Issue of GST compensation

(Mains GS 3 : Indian Economy and issues relating to planning, mobilisation of resources, growth, development and employment.)

Context:

Implementation of the Goods and Services Tax (GST) in India was a grand experiment in cooperative federalism in which both the Union and the States joined hands to rationalise cascading domestic trade taxes and evolve a value-added tax on goods and services.

Compensation requirements:

- To allay the fears of States of possible revenue loss by implementing GST in the short term, the Union government promised to pay compensation for any loss of revenue in the evolutionary phase of five years.
- The compensation was to be calculated as the shortfall in actual revenue collections in GST from the revenue the States would have got from the taxes merged in the GST.
- This was estimated by taking the revenue from the merged taxes in 2015-16 as the base and applying the growth rate of 14% every year.

To finance the compensation requirements, a GST compensation cess was levied on certain items such as tobacco products, automobiles, coal and solid fuels manufactured from lignite, pan masala and aerated waters.

Reason for mistrust:

- In 2018-19, the shortfall in the payment requirement from the cess collections was ₹24,947 crore which could be met from the surpluses of the previous two years kept as balance in the compensation fund.
- However, in 2020-21, due to the most severe lockdown following the novel coronavirus pandemic, the loss of revenue to States was estimated at ₹3 lakh-crore of which ₹65,000 crore was expected to accrue from the compensation cess.
- Of the remaining ₹2.35 lakh-crore, the Union government decided to pay ₹1.1 lakh-crore by borrowing from the Reserve Bank of India under a special window and the interest and repayment were to be paid from the collections from compensation cess in the future.
- However, the entire compensation payment episode plunged the Union-State relationship to a new low, creating humongous mistrust.

Still in transition:

Although it was hoped that the tax structure would stabilise in the first five years, the reform is still in transition.

Technical issues:

- The technology platform could not be firmed up for a long time due to which the initially planned returns could not be filed which led to large-scale misuse of input tax credit using fake invoices.
- The adverse impact on revenue collections due to this was compounded by the pandemic-induced lockdowns.

Revenue uncertainty:

- GST is the major source of revenue for the States and considering their increased spending commitments to protect the lives and livelihoods of people, they would like to mitigate revenue uncertainty to the extent they can.
- They have no means to cushion this uncertainty for the Finance Commission which is supposed to take into account the States' capacities and needs in its recommendations has already submitted its recommendations; the next Commission's recommendations will be available only in 2026-27.
- More importantly, the structure of GST needs significant changes and the cooperation of States is necessary to carry out the required reforms.

Reforms required:

- The States face loss of motivation as they have no taxation powers, their GST revenues are uncertain, the supposed economic benefits seem phantom, and the hypocrisy of 'cooperative federalism' looms large thus to deal with these issues the structure of GST requires significant reforms.

- Almost 50% of the consumption items included in the consumer price index are in the exemption list; broadening the base of the tax requires significant pruning of these items.
- Sooner or later, it is necessary to bring petroleum products, real estate, alcohol for human consumption and electricity into the GST fold.

Simplifying the structure:

- Economists and commentators point to the multiple rates structure, high tax slabs and the complexity of tax filings as the problems underpinning India's GST.
- The present structure is far too complicated with four main rates (5%, 12%, 18% and 28%). This is in addition to special rates on precious and semi-precious stones and metals and cess on 'demerit' and luxury items at rates varying from 15% to 96% of the tax rate applicable which have complicated the tax enormously.
- Multiple rates complicate the tax system, cause administrative and compliance problems, create inverted duty structure and lead to classification disputes.
- Reforming the structure to unify the rates is imperative and this cannot be done without the cooperation of States but states would be unwilling to agree to rationalise rates unless the compensation payment for the revenue loss is continued.

For cooperative federalism:

- Reforming the structure to complete the process of transition to a reasonably well-structured GST is important not only to enhance the buoyancy of the tax in the medium term but also to reduce administrative and compliance costs to improve ease of doing business and minimise distortions.
- It has been pointed out by many including the Fifteenth Finance Commission that the compensation scheme of applying 14% growth on the base year revenue provided for the first five years was far too generous.
- The issue can be revisited and the rate of growth of reference revenue for calculating compensation can be linked to the growth of GSDP in States to ensure the comfort of minimum certainty on the revenue.

Conclusion:

Extending the compensation payment for the loss of revenue for the next five years is necessary not only because the transition to GST is still underway but also to provide comfort to States to partake in the reform.