

## **GST compensation: An erosion of trust**

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Introduction of Goods and Services Tax [GST] was the culmination of 14-year-long thought process that began in December 2002. One of the main concerns of the States was the revenue loss which may occur when the States subsume their taxing powers and when the taxation system changes from origin based to destination based.

The issue of GST compensation was discussed in the Empowered Committee meetings held on 14th June and 26th July, 2016. The States had unanimously agreed that the compensation should be paid in full, for a period of five years. This sentiment of the States was shared with the then Union Finance Minister who was appreciative of the concerns of the States and he assured the Empowered Committee that the Centre is committed to give full compensation for a period of five years.

The States were rightfully concerned about the compensation to be made statutory, in view of their sour experience with VAT compensation. So, they were assured of compensation by the central government and it was incorporated in the constitutional amendment bill and further to allay the fears it was mandated that "parliament shall, by law" provide for compensation, instead of "may". The above facts are evident from the words of then Finance minister while replying to the debate in the Rajya Sabha, while the constitutional amendment bill was discussed on 3rd August, 2016. Hence, it cannot be denied that compensation package and the comfort it provide to the States was the deal breaker in implementing GST across the country.

Accordingly, while the compensation law was discussed in the GST Council, only the modalities of payment of compensation were discussed. Funding of compensation through cess came up subsequently and the States had agreed to the levy of cess after prolonged discussions. During the discussions in the various meetings of the Council in 2016 and 2017,

the relationship between compensation and compensation cess was extensively discussed. Apart from Kerala, the Ministers from Andhra Pradesh, Punjab, Uttar Pradesh, Rajasthan, Telangana, West Bengal, Assam, Gujarat and Karnataka had elaborately raised the point that the obligation to give compensation should not be restricted to the amount of compensation cess and in case of any shortfall, the shortfall should be made good by the Centre. In response to these discussions, the then Hon'ble Chairperson and Union Finance Minister had assured that *“compensation to States shall be paid for 5 years in full within the stipulated period of 5 years. He added that in case the amount in the Compensation Fund fell short of the compensation payable in any bimonthly period, the GST Council shall decide the mode of raising additional resources, including borrowing from the market which could be paid by collection of cess in the sixth year or further subsequent years”*.

Even during this pandemic, one has to contemplate on the reasons of the current compensation imbroglio. It was after much deliberation that the 14 per cent hike in compensation was guaranteed to the States. But the optimistic mood regarding the buoyancy of GST prevailing then has not been borne out by the actual outcome even after three years. The implementation has been lackluster, with the IT backbone yet to be completed and tax administration handicapped by too many impediments. Further, the pre-election sharp reductions in tax rates without serious examination of the revenue implications have also contributed to the fall in revenue. The current rates are not revenue neutral.

The widening of the compensation deficit had become evident much before Covid with the sharp decline in GDP growth during 2019-20. The 37th GST Council meeting at Goa witnessed strange spectacle of the Union Finance Commission Chairman addressing the Council to plead to the States to re-visit the compensation formula. 14 per cent growth was unsustainable in the macro economic scenario that prevailed in the country. State after State, irrespective of political affiliations, had rejected the proposal and refused to discuss it. This reflects the true feeling of the Council on the issue. In the 39th GST Council meeting at New Delhi it was assured that a special meeting would be convened to discuss the compensation issue that had taken as serious turn after the reference in the budget speech that the compensation would be limited to fund availability in the cess fund.

The matter of compensation was raised by the States in the 40th Council meeting where it was decided that views of States on how to resolve the compensation deadlock would be gathered, and after assimilating the same, the Centre would do all the due diligence on the

mode with which this can be accomplished, get all the opinion, compile and share with the States. But in the 41st meeting when the States presented their views, the Centre discussed the opinion of Attorney General and placed before the States two options of borrowing. It was also unilaterally decided that the States should opt one within 10 days. This has been done in a way with scant regard for democratic deliberations.

The functioning of the GST Council in last few years, however, has not lived up to the principles laid down. In the 41st Council meeting no agenda note was circulated and not even the AG's opinion was shared with the States before the meeting. The presentations were made and at the end of the meeting two options are put before the States and the States are asked to choose one of them within a week. In default, the States are threatened that choosing none of the option would mean no compensation. In the circumstances if the avowed principle of consensus is not being upheld, the legal provisions for Dispute Resolution Mechanism within the Council should be activated without delay.

Option one introduced a new concept of dividing the revenue losses 'on account of implementation of GST' (the phrase used article 19 of the Constitutional Amendment Act)" and "due to the pandemic". The compensation on account of "due to the pandemic" would be deferred to year 2022 with no clarity on whether interest for two years would be paid. Events like, recessions, pandemics, demonetization etc. where never the considerations when compensation formula was devised. The compensation law clearly defines how compensation is to be calculated and it has no reference what so ever to any conditions whether it be Act of nature, Gods or man. The phrase "on account of implementation of GST" would only mean "the loss of State autonomy in taxation where they are deprived of raising resources on their own". Secondly, the Centre also argued with the States that AG had opined that the Central Government is not legally bound to compensate the States from the Consolidated Fund of India (CFI). The Centre also put forward the argument that an opposition member's amendment to compensate the States from CFI, to the constitutional amendment bill was rejected by Lok Sabha by voting. Given the history of the discussions, the consensus reached by the States and Centre regarding compensation bringing up these type of arguments to coerce the States to accept one of the two options, is a lowest point in the Centre-State fiscal relations.

There is significant erosion of trust. Circumstances point to a situation where the Centre's actions are constricting the State resources and its financial autonomy. Since cesses are kept

outside the divisible pool, the States being given only 32 per cent of the Centre's resources against the promised 42 per cent. The Central Government incorrectly appropriated a sum of Rs. 88,344.22 crore in 2017-18 and Rs 13,944 crores in 2018-19 from IGST account by crediting it to the Consolidated Fund of India. As a result of the continued adoption of the erroneous process of devolution of IGST to States and retention of un-apportioned balance in the CFI instead of first apportioning IGST between the Centre and States/UTs and then devolving States' share from the amount apportioned to the Centre, States had overall received less funds on account of IGST. This also implies that tax receipts of the GoI were overstated to that extent and the revenue deficit understated during the year. To this extent, there was an artificial revenue shortfall in the States and the Central Government used the Compensation Fund to make good the short fall. This did not give the correct picture of revenue. This wrong practice continued in 2018-19 also, in spite of the fact that the error was pointed out by Accountant General.

The much-required amendment in the CST Act which restricts industries from purchasing petroleum products at 2 per cent from other States despite constant request by all States irrespective of political affiliation has not materialized. This is causing considerable revenue loss to the States, petroleum products, being one of the independent revenue sources to the States after the implementation of GST. Now, the latest one is where the States, with their limited borrowing capacity are required to bear the full burden of GST compensation loans. The borrowings of the States were independent of GST Compensation. Now it gets tied to the compensation.

There are two cardinal principles on compensation which are non-negotiable.

- i.) There can be no bifurcation of revenue shortfall for compensation purposes as due to pandemic and due to implementation of GST. Entire shortfall needs to be compensated. It is the constitutional right of the States.
- ii.) Compensation cannot be linked to normal borrowing or additional borrowing limits allowed to States.

Both the options presented by the central government infringe upon the above two cardinal principles and therefore not acceptable.

Once we accept the two basic principles then we can discuss and try to arrive at the consensus regarding the following issues:

- i) Who borrows-Centre/ State or in what proportion
- ii) What amount to be borrowed this year and what amount to be deferred to 2022?
- iii) Repayment through extension of the cess beyond five years.
- iv) Or any other relevant matter.

It's important that at least a part of the Compensation to the States be paid immediately given the shortfall in the revenues of the States and the financial crunch. The States are not for supporting for any additional expenditure but to maintain their budgeted expenditure. It is against all principles of macro -economics to enforce a cut in the expenditure of the States that account for 60 per cent of the total expenditure of governments in India. As is well known India has one of the weakest stimulus packages and the worst economic contraction in the first quarter of FY 20-21.

If there is no consensus in the GST Council on the above negotiable issues, the legal provisions for Dispute Resolution Mechanism within the Council should be activated without delay. Interim payments towards compensation shall continue in the interim period. Further, the long standing demand of the States to appoint a Vice-Chairperson to the GST Council shall be considered and implemented at the earliest.