The road ahead on revenue compensation to the states

The implementation of the Goods and Services Tax (GST) on July 1, 2017, was a landmark reform. The reform is still evolving, and the GST Council meets today to deliberate on the rationalisation of the structure of the tax. One important matter that the states will push is the issue of extending the period of compensation in the revenue shortfall to a few more years. All states have been facing shortfalls of various magnitudes and want the assurance of minimum revenues for a few more years, until the tax stabilises.

The GST reform has led to many gains, and these include creating a stronger common market by removing impediments to the movement of goods, minimising the cascading effect of the tax, and reducing the compliance burden on taxpayers by subsuming all domestic trade taxes on goods and services in GST. However, unlike in many other countries, GST is yet to become a "money machine". The disappointing revenue collection is not only due to the economic slowdown caused by the pandemic, but also due to the inability to stabilise the technology platform, leading to significant evasion of the tax. The good news is that the post-pandemic economic recovery and the improvements in the technology platform have helped generate revenue collections of more than ₹1 lakh crore every month, during the last 10 months and the improvement is likely to continue.

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Implementing GST by combining 13 domestic trade taxes levied by the Centre and states was by no means easy. It involved building consensus on the structure and operational details of the tax among states and Union Territories, besides the Centre. To persuade the states to agree to the reform, the Centre agreed to compensate them for the shortfall in their revenues for five years. The shortfall was to be calculated by applying 14% growth over the revenue from the taxes subsumed in GST, taking 2015-16 actuals attested by the comptroller and auditor general. To finance compensation requirements, the compensation cess was levied on luxury and "non-merit" goods such as aerated drinks, coal, pan masala, cigarettes and automobiles over the peak GST rate of 28%. However, as the pandemic struck, the revenue from cess fell well short of the required amount and the Centre borrowed and transferred to the states ₹1.1 lakh crore in 2020-21 and ₹1.59 lakh crore in 2021-22 from the Reserve Bank of India (RBI).

To service this debt, the period of levying compensation cess has been extended till March 2026. However, the period of compensation to the states ends on June 30. Many states are naturally concerned with the lack of assurance on stable revenues from the tax after June 30 and want the Council to recommend extending the compensation period for a few more years. Their argument is that the reform is still evolving, the technology platform is yet to fully stabilise and the promised improvement in the compliance to enhance revenue buoyancy is yet to materialise. As GST is the most important tax, they seek to extend the period of revenue protection for a few more years. Thankfully, the buoyancy of the tax has shown a significant increase in recent months and is likely to show further improvement with economic recovery and better compliance, and therefore, the revenue consequences of discontinuing the compensation payments to the states may not be large. Nevertheless, the states would want the comfort of assured revenues from the tax.

The Centre, on the other hand, is concerned about the additional burden of providing compensation due to limited fiscal space. Even as the compensation cess was extended up to June 2026, the entire proceeds of the compensation cess will be used for servicing and repaying loans. Besides, the compensation formula adopted so far by assuring 14% growth every year was too generous as the actual growth of the subsumed taxes in GST in the preceding three years was just 8.9%.

It remains to be seen how the Council will tread on the issue. The tax is still evolving and needs important reforms. The reforms include pruning the exemption list, rationalising the rate structure and bringing petroleum products and electricity into the ambit of GST. These can be carried out only when the states agree. The recent Supreme Court judgment that the Council is merely a recommendatory body and the sovereign rights for changing the structure and operations rest with the Parliament and state legislatures has increased the bargaining power of the states and has made it necessary to build consensus for reforms.

Assuring the states of the comfort of minimum revenue guarantee could be used as leverage to reach agreements. The Council will do well to fix the benchmark by limiting the growth to 8-10% from the actual revenue collections in 2021-22. As the economy recovers and with the improved compliance, the actual growth in revenue would be higher and this may obviate the need for compensation for many states. It remains to be seen how the Council will tread this difficult path.

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The views expressed are personal