THINK CHANGE FORUM

ST Rate Rationalization: Should Not Be an Exercise Reinventing the Wheel, But Accelerating Its Spin

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Research

A White Paper by Nilanjan Banik, Professor, Mahindra University, Hyderabad

Introduction

The proposed introduction of a new fifth GST slab in India for demerit goods, alongside the sub-division of product categories based on price points under HSN (Harmonized System of Nomenclature) codes, presents significant concerns for the Indian economy, particularly for businesses at large, including small and medium-sized enterprises (MSMEs). While the intent may be to target demerit and luxury goods, the complexity of the proposal could have counterproductive consequences.

This white paper examines these proposed changes, outlines potential risks, and offers recommendations for creating a more balanced and growth-oriented tax structure. India's GST collections have experienced remarkable growth in recent years. Between **2017-18 and 2023-24, monthly GST revenues doubled, reaching ₹1.68 lakh crore, with an all-time high of ₹2.10 lakh crore in April 2024.**

With GST collections already at record levels, exceeding Rs 20 lakh crore in 2023-2024, there is no urgent need to introduce an additional 35% tax slab, particularly when India's economy is already grappling with challenges like a slowing growth rate of 5.4%. When GST was launched, the goal was to bring businesses under the tax net through a simplified tax structure.

This growth followed the government's decision in 2017 to reduce the number of items under the 28% GST slab from 224 to just 50, simplifying the tax structure for businesses. The move to cut down on high-tax items eased compliance, fostering increased economic activity. With GST collections already at record levels, there is no pressing need to introduce a 35% tax slab, especially with India's economy already facing challenges such as slowing growth.

The changes proposed by the Group of Ministers tasked with suggesting GST rate rationalization represent a significant shift in the current GST structure and may have a regressive impact, potentially undermining broader industry performance and investor sentiment. It signals the potential onset of a higher tax regime, beginning with a few items but likely expanding to include more goods under categories like luxury or sin goods.

Additionally, raising tax rates may incentivize the growth of the parallel economy, increase black money circulation, and encourage tax evasion, ultimately undermining a compliant tax system. Here are some recommendations for the perusal of the GST Council and the GoM:

Recommendations

Adopt Global Best Practices:

- Globally, more than 170 countries have adopted the concept of value added tax, which has been anchored on simplicity and predictability of the taxation policy. India, as the 5th largest economy, should take cues from the top global economies, as none of top 4 economies have a peak tax rate higher than 20%. Over 80% of countries globally maintain VAT rates below 20%
- It is well established that the most efficient tax systems in the world expand their tax base by broadening the coverage of economic activities, minimizing exemptions, reducing cascading and double taxation, and promoting better compliance by lowering the overall tax burden on goods and services. As an economy intending to be counted among the developed world, India must also follow this proven approach to grow its tax base.

Prioritize Tax Moderation:

- The current approach should not deviate from the original conception for GST as envisioned in The Kelkar Task Force in 2004 which had recommended that “Expanding the tax base rather than increasing rates, is hence the preferred strategy, a rational tax system is one with very few rates and low rates and it is particularly important to have single rates in the area of indirect taxes”
- The Indian consumer is highly sensitive to price changes, and frequent ad-hoc tax increases lead to distortions, tax avoidance, and hinder GDP growth. An approach of tax moderation will ensure competitiveness, especially for products already in the highest tax brackets, while unlocking the true potential of India's tax system.

Simplify the GST Structure for boosting growth and MSMEs:

- The current four-slab GST structure (5%, 12%, 18%, 28%) should be simplified to three slabs—5% for essential goods, 12% or 15% for most products, and 28% for luxury or demerit goods such as tobacco.
- A price-based classification is regressive, halting upward mobility in lifestyle and creating social class-based taxation. Simplifying the GST structure to a one-slab-per-product-class system will ease the burden on businesses, especially MSMEs, reduce administrative complexities, and promote consistent economic growth.

Reconsider the Compensation Cess Strategy:

- The Compensation Cess introduced to be applicable from 2017 to 2022, to cover for state revenue losses, was extended until 2026 to help repay loans that states had to raise to cover for revenue shortfall, compounded particularly by the COVID pandemic. While this was a necessary measure, there is no justification to continue the Cess, once these loans are repaid.
- If extended further, revenue from the Compensation Cess should be used to rationalize and moderate GST rates, which will help reduce inflation and stimulate consumption. Maintaining tax rate predictability and avoiding frequent changes will help keep the market and business environment stable.

Targeted Support for MSMEs:

- MSMEs form the backbone of India's economy and require specific support to thrive under the GST regime. Simplification of GST structure would reduce the administrative burden on MSMEs, and improve overall compliance.
- The government should introduce tax incentives like subsidized compliance technology, and avoid frequent reclassification requirements to reduce the operational burden. Supporting MSMEs in navigating the GST system will foster their growth and, in turn, bolster the broader economy.

Challenges with the current GOM proposal

Adoption of the current GoM proposal would have far-reaching implications, as analyzed below:

Increased Complexity in GST Classification and Compliance

One of the central issues with the proposal is the significant increase in complexity for businesses in complying with a revised GST framework. Currently, the GST classification relies heavily on HSN codes, which categorize goods based on their nature. However, sub-dividing these categories further by price points or perceived harmful impact will only complicate this system.

- **Detailed HSN Codes**: The current HSN structure is already intricate, comprising 21 sections, 99 chapters, approximately 1,244 headings, and 5,224 subheadings. Introducing further sub-classifications would create additional layers of complexity, burdening businesses with more administrative tasks.
- **Compliance Costs**: The need for more detailed tax filings and frequent product classification assessments will increase administrative costs for businesses, especially for MSMEs that operate on tighter budgets and resources.
- **Economic Implications**: Many developed countries, such as Australia, Canada, New Zealand, and Japan, have a single GST rate which is lower that of India, typically ranging between 5% and 15%. A higher multi-layered GST slabs could have the unintended consequence of dampening consumption and negatively impacting businesses. As suggested by the Laffer Curve principle, excessively high tax rates can dampen consumption and lead to a shift towards lower-taxed or untaxed substitutes ultimately reducing tax revenue collection.
- **Wider Implications**: Presence of a new higher slab may lead to demands from tax collectors to include more goods with higher health or environmental impact into the higher GST slab – such as alcohol, plastics and premium goods, leading to a frequent reclassification demands.

Impact on Small and Medium-Sized Enterprises (MSMEs)

MSMEs, which play a crucial role in India's economic landscape, are likely to be disproportionately impacted by the new tax structure. These businesses often work with thin margins and have limited capacity to absorb the costs of frequent reclassification or complex tax filings.

- **Cost of Compliance**: Small businesses will face higher administrative costs, requiring them to hire experts or invest in new tax compliance technologies and software, further increasing their financial strain.
- **Loss of Export Market**: An increase in the GST slab to the next highest level may lead up to 8% rise in the price of readymade garments, making our exports uncompetitive in the global market. The textile industry employs around 40 million people. An uncompetitive textile and apparel industry is bad news for PM Modi's Make-in-India programme and creating jobs.
- **Disproportionate Burden**: MSMEs operating in sectors like food processing, packaging, and consumer goods, where product prices and classifications vary significantly, could see their tax liabilities increase if their products are pushed into the new 35% GST slab, and a price-based rate system is implemented.
- **Risk of Market Consolidation**: Larger businesses, which have the resources to manage compliance costs, may gain a competitive advantage, squeezing out smaller players from the market. This could lead to market consolidation, undermining the goal of promoting a diverse and competitive business environment.
- **Distribution of Income:** Evidence suggests that goods and services produced by the MSME sector are primarily labor-intensive, thereby creating employment opportunities. The majority of these goods and services by the MSME sector are consumed by individuals from middle and lower-

income backgrounds, who tend to have a higher marginal propensity to consume, in contrast to the high-income class. From the perspective of sustaining economic growth helping growth of MSME sector is important.

Slowing Economic Growth

India's economy is already facing a slowdown. GDP growth for the July-September quarter slumped to 5.4%, much lower than consensus estimates and below the Reserve Bank of India's 7% projection and annual growth forecasts are being revised downward.

- An increased GST on goods in high demand, could worsen these conditions by discouraging consumer spending and corporate earnings. The tax on sin goods is price inelastic, meaning that consumers (who are otherwise addicted to the habit) will continue to consume them. Since most of the lower and lower-middle income household consumed products such as tobacco and carbonated soft drinks, a higher GST will negatively impact the already worsening income distribution.
- **Corporate Earnings**: Top Indian companies registered their worst quarterly performance in over four years for the July-September 2024 period. As per forecasts by Goldman Sachs, India's GDP growth is expected to fall to 6% for the year through March 2025, down from an earlier estimate of 6.4%. In such a scenario, the new tax structure could further dampen business sentiment and delay economic recovery.
- **Increased Cost of Doing Business:** A complex GST structure can increase the cost of doing business. Take for example, the gaming industry. Gaming differs from lotteries, gambling, and betting in that its outcome depends on the skills of the players, rather than chance. About 35-40 firms are being probed by the DGGI and the Supreme Court ruling gives it the power to continue investigations, while probes against another 100 firms may be launched soon. This may kill an industry with a big potential for start-up players and ability to generate businesses/revenue for the government.

Hindering Private Investments and Economic Growth

A key goal of GST rationalization should be to encourage both public revenue growth and private sector investments. The introduction of the 35% GST slab and reclassification of higher priced goods into higher GST slabs, could delay private investment in key sectors, thereby stalling job creation and economic growth.

- **Private Investment Decline**: According to Care Ratings, private capital expenditure (capex) has been on the decline. In FY24, it was ₹9.4 trillion, slightly lower than the ₹9.5 trillion in FY23. Retail, in particular, is one of the sectors worst affected by this downward trend. The new GST proposal exacerbates this issue, discouraging investment in the retail and consumer goods sectors.
- **Top Indian companies registered their worst quarterly showing in more than four years for the July-September period**, raising concerns that a lurking economic slowdown had begun to affect corporate earnings.
- **Delayed Consumer Spending**: With consumer demand likely to be reduced due to higher taxes on non-essential goods, businesses may be hesitant to invest further, waiting for a resumption in consumer spending. This creates a vicious cycle of delayed investment and sluggish economic activity.
- **Disruption of Business Activities:** Higher tax structure can also act as an "industry killer" take for example the case of gaming and crypto currency. For example, the hike in GST rate from 18% to 28% on the gaming industry has seen several businesses moving out to Singapore. Similar is the case with crypto currency with most of the businesses moving out to Dubai and Hong Kong. According to NASSCOM the Indian cryptocurrency market has been growing exponentially over the last few years and is expected to reach up to $241 million by 2030 in India and $2.3 billion by 2026 globally. The government is not only losing out on the revenues generated by these businesses but also on both direct and indirect employment opportunities.

Negative Pressure on Jobs and Livelihood Creation

The proposed introduction of a new fifth GST slab, is likely to have a significant adverse effect on employment and livelihood creation in India. While the intention may be to generate additional revenue for the government and curb consumption of sin goods, this move risks imposing undue pressure on several key sectors that drive job creation.

- **Pressure to reduce unemployment:** According to the Centre for Monitoring Indian Economy (CMIE), India's unemployment rate stood at 7.8% in September 2024, slightly improving from the 8% average in 2023, but still significantly higher than the 5.27% rate in 2019. MSMEs, which account for about 40% of the country's employment and can play a crucial role in providing jobs in rural and semi-urban areas, are particularly vulnerable to frequent changes in the GST structure and rates. The present disruption can hamper their growth, leading to a slowdown in employment generation within this vital sector. According to estimates from the Clothing Manufacturers Association of India, an increase in GST could lead to the closure of these units, resulting in a loss of 1 lakh jobs.
- **Job losses in affected Sectors:** The sectors targeted by the 35% GST slab, such as aerated beverages, tobacco, luxury goods etc have a significant employment and livelihood value chains, permeating through the urban and rural fabric of the country. These sectors are already

struggling with shrinking margins and low growth rates. The additional tax burden may lead to increased prices, reduced consumer demand, and ultimately, job losses in these sectors.

- A study showed that the beverages sector contributed INR 7,91,599 million to the economy and created 6,91,491 jobs in 2018-19. The tobacco industry supports 4.57 crore livelihoods, with 70% tied to agriculture, and millions more in packaging, warehousing, and related sectors. Between 2013 and 2023, declining tobacco production led to a loss of 238 million man-days of employment.

Conclusion

Introduction of GST was envisioned to expand India's GDP by around 2%, laying the foundation for future tax reductions. However, complex tax structures and high rates lead to evasion and litigation, undermining its potential. To disincentivize tax evasion and maximize revenue from the legal economy, the government must focus on simplifying the GST framework and lowering the overall tax burden. Instead of considering any new tax increases or higher slabs, the government should address the current complexities and align with the realities of businesses and consumers. A simplified tax system will encourage private investment, job creation, and economic growth while making the nation more tax-compliant. By adopting a balanced and rational approach, India can support MSMEs, promote a competitive business environment, and sustain its economic trajectory.

About the Author:

Prof. Nilanjan Banik, is a leading Indian Economist, and holds the following academic positions:

- Professor, Mahindra University, Hyderabad (July 2021 - Present).
- Visiting Professor, Indian School of Business, Hyderabad (April 2024-Present).
- Research Fellow, Hankuk University of Foreign Studies, South Korea (September 2019-Present).

Prof. Banik works focus on the application of time series econometrics in issues relating to international trade, market structure and development economics. Prof. Banik has project experience with Geneva Network, United Kingdom, Australian Department of Foreign Affairs and Trade, Australia; Laffer Associates, USA; Ministry of Commerce, Government of India; Research and Information System for Developing Countries (RIS), New Delhi; Indian Council for Research on International Economic Relations (ICRIER), New Delhi; Center for Economic Policy Research, UK; Asian Development Bank Institute, Tokyo; Asian Development Bank, Manila; South Asia Network of Economic Research Institutes (SANEI); UNESCAP-ARTNeT, Thailand, Australia India Institute, University of Melbourne; Copenhagen Consensus (India Consensus), Denmark; and World Trade Organization, Geneva.

He has teaching experience with Utah State University, USA; University of Durham, UK; University of Greenland, Nuuk; Institute for Financial Management and Research, Chennai; Indian Institute of Management (Indore, Rohtak, Nagpur, and Ranchi); Madras School of Economics; and Reserve Bank Staff College, Chennai. He has also provided training for lateral recruits for Union Public Service Commission, Government of India, and ICICI Bank.

He has publication in International Review of Economics and Finance, Empirical Economics, Review of Development Economics, Development Policy Review, Journal of World Trade, Asia Pacific Trade and Investment Review, Asian Development Bank Working Paper, Economic and Political Weekly, Foreign Trade Review, etc. He has contributed in edited volume with publisher, like, Elsevier, Springer Verlag, Routledge, etc. Additionally, he has written a book on Indian macro economy which is published from Sage. He also has the distinction of writing editorials for all major English dailies in India, and abroad including that of Wall Street Journal and Huffington Post. He has written over 175 editorials.

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We have not seen any such thing in India and our system therefore works.

"There was this huge proposition which was put by many of us at FICCI, etc, to go back and say that given the fact that we have got Make in India, Manufacture in India initiative going on and you want people to set up chip manufacturing and whatever else in India, it is important to grant a tax benefit of 15%," says Dinesh Kanabar, CEO, Dhruva Advisors.

Do you agree when Mr Vickery says that it is more prudent, perhaps more responsible, like he says, to effectively hike corporate tax rates? That is what Kamala Harris is proposing. Do you think there is a case, looking at our own taxation system here in India, the current regime slashed corporate tax rate. The finance min[...]s said that cutting corporate tax

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