GST Compensation Standoff

This editorial analysis is based on the article **Grim Sovereign Tangle: On GST compensation standoff**, which was published in The Hindu on 3rd of September 2020. It analyses the issue of Goods And Services Tax (GST) compensation to states and the controversy related to it after the conclusion of the 41st GST Council meet.

Three years after the introduction of India's new indirect tax regime, **GST**, it has started to face an existential crisis. The gains of GST have started to quickly erode as the slowdown in the economy, exacerbated by the **Covid-19** lockdowns, has thrown all revenue calculations to the wind.

Due to huge shortfalls in the tax collection under GST the Central government and State Government has come at loggerheads as Centre has shown its incapability to compensate the States as promised under the **GST Act 2017**.

Goods And Sales Tax (GST)

- GST is one of the biggest indirect tax reforms in the country.
- It is a significant step in the reform of indirect taxation in India which amalgamates most of the indirect taxes of the Centre and States into a single tax.
- This has helped mitigating the double taxation, cascading effect of taxes, multiplicity of taxes, classification issues etc., and has led to a common national market.
- It was introduced with the slogan of 'One Nation One Tax'.

GST Compensation

- After the introduction of GST States have very limited taxation rights as most of the taxes, barring those on petroleum, alcohol, and stamp duty, were subsumed under GST.
    - GST accounts for almost 42% of states' own tax revenues, and tax revenues account for around 60% of states' total revenues.
- Under the **GST (Compensation to States) Act, 2017**, states are guaranteed compensation for loss of revenue on account of implementation of GST for a transition period of five years between 2017 and 22.
- The compensation is calculated based on the difference between the states' current GST revenue and the protected revenue after estimating an annualised 14% growth rate from the base year of 2015-16.

Logic Behind GST Compensation

- In theory the GST should generate as much revenue as the previous tax regime.
- However, the new tax regime is taxed on consumption and not manufacturing.
- This means that tax won't be levied at the place of production which also means manufacturing states would lose out and hence several states strongly opposed the idea of GST.
- It was to assuage these states that the idea of compensation was mooted.

- To make this promise watertight, the idea of compensation was both written into the Constitution and its finer details passed by way of central legislation.

Issues

- The Union Finance Minister in a recently held **41st GST Council** meeting asserted that the Centre will not be able to compensate the States.
- The Central Government is asserting that GST collections have sharply come down this year due to the Covid-19 pandemic.
- The GST compensation requirement is estimated to be around Rs 3 lakh crore this year, while the cess collection is expected to be around Rs 65,000 crore. Thus there is an estimated compensation shortfall of Rs 2.35 lakh crore.

Centre’s Recommendation

- States have been given two options to remedy the situation and both require them to borrow from the market.
- The Centre contends that only ₹97,000 crore of the revenue shortfall is from implementation of the GST, while ₹1.38-lakh crore is due to extraordinary circumstances posed by an **‘Act of God’ (The Covid-19 pandemic).**
- States can either borrow ₹97,000 crore, without having it added to their debt and with the principal and interest paid out from future cess collections, or they can borrow the entire ₹2.35-lakh crore shortfall, but will have to provide for interest payments themselves.
- The Finance Ministry has argued that higher borrowing by the Centre will push up interest rates and dent India’s fiscal parameters.

State’s Objection

- Five states and Union Territories of Kerala, Punjab, West Bengal, Puducherry and Delhi have voiced their concerns over the proposals.
- They are stating that the Finances of the states are under severe strain, resulting in delays in salary payments and sharp cuts in capital expenditure outlays due to the pandemic and lockdowns.
- They are also battling the Virus and hence they need to spend on their healthcare too.
- In light of these circumstances several states have rejected both the options and have urged the Centre to rethink.
- They say that while the Centre chose to pin much of the blame for the delays on GST compensation payments on the pandemic it started before the pandemic.
    - The payments due for August-September 2019 was delayed and since then, all subsequent payouts have seen cascading delays.
- In Fact the Centre had admitted to problems on compensation payment in the 37th GST Council meeting held in Goa in September 2019 itself.

Way Forward

- It is time for states to accept the realities and agree to a lower level of compensation, ideally linked to the growth rate of the Indian economy in nominal terms.
- States can’t turn blind sight to the aftermath of the pandemic.
- The Union government must also need to lead the country out of its GST impasse by borrowing more from financial markets or directly from **RBI**.
- The Centre must understand that it is their statutory obligation and they can’t abrogate it.
- States should reciprocate by settling for a more realistic compensation for time being while exploring the options suggested by the Centre.

Conclusion

- The country's grand federal bargain in the form of GST should not be weakened to an extent that the very idea of a national tax comes under threat.
- GST reforms must not fall victim to the trust deficit engendered by this standoff between the Centre and the States.
- They must cooperate and coordinate in this hour of pandemic to bolster common interest.

What is it?

- GST aims to stitch together a common market by dismantling fiscal barriers between states
- It is a single national uniform tax levied across the country on all goods and services

Present Situation

- The Centre and states levy multiple taxes such as excise duty, octroi, central sales tax (CST), value-added tax (VAT) and entry tax, among others

Why amend the Constitution?

- Under current laws, only the Centre can impose taxes on services
- GST will empower states to collect service taxes

What about tax rates?

- There has been no agreement yet on tax rates for various goods and services
- States want the rate to provide relief to common citizens and small businessmen while preventing loss of revenue for states
- A panel headed by chief economic adviser Arvind Subramanian has recommended a revenue-neutral rate of 15% to 15.5%, with a standard rate of 18%
- The revenue-neutral rate is the rate at which there will be no revenue loss to the Centre and states under GST

Compensating states

- States want 100% compensation for the first five years, and want this specified in the main law through " fool proof" wording
- In the original Bill, the Centre had proposed 100% compensation for first three years, and 75% and 50% for the next two years, respectively
- The Centre has acceded to the states' demand and modified the Constitution Amendment Bill

What Happens After GST

1. GST will replace all local and central indirect taxes with a single tax.

2. States & the Centre will collect identical rates of taxes

3. E.g. If 18% is the GST rate, states and the Centre will get 9% each, called the SGST and CGST rates

Central Taxes

The Centre levies various taxes currently. GST will subsume all

- Countervailing Duty
- Additional Excise Duty
- Central Excise Duty
- Additional Customs Duty
- Cesses and Surcharges
- Services Tax
- Special Additional Customs Duty

50% Centre

State Taxes

Different states, different taxes. All these will be replaced by one indirect tax

- Vat/sales Tax
- Local Taxes
- Purchase Tax
- Levies
- Tax on Lottery and Betting
- Mandi Tax/Other State-Specific Local
- Entertainment Tax
- Tax on Inter-State Sales
- Luxury
- Octroi/ Entry Tax

50% State

- Rates may be specified in subordinate legislation–SGST law, CGST law by later this year.
- It backbone GST Network (GSTN) to be tested after rates are finalised; GSTN will enable real-time tax returns, registrations, input credit etc.

Inter-state movements

- The Centre would collect the Integrated Goods and Services Tax (IGST) on inter-state supplies
- IGST has been designed to ensure seamless flow of input tax credit from one state to another
- The IGST rate would roughly be equal to CGST plus SGST

What next

- More discussion on rates in the months ahead

Price impact

- The impact on prices is unknown
- Experts say GST will make most services costlier
- The 13th Finance Commission estimates prices of agricultural goods will increase by 0.61% to 1.18%, while prices of manufactured items will fall by **1.22%** to **2.53%**
- It will lower the overall tax inputs and make exports competitive

Timeline

2006-07: The govt moots a proposal for GST in the Budget; negotiations with states begin

2008: The govt. constitutes the empowered committee (EC) of state finance ministers

2009: The committee releases its first discussion paper

2011: The UPA govt. introduces the Constitution Amendment Bill for GST in Lok Sabha (LS)

Aug 2013: The Parliamentary Standing Committee submits its report; the govt incorporates recommendations of the committee in the Bill

Sep. 2013: Revised bill sent to the empowered committee

Dec 2014: The Constitution Amendment Bill introduced in the LS

May 2015: LS passes the Bill

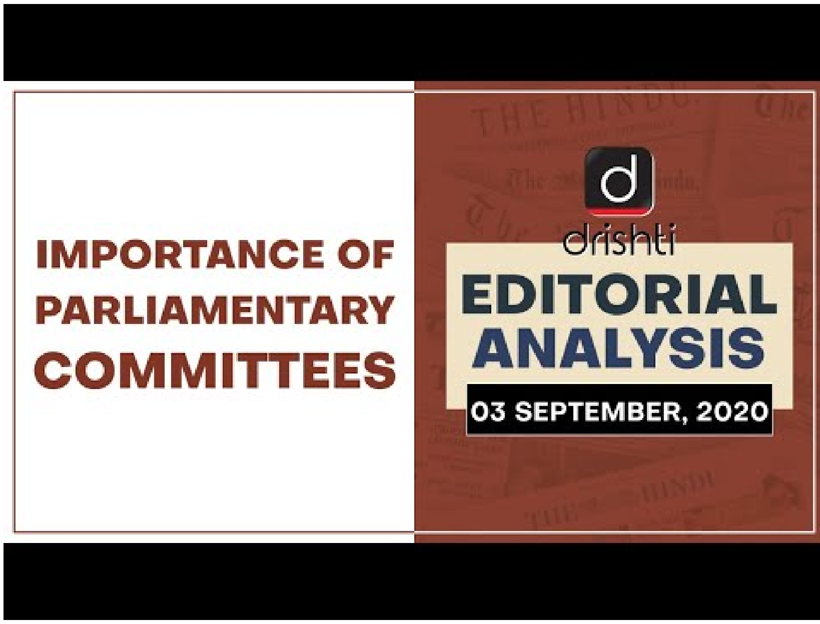
August 2015: Congress insists on capping GST rate at 18%, and specifying the same in the Constitution Amendment Bill

July 2016: The Centre and states agree against capping GST rate in the Constitution Amendment Bill

Aug 2016: Rajya Sabha passes Constitution Amendment Bill Industry hails reforms, says will make doing business easier

Drishti Mains Question

GST reforms should not fall victim to the compensation standoff between the Centre and States. Discuss.



Watch Video At:

https://youtu.be/xT9DB80VFXI

This editorial is based on **"A Unity of Purpose"** which was published in The Indian Express on September 3rd, 2020. Now watch this on our Youtube channel.