GST reform in two steps

Rate rationalisation can be the long-term goal, while a unilateral reduction in central GST could boost domestic demand in the short term

ILLUSTRATION: BINAY SINHA

The economic environment facing Indian business has received a new shock. The punitive tariffs announced by the United States government came into effect on August 27, levying a 50 per cent import duty on a range of Indian exports. The impact of these tariffs is expected to be felt across sectors, including garments, footwear, gems and jewellery and shrimp exports. Significant second-round effects are also anticipated, such as a reduction in imports related to exports of goods. Gems and Jewellery is one such sector, where exports are closely linked to the import of raw diamonds.

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While diplomatic channels continue to explore the possibility of returning to a regime with more modest tariffs, the responses by the Government of India will clearly encompass a range of initiatives, including the exploration of new markets and designing policies to support exporting units in the short run. Apart from policy initiatives targeting the export sector, it is also possible to conceive of more broad-based measures to stimulate domestic demand as an alternative to export demand. Reform through the rationalisation of goods and services tax (GST) rates could be one such measure. We explore some design questions and options in utilising the proposed change to address the short-run as well as the long-run expectations of the economy.

Reforms in the GST regime can have two broad objectives at the present juncture. First, honouring the long-standing commitment to rationalise the rate structure and reduce the number of tax slabs, the reforms need to focus on an optimal structure. This process of rationalisation is oriented towards the long-term needs of the economy, and should aim to establish a regime that can be sustained. Second, in the short run, given the shock to the economy and the uncertainty prevailing in the world economy, a stimulus to domestic demand can be an objective. Two components to this demand are household consumption and expenditure by governments, preferably capital expenditure by governments. In designing the proposed regime, an attempt needs to be made to keep both these factors in perspective.

Some issues to consider while designing reforms can be:

- To stimulate demand, a reduction in tax rates would be recommended. A positive impact on demand would require that the lower taxes be passed through into lower prices. Anti-profiteering provisions were used at the time of GST introduction to induce a timely pass-through. Given the contentious nature of such provisions, it is desirable to rely on market forces. However, such a process might take time to play out, which in turn implies the boost to demand will happen gradually.
- The impact of a reduction in tax rates depends on the price elasticity of demand. When demand is highly elastic, a reduction in the tax rate can support an increase in revenue collection by stimulating higher demand. For elasticities below one, the impact on revenues can be adverse. The net effect on GST revenues, therefore, remains uncertain.
- GST constitutes an important part of the revenues for state governments. With Fiscal Responsibility and Budget Management commitments and limitations on the borrowing space available to states, any short term adverse implications on state revenues would have direct implications for capital expenditure by state governments. It should be kept in mind that the Finance Commission is currently finalising its recommendations, perhaps based on the existing tax regimes in place. Any change in the rates, through the impact on Central revenues, can have second-order impact on state finances as well.
- In a federal economy, macro-stabilisation responsibility rests with the Union government, supported by its ability to borrow in the event of economic uncertainties. Short-term uncertainties should therefore be shouldered by the Union government.

Given these considerations, one possible way to structure GST reforms to address both sets of considerations can be summarised as follows. GST reforms can be undertaken in two parts. The first part relates to the long-term objective of reducing the number of tax rates, with the goal of remaining broadly revenue neutral — that is, raising the same amount of revenue as the present rate structure yields. A useful benchmark for this is to look at revenues as a percentage of gross domestic product (GDP) — we should aim for a stable ratio. Such convergence requires raising tax rates on some commodities while reducing them on others. For instance, a range of goods, currently exempt, can be brought into the tax net at a lower rate. Alternatively, some of the goods in the 12 per cent slab could be moved to the higher slab. A suitably structured two or three rate regime could be sustainable in the medium term and provide a degree of policy certainty for investors.

The second component of the current reform agenda can be a short-term unilateral reduction in tax rates by the Union government — reducing the Central GST without changing State GST. This would be similar to the reduction in central excise duties undertaken to mitigate the impact of the global financial crisis. The incentive so provided can be reversed once the system has stabilised. The impact on state finances would be smaller if the adjustment is undertaken by the Union government. Clearly, some relaxation in fiscal prudence norms would be required to ensure that the demand stimulus from government expenditure is not undermined by the tax stimulus measures. In other words, short term increase in fiscal deficits might be called for.

Such a two-part reform process could build bridges with state governments and provide greater policy certainty — some food for thought!

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The views are personal