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Should GST cut lead to lower prices? Economics 101 for babus: Taxes are only one factor in prices

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Fast food chain Subway was recently given a clean chit by the National Anti-Profiteering Authority (NPA), in a complaint filed against the company that it had increased product prices when GST rates on the restaurant sector were lowered. The NPA ruled that the cost of production for the company had increased because tax cuts on the final output prices were accompanied by a decision to disallow tax rebates for purchase of various inputs.

In contrast, a few weeks earlier the NPA ordered an outlet of Lifestyle international in UP to pass on GST cuts to consumers for each and every product. It asked the company to refund the excess amount charged along with interest from the date of purchase, and if customers can't be identified then to deposit excess profits into a consumer welfare fund. It also ordered a further investigation into alleged profiteering.

So here is a question: Should changes in indirect tax rates lead to a proportionate change in the product prices? And if so, shouldn't it operate both ways – shouldn't an increase in tax also lead to an equivalent increase in prices? Does this make sense at all?

Prices are determined by interaction of supply and demand in a market economy. When a supplier is legally required to deposit tax revenue in the government's account, it affects the price at which he can supply a product in the market. But, the economic incidence of tax – who actually bears the burden of the tax – does not depend on who is required to deposit the tax to the government.

When a tax rate is lowered, as in the case of GST for a number of products in recent months, sellers can now afford to sell products at lower prices. But should they always do that? Imagine demand for a particular product is not very price sensitive, perhaps because people really want to buy that product or that there are few substitutes available. Alternatively, say overall demand for a product has increased. Perhaps, incomes have increased or tastes and preferences have changed.

Now, while the supplier can supply a product at a lower price because of a reduction in tax, but the quantity demanded of a product has increased for whatever reason, what should happen to the price? Clearly, it will be determined by the strength of the two effects. If an increase in demand is sufficiently large, the seller will have the ability to charge a higher price than before and make higher profits.

Is there anything wrong if this happens? If consumers really think the product price is unjustified they would move to a cheaper substitute, in which case the higher price can't be sustained by the seller if profits are to be maximised.

But what if the prices of substitutes have also risen? Well, that again suggests enough number of people are ready to pay these prices. It is difficult to imagine that a large number of sellers in sectors such as fast food restaurants can collude effectively with each other to keep prices high.

Further, the production cost of companies can change for several reasons other than tax changes. Suppose a tax rate is lowered, but labour or transportation cost increases, or perhaps the price of raw materials increases, it is the net effect that will be reflected in the final product prices.

Investigating changes in prices due to GST changes is a futile exercise, one that has an enormous opportunity cost, both monetary and non-monetary. In monetary terms, it's a waste of taxpayers' money which can be used more productively elsewhere. In non-monetary terms, it's a waste of precious time of the tax experts sitting on the NPA panel. Let the law of supply and demand take over, unless of course there is evidence of collusion.

The article can be read online at - https://blogs.timesofindia.indiatimes.com/toi-edit-page/should-gst-cut-lead-to-lower-prices-economics-101-for-babus-taxes-are-only-one-factor-in-prices/