GST under Strain*

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The Finance Minister of Kerala, Thomas Isaac, has declared it a “betrayal” of trust. He was commenting on the statement reportedly made at a meeting of the Parliamentary Standing Committee on Finance by Union Finance Secretary Ajay Bhushan Pandey, that the Centre, in financial year 2020-21, would not fully compensate the states for any shortfall in revenues from Goods and Services Taxes. The shortfall was to be computed relative to a trajectory where state revenues grew by at least 14 per cent every year, starting from a base value computed for 2015-16. Clearly, that was the revenue growth the GST regime was expected to deliver.

The Centre’s declaration came as evidence showed that revenues from the cess imposed to finance the compensation were proving inadequate to meet the shortfall in state revenues from GST. As a result, even after dipping into the surplus available in the compensation fund, accumulated when cess collections exceeded the revenue shortfall during the first two years of the GST’s existence, the Centre was short of resources adequate to meet the shortfall of the states in 2019-20. For that year, the required compensation pay out to the states worked out to Rs. 1.65 lakh crore. Collections from the cess in that year, on the other hand, stood at around Rs. 95,500 crore. This was an unexpected outcome because in 2017-18, during which year the GST regime was in place for 9 months, collections from the compensation cess amounted to Rs. 62,611 crore, while pay out to the states to cover revenue shortfall relative to target was only Rs. 41,146 crore. Similarly, in financial year 2018-19, cess collections were, at Rs. 95,081, crore well above the pay out of around Rs. 69,275 crore. Though the average monthly surplus declined from around Rs. 2,400 crore in the first year of the GST regime to around Rs. 2,150 crore in the second, the change was not of a magnitude that gave cause for concern.

These surpluses meant that at the beginning of financial year 2019-20 a sum in excess of Rs. 45,000 crore was available in the compensation fund, which seemed a comfortable buffer. With three years to go before the practice of compensating the states was to end, better implementation and minor tweaks to rates and categorisation would, it was presumed, allow the regime to fend for itself. All this, however, was well before the recession that overwhelmed the economy in 2019-20 adversely affected GST collections starting around August. Compensation collections in that financial year remained at around the previous year’s level, while the revenue shortfall of the states rose sharply, resulting in an average monthly deficit of close to Rs. 5,800 crore in cess collections relative to compensation requirement. That more than wiped out the surplus available in the compensation fund, necessitating transfer of a sum of Rs. 33,412 crore from the Consolidated Fund of India to the compensation funds, to meet the dues of the states. The Centre’s belief that the compensation cess would serve its purpose over the five years when its contribution was needed had proved wrong.

The message was clear. So long as growth was reasonable, the GST regime seemed to be on a trajectory where it can be put on a firm footing. But if growth slowed, the system needed life support. The compensation fund could prove inadequate even as a temporary five-year crutch till the system’s design was altered. Moreover, with signs that slow growth would be the new normal for the foreseeable future, this would also imply that the states would be substantially short of promised revenue growth once the five-year period over which the compensation was to be paid came to an end. It appeared that the Centre would have to make transfers from its own kitty to fully compensate the states for the next two years. In addition, it was likely to come under pressure from revenue-short states, through the GST Council, to continue with the compensation arrangement after its five-year term.

That was before the pandemic induced sudden stop in economic activity and subsequent developments that have resulted in the economic contraction (rather than slowing of growth) that is expected not just this year but possibly in the next as well. That would affect state revenues even more severely, increasing the shortfall relative to target. GST collections over April to July 2020 were, at around Rs. 2.7 lakh crore, more a third lower than that during the corresponding period of the previous year. It was true that collections were particularly low during the lockdown in April and May 2020, and as restrictions were lifted economic activity and collections were slowly recovering. But collections in July were lower than in June, suggesting that, overall, 2020-21 would be a particularly bad year for collections and the revenue shortfall of the states relative to the level warranted by a 14 per cent growth rate would be huge.

This is why the centre has decided to renege on its commitment to the states, claiming that its responsibility ends with transferring sums generated from the compensation cess to the compensation fund. After the statement by the Finance Secretary on the matter, came news that the Centre had referred the issue of finding an alternative to compensation payment to the Attorney General (AG). The AG has reportedly held that the central government was under no obligation to compensate states for any shortfall in GST collections, and that it was up to the GST Council to find a solution.

But the Centre must have a position, since it has a strong presence in terms of votes in the Counci. A majority in the Council may still decide that the Centre has the responsibility to cover shortfalls in state revenues. If transfers from the Centre to the compensation fund were not made, financing the compensation would require the GST Council to either agree to raise rates to enhance revenues and cover the shortfall or for the GST Council to recommend resort to borrowing to finance the short fall. Raising rates when economic activity is shrinking is clearly not a feasible option as it would only aggravate the demand compression that needs to be counteracted. More so, since the magnitude of the duty hike required to generate the revenue needed would possibly be large.

One suggestion from the Centre is that the GST Council itself can borrow to enhance the compensation fund, and the period over which the compensation cess is levied can be extended beyond the five year compensation period to mobilise the funds needed to service that debt. Besides the fact that this absolves the Centre of the responsibility of compensating the states, it also amounts to getting the states to accept that a chunk of additional resource mobilisation in the future would be reserved for servicing debt that finances shortfalls in the present. That would undermine the ability of the states to find ways of covering revenue shortfalls in the years when the compensation principle no longer holds. A third option is to provide states the leeway to borrow to cover their own shortfalls. But that would mean that the states would have to fend for themselves when servicing the cost of that debt in future when there is no compensation fund available to cover revenue shortfalls.

Not surprisingly the states are protesting against the Centre's decision in the midst of a crisis to renege on a commitment it had made. In the drive to persuade states to endorse the plan to migrate to a GST regime, the previous NDA government and its Finance Minister Arun Jaitley had made all kinds of claims about the way the GST would change the fiscal game. The states did need persuasion because the transition implied that they would be giving up the power they had to decide on the indirect taxes that they could set and levy. If each commodity was to be taxed at the same rate across the country, rates would be decided through compromise at the GST Council, and any change would have to be agreed upon there.

To convince the states that this was in their own interest, a projection made by central advocates of the GST was that the revenues from the new taxes would, at the minimum, grow by 14 per cent a year. To show that the Centre was confident that this prediction would prove right, it said that for the first five years the Centre would compensate the states for any shortfall in revenue growth relative to this minimal projection. There was the proverbial catch, however. The Centre extracted from the GST committee a decision that a special cess would be imposed to mobilise resources that would help finance this compensation, if needed. That obviously meant that there was no guarantee that in the first five years at least the projected revenue growth would be realised. If it did not, the states would lose out after those first five years, unless GST rates were tweaked and raised to ensure the promised growth rate in the post-compensation period. Moreover, there was no guarantee that the cess chosen to be levied would garner enough to finance the compensation. The states clearly saw this as the Centre's problem, at least for five years. The Centre it is now clear thinks it is merely a manager of the cess fund, with the adequacy of the tax a problem to be address by the GST Council.

The recent controversy makes clear that the states had been misled. Punjab Finance Minister Manpreet Singh Badal has in a letter reminded Union Finance Minister Nirmala Sitharaman that when pushing for the GST the Centre had provided "innumerable assurances" of "assured and unhindered compensation". The Centre has clearly chosen to renege on those assurances by hiding behind the argument that there is no constitutional requirement that the Centre should ensure compensation of state revenue shortfalls.

This controversy is a diversion from two trends that must be addressed by both the Centre and the state governments. The first is the evidence that the crisis faced by the GST regime predates the Covid-19 pandemic, the effects of which on the economy were felt only from April, or in the current financial year (2020-21). Even by March 2020, or at the end of three financial years after inception (in July 2017), it was clear that the GST regime was not delivering anywhere near the revenues it was expected to generate. Total monthly collections from state (SGST), central (CGST), and integrated (IGST) goods and services taxes and the compensation cess, first crossed Rs. 1 lakh crore in April 2018. Yet there have been only 9 out of the 33 months till March 2020 in which that mark has been exceeded in nominal terms. Further there have been only 4 months in which the figure has topped Rs. 1.05 crore. In sum, the picture is one of near stagnation in GST revenue growth, as opposed to the expected 14 per cent growth. GST collections rose from 5.8 per cent of GDP in July 2017-18 to 6.2 per cent in 2018-29 and then fell to 6 per cent in 2019-20, even though GDP growth slowed in the last of these years.

The second is that, since three years is time enough for a policy regime to stabilise, this inability to generate the expected increase in revenues from GST by the end of financial year 2019-20 points to the failure of the regime. So even if the Covid-19 induced crisis had not struck, the central and state governments needed to find ways to address that failure. The only possible solution seems to be a significant increase in tax rates across GST slabs. There is no guarantee that this would indeed be an intervention that would work. But even assuming it would, that solution involves imposing heavy burdens on all sections of the population that pay some set of indirect taxes, and therefore is intrinsically regressive. Even if not a failure in a purely fiscal sense, the GST would definitely be a failure from a welfare perspective. In all probability the GST regime would be a failure in both senses. Rather than tweaking the regime, it possibly is time to find ways of overhauling or replacing it.

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