

## **Compensation to States – the biggest compromise**

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Given the geo-political settings in a federalist nation like India, introducing a massive tax reform, viz., GST is no less an achievement. Introducing a common base of taxation for both units of the Federation (Centre and the States), surrender of exclusive taxing rights on demarcated domains, loss of power to fix the tax rates in their respective domains and the all pervasive role of the GST Council with the majority skewed in favour of the Centre are some of the unimaginable achievements of GST, which has brought about co-operative federalism at its best. But the road to such achievement was not smooth and various compromises have to be made by all the stakeholders in the process.

Continuing with the existing separate Centre and State levies on petrol and diesel and continuing to keep the taxation on alcoholic liquor within the exclusive jurisdiction of the States are some of the compromises made, which, though may be against the spirit of GST, but are necessary at least in the short term.

Another biggest compromise, by the Centre to ensure implementation of GST is the commitment from the Centre to compensate the States for any revenue loss on account of implementation of GST for a period of five years.

Prior to introduction of GST various forms of indirect taxes, such as Excise Duty, Service Tax, VAT, CST, Entry Tax, etc. were being levied by the Centre and the States at different rates, within their exclusive domain. A massive tax reform like GST, where a plethora of indirect taxes are to be subsumed into a single TAX, which has only a limited rate structure (0, 5, 12, 18 & 28%), a much talked about RNR (Revenue Neutral Rate) notwithstanding, no one can predict as to whether the tax revenues would be the same under GST regime also. Subsuming several taxable events into one (supply of goods and services being the taxable event under GST), unifying the valuation provisions, fixing the GST rate vis-à-vis the cumulate rate of taxes levied on each item of goods and services under the legacy regime (with the cascading effect thereof), foray into new tax domains (States would get power to levy tax on services, which was hitherto not available) are the challenges, which can defy any projections in this regard.

So the biggest challenge for introduction of GST was the need to assure the States that their future revenues would be protected under GST also.

If we look at the 115<sup>th</sup> Constitutional Amendment Bill, 2011 which was introduced to bring in various amendments to the Constitution to pave way for introduction of GST, there were no provisions in the Bill, requiring the Centre to provide any compensation to the States for the revenue loss on account of introduction of GST.

The Parliamentary Standing Committee which examined this Bill had an occasion to discuss the issue of Compensation to States. Dr. Vijay Kelkar, who tendered evidence before the Parliamentary Committee has deposed as below.

*The changeover to GST is designed to be revenue neutral at existing levels of compliance. Given the design of the \_flawless GST, the producers and distributors will only be pass through for the GST. Further, given the single and low rate of tax the benefit from evasion will significantly reduce. Therefore, there will be little incentive for the producers and distributors to evade their turnover. Accordingly, this policy initiative should witness a higher compliance and an upsurge in revenue collections. This will also have an indirect positive impact on direct tax collections. Further, given the fact that GST will trigger an increase in the GDP, this in turn would yield higher revenues even at existing levels of compliance. Another important source of gain for the Government would be the savings on account of reduction in the price levels of a large number of goods and services consumed by the Government. However, to the extent, the Central Government will be required to incentivise the States to adopt the GST, there will be an increase in the budgetary outgo. Given the smallness of the size of the compensation, it is expected that there would be a net gain in the tax revenues. This should enable the Central Government to better manage its finances.*

But some of the State Governments were apprehensive especially with their experience of seeking CST Compensation from the Centre. Shri. Sushil Kumar Modi, who was the Chairman of the Empower Committee of the State Finance Ministers had this to say.

*However, in the initial few years of the implementation of GST, because of subsumation of several State Taxes, removal of the cascading affect, provision of additional set-offs may result in some State specific losses and, therefore, there may be a need for provision of GST compensation to such States in the initial few years.*

Finally, the Parliamentary Standing Committee has made the following recommendation.

*Compensation Mechanism*

*4. The Committee note that differences had emerged between the Centre and States on account of CST compensation to the States arising out of phasing out of CST. Further, during their interactions with State Governments, the Committee observed that one of the major concerns over implementation of GST is Revenue Neutrality Rate (RNR). Some States generating high tax revenue have expressed apprehensions on the possibility of suffering revenue losses after the implementation of GST. The Committee note with concern that no structured mechanism has been formulated so far to attend to this problem. The Committee would, therefore, recommend that a well-defined automatic compensation mechanism may thus be built in, which would ensure that trajectories of revenues being contemplated are maintained at least in the short turn. Suitable amendments may accordingly be made in the Bill providing for a built-in permanent compensation mechanism with a view to addressing the legitimate revenue concerns of States. For this purpose, a GST 67 compensation Fund may be created under the administrative control of the GST Council.*

The Constitution (115<sup>th</sup>) Amendment Bill lapsed with the dissolution of the 15<sup>th</sup> Lok Sabha.

A fresh bill, The Constitution (122<sup>nd</sup>) Amendment Bill was introduced in 2014 to amend various provisions of the Constitution, towards introduction of GST. Clause 19 of this Bill read as,

**19.** *Parliament may, by law, on the recommendation of the Goods and Services Tax Council, provide for compensation to the States for loss of revenue arising on account of implementation of the goods and services tax for such period which may extend to five years.*

This bill was also referred to the Parliamentary Standing Committee on Finance.

Though it was represented before the Committee that the phrase “Parliament may” should be made as “Parliament shall”, after taking note of the legislative practice in this regard, the Committee did not agree to the above. But the committee suggested that the provision be re-drafted as below to ensure such compensation is paid for a period of five years.

**19.** *Parliament may, by law, on the recommendation of the Goods and Services Tax Council, provide for compensation to the States for the loss of revenue arising on account of implementation of the Goods and Services Tax for a period of five years.*

This recommendation has been accepted and clause 19 of the Bill has become Section 18 of the Constitution (101<sup>st</sup> Amendment) Act, 2016, which is reproduced below. Though the Standing Committee did not recommend substitution of “may” by “shall”, the Parliament thought it fit to do so.

**18. Compensation to States for loss of revenue on account of introduction of goods and services tax.** — *Parliament shall, by law, on the recommendation of the Goods and Services Tax Council, provide for compensation to the States for loss of revenue arising on account of implementation of the goods and services tax for a period of five years.*

Thus, even though the revenue loss on account of implementation of GST may also impact the Central revenues, a big compromise has been made by the Centre, by undertaking to compensate the States for any revenue loss arising on account of implementation of GST for a period of five years. Being a motherly constituent of the federal entity, the Centre’s assurance is understandable.

In accordance with the above mandate, the Parliament has enacted Goods and Services Tax (Compensation to States) Act, 2017.

The projected growth rate of revenue is fixed at 14 % under Section 3 of the Act. The base year is taken as 2015-16 under section 4 and the manner in which the tax revenue of the States in the base year has to be computed has been laid down in Section 5 of the Act.

The manner of computation of the compensation payable to a State is laid down under sub section (3) of Section 7, which is worth of reproduction.

*7 (3) The total compensation payable for any financial year during the transition period to any State shall be calculated in the following manner, namely :—*

*(a) the projected revenue for any financial year during the transition period, which could have accrued to a State in the absence of the goods and services tax, shall be calculated as per section 6;*

*(b) the actual revenue collected by a State in any financial year during the transition period shall be —*

*(i) the actual revenue from State tax collected by the State, net of refunds given by the said State under Chapters XI and XX of the State Goods and Services Tax Act;*

*(ii) the integrated goods and services tax apportioned to that State; and*

*(iii) any collection of taxes on account of the taxes levied by the respective State under the Acts specified in sub-section (4) of section 5, net of refunds of such taxes,*

*as certified by the Comptroller and Auditor-General of India;*

*(c) the total compensation payable in any financial year shall be the difference between the projected revenue for any financial year and the actual revenue collected by a State referred to in clause (b).*

For the purpose of meeting the revenue requirements to pay such compensation, a CESS, known as Compensation Cess is sought to be levied under Section 8 of the Act. As per sub-section (2) of Section 8, the Compensation CESS is leviable on supply of such goods and services as mentioned in the Schedule to the Act at such rate, not exceeding the rate mentioned in the said schedule.

The said Schedule specifically identifies certain commodities such as Pan Masala, Tobacco, Coal, Aerated Water, Motor vehicles and indicates the maximum rate at which Compensation Cess can be levied on supply of such goods. The Schedule also lays down that Compensation upto a maximum of 15 % on value can be levied on any other supplies.

Notification 1/2017 Compensation Cess (Rate) dt. 28.06.2017 has been issued, prescribing the rate of Compensation Cess for various supplies and apart from those supplies mentioned specifically in the Notification, all other supplies have been exempted from payment of Compensation Cess.

The Compensation Cess thus collected shall be credited to a Special Fund, viz., GST Compensation Fund, created under Section 10 of the Act, from which the compensation payable to the States shall be paid.

It may be observed from the above discussion, the Compensation promised by the Centre to the States is to meet the revenue loss of the States, "on account of implementation of GST". If the GST collections are less than the collection of various tax revenues by the States under the legacy levies, with 14 % projected growth rate per annum, the shortfall is to be compensated by the Centre, from out of the GST Compensation Fund, created for this purpose, from out of the compensation CESS levied on specified supplies. No one can predict the revenue yield on account of GST vis-à-vis the revenue yield from legacy levies, as the fixation of a perfect Revenue Neutral Rate is practically impossible. Further, the impact of implementation of GST on the overall economic activity in the country is also unpredictable. Such uncertainties were the biggest barriers for introduction of GST, which the Centre has overcome by agreeing to compensate the States for any revenue loss.

No one could have hardly thought that a Pandemic of global proportion would ensue during the transition period of five years, severely impacting the global economic activity and lead to severe loss of revenue for the Government with much reduced GST collections.

The moot question is whether the Centre is bound to compensate the States fully, even though the reduction of GST collections is not only due to “implementation of GST” but also due to this force majeure event. In the author’s opinion, the economic fallout of Covid-19 is universal and every one including the Central Government, State Governments, businesses have been bearing the brunt. Even if GST was not implemented, there would have been revenue loss for the Governments from out of the legacy tax revenues also. So, in all fairness the Centre can be said to be responsible to compensate the State Governments, only with reference to the loss on account of implementation of GST and not the loss arising out of the pandemic driven economic fall out.

Then the question is how to determine as to how much of revenue loss to the States is on account of implementation of GST and how much of the same is due to the general economic fallout on account of Covid-19?

The projected nominal growth rate for the purpose of compensating the States was fixed at 14 % per annum, by considering the year 2015-16 as the base year. After giving effect to the severe economic setback suffered on account of this pandemic, this projected nominal growth rate could be reworked and the loss of revenue on account of implementation of GST could very well be arrived at.

But, rather than being economical, the issue is more one of political, where everyone strikes to gain a point. It is very easy for the opposition ruled State Governments, to allege abdication of responsibility by the Central Government, especially when the dynamics of this Compensation is not understandable by the masses. No doubt, it is also the duty of the Centre to offer financial assistance to the States, during such extra-ordinary circumstances, but it is based on the resources available with the Centre and rational distribution of the same, but not by way of forced extraction.

The Centre’s move to bring in a provision for compensating States for any revenue loss on account of implementation of GST itself, is a costly compromise. Lest, GST would not have seen the light of the day. But, at the same time, is it not a disincentive for the States to effectively implement the GST, check the evasion and collect all taxes which are due? When there is a promise by the Centre to compensate any revenue loss, what is the incentive for prudent and vigilant tax administration by the States? So, basically, the compromise made by the Centre itself is a big price, to bring in co-operative federalism at least in the economic domain, the ugly head of which raises now, more prominently.

There is another easy way for the Centre to solve the problem, which may be politically imprudent. The GST (Compensation to States) Act, 2017 enables the Centre to levy Compensation CESS on any supplies upto 15 % and by an executive notification, this can be implemented. But, imposition of additional GST, especially at a time when the citizens are reeling under severe economic stress may not be a prudent choice.

Many States are vociferously asserting that it is the Constitutional duty of the Centre to compensate the States due to revenue loss. A careful reading of the Constitution (101<sup>st</sup> Amendment) Act, 2016 would reveal while sections 1 to 17 of the Act seeks to amend various Articles of the Constitution, Section 18 dealing with Compensation (along with Section 19 containing transitional provisions and Section 20 dealing with power to remove difficulties), remain as part of the statutory provisions under the Amendment Act only and not made into part of the Constitution.

The need of the hour is to first identify the revenue loss to both Centre and States on account of GST implementation and on account of the pandemic caused economic set back. While the Centre is constitutionally bound to compensate the States for the former, there is no justification for seeking compensation for the later, when the problem is unique to both. All stakeholders have to accept that the economic clock has been turned back and we should begin our march from the first step all again and together march forward, instead of indulging in blame games and political blackmailing. Already the last few months' GST collections indicate a slow turn around, which has to be nurtured further.

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