Is the Value Added Tax Reform in India Poverty-Improving? An Analysis of Data from Two Major States

by Ajitava Raychaudhuri, Sudip Kumar Sinha and Poulomi Roy

India witnessed a switchover to the Value Added Tax (VAT) system from Sales Tax regime starting fiscal 2005. The change is widely anticipated to be not only welfare enhancing for the consumers due to less cascading but also revenue neutral through rate differentials on different commodities. The question that remains more or less unanswered is whether this tax reform is pro-poor or not.

The basic question that is addressed in the current paper is how far the switchover to VAT in India can be regarded as pro-poor. The tools used are concentration ratios, Lorenz curve and consumption dominance curves. Since VAT is implemented in individual states, two major states are taken into account—namely Maharashtra and West Bengal. The assumption is that the tax reform is marginal, so that consumption patterns have not undergone any drastic change.

The government ‘White Paper’ on VAT in India describes the main reason behind the introduction of VAT is to enhance the efficiency and transparency of the commodity tax system and to increase buoyancy of such tax revenue. The policy makers did not consider poverty alleviation or income redistribution as a critical component of such a reform process. Present study has highlighted the effect of this switchover to VAT on poverty ratios in two major states in India as mentioned before.

In the analysis, the commodities were chosen based on two criteria: First is the weight of a commodity in the consumption basket. Second, keeping revenue considerations in mind, those commodities were chosen for which we can compare a rise in tax on one commodity with a fall in tax on another commodity. To find the revenue neutral impact of reform on poverty we have considered six commodities: rice (non-Public Distribution System or non-PDS), spice, milk (liquid), biscuits, LPG and Sandal.

The analysis in the paper shows that LPG, milk (liquid) and biscuits are the items on which more tax makes the tax system progressive. Though there was an increase in tax on biscuits in both the states, tax on LPG and milk (liquid) has been reduced. This reduction in tax on LPG and milk (liquid) definitely will improve the condition of the richer households than poorer households. The observed rise in tax on sandal on the other hand will make the tax system regressive in nature. The reduction in tax on rice (non-PDS) and spice appeared to be good step as the expenditure on these commodities is more concentrated among the poor than the rich.

With the consideration of revenue neutrality the paper has tried to analyse the impact of reform on poverty when there is an increase in tax on one commodity and decrease in tax on another commodity. For this purpose we have considered the different combinations of two commodities and checked whether the direction of reform is pro-poor, by using consumption dominance curves of various orders. There is a rise in tax rate of biscuits and sandal and decrease or no change in tax rate of rice (non-PDS), spice, milk (liquid) and LPG. The rise in tax on sandal in both the states contradicts the direction of pro-poor nature of reform. We find that the direction of change in tax on LPG in both the states is also inconsistent with pro-poor reform. Again keeping milk (liquid) under exempted commodity list in West Bengal and Maharashtra is found to be somewhat beneficial to comparatively richer households more. The examination of the role of PDS commodities shows that it is pro-poor to give subsidy to rice and kerosene through PDS by increasing tax on milk (liquid).

The analysis done here gives some indications about the design of VAT in India. The political economy factor clearly shows up in case of petroleum products like LPG. Hopefully, more such comparative studies among more states in India, along with additional dimensions like gender, region and castes will throw more information on the pro-poor dimensions in the design of VAT.

This Policy research brief is based on the Working paper PMMA 2007-18