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INDIAN FEDERALISM PERSPECTIVES

The Centre for Multilevel Federalism (CMF) was founded in 2010 to bring together scholars from different disciplines including political science, economics and sociology, public policy experts, lawyers, and journalists interested in the working of federalism in India. One of our strengths lies in the territorial spread of our network. Today we have over 60 members, working in different universities and research institutions in India as well as in other parts of the globe. With its distinguished international advisory board, the Centre has moved from strength to strength.

The Bharatiya Janata Party (BJP) led National Democratic Alliance promised to write a new chapter on centre-state relations when it came to power in 2014. It was supposed to inaugurate a new era of cooperative federalism marked by greater dialogue and consultation between different levels. The BJP like the Congress has been a "reluctant federalist" and it was surprising that it promised a radical restructuring of centre-state relations. Nearly seven years down the line, the centre continues to ride roughshod over the states and the party has used the strong-centre framework to strengthen itself. Given that the BJP is in power in most states, centre-state relations are probably being worked through intra-party channels bypassing conventional institutional mechanisms. However, this has not helped the non-BJP states.

In this issue of the IFP, Govind Bhattacharjee examines the working of the Goods and Services Tax (GST) until now. He underlines the point that the centre needs to be more accommodative of the needs of the states. While the present composition of the GST Council may allow the centre to get away the current practice is unlikely to set a good precedent. The states, especially, the non-BJP ruled states need to be taken on board and the GST Council has to be worked with care to ensure the success of the GST as well as the institutionalisation of the process.

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K K Kailash
01 February 2020

GST Council: A Breach of Trust?
Govind Bhattacharjee

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The 101st Amendment to the Constitution launched the Goods and Services Tax (GST). This new tax replaced seven indirect taxes and duties and 13 cesses by the Centre and seven indirect taxes collected by the states. The GST promised a common market by supplanting an antiquated, multi-layered, multi-point, multi-tax system circumscribed by an odious Inspector Raj. This "Good and Simple Tax" as the Prime Minister said was supposed to transform the industrial and economic landscape. Being transformational, it was necessarily disruptive, and even painful, especially for the unorganised informal sector. Three years down the line, however, much of the promises remain unfulfilled. There has been more disruption than transformation, and the promised Good and Simple Tax remains a dream.

The GST is Information Technology (IT) driven and was supposed to increase transparency, speed and efficiency and reduce corruption and leakages. However, since its inception, it has been riddled with glitches. For instance, even at its launch, chaos prevailed due to technical problems with the Infosys-built GST Network (GSTN) portal. Given the underlying complexity, the issues and glitches were not unexpected. It would be somewhat naïve to expect that the replacement of a highly fragmented and divided tax system by a unified system at one go would be smooth.

Given the glitches, an essential feature of the GST, preventing fraud and evasion – the provision of automatic matching of invoices of the buyer and the supplier - had to be sacrificed. The result is a proliferation of fraud and evasion by companies that vanish once they claim refunds based on fake invoices. Around 12000 cases have been registered, and 385 people have been arrested till date. To check fraud, the government has tweaked GST rules and regulations, but this has only made compliance more complicated.[1]

This is of course, not to undermine the positive benefits of the GST. The GST is one of the most ambitious and path-breaking economic reforms and comes after nearly three decades of negotiation and efforts. Among the countries that have attempted such reform, none can come near to India in terms of the complexity of federal structure, size and population, and the diversity and asymmetry between its constituent parts. It has eliminated multiplicity of taxes and cesses and brought down the rate of effective tax on most items. The ominous Inspector Raj and long queues of trucks at the state entry barriers are things of the past. While it has

hurt the informal sector, it has also nudged them to formalise. There have been around 40 lakh new registrations since its launch. Formalisation alone can give access to capital, skills and technology, and social security – presently all these are denied to the small dealers.

The architecture of the GST includes three Central legislations[2] and a federal dispute resolution body called the GST Council. The 101st Amendment also provided for compensation to be paid to the States for loss of revenue arising on account of the GST implementation; this necessitated the legislation of another Act of Parliament - the GST (Compensation to States) Act.

Besides, the States and Union territories with legislatures, viz. Delhi and Puducherry, have their own GST legislation for levying the State GST (SGST), collected by the Centre but assigned to the states. The distribution of the GST between the Union and the States are guided by the amended article 270(1A). Under the amended Article 269A(1), IGST is levied and collected by the Union and apportioned between the Union and the States as provided by Parliament by law based on the recommendations of the GST Council. The Centre cannot levy any surcharge on GST to appropriate it for Union's purposes.

The amended Article 279A provides for a Goods and Services Tax Council (GST Council) to examine issues relating to goods and services tax and make recommendations on parameters like rates, exemptions and threshold limits. The Council functions under the Union Finance Minister's Chairmanship and has the State Finance ministers as members. It provides that every decision of the Council shall be taken by a majority of 75 percent votes. While discharging the functions conferred by Article 279A, the GST Council shall be guided by the need to have a harmonised structure of the tax and develop a harmonised national market for goods and services. The GST Council is also required to establish a mechanism to adjudicate any disputes between governments and those arising out of its recommendations.

As regards the compensation, the GST (Compensation to States) Act, 2017 provides that Parliament may, by law, on the recommendation of the GST Council, provide for compensation to the States for loss of revenue arising on account of implementation of the GST (after taking into account the collections against SGST) for a maximum period of five years. The Act further provides that to calculate the compensation amount in any financial year, 2015-16, will be reckoned as the base year, from which revenue will be projected at a growth rate of 14% per annum for the five years. The base year tax revenue will consist of the states' tax revenues from State VAT, Central Sales Tax, Entry Tax, Octroi, Local Body Tax, Taxes on Luxuries, Taxes on Advertisements, etc., barring the revenues from alcohol and petroleum products. To fund compensation and make up for revenue losses under the GST, a clean energy cess is levied on coal at the rate of ₹400 per ton. A compensation cess levied on luxury and sin goods like cars, tobacco products and soft drinks to fund the GST Compensation Fund.

The IGST and the GST compensation have since become bones of contention between the Centre and the States. The IGST problem arises from the spillover of unadjusted amounts from one accounting year to the next. Accretion and apportionment of IGST would always be an ongoing process, but this was not recognised in the Act. Article 269A of the Constitution provides that GST on inter-State supplies and imports shall be levied and collected by the Union and apportioned between the Union and the States. This does not create a new tax, but only provides a mechanism for collecting CGST and SGST in the case of inter-state trade and imports.

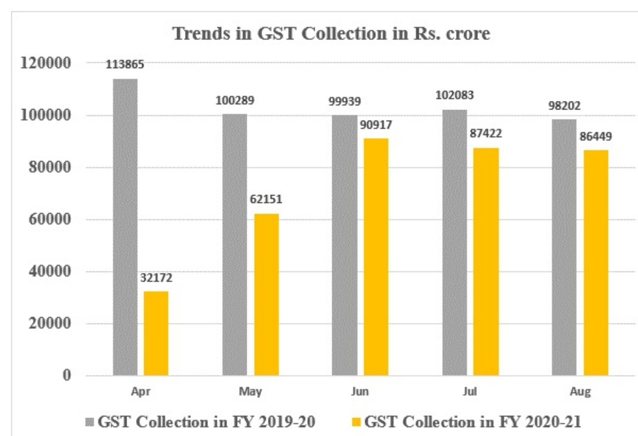
IGST thus is not a different tax – part of it goes to the Consolidated Fund of India as CGST, and the rest goes to the Consolidated Funds of the States where the supply of goods and services have occurred, as SGST. Pending their allocation, collections from the IGST are presently parked temporarily in the Consolidated Fund of India. The IGST Act does not provide for the eventuality that the collections from IGST may remain unapportioned beyond a year. In such a

case, the only viable alternative is to treat the entire unallocated amount as CGST and take it to the Consolidated Fund of India, pending final adjustments. Once treated as CGST, 42% of the net proceeds would automatically devolve to the States. More or less, the procedure is being followed, but there is a huge backlog that remains to be adjusted, depriving the states of their dues. The GST Council may facilitate this process, using powers under amended Section 25 (1) of the IGST Act which provides that the government will act according to the recommendations of GST Council in case of any difficulty till June 2022.

Most decisions in the GST council have been through consensus, and this has been cited as a shining example of cooperative federalism in a country where the Centre and the opposition-ruled states rarely see a middle ground. The only instance of voting was in the 38th meeting in December 2019, which proposed a higher single rate for lotteries. A total of 21 members of the GST Council voted in favour of a uniform rate; seven (including Kerala, Chhattisgarh, West Bengal, Madhya Pradesh, Maharashtra, and Puducherry) voted against; and three members abstained — paving the way for a single 28 percent rate instead of the existing 12 percent.

The voting rules require that every decision of the GST Council has to be taken by a majority of not less than three-fourths of the weighted votes of the members present. The central governmentgovernment's vote has a weightage of one-third of the total votes cast, and the votes of all the state governments taken together have a weightage of two-thirds of the total votes cast in any meeting. Of the 30 states and Union Territories, 17 are ruled by the NDA. This automatically makes voting an academic exercise only, unless the BJP's allies in the NDA switch sides. GST compensation is now threatening to destroy that fragile harmony by bringing fissures to the fore and in a much more severe manner. With low revenues and high debt, the precarious financial position of states is widening the divide between the Centre and the states.

Even before the pandemic, GST revenues were falling. The pandemic has wrought havoc and collections are nowhere near the last year's level. It has equally affected the Central finances, mainly its revenue from the GST itself as seen from the Chart below.



Source: PIB Press Release dated 01/09/2020

The payment to states is made from collections in the GST Compensation Fund. But the collections in the fund have often been inadequate. For 2019-20, the total compensation paid was Rs 1.65 lakh crore against the compensation fund collections of just Rs 95,444 crore, and the Centre had to tap the balance of cess from the previous years as well as Rs 33412 crore from the Consolidated Fund of India on account of IGST to meet the States' dues.[3] GST payments to states for the current fiscal have been pending since April 2020. Over Rs. 1.5 lakh crore of GST compensation is pending towards states for the period April-July, 2020, as the cess collected in the current financial year was insufficient to pay the dues. The actual collections under the fund now cover only half the monthly requirement of Rs 14,000 crore.

The issue of compensation cess is unlikely to be resolved in the foreseeable future. According to estimates by rating agency ICRA, nine states — Karnataka, Kerala, Gujarat, Maharashtra, Punjab, Haryana, Rajasthan, Tamil Nadu and West Bengal — would need 60,000-70,000 crore in the current financial year as GST Compensation. What makes it difficult is the unrealistically high rate of compensation pegged at 14 percent.

The then Finance Minister Jaitley had explained, "For each year, a 14 per cent increase is

guaranteed. Thus, with three 14 per cent increases compounded annually over the base year of 2015-16, this is close to reaching 50 per cent in the second year itself. It is almost an unachievable target." As against compensation of 14 percent, the overall growth in collections in the current year till October was only 2 percent.[5] The pandemic did not allow the state to make up for the shortfall by increasing their revenues from the few areas left to themselves – petroleum, alcohol, real estate and electricity. The shortfalls are primarily due to their primary revenue sources getting subsumed in the GST; e.g., Punjab used to get 25 per cent of its revenue from agriculture purchase tax, and infrastructure development tax and both got subsumed in GST. The shortfall percentages are very high for some states, as seen from the tale below. The Act does not deal with this unprecedented shortfall of compensation cess.

The inability to pay the GST dues was not just

State	Revenue Shortfall (%)[6]
Chhattisgarh	25
Puducherry	40
Punjab	36
Himachal Pradesh	35
Uttarakhand	32

Source: Dipak Mondal, "GST Shock for States", Business Today, GST Shock for States- Business News (businesstoday.in)

due to the economic morass triggered by the pandemic. The reduction in GST rates for many items had resulted in an inverted duty structure where the duty on the final product was less than the duty on the inputs, requiring higher refunds. The options before the GST Council were either to (1) rework the slabs or increase rates to correct the inverted duty structure; (2) increase the rates of compensation cess and expand the item base, or (3) allow the states to borrow more and repay the borrowing using future collections, that is, by extending the compensation cess beyond 2021-22.

Given the mayhem and the contraction of the GDP, the Centre was wary of raising or expanding the scope of the cess that might cause further job losses. The Centre thus had only two options: either allow the states to borrow or meet the shortfall from its resources which must come from its borrowings, with corresponding fiscal and monetary implications. Yields of government securities (G-Secs) will harden, putting pressure on interest rates across the economy; credit rating agencies also may view this negatively. Besides, with the fiscal deficit already having exceeded the full-year target of Rs 7.96 lakh crore, it was really a Hobson's choice for the Centre.

The Solicitor General opined that the Centre was not legally obliged to pay full compensation to the States. Armed with this advice, in the 41st GST Council meeting in August 2020, the Centre offered the states two options. It cited the unprecedented economic contraction and consequent revenue shortfall due to the pandemic as an "Act of God", to rescind its promise to pay the States compensation. The estimated shortfall of Rs 2.35 lakh crore in the current fiscal was divided into two segments through some accounting jugglery: Rs 97,000 crore on account of GST implementation and the rest due to revenue loss attributable to the Covid-19 pandemic.

Option-I allowed for an additional borrowing of Rs 97000 crore under a special borrowing window of the RBI at G-Sec-linked interest rates. This was to be repaid in full including interest from the compensation fund, without being counted as States' debt, while the rest Rs 1.38 lakh crore will be reckoned as States' debt. Option-II allowed states to borrow the entire shortfall from the market, of which only the principal will be paid from the compensation cess while the interest burden will lie on the States' shoulders. However, it appears that the Centre might allow the interest to be paid from the cess without creating any burden on the exchequer. The compensation cess will continue to be levied beyond FY22 till the States' debts get liquidated.

Under the Centre's stimulus package, States were given additional borrowing space by raising their borrowing limits from 3 to 5 per cent of GSDP. However, save 0.5 percent, the rest was available only on their implementation of various reform

measures like One Nation One Ration Card, Ease of Doing Business, power distribution, and augmentation of municipality revenues. Even the 0.5 percent was conditional upon achievement of the milestones prescribed in respect of the reforms. Option-I allowed the States to carry forward any unutilised borrowing space up to 1 per cent of GSDP unconditionally to the next fiscal. The Centre would coordinate the borrowing and bear the extra interest cost above the G-Sec yield through a subsidy. However, no such extra borrowing space would be available for Option-II; the total borrowing exceeding Rs 97000 crore will count as the States' liability. The interest would be decided by the market and not linked to G-Sec yields.

States are understandably furious at what they see as "betrayal" of the Centre, especially the opposition-ruled ones. They feel the distinction in the shortfall on account of GST implementation and the pandemic is "unconstitutional". In any case, they want the entire borrowing to be accommodated by increasing the borrowing limit. They are apprehensive that the borrowing would translate into "mortgaging of the future". States have a legitimate grouse because the delay in compensation payment has pushed their already precarious finances to the brink and because they get no share from the various cesses and surcharges levied by the Centre on items like petrol, diesel, education, health or social welfare.

However, 21 states - Andhra Pradesh, Arunachal Pradesh, Assam, Bihar, Goa, Gujarat, Haryana, Himachal Pradesh, Jammu & Kashmir, Karnataka, Madhya Pradesh, Manipur, Meghalaya, Mizoram, Nagaland, Odisha, Puducherry, Sikkim, Tripura, Uttarakhand and Uttar Pradesh having opted for the first option, the decision by voting was a foregone conclusion. The opposition ruled Jharkhand, Kerala, Maharashtra, Delhi, Punjab, Rajasthan, Tamil Nadu, Telangana, and West Bengal had initially rejected both options, but realising they have minimal options, fell in line one by one.

Understandably it was not an easy decision for the Centre, and it militates against the spirit of cooperative federalism. As regards borrowing by the States, there may not be much difficulty. The market is awash with liquidity with little demand for credit as evidenced by the FCI being able to raise a Rs 75000 crore loan at only 4.6 percent. Banks are flush with funds from the stimulus package which are being parked at the RBI at the reverse repo rate. But the Centre still can regain the States' trust by increasing their borrowing limits further to accommodate the entire Rs 2.35 lakh crore. In federal relations, trust is as vital as legality.

While denying the payment of GST compensation to the States and instead of asking them to borrow, the Centre may have been legally correct, but it must not be forget that the states had made an enormous sacrifice in surrendering their taxing powers while agreeing to implement the GST regime to make India a unified market based on what was promised to be a "Good and Simple Tax". The promise remains to be fulfilled. The GST council's latest decision may have driven an uncomfortable wedge between the Centre and the States. A unique federal institution without precedent, like the GST Council which could be instrumental in bringing convergence between the Centre and the states beyond politics, must not be allowed to become dysfunctional. To ensure that it survives and thrives as a true federal diadem, the Centre has much more responsibility than the states.

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Notes

[1]"GST Registration Norms Tightened", Times of India, New Delhi, December 24, 2020.

[2]Central GST (CGST) Act, Integrated GST (IGST) Act and Union Territory GST (UTGST) Act.

[3]In 2018-19, collections were ₹95,081 crores against the release of Rs 69275 crore, and in the first year of GST, collections amounted to Rs. 62596 crore against the release of Rs 41146 crore.

[4]GST Shock for States- Business News (business

today.in). Read here

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