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GST at crossroads

The tax has reached a turning point in its evolution where reforms must focus on rethinking its design

In its evolution, the goods and services tax (GST) regime is reaching a point where discussions on design changes need to be explored. The back-to-back loans taken by the Centre to meet compensation commitments following the Covid-19 pandemic are expected to be repaid by November 2025. The legal limit for the levy of the compensation cess extends till March 2026. This is a critical point in the evolution of the tax, where a significant comprehensive reform can be discussed. Beyond the question of whether the cess should be extended in its current or a different form, there are a few other design issues that need to be explored and sorted out.

To begin with, it is important to ask what the rationale for reform should be. Reform in the design could be driven by the need to raise additional revenues. Alternatively, given the level of revenues being raised, reform could target changing the rates to reduce the cost of compliance and administration. Fewer tax rates are argued to lower the cost of compliance and administration, by reducing the scope for misclassification and the resulting disputes. A third factor to consider is reducing the extent of distortion caused by the regime — commodities with more elastic demand should face lower taxes, while those with inelastic demand should be taxed at higher rates.

R KAVITA RAO

The issues to consider are: Should the rates be rationalised to bring down the number of rate slabs, how should cess be dealt with, and can the base for GST be expanded in any significant manner? We will briefly look at each of these aspects.

The medium-term goal for GST has been to reduce the number of rates from the present four to two slabs. By definition, such a rationalisation would require raising tax rates on some goods/services while reducing on others. Given that the tax system provides credit for input taxes paid, any change in the tax regime that increases taxes on commodities/services predominantly used as inputs would be counterproductive — duty-structure inversion could imply the need for subsequent changes in tax rates.

Further, with buyers claiming input tax credit, the increased tax rates would not result in any additional revenue, even if the demand for these commodities remains unchanged. In other words, for any such rationalisation, it would be useful for all goods and services to be classified into two categories — inputs to taxable activities and others. Changes in tax rates on the latter are likely to have revenue implications, but those on the former are not. This process, however, would lead to changes in rates for many goods and services, which could be disruptive. Such changes must be managed carefully, both politically and economically.

Another element in the discussion on rate rationalisation is the possibility of differentiating tax rates depending on the price of the commodity — lower tax rates on commodities with lower prices and higher rates for the rest. This regime is in operation for footwear and apparel, with thresholds of ₹500 and ₹1,000, respectively. Goods valued below the threshold are taxed at lower rates, while those above are taxed at a higher rate. These classifications are proposed with the intent of reducing the tax liability of lower-income households. Recent reports on the deliberations of the Group of Ministers (GoM) on rate rationalisation suggest the possibility of segmenting additional commodities into multiple categories based on price.

However, rate rationalisation must keep in mind the cost of compliance and administration when proposing changes to the regime. Multiple slabs can encourage misreporting of values and mis-specification of contracts, which would impose an additional burden on tax administration and might lead to more disputes. Further, it appears that this process would take the regime away from the end goal of fewer tax rates rather than towards it.

Turning to the compensation cess, the current legal position allows for its levy till March 2026. The back-to-back loans being serviced through revenues from cess will be paid off by November 2025. Clearly, the current purpose of the cess would have been fulfilled. The cess, however, yields significant revenues and the commodities on which it is currently applied qualify as luxury, polluting, or sin goods. There remains some rationale for continuing to tax these goods at higher rates. Revenue considerations suggest that an equivalent tax be retained even after the cess is no longer in operation, unless it can be established that these commodities have a high price elasticity of demand. The result, however, is a further divergence from the medium-term goal of fewer rates — we are likely to observe an increase in the number of primary rates.

In the context of overall reform in the GST structure, an important question to ask is whether there is merit in expanding the GST base. While there are discussions on the need to bring in petrol and diesel into the ambit of GST, there are many counter-arguments as well, given these are polluting fuels. One sector that does need to be brought under the regime is electricity — generation and distribution. Apart from the fact that electricity is an input for all major activities in the economy, there are two other reasons to consider.

First, investments in the electricity sector are resource-intensive and involve substantial taxes on purchases. Incorporating the sector into GST could moderate the price of electricity and reduce the extent of cascading. Second, there is likely to be a shift in the economy, with greater focus on electricity as a source of energy. In the medium term, this could contribute to making the tax more buoyant, especially if demand for petrol and diesel moderates — the latter being a significant source of revenue for both central and state government revenues. In the short term, however, the change could result in loss of revenue — especially for state governments. The discussion suggests that while widespread rate rationalisation is needed, revenue concerns and the need for stability may lead to incremental changes, keeping the regime closer to the status quo.

The writer is director, National Institute of Public Finance and Policy, New Delhi