

## **Why the States shall not compromise on GST compensation?**

K J Joseph<sup>1</sup> N Ramalingam<sup>2</sup>

<sup>1</sup> Director, Gulati Institute of Finance and Taxation, Thiruvananthapuram.

<sup>2</sup> Associate Professor, Gulati Institute of Finance and Taxation, Thiruvananthapuram

The marriage between the Centre and the States in India, as is well known, has never been a very happy one. Yet the couple never went for a divorce and for the rest of the world they appeared happy. This has been made possible *inter alia* by mechanisms like finance commission and the ever-compromising approach of the States. Which in turn was rewarded by various constitutional commitments by the Centre. The most recent compromise has been the implementation of the Goods and Services Tax. It was possible only through more than a decade long negotiation wherein the both surrendered many of the privileges of indirect taxation that they hitherto enjoyed. The States, which together account for around 60 per cent of the combined expenditure of Centre and States, have been enticed to compromise with a constitutional guarantee of 14 per cent growth in their tax revenue under GST. Hence, had there been no GST Compensation, GST would not have been there for establishing the long cherished 'One Nation, One Tax' regime. The whole process has been touted as the success of cooperative federalism in the largest democracy of the world.

As the Indian economy made a U-turn from the fastest growing economy to the one that recorded the lowest growth leading to the drying up of the revenue sources, the Centre altered its position. The Centre sought to get relieved from the burden of GST compensation. By attributing the Covid induced slump in the economy as an 'Act of God', the Centre took the stance that the States should borrow rather than demanding compensation from the Centre. The States, however, have been under severe fiscal stress. The stress has been mainly on account of heavy expenditure incurred towards saving the lives and livelihood of people affected by the pandemic when the revenue growth being negative. Obviously, the States

have not been in a position to compromise on GST compensation. Much has been said on these lines.

What is missing and much needed for proactive deliberation is a reflection on the context and rationale for GST compensation for the State.

### **1. Tax revenue surrendered**

The outcome of the GST is that the tax revenue is shared equally between the Centre and the States. Given the equality in the distribution of outcome, the question arises whether the cost of establishing GST has also been equally shared. The cost is viewed in terms of the pre-GST revenue surrendered by States and the Centre. A clear answer to the question is available from the Arvind Subramanian Committee Report (2015) titled Study on the Revenue Neutral Rate and Structure of Rates for the GST. The Committee has shown that the revenue forgone by the Centre has been Rs 3.28 lakh crore whereas that by the States being Rs 3.69 lakh crore. Our estimate revealed that this amounted to a surrender of 51.8 per cent of the States' total tax revenue and 28.8 percent for Centre's gross tax revenue. While in absolute terms the difference is not substantial, in relative terms the surrender by the States was almost twice that of the Centre. In such a context, GST compensation is the constitutionally paid price for the higher surrender that the States have made.

### **2. Compromised revenue neutral rate**

A pre-condition for establishing GST has been to arrive at the Revenue Neutral Tax rate such that the potential revenue loss to Centre and the State is minimized. A Task Force headed by Arvind Modi in 2009 recommended CGST rate at 5 per cent and SGST rate at 7 per cent. The Aravid Subramanian committee recommended 8 per cent and 9 per cent respectively for the Centre and State for protecting revenue allocation. Thus, it is evident that for minimizing the revenue loss, the tax rate should have been higher in case of States as compared to the Centre. However, with the expectation of the constitutionally guaranteed GST compensation, the States agreed to reduce the tax rate such that today CGST is imposed at the same rate as SGST.

### **3. Forgone tax base**

To greater extent, tax revenue depends on the tax base. During pre-GST period the tax revenue for the Centre from the industrial output (excise duty) has been limited only to the point of manufacturing indicating a very narrow tax base. On the other hand the States were

entitled to a much wider tax base as they could levy tax on the entire supply chain up to the final consumption point. More importantly, the post manufacturing stages in the value chain accounted for about 50 per cent of the value addition on which only States could levy tax.

With the introduction of GST, the Centre expanded its tax base at the cost of States and they have forgone substantial revenue for building 'one nation one tax' system. Here again it is important to note that other than GST compensation there has been hardly any other provisions in the GST Act to pay for sharing the tax base

#### **4. Forfeited cascading revenue**

While cascading of tax is generally considered as inimical to economic efficiency, it is used to serve as an additional source of revenue mobilization by the States during pre-GST period. While the Centre has also been able to mobilize additional resources on account of tax cascading, given their higher tax base the benefits used to be proportionately higher for the State. Therefore, with GST that addresses the issue of cascading, the state lost more as compared to the Centre. It is with the expectation of GST compensation that the States have forgone this additional resource of revenue.

#### **5. Conceded tax rate**

Apart from the tax base, the tax revenue is governed by the tax rate. During the pre-GST period most of the goods attracted a tax rate of 14.5 per cent by the States. With the introduction of GST, the 14.5 per cent category goods have been brought under the 12 per cent or 18 per cent category wherein the States' share being 6 per cent or 9 per cent respectively. Only a few goods were brought under the category of 28 per cent wherein the share of the States is 14 per cent. Thus, viewed instead of the 14.5 per cent on much of the taxable goods during the pre-GST period, with GST the States lost 8.5 per cent for those goods brought under 12 per cent and 5.5 per cent in case of those with 18 per cent. This loss has also been expected to be covered under the GST Compensation

On the whole, it is high time to recognize that the GST Compensation Act is premised on the explicit recognition of the unconditional surrender that the States together have made towards evolving a one common market with one tax - a key ingredient in the making a globally competitive economy. Hence there is reason to believe that in the absence of GST compensation, GST would not have been born. This being the case, one fails to understand the reason as to how the GST could continue without GST compensation even after five years unless there are mechanisms built in to ensure that the States receive higher share of the tax

revenue. Hence in the interest of sustaining cooperative federalism the GST compensation cannot be confined to a limited period of five years; as long as there is GST there shall be GST compensation for the State.