

# On the Use of a “Goods and Service Tax” in India

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Note prepared for presentation at the Conference on “Socio-Economic Impacts of GST in India: Introduction, Reforms, Consumption Patterns and Fiscal Federalism”, March 28-29, 2026, Thiruvananthapuram, India.

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## Introduction

Until the years after World War Two there had been relatively little interest, on the part of governments (except for the Centrally Planned Economies of the Soviet Union), in changing the income distributions that the free markets and the existing laws on ownerships of property and capital generated. The existing income distributions had been seen as natural outcomes of the economic world, just as weather conditions and life expectancies had been seen as outcomes of the natural world. These had been seen as outcomes about which governments could or should not do anything.

In the years after World War Two and after the tragic event that for many countries had been the Great Depression in the 1930s, an event that had left millions of families without any incomes and in absolute poverty, general views on the government role had started to change. Some governments, including those of the UK and the USA, had accepted the view that they had some responsibilities in promoting full employment and limited safety nets for families and individuals that needed assistance, for reasons that included: old age, illnesses, serious disabilities, unemployment and others. By that time the sizes of families, that in the past had been large and that had provided some basic assistance within them for family members in need of assistance had started to shrink, reducing the in-family redistributing role.

What in time would come to be called “welfare states”, countries that had adopted some policies of social assistance to needy families and individuals, had come into existence, especially in Europe, but also in the United States and in a few other places. By the 1950s and the early 1960s there were several such countries in existence. These “welfare states” required higher tax revenue than in the past to finance the higher public spending that the new policies required. Therefore, tax rates and tax levels had gone up.

In a book published in 1959, a book that remained very influential for a couple of decades, called The Theory of Public Finance, the German born economist, Professor Richard Musgrave, who lived in the United States, had provided a coherent theory and a description of the three public finance roles that modern governments were expected to play. Those roles were: some *redistributions of national incomes* that the work of the free market and the existing property rights generated, as one of the three fundamental objectives that governments were expected to promote. The other two

objectives were: *stabilization of the economy*, along the then popular Keynesian thinking, and the allocation of national *resources* necessary to finance the *public goods* that economies always needed. The resources to finance these *public goods* would not come voluntarily from private sources. They would have to come from government budgets. The public goods might also include some so-called “quasi -public goods”, goods that might also require public assistance, such as education, public health, expenses for research and development, and some others.

## **The Discovery of the Value Added Tax in France, in the 1950s**

In the mid 1950s, France had introduced a novel tax, a tax that had not existed or been used in the past. It was a tax based on net domestic consumption and imposed at a flat rate. It was called a *value added tax* and was collected from producers on the net value (the value added) of what they sold. The novelty of this tax was that it was imposed on *values added* and not on the gross value of sales, as sales taxes had been imposed in the past. This was to avoid double counting, or tax on tax. This new tax could generate a lot of revenue without disturbing the allocation of resources, and at a time when new revenues were badly needed by governments to finance the newly created welfare states.

This new tax soon became popular in countries that had wanted more public revenue. The use of this tax soon spread to other European, Latin American, and some African countries. This tax exempted exports, because they were consumed abroad, and fully taxed imports. The tax could be included directly in the prices of the goods and services sold, without the need to disclose it separately.

Later, some countries, and especially Anglo-Saxon countries, made some modifications to the French original version of the tax and called it a “goods and service tax”. The “goods and service tax” used different tax rates on different goods and services, depending on the assessed degree of necessity of the goods and the services to families and individuals. Generally, goods and services that were considered less essential, and thus reflexed some *luxury* characteristics, were taxed at higher rates. The goods and services considered necessities were taxed at lower or, in some cases, even at zero rates. This made the tax more equitable, but it also created some complexity in its administration and made it easier for enterprises to evade it. The goods and service tax created also some rent -seeking pressures for lower or zero rates for more goods

and services. Therefore, greater equity was achieved at greater administrative and revenue costs.

In its original French version, the value added tax had been expected to be levied at one rate on all goods and services consumed. In that original version, it could provide more revenue to countries' governments and more information on taxpayers to the tax administrations. The "goods and service tax" version, that came later and that used different tax rates on different goods and services, introduced complexity and some rent seeking attempts by citizens and tax avoiding attempts by sellers, leading to some revenue losses. Generally, the countries that used the original version of the value added tax ended up with higher tax revenue in their GDPs. Today, most countries of the world make use of some versions of the value added tax, including the "goods and service version".

The value added tax had been intended to be used by national governments, and not by local governments in federal countries. When it was used by local jurisdictions, as it was in Brazil, it generally led to greater difficulties including "tax wars" between jurisdictions.

A notable and rare exception in the adoption of this tax has been the United States. For various reasons, including the fact that in the US local governments, called "states", had been using traditional excise taxes in the past, the USA has so far chosen not to adopt the value added tax, or a national tax on goods and services. It is now the only advanced country without such a tax, and a rare exception among all the countries of the world, that now use some versions of the value added tax. By so doing, the USA lost a major source of badly needed and easy to get revenue. The current tax level in the USA is the lowest among all the advanced countries. In some cases, it is as much as 20 percentage points of GDP lower than in some European countries, such as France.

The US fiscal situation has been deteriorating at a worrisome pace in recent years, and its public debt has been rising rapidly, generating growing default concerns. This is happening in spite of so far, good growth performance of the US economy and low unemployment rates.

Especially the Anglo-Saxon countries adopted modified value added taxes, versions that taxed different goods and services at different rates. They did this with the goal of making this tax more equitable for families. However, these, modified value added taxes, versions of “good and service taxes”, have created more administrative difficulties and inevitably they have ended up generating lower tax revenue, to the countries that adopted them.

From the beginning, there had been concerns on the part of some economists that, because poor families consume all or most of their incomes and save little or nothing, they would be the ones most affected by the value added taxes. This concern had led several countries to modify the original version of the value added tax into *goods and service taxes*, taxes that favored the consumption of essential goods and services over less essential ones, by imposing lower or zero rates on them, and higher rates on less essential ones. Thus, for equity reasons, the original value added tax had come to be considered less desirable than, say, had been seen to be taxes on incomes or wealth. For this reason, several countries, and especially Anglo-Saxon countries, modified the original value added tax and chose a version with multiple rate

As we have mentioned, the attempt to make these taxes satisfy some criteria of tax fairness or equity led to administrative complications and to some revenue losses. Continental European and especially Scandinavian countries chose the larger tax bases with single tax rates to collect more revenues and to finance more ambitious welfare states.

## **Could Value Added Taxes Be Part of an Efficient Redistribution Policy?**

Although no country has so far adopted the policy that will be suggested below, such a policy would be simple to both introduce and use. Its efficiency and administrative difficulties would be minimal once the proposal was introduced. It would be an ideal policy for a country such as India that now has a high growth rate but a Gini coefficient that, while not too high for the income distribution, is high for the distribution of wealth. The proposed policy would reflect a view enunciated six centuries ago by Leonardo da Vinci, who believed that “simplicity is the ultimate form of sophistication”.

Economists have rarely followed Leonardo view. Generally, policies aimed at redistributing income or wealth have been thought to require complex and progressive income taxes, or taxes on property and profits combined with complex spending policies. Such taxes and policies are not easy to use and administer, and over time they tend to raise efficiency concerns, among many economists, and to become increasingly more complex and open to abuses. The revenues from income and wealth sources, combined with complex spending policies, generate corruption, rent seeking, efficiency concerns, and other difficulties. Simpler policies have rarely been suggested, because they are considered simplistic, and even more rarely adopted. Leonardo's view has been ignored by most economists and governments.

Most countries, including India, have good demographic statistics on the citizens that live in them. And most countries, including India, would be able to impose and administer a value added tax that were imposed with a single rate, on consumption that would include imports and exclude exports.

This value added tax would provide revenue to the *national* government, revenue that could be used to transfer a strictly equal absolute amount, on a yearly or monthly basis, to each citizen. If this policy were used all rich and poor citizens, without distinction, would receive the same per capita payment from the government. The payments could be easily distributed by using credit cards that would credit the amount and that would be made available to the citizens or, in the case of under age children, to their parents.

The collection of the tax revenue to be redistributed would reflect the personal spending of each citizen, rich and poor, and the spending of high and low spenders. It would thus reflect the different spending patterns, as reflected in the consumption of each citizen. Naturally, the richer are the individual spenders the more they would have spent. Therefore, richer citizens would be contributing more to the total amount to be distributed. In this policy, the poorest citizens, who generally spend the least amount, would end up benefiting the most from this policy, because they would receive the same per capita amount as the richest citizens. The richest and greatest spenders would end up losing the most from this policy, because the value added taxes that they would pay would far exceed the payments that they would receive from the government.

Naturally the higher would be the rate at which the value added were taxed, the greater will be the redistributive impact of this policy. The redistribution would take place in a

simple way, in a way that Leonardo da Vinci would have approved. The price level would automatically include the tax rate, so that there would be no need to disclose the tax payment separately, when purchases were made, as it is often done with excise taxee.

## **Conclusions**

It is difficult to think of a simpler and more efficient policy of redistributing income than the one suggested in this paper. Its use would be very simple and efficient. The redistributive impact could be easily and incrementally changed from time to time, to reflect changes taking places in the distribution of income or wealth in the economy. The higher became the Gini coefficients, the higher could be the tax rate, and vice versa. The change in the rate of a value added tax would be by far less damaging to economic efficiency than might be changes of any other tax. The administration of this tax would be very simple, as all the quantitative elements needed would be readily available.

Before concluding, a word of caution could be added. The use of the above policy would inevitably invite some pressure for some changes, presumably to make it even more effective. For example, there would be pressures to replace the value added tax with a goods and service tax, to make the policy more redistributive. Or there would be pressures to change the equal per capita payments to the citizens, to reflect some personal characteristics of those who receive them, such as age, physical conditions, or size of families. These attempts should be resisted because, over time, they would make the policy less simple, violating Leonardo's basic principle of simplicity.