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Reform of GST: Options and optics

The tools available are a reduction in the number of tax rates and structuring or restructuring the compensation cess

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There is a lot of anticipation regarding the next phase of reforms of goods and services tax (GST). It is learnt that the Prime Minister's Office has given an in-principle nod to a revamp of GST. The stage is now set for discussion and decisions in the GST Council. This note is a thought experiment to explore options and implications of possible reforms focusing on revenue considerations. The concerns that could guide choices in the reform agenda are those of governments and the taxpayer/consumer community. For governments, there could be a need to increase the effective tax rate. In a reply to a question in the Lok Sabha on February 11, 2025, Union Finance Minister Nirmala Sitharaman said the average GST rate for 2023-24 was 11.64 per cent in comparison to 15.8 per cent in the pre-GST era. At the very least, the present average rate and the associated revenue performance need to be sustained. On the other hand, as would be expected, taxpayer/consumer aspirations would argue for a reduction in the number of tax rates.

The tools available to the GST Council to address these concerns are twofold: A reduction in the number of tax rates and structuring or restructuring the compensation cess. Lowering the number of tax slabs has been part of the discussion on GST reforms ever since the introduction of the tax. Arun Jaitley as Union finance minister had articulated the need to reduce the number of rates, even combining the 12 and 18 per cent "standard rates" into a single rate, once revenues stabilised under GST. Multiple tax rates are said to increase the cost of compliance and the cost of administration since they create scope for misclassification as well as inverted duty structures.

Two important aspects to consider while exploring options for reducing the number of tax rates are the composition of tax revenues by tax rates and an understanding of the elasticity of demand, ie the sensitivity of demand to changes in the tax rates. While information on price elasticity is not readily available, that on the composition of tax revenues is available. In response to another question in Parliament, Minister of State for Finance Pankaj Chaudhary reported 70-75 per cent of GST collected in 2023-24 came from the 18 per cent rate while just 5-6 per cent came from the 12 per cent bracket. Further, 6-8 per cent of revenues was from the 5 per cent slab, and the highest tax slab of 28 per cent contributed 13-15 per cent last financial year.

From these figures, it is clear that the 5 per cent and 12 per cent slabs contribute less than the higher ones. In modifying the tax rates, clearly, revenue risk is minimised if the focus is on these slabs. Rationalising the 18 and 28 per cent slabs would not help if the goal is to reduce the number of tax slabs. Some options that can be considered are:

a) The 5 per cent and 12 per cent slabs can be merged into an 8 per cent slab. Since the revenue contribution from these slabs is similar, the impact on revenue can be minimal.

b) The 12 per cent slab is eliminated. Some of the goods are moved to the lower rate while others are moved to the higher rate. This is to maintain revenue neutrality.

c) The 12 per cent slab can be eliminated and all goods can be moved to the 5 per cent slab. This will result in a revenue loss to governments — of 5-6 per cent of GST.

The first and the second options would face some political-economy considerations. There could be resistance from sectors which face an increase in tax rates. The third imposes a cost on governments, and would be acceptable to the taxpayer-consumer communities.

Turning to the other component of the tools for GST reform, ie restructuring the compensation cess, some background information may be kept in mind. The cess contributes sizeably to revenue collected within the GST regime. Any reform in the GST regime that entails an elimination of the cess would imply a corresponding reduction in revenue — ₹1.44 trillion in 2023-24 and ₹1.49 trillion in 2024-25, or 7.6 per cent of net GST. For the first five years, revenue from the cess accrued to the states — with a focus on their "revenue loss". In subsequent years, it accrued to the Union government for servicing loans taken to honour commitments for compensation for the revenue loss. In other words, in the last two years, revenue did not accrue to either the Centre or the states to meet the current expenditure needs. Given this context, it is possible to argue that revenue from the cess or its restructured equivalent would constitute an additionality in terms of available revenue. Incorporating this notion into the framework for GST reform could expand the scope of options.

The cess can be subsumed in the peak GST rate. It applies mainly to luxury, polluting and sin goods. Hence, retaining these taxes is justifiable and equitable. This would mean that the Union and state governments would have equal shares in revenue collection. What the cess yields is of the same dimensions as revenue from the 12 per cent slab. The third option above can now be revenue-neutral.

An alternative option is to eliminate the cess. Revenues of the Centre and the states remain unchanged. This measure in and of itself does not appeal to the average person on the street as a measure of rationalisation of GST and leaves concerns of fairness unaddressed. Clearly, the optics are not attractive.

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The views are personal