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EcoFlash

India: fiscal policy to support growth

Despite robust growth between April and June 2025 (probably overestimated), the government is stepping up measures to support the Indian economy. The "Goods and Services Tax Council", which is due to meet on 3 and 4 September, is expected to approve a cut in VAT rates. This measure would counteract the effects of the increase in US tariffs without weakening the central government's finances.

Strong GDP growth

Real GDP growth reached 7.8% year-on-year (y/y) in the first quarter of the Fiscal year 2025/2026 (April-June 2025). This is one of the highest rates of growth among emerging Asian countries, along with Vietnam (+8% y/y over the same period). However, the reality is more nuanced, as the very low GDP deflator (+0.9% y/y) has increased real growth. This effect is unlikely to last.

Activity has been sustained by the dynamism of rural household consumption and the sharp rise in public spending. Urban household consumption remained sluggish, as illustrated by the low level of car sales, VAT receipts and air traffic. Investment slowed. Although exports remained robust, the contribution of net exports to GDP growth was negative due to the rise in imports in conjunction with the sharp increase in inventories. The services sector recorded the strongest growth (+9.3% y/y), while activity in the mining industry contracted.

Risks for exports and private investment

GDP growth is expected to slow sharply over the next few quarters. The Indian economy remains mainly driven by domestic demand, but it could be penalised by the tightening of US trade policy in the short, medium and long term. If the Trump administration were to maintain US customs duties on Indian products at much higher levels than in other Asian countries (the effective rate has been raised from 2.4% at the end of 2024 to 36.2% today, compared with 19.3% in Vietnam), this would weigh on growth (-0.6pp over a full year[1]). The United States is India's leading export trading partner (18.3% of its goods exports in 2024) and its leading investor (excluding Singapore and Mauritius, through which international financial flows pass). The sectors most vulnerable to a rise in US customs duties would be the most labour-intensive. With the electronics sector exempt for the time being, jewellery and textiles (11.5% and 10% respectively of its exports to the United States) are the sectors most affected. If the electronics and pharmaceuticals sectors were taxed at 25%, the effective tariff on Indian products would rise to 43% and the impact on Indian growth could amount to 0.7pp of GDP.

What would be the impact on foreign investment? Despite solid growth, an abundant and cheap labour force and advantageous tax conditions, India is struggling to attract foreign direct investment (FDI). Net FDI inflows, although accelerating slightly in Q1 2025, have only reached 0.7% of GDP over the last four quarters (vs. 4.6% of GDP in Malaysia and 4.1% of GDP in Vietnam). Despite the high level of uncertainty surrounding world trade, there was hope that India would benefit from the tightening of US tariff policy and would become more attractive to foreign companies looking to diversify their manufacturing base. What's more, FDI in India is mainly concentrated in services, electronics and telecommunications (43% of FDI received), which for the time being are not affected by the rise in US customs duties. However, the 'surtax' imposed by Washington on Indian goods has changed the situation. If it remains in place, it will severely restrict the country's industrial development, weighing not only on short-term growth but also on the medium- and long-term outlook.

Expansionary fiscal policy to support growth

Faced with these downside risks to growth, in August the government announced a tax reform to stimulate household consumption in the coming weeks. Although the details of the rates to be applied to different consumer goods are not yet known, products taxed at 12% could be reduced to 5% and those taxed at 28% (such as cars) would see the rate reduced to 18%.

Given that the fiscal multiplier for a VAT shock is estimated at 1.08, that consumption of non-durable goods amounts to 24% of GDP and that of durable and semi-durable goods to 5.9% of GDP, **the reduction in VAT rates could generate a 0.6pp increase in growth. The question is whether, by adopting such a measure, the government is not running the risk of weakening its public finances.**

[1] Assuming that the elasticity of exports to tariffs is 1 and taking into account the 85% share of Indian value added in its exports, according to the OECD.

Lowering VAT rates would not weaken public finances

Public finances are the Achilles heel of the Indian economy. The low level of fiscal revenues (9.3% of GDP in FY 2024/2025) and the heavy interest burden on the debt - which consumes 36.3% of its revenues - severely restrict the government's ability to sustain activity and make the investments that are essential to attract foreign companies and develop industry.

The government has been engaged in a process of consolidation for many years. However, although they have fallen from the peak reached in 2020/21, central and general government deficits were still higher last year than they were before the COVID-19 epidemic. For the FY2024/2025, they amounted to 4.8% and 7.8% of GDP respectively (vs. 4.6% and 7.2% in FY2019/2020) and total debt reached 82.9% of GDP.

In the budget for FY2025/2026, the central government plans to reduce its deficit to just 4.4%. Such a target looks achievable despite the cut in VAT rates. Given that 65% of VAT revenue is collected on products taxed at 18%[2], the shortfall in central government tax revenue is estimated at between 0.5% and 0.6% of GDP for a full year. The cost to central government would be offset by the cessation of financial compensation paid to the States, which will take effect on 31/03/2026 (estimated at 0.5% of GDP). The Member States have already included this anticipated shortfall in their budgets since the introduction of VAT in 2017/2018. To compensate for the loss of VAT revenue (on average 42% of their total revenue), a VAT rate of 40% on luxury goods should be introduced.
Without weakening the central government's public finances, the reduction in VAT rates would support growth. According to the Indian government, growth could reach between 6.3% and 6.8% for the current fiscal year.

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[2] VAT receipts on products taxed at 5%, 12% and 28% represent 7%, 5% and 11% respectively of total General Government receipts.