



GST 2.0 - A Much Needed Rationalisation

Highlights:

- ✓ *The GST Council in its 56th meeting approved a two-tier tax system of 18% for standard goods and 5% for merit goods, along with a 40% tax on 'sin' goods and luxury products.*
- ✓ *The net revenue loss is estimated to be ~₹48,000 crore. While the fiscal deficit might widen by ~10-20 basis points to 4.50%-4.60%, the move is expected to bolster overall GDP growth and also moderate inflation.*
- ✓ *Bond market yields have hardened since the Prime Minister's Independence Day announcement as the reform casts doubts on the government's ability to confirm to fiscal targets.*

The Union Government has announced a major reform in the goods and services tax (GST) structure. The reforms aim at reducing the tax burden on economic stakeholders and simplify the structure by reducing the extant 4-tier tax system into a 2-tier tax system. With effect from September 22, 2025, the extant regime of 5, 12, 18 and 28 per cent tax rates will be a system with just the two tax rates of 5 and 18 per cent for merit and standard goods respectively, with an additional layer of a significantly higher tax rate of 40 per cent for 'sin' goods and luxury products such as tobacco and luxury cars. This change is a key step towards achieving the objective of one-nation-one-tax. The revenue implications are estimated on a net basis to be ~0.1 per cent of GDP, widening the fiscal deficit too, by 0.1 per cent.

The GST regime implemented on July 1, 2017 was a watershed moment in India's history of public taxation. The central objective of the GST was to eliminate multiple taxes and ultimately achieve the objective of one-nation-one-tax. Given this objective, the recent rejig is a step in the right direction. It has taken eight years to reduce the extant 4 tax slab structure to a 2 tax-slab structure owing to the fiscally federal nature of the Indian tax system, where the concurrence of all states is crucial for the successful implementation of any reform. The common individual, aspirational middle class and overall trade are expected to benefit from this reset.

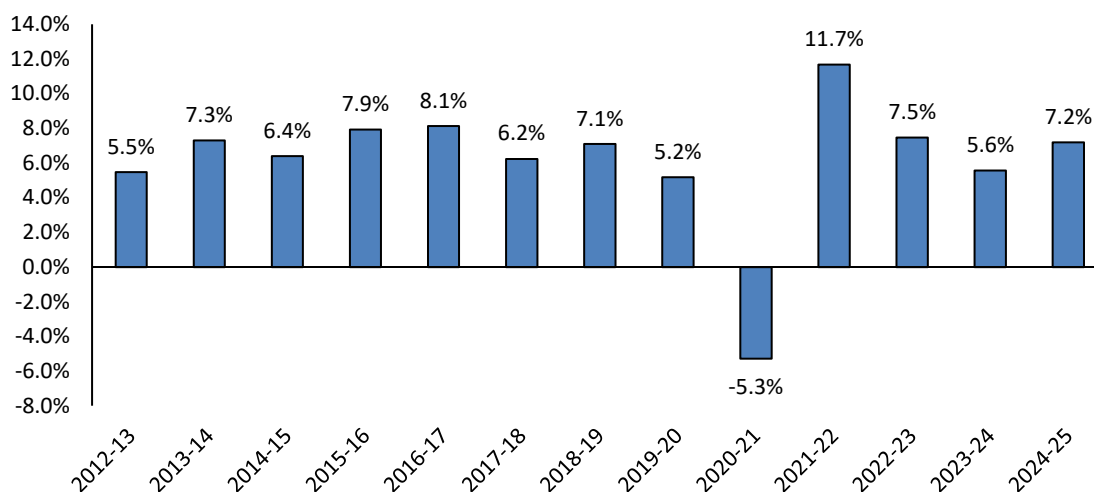
The reforms entail moving 99 per cent of the goods and services in the current 12 per cent slab to the 5 per cent slab and 90 per cent of the items in the 28 per cent slab to the 18 per cent bracket. The estimated boost to consumption owing to the GST tax reset is expected to be ~₹1.8-2.0 lakh crore or ~0.40-0.60 per cent of nominal GDP.

The role of consumption expenditure in India: In India, consumption spending has been the major engine of headline growth. The share of private consumption spending at 56.6 per cent is the highest amongst all the driving factors of economic growth from the expenditure viewpoint. The rate of growth barring the shock of the COVID years has not changed noticeably and remains at an average of 6.2 per cent.



The driving factors of consumption in India remain varied - from the monsoons affecting rural consumption to factors such as corporate balance sheets and profits that affect urban consumption.

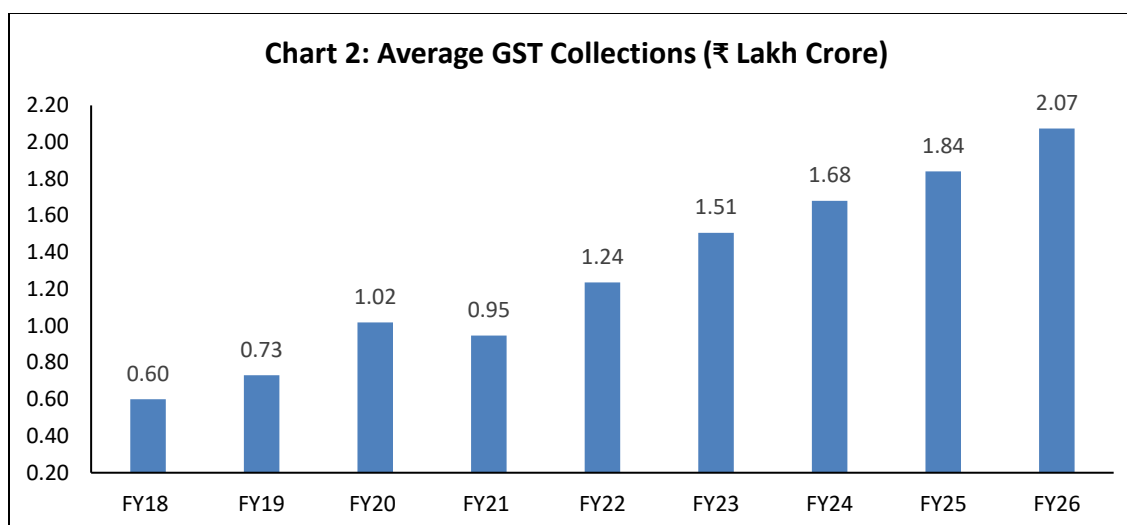
Chart 1: Private Consumption (YoY, per cent)



Source: MoSPI, STCI PD Research

The GST reset will provide a much-needed boost to consumption and also have a moderating effect on headline CPI inflation assuming that there is a full pass-through of the tax cuts from the corporates to the households. The effects of the reset are likely to be mixed as many goods and services have moved from higher to lower tax slabs i.e. from 28 per cent to 18 per cent, while others have moved from lower to higher tax brackets such as from 12 per cent to 18 per cent, or even from 28 per cent to 40 per cent as in the case of luxury products. While this diversity of changes is expected to have a mixed effect on private consumption, overall, it is expected that this regime change will lighten the tax burden on MSMEs, middle class consumers and farmers. The boost to disposable income in the hands of the consumers will lead to an increase in overall consumption, savings and investments in the domestic economy.

Impact of GST changes: Since its implementation in 2017, the monthly average GST collections under the regime have grown and stabilized from ₹60,000 crore to ~₹2 lakh crore with an average compounded annual growth rate of around 8 per cent. In addition to the GST reset, this year the government has also provided an income tax rebate on incomes up to ₹12 lakh. While the Budget estimates place the revenue loss at ~₹1 lakh crore, we expect this measure to provide a much larger boost of around ₹1.8-2 lakh crore to domestic consumption in FY2025-26. Hence, the total support to consumption from the income tax rebate and the GST tax reset could range within ₹3.5-4 lakh crore, i.e. ~1-1.2 per cent of GDP.



Source: CGA.

Expected fiscal strain - A back of the envelope calculation: If we consider the government's estimates, the exchequer stands to face an overall revenue loss of ~₹1.50 lakh crore from the reduction in income tax and the GST rationalization. The other facet of fiscal strain will arise out of a falling deflator - the effect of which was seen in the recent GDP print - leading to a fiscal deficit of 4.50-4.60 per cent. While this should not lead to any additional borrowing as it is only a numerical adjustment, it can affect market sentiments in an adverse manner. In addition to this, the pressure on the fiscal front arising out of the ongoing US tariff tantrums is unknown.

Table 1: Fiscal Dynamics in Broad Stokes

Major Heads (in ₹ Lakh Crore)	Spending	Revenue
Fiscal Deficit FY2025-26	15.68	
Gross G-sec Borrowing	14.82	
Revenue Loss due to Income Tax Rebate	1.00	
Net Revenue Loss due to GST 2.0	0.48	
Worst expected Loss in GDP due to Tariff Tantrums	3.26	
RBI's Dividend for FY2024-25		2.69
PSE/PSU Dividends to Union Government		1.25
Total	3.75	3.94

Source: CGA, RBI, STCI PD Research

Assuming the worst outcome of reaching an impasse on the bilateral trade talks with the US, estimates point to a 1 per cent loss on GDP for India, i.e. USD 35-37 billion dollars for FY2025-26. This means exports alone will face a hit of around ₹3.26 lakh crore in this year. Adding to this the ₹48,000 crore net revenue loss implication from the GST tax rejig may result to a total revenue shortfall of ₹3.75 lakh crore. On the other hand, RBI has transferred a record dividend of ₹2.69 lakh crore to the Union Government for the year FY2024-25 which along with the expected dividend of ~₹1.25 lakh crore from PSEs and nationalized banks for FY2025-26, adds up to ₹3.94 lakh crore which at least for now is outpacing the total expected fiscal strain created by the GST rejig



and Trump tariffs. The revenue loss of ₹1 lakh crore from the income tax rebate has been excluded from this calculation as it has already been accounted for in the Union Budget estimates for FY2025-26.

The bond market sees quick Ricardian equivalence: The concept of Ricardian equivalence postulates that a tax cut today implies higher borrowings now and higher taxes in the future. The Ricardian view further indicates that households will increase savings anticipating the higher tax outflows in the future and hence consumption may not increase due to a tax cut, or at least not with a one-to-one correspondence. The first to react to this equivalence are bond traders, as they envisage a higher fiscal deficit owing to the revenue loss from a tax cut.

The argument that a tax cut will lead to a boost in consumption may only hold partially in a country as diverse as India. While generalizing this for all households might be difficult as all households might not envisage this so-called equivalence between current tax cuts and future higher taxes, bond traders who track these changes daily are quick to rationalize. Post the reform announcement on August 15th, bond yields hardened by 15-20 basis points traversing from 6.40 per cent to 6.61 per cent by August 26th - this yield movement also includes the effect of the tariff tantrums of the US. While in the short run, domestic consumption may get a boost due to the tax cuts, it would only be short lived and it is unlikely that there are major multiplier effects, as the economy adjusts to lower levels of taxes.

Conclusion: The GST regime is a step in the right direction, though the fiscal effects remain debatable. The government is expected to face a revenue implication of ₹48,000 crore which is equivalent to 0.1 per cent of GDP. This revenue shortfall along with the external headwinds of steep US tariffs on Indian exports are expected to create a fiscal strain of ₹3.75 lakh crore, while the revenue streams of a record central bank dividend and PSE/PSB dividends expected this year should add up to ₹3.94 lakh crore, allowing some fiscal headroom to the government. Over time, GST collections are expected to recover as consumption increases. The estimates, as they stand today, do not point to significant fiscal pressure.

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