading sales tax system and preceded with harmonised tax rates throughout the country. The VAT compliance has presented a positive picture but it has to be identified whether taxpayers are comfortable with information component of the tax system and cost required to comply with tax liabilities.

VAT is a tax levied and collected at every stage of value addition. Business enterprises have to comply for their share of tax on the value addition done by them. For fulfilling VAT obligation, they have to carry out number of activities which involve time, money and psychological cost. The tax has been appreciated though many times conceived to be complex and difficult to understand by people in general. The indirect tax system which has involvement of many authorities, in administration, observed to be time consuming and create greater time cost of VAT compliance. Administrative procedures have a significant impact on how long it takes to comply with VAT. It takes less time to comply, on average where business uses computers for account keeping and online filing and payment of VAT. The frequency with which VAT returns are required (monthly/ quarterly), and the amount of information requested has a significant impact on the time it takes to comply. Compliance takes longer where extra documentation has to be submitted with the return. For complying with VAT the business community i.e. the tax payers have to undertake number of activities discussed as under.

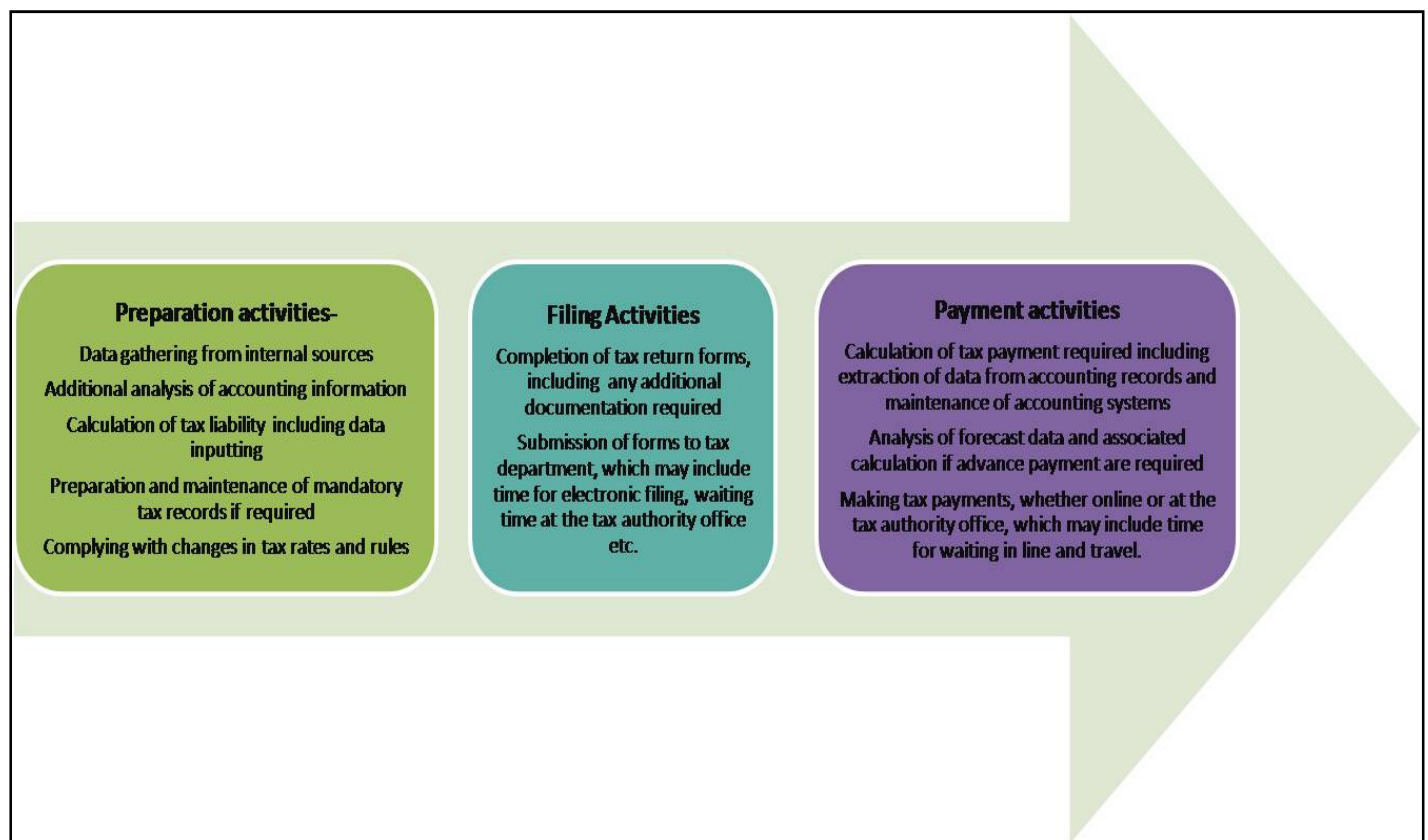


Figure 4: VAT Compliance activities

Source: PWC Report the impact of VAT compliance on business.

7. Factors affecting compliance cost of VAT

The nature of VAT effectively requires taxpayers to account for every business transaction accurately in real time, because the tax treatment of each supply of goods is decided when the supply occurs and must be reported and accounted for on the VAT return shortly after the transaction. This necessitates the effective use of technology and well-designed business processes to capture the relevant data and ensure that the complex VAT rules are correctly applied to the transaction. Filing VAT returns is another task that requires accuracy within a limited time frame. In general, the shorter the VAT reporting period, the shorter the filing deadline. While businesses also pay VAT on their purchases and may recover some or all of that input VAT, this recovery can occur only if the company complies fairly with rules and keep required records and documents needed. Introducing VAT rules in their accounting system and process would insure appropriate recovery of input VAT and also better accounting practise useful all time. Meeting VAT obligations require the dealers to prepare the relevant accounts and file the tax on time. It has been observed that business community finds it difficult to understand and comply with VAT. In such a situation they need the help of experts in the field. They hire tax consultants and Chartered Accountants not only for audit purpose but also for carrying out activities associated with VAT compliance. There are number of factors which affect compliance cost of VAT discussed as under.

- Simplified calculation
- Frequency of VAT returns filing
- Accounting system employed
- Area and degree of external assistance
- Time spent on preparation
- Fees paid for external assistance
- Documentation required
- On line Connectivity with tax authority
- VAT rates and changes taking place

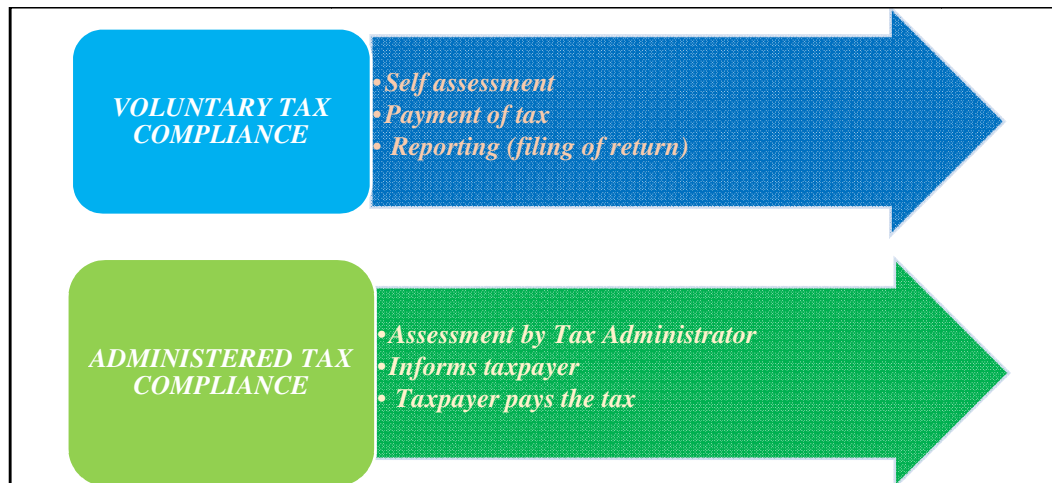


Figure 5: Tax Compliance.

Compliance with VAT requires number of activities which require different time. On an average monthly return filling requires 125 hours for the task whereas lesser time of 81 hours is required for quarterly return filing (PWC 2011). In India the dealers registered under VAT act are required to file quarterly returns and thus seem to devote lesser time for return filing. VAT compliance requires documentary support. When more documents are needed it require more time to comply with VAT. Where lesser documents are needed it takes on an average 76 hours whereas more documentation require more time i.e. about 158 hours (PWC 2011). Two third of the time i.e. 82 hours are required for preparation for return filling whereas 24 hours are required for filling activity and 19 hours for activities related to payment.

When tax system experience lesser changes over time it becomes easy to comply with VAT as against frequent changes in tax rates and rules. Consulting on tax rates consumes grater time and thus leads to more cost of tax compliance. When the tax department has to deal with more than one consumption tax it requires more time to administer the tax on one hand and on the other again more time to comply with the particular tax. Countries which have one commercial tax administered by the department require lesser time for tax compliance. It takes 114 hours for compliance under one tax system and takes 225 hours under many tax systems. In India there are three different consumption taxes – Central sales tax and State VAT, administered by the State Revenue Department; and CENVAT, by the central authority. As a result, it comes under the group of countries which require more time for VAT compliance due to more consumption taxes.

PWC conducted a study to look at the differences in the time required for VAT compliance in different countries, and to demonstrate how the way in which taxes are implemented using different administrative practices can have a significant impact on the compliance cost for business. It suggests that different administrative practices and the way in which VAT has been implemented are key reasons for the range in hours that it takes to comply with VAT requirements are:

- More time is spent on compliance activities where VAT is administered by a separate Tax Authority.
- More time is spent where tax administration is weaker (as measured by the time it is likely to take to obtain a refund).
- The frequency of returns and the amount of data which has to be submitted have an impact on how long it takes to comply.
- Less time is spent where business uses online filing and payment. The compliance burden tends to be lower in the developed world and higher in lower income countries.

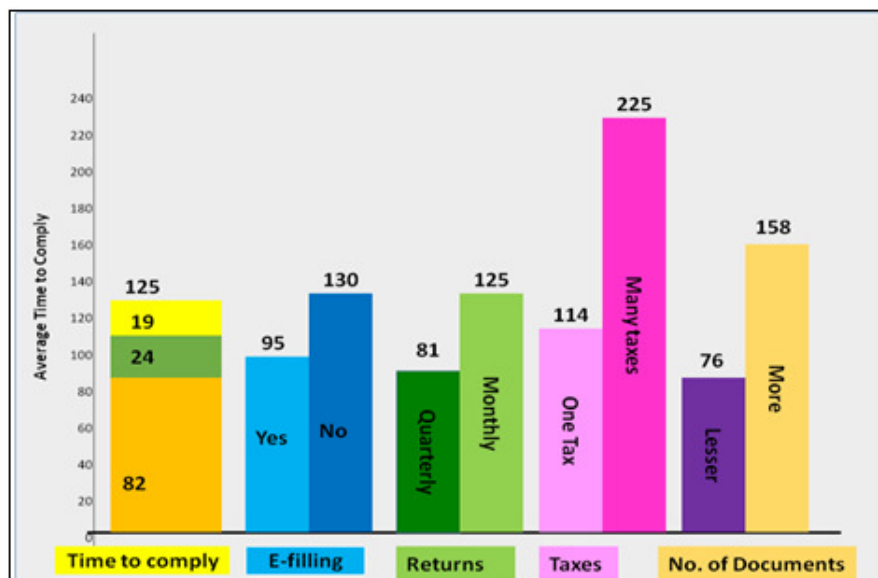


Figure 6: Average Time to Comply with VAT with reference to different variables
Source: Based on PWC report

8. Compliance Cost of VAT in M. P.

The tax payers in M.P. find VAT as a tax which is difficult to understand and comply. This creates the psychological cost of tax compliance which they avoid by taking the help of Tax consultants and C.A. and as a result the tax payers have to bear the money cost of tax compliance. It has been reported that more time devoted and more fees paid to tax consultant for VAT compliance increases the compliance cost of VAT. Many other factors which affect compliance cost of VAT are

- Simplified calculation: When the system and structure of tax is simple the taxpayers need lesser time and money for preparing and filing VAT return. The enterprise which deal in number of commodities require more time for preparation of VAT compliance like a dealer dealing in FMCG (fast moving consumer goods). It has been reported by the tax consultants in the survey that small but large number of bills require more time for VAT filing preparation.

- Frequency of VAT returns filing: The tax payers need to prepare vat return every time they are required to file the return. When the frequency of return filing is less compliance cost of VAT is less as compared to the situation when the return filing has to be done frequently. VAT in M.P. requires tax payers to file quarterly returns and thus they have to repeat activates related to VAT compliance and it involves time cost.

- Accounting system employed: Computerised account keeping practice save time on one hand but on the other need investment and trained personnel. Manual account keeping require greater time for preparation of VAT return. It has been reported that those who keep accounts themselves manually devote more time for recording of transactions on one hand and the outside expert again devote more time to make the record usable for VAT return.

- Area and degree of external assistance: Technology based account keeping require assistance in smaller degree as against manual account keeping require help in almost all activities associated with VAT compliance.

- Documentation required: VAT compliance requires documentary support. When more documents are needed and also information dissemination regarding needed documents is not proper compliance cost becomes more.

- On line Connectivity with tax authority: VAT has been the tax of modern times based on IT. Return filing takes place using internet. When there exists all time online connectivity tax compliance takes place fast and delay can be avoided thus compliance cost can be controlled.

- VAT rates and changes taking place: When tax system experience lesser changes over time it becomes easy to comply with VAT as against frequent changes in tax rates and rules. Consulting on tax rates consumes grater time and thus leads to more cost of tax compliance.

The study found a blurt picture on the issue of compliance cost as required information could not be gathered as the respondents were not clear about time involved in VAT preparation activities. The respondents were found reluctant to respond on issue of money involved in VAT compliance. It has been reported that the business enterprises are ready to pay for assistance of outside expert for VAT compliance there by avoid the psychological cost involved.

9. Conclusion

Simplicity is one of the commonly accepted key tenets of any sound taxation system. VAT structure and operation procedure need reducing complexity which will reduces compliance costs, administrative costs, and thereby taxpayer uncertainty. Such an outcome could lead to improved levels of voluntary compliance. A tax system buried in red tape and complexity will reduce investment, innovation and risk taking and ultimately reduce productivity and economic growth. VAT in Madhya Pradesh possesses three main types of complexity technical complexity, compliance complexity and structural complexity. The first two types of complexity in

particular would appear to be problems in the state given the general population's relatively low educational standards and low levels of financial literacy. It has been noticed that excessive complexity increases fling and administrative costs and it has impact on voluntary compliance. It has been observed that the more complex the tax legislation and regulation the greater the knowledge gap or information asymmetry between legislators and taxpayers, and the greater the costs to the taxpayer of complying with the legislation. Compliance cost is not a leading factor about paying taxes. There are other factors with compliance costs. Audit, penalties and sanctions play a vital role in changing taxpayers attitude towards VAT non-compliance.

A good tax system must satisfy four principles: simplicity, equity, ability to pay and efficiency. A tax system or its basics should be understood by the majority of the citizens. It must also be simple to operate, so that the collection of taxes (administrative costs and compliance costs) is inexpensive. Taxpayers should not be subject to frequent changes on rates or bases and the costs of compliance for tax payers and of collection for the governments should be minimal.

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