Making up for shortfalls in GST collection

The GST (Compensation to States) Act assumes a 14% growth target for States, which is unrealistic

M.R. MADHAVAN

Two weeks ago, the Central government announced that it has released the Goods and Services Tax (GST) compensation dues to States for 2019-20. The total compensation was Rs 1,65,302 crore while the compensation cess fund collected was Rs 144 crore. The shortfall was made up by excess collections in earlier years as well as some of the balance of inter-State GST from earlier years. This raises the question of how the compensation will be made in the current year.

Background of the cess
The GST compensation cess has an interesting background. GST subsumed several taxes, including those which were the preserve of the States, such as sales tax, and therefore required an amendment to the Constitution of India. As the amendment affected the Seventh Schedule (which delineates the jurisdiction of the Centre and the States), it required ratification by the legislatures of half the States. That is, this Constitution Amendment needed wide political support.

Prior to GST, States exporting goods to other States collected a tax. GST is a destination-based tax, i.e., the State where the goods are sold receives the tax. This implies that manufacturing States would lose out while consuming States would benefit.

In order to convince manufacturing States to agree to GST, a compensation formula was created. The Constitution Amendment Bill, introduced in 2014, and passed by the Lok Sabha, had two provisions. First, it provided for a 1% tax on inter-State trade, which would be assigned to the supplying State. Second, it made provisions for a law to be passed by Parliament to provide compensation to States for loss of revenue for a period up to five years. However, a Select Committee of the Rajya Sabha recommended that the compensation be guaranteed for a period of five years. This was accepted when the Bill was passed by the Rajya Sabha, and subsequently by the Lok Sabha. As tax receipts of manufacturing States had been protected by the guarantee, the provision of the 1% tax on inter-State trade was dropped.

The cess fund
The modalities of the compensation cess were specified by the GST (Compensation to States) Act, 2017. This Act assumed that the GST revenue of each State would grow at 14% every year, from the amount collected in 2015-16, through all taxes subsumed by the GST. A State that had collected tax less than this amount in any year would be compensated for the shortfall. The amount would be paid every two months based on provisional accounts, and adjusted every year after the State’s accounts were audited by the Comptroller and Auditor General. This scheme is valid for five years, i.e., till June 2022.

A compensation cess fund was created from which States would be paid for any shortfall. An additional cess would be imposed on certain items and this cess would be used to pay compensation. The items are pan masala, cigarettes and tobacco products, aerated water, caffeinated beverages, coal and certain passenger motor vehicles. The Act states that the cess collected and “such other amounts as may be recommended by the [GST] Council” would be credited to the fund.

In the first two years of this scheme, the cess collected exceeded the shortfall of States. In the third year, 2019-20, the fund fell significantly short of the requirement. This was on account of slowdown in tax collections as the economy slowed down coupled with negative growth in sectors such as motor vehicles which contributed to the cess fund.

Issue and possible resolution
Most economists expect negative real GDP growth this year, and nominal GDP to be close to last year’s level. As indirect taxes are levied on the nominal value of transactions, this is likely to result in significant shortfall for States from the assured tax collection. A key source of the problem is that the 2017 Act guaranteed a tax growth rate of 14%, which is unachievable this year. Whereas no one could have foreseen the pandemic and its impact on the economy, the 14% target was too ambitious to start with. Given the government’s inflation target at 4%, this implied a real GDP growth plus tax buoyancy of 9%. That this was an unrealistic target is evident from the shortfall last financial year, when the lockdown was for less than two weeks.

As we have discussed above, the Central government is constitutionally bound to compensate States for loss of revenue for five years. The assumed rate of growth of a State’s GST revenue is set at 14% by Parliament through the 2017 Act. There are several possible solutions to this issue.

First, the Constitution could be amended to reduce the period of guarantee to three years (this ending June 2020). This would be difficult to do as most States would be reluctant to agree to this proposal. It could also be seen as going back on the promise made to States when they agreed to subsume their taxes into the GST.

Second, the Central government could fund this shortfall from its own revenue. States would be happy with this proposal. However, the Centre’s finances are stretched due to shortfall in its own tax collection combined with extra expenditure to manage the health and economic crisis. It may not be in a position to give further support to States.

Third, the Centre could borrow on behalf of the cess fund. The tenure of the cess could be extended beyond five years until the cess collected is sufficient to pay off this debt and interest on it.

Fourth, the Centre could convince States that the 14% growth target was always unrealistic. The target should have been linked to nominal GDP growth. If the Centre can negotiate with States through the GST Council to reset the assured tax level, it could then bring in a Bill in Parliament to amend the 2017 Act.

The Constitution makes it obligatory for the Centre to make up for shortfall by the States. The cess collected will not be sufficient for this purpose. The GST Council, which is a constitutional body with representation of the Centre and all the States, should find a practical solution.