What could be in store with GST rationalisation

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As the US tariffs kick in and impact India's trade with its largest export destination, the Goods and Services Tax (GST) Council took a timely decision to lower GST rates for a considerable number of items, to boost domestic demand. Lower GST rates are expected to be passed on to consumers in the form of lower prices, which will provide them with additional purchasing power.

Lifting domestic demand is likely to offset falling external demand for Indian goods. The course expected now is goods with new, lower prices will hit the market stacks once the stock of goods lying as inventories in different stages of trade/distribution is exhausted. It is expected that the Union government will soon notify the new tax rates under the CGST Act, and the states will follow with similar notifications under their respective SGST Acts.

The speed of adjustment of prices, with reference to the new tax rates, will vary from commodity to commodity, depending on the gestation period between purchase of inputs and sale of finished products and the size of the existing stock of finished goods.

It is expected that governments will allow transitional credit provisions for businesses to adjust to the difference in the tax rates between the new and old rate regimes on inputs and finished goods. This provision could help businesses accommodate the difference in the availability of eligible input tax credit (ITC) and output tax liability arising due to GST rate restructuring. If this provision does not take effect, it is unlikely that the prices of many commodities will fall soon.

A swift move can help businesses capitalise on the forthcoming festive season to boost demand. Consumers will be disappointed if prices do not reflect the reduced tax rates.

The rate rationalisation move will have three distinct areas of impact: Revenue, economic growth, and formalisation of the economy. Reducing tax rates for a considerable number of items and raising tax rates for some will have a clear revenue impact.

The ultimate revenue impact will depend on changes in the prices of goods and services and resulting changes in consumer behaviour. Rising demand for goods and services will boost the economy and, therefore, GST collection.

Given the present GST return system, assessing the size of the revenue effect is challenging as GST rate-wise tax collection figures are not available. The revenue impact of the GST rate restructuring will vary from state to state, depending on the size and composition of the consumption basket of consumers.

It should be noted that there will be an additional revenue stream for states as the GST compensation cess will be subsumed into the GST rates. The highest GST rate has been raised to 40% from 28%, and this change will apply to commodities that previously attracted GST cess. States together will receive 70.5% of the additional GST of 12% in addition to 28% tax on these commodities.

However, unlike GST compensation cess, a large part of this additional revenue, except the tax devolution part, will be realised by the states where consumption of the "sin goods" and purchases of luxury cars are high.

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A lower GST rate will boost consumption, and, therefore, it will increase economic growth. An assessment based on Computable General Equilibrium modelling may provide some numbers on the impact on economic growth due to reductions in GST rates.

Higher economic growth can be expected to boost tax revenue, subject to the caveat that tax collection also depends on tax compliance and tax efficiency. It is expected that lowering the GST rates may encourage a segment of businesses to take GST registration and integrate them with a larger network of supply chains.

A business with input tax credit greater than its output tax liability could apply for GST registration to claim ITC. Even businesses with lower value addition may find the new GST structure attractive.

This will help in the formalisation of the economy. It is expected that the new GST rate structure may face higher demand for refunds. Instances of an inverted duty structure, where the output tax rate is lower than the input tax rate, may rise.

As the majority of GST rates on services remain unchanged or have been raised, the possibility of a larger number of instances of inverted duty structure cannot be ruled out.

A broad-based lower rate is desirable for a modern VAT system. However, the new GST rate structure has lengthened the list of exempted items, which will have a revenue impact.

The GST is one of the most important sources of the states' own tax revenue. Any revenue uncertainty related to GST makes states' finances vulnerable to shocks. States will realise the revenue impact of GST rate rationalisation in the third and fourth quarters of the financial year 2025-26.

If they face a revenue shortfall with respect to the budgeted state GST figures for FY26, they will run a revenue as well as a fiscal deficit. Suppose the central transfers to states in terms of states' share in central taxes and grants-in-aid do not compensate for the revenue shortfall in own tax revenue mobilisation of states. In that case, there will be a revenue deficit, and eventually it will turn into a fiscal deficit if states stick to the expenditure side of the budget.

Considering the uncertainty surrounding the GST revenue stream, states will have to be flexible in adjusting their expenditure to adhere to the fiscal consolidation path.

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