GST, End of Compensation Regime and Stress on State Finances

No. 376
23-March-2022

R Kavita Rao

National Institute of Public Finance and Policy
New Delhi

GST, End of Compensation Regime and Stress on State Finances

R Kavita Rao

Professor, National Institute of Public Finance and Policy, New Delhi

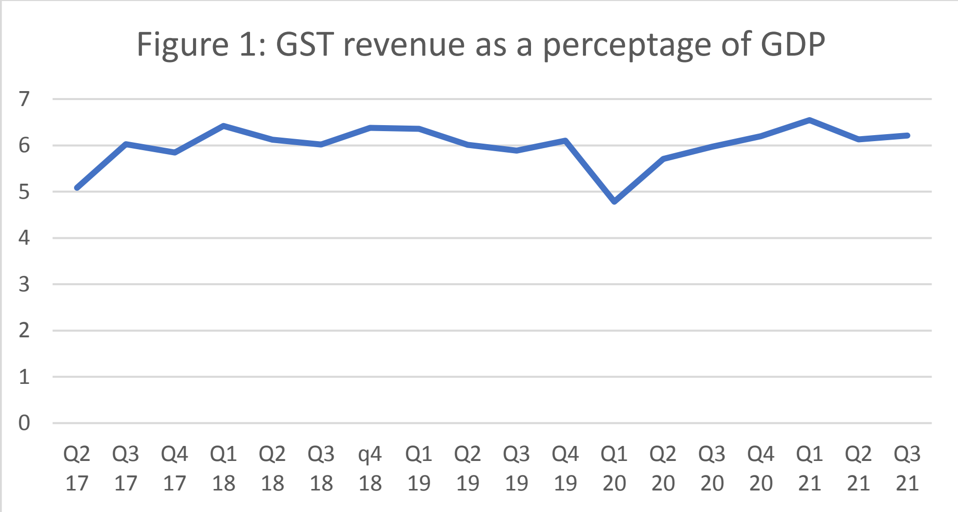
The introduction of GST in the country constitutes a major departure from the then existing regime of taxation of goods and services. Apart from a change in the structure and the level of taxes on different sectors, the change in regime also brought in a significant change in the operational autonomy of tax policy for both the Union government and the state governments. The expectation at the time of introduction of GST was for the regime to acquire stability and buoyancy within a few years. With this in mind, the Union government proposed to assure a reasonable growth in revenues for the state governments for a period of five years.

The period since the introduction of GST has been one of considerable turmoil in the economy. COVID 19 pandemic in its many waves has disrupted the economy and resulted in lower economic growth and slower growth in tax revenues. With the economic shocks, the revenue performance of the Union and States has been correspondingly poorer than in the pre-GST period. Further, the GST regime is soon going to complete five years in operation. Therefore, there are two big challenges the governments face in going forward: one, there is need to raise the level and the rate of growth of revenues to ensure that the regime provides adequate revenues in the medium term and second, in the short run, there is a potential shortfall of revenues for states which needs to be addressed in some manner to ensure short run viability. There is considerable discussion on the first aspect with a focus on the need for recalibration of the rates of tax for GST. The present note is an attempt to present the contours of the second challenge and explore options available to the GST Council on this front.

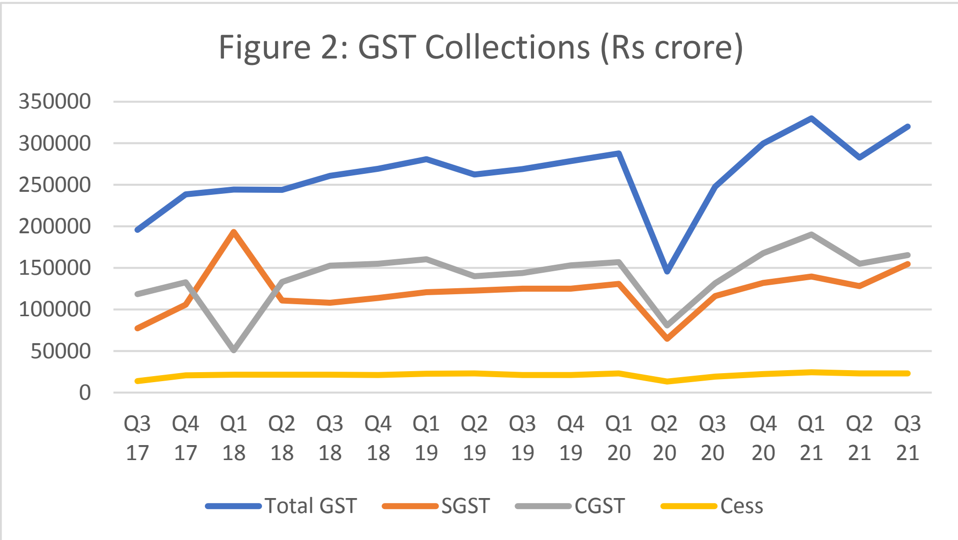
The paper is organised as follows: Section 1 highlights the differences in revenue performance of states pre and post GST alongside figures of GST compensation claimed by the states during this period. Section 2 explores the impact on GST revenues inclusive of compensation, once the current regime comes to an end. In particular, it identifies states which could experience a decline in revenue in 2022-23. In light of the challenges that states would face to find offsetting revenues, section 3 explores some alternative mechanisms for smoothing the revenue profile of the states.

1. Revenue Performance under GST

The volatility in economic activity in the country and the resultant volatility in revenue collections implies that in order to understand the revenue performance of GST, one cannot look at the gross collections per say. Figure 1 below presents the ratio of GST collections to GDP. As is evident from the figure, the ratio has remained around 6 percent or slightly higher for most of the period.

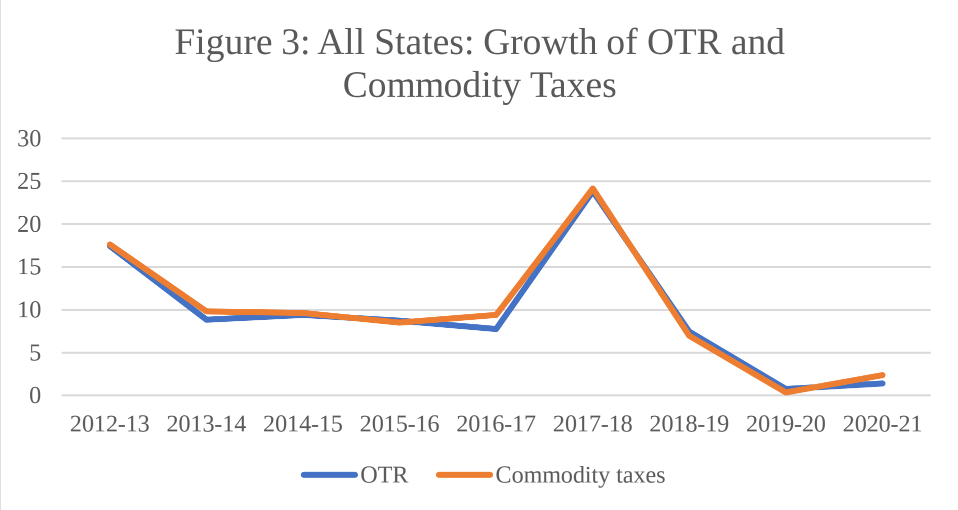


Trends in gross revenue collections in Figure 2 shows that the revenue from SGST including IGST settlement seems to be consistently lower than the revenue attributable to Union government (here defined as all GST revenue net of Cess and SGST with IGST settlement). Staggering of the settlement process can be one reason for this observed difference between revenues to Union and state governments.



Note: Revenue from GST compensation cess is kept separate from the other revenue collections.
Source: https://www.gst.gov.in/download/gststatistics

Turning to revenue collections for the states, it is illustrative to compare the growth in revenue collections pre and post GST. Given that the revenues attributable to the taxes subsumed in GST are not readily available for years other than 2015-16, a comparison of Own Tax Revenues (OTR) of the states taken together and revenues from taxes on commodities and services are presented as close approximations (Figure 3). It is evident that the average rate of growth prior to GST appears to be higher than that in the years subsequent to the introduction of GST.



Note: For all years data for accounts are used except for 2020=21, where RE is used.
Source: RBI State Finances data.

Further, as Table 1 shows, the average growth in revenue for taxes on commodities and services varies considerably across states. Two features are evident from this table. One, for some states, implementation of GST resulted in an increase in the average growth rate while in others, there is a decline when compared to the pre-GST period. Two, most of the major states report growth of less than 14 percent – the nominal growth assured by Government of India.

Table 1: Average Growth of Revenue from Taxes on Commodities and Services (Percent)

States with Lower Growth			States with Higher Growth		
	Pre GST	Post GST		Pre GST	Post GST
Bihar	13.3	11.2	**Andhra Pradesh**	2.0	6.7
Chhattisgarh	12.6	4.4	**Arunachal Pradesh**	18.4	34.6
Goa	10.5	3.4	**Assam**	10.2	12.5
Gujarat	8.6	7.2	**Manipur**	11.5	31.3
Haryana	11.8	7.9	**Meghalaya**	11.5	21.5
Himachal Pradesh	11.7	3.0	**Nagaland**	12.0	23.2
Jammu and Kashmi	11.0	10.4	**Tripura**	11.0	12.3
Jharkhand	13.8	11.1	**Uttar Pradesh**	10.7	11.3
Karnataka	12.6	3.3			
Kerala	11.6	2.1			
Madhya Pradesh	12.1	4.4			
Maharashtra	9.7	9.5			
Mizoram	21.1	18.3			
NCT Delhi	9.7	-1.2			
Odisha	11.2	9.8			
Puducherry	9.4	0.2			
Punjab	10.5	2.1			
Rajasthan	13.0	11.5			

	States with Lower Growth		States with Higher Growth	
	Pre GST	Post GST	Pre GST	Post GST
Sikkim	19.0	10.2		
Tamil Nadu	8.4	6.0		
Telangana	28.5	12.2		
Uttarakhand	14.4	-0.3		
West Bengal	14.1	8.0		

Notes: 1. Pre GST is the average growth over the period 2011-12 to 2016-17.
2. Post GST is the average growth over the period 2017-18 to 2020-21.
3. For Andhra Pradesh and Telangana, the pre-GST period is taken to be 2014-15 to 2016-17, given the reorganisation of erstwhile Andhra Pradesh.

Source: Computed using RBI State Finances database.

To get a sense of the extent of dependence of the states on the resources provided as compensation, Table 2 provides trends in total compensation paid to states by year along with total revenue states earned through SGST and IGST settlement. The table clearly shows that there is compensation dues have become quite large in comparison to the revenues generated through GST.

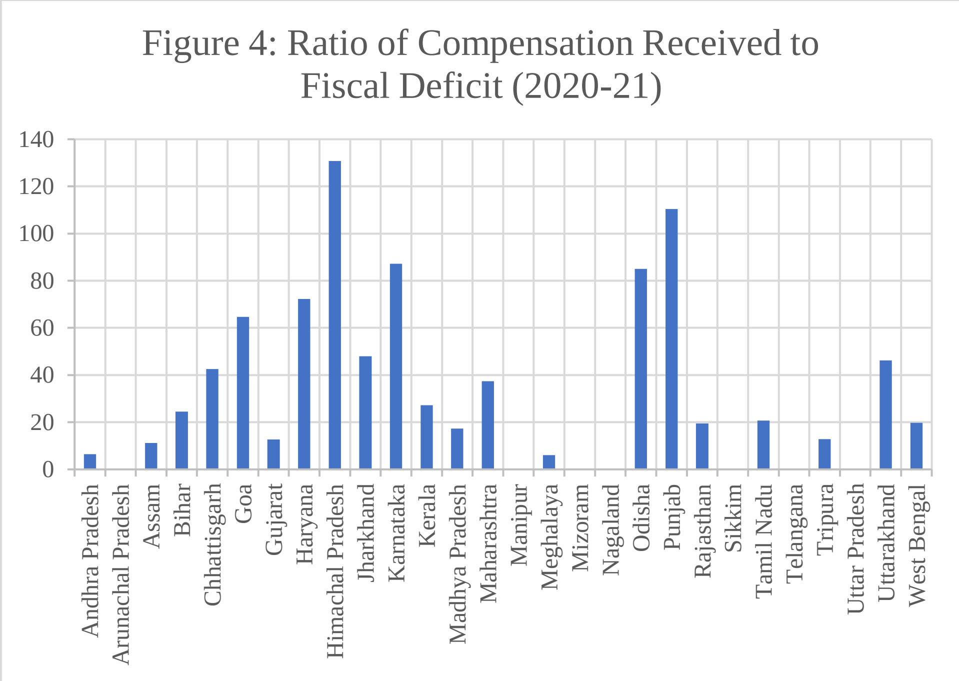
Table 2: GST Revenue and Compensation Received for all States together (Rs crore)

	Compensation Dues	Total SGST Revenue
2017-18	49276	376186
2018-19	81887	453736
2019-20	165302	503704
2020-21	287134	452398
2021-22	259000	548303

Note: Compensation dues for 2021-22 are estimates and Revenue for 2021-22 is upto February 2022.

Source: PIB press releases, https://www.gst.gov.in/download/gststatistics

To understand the dimensions of the role played by GST compensation in State Finances, Figure 4 below provides a comparison of the ratio of GST compensation received to fiscal deficit for 2020-21. The figure suggests that the size of the compensation is considerable and end of the compensation regime in the absence of any other measures could considerably affect the ability of states to maintain their spending programmes without taking recourse to expenditure compression in some way. The problem is more pronounced for states like Himachal Pradesh, Punjab, Karnataka and Odisha.



Note: Figure for compensation reported in the Revised Estimates for 2020-21 could be underestimated since some of the claims have been settled only in 2021-22. Some States have not reported compensation figures in the RE figures.
Source: RBI State Finances.

2. Projected Implications for State Revenues for the Year 2022-23

In an attempt to facilitate the adoption of GST, the Union government agreed to a proposal to provide an assurance in growth of revenue for the states for a period of five years from the date of introduction of GST. The assurance implied a 14 percent rate of growth of revenue for the states, with 2015-16 being the reference year. The compensation period however is coming to an end in June 2022. In other words, from July 2022, it is expected that the states would be on their own so far as GST revenues are concerned. What is the implication of this for state revenues from GST?

Using some assumptions, we attempt to present a picture of the likely scenario of states revenues from GST. The revenue collections currently available pertain to the period April 2021 to February 2022. Average of the levels achieved in the last six months was used as an estimate of the revenue for March 2022. With this assumption, we get an estimate of the likely revenue for 2021-22 for individual states.

Using the revenue from the basket of taxes subsumed in GST in 2015-16, as the benchmark and assuming at 14 percent growth annual growth in revenue, one can derive the amount of compensation due to individual states. These figures could be slight over-estimates since they do not take into account any revenues the states have earned from the subsumed taxes by way of resolution of disputes.

For the next financial year, there is a challenge. Compensation on account of shortfall in revenue is available only for the first three months. The likely revenue from GST for the states can be derived by using some assumptions on the rate of growth of revenue for the next financial year.

For states which did not require any compensation on revenues, the revenue for 2022-23 would merely be the rate of growth applied to revenues of 2021-22. On the other hand, for states which have needed compensation, revenue can be derived as follows:

$$GST_{i,t} = 0.25 * R_{i,t} + 0.75 * GST_{i,t-1} * gr$$

Where

$GST_{i,t}$ is the revenue from GST in the i^{th} state in the t^{th} year,

Gr is the rate of growth of GST revenue and

$R_{i,t}$ is the protected revenue for the i^{th} state in the t^{th} year.

$$R_{i,t} = R_{i,0} * (1.14)^{t+2}$$

where t=0 for 2015-16.

Table 3 provides two alternative scenarios for 2022-23 - one assuming rate of growth of revenue of 14 percent in 2022-23 and the second assuming a higher rate of 20 percent. In each case, the column titled "Estimated Revenue" is the revenue estimated for 2022-23 and the column titled "Shortfall" captures the shortfall with reference to the protected revenue for 2021-22. In other words, it captures the extent to which revenues in 2022-23 would be lower than those in 2021-22. The table shows that for a growth rate of 14 percent, 14 states would report a shortfall. As would be expected, with a higher growth in revenue of 20 percent, the number would decline to 10. The amount of shortfall too declines. In addition, another 8-10 states would record rates of growth of revenue of less than 10 percent.

Table 3: Estimates of Revenue Shortfall in 2022-23
(Rs crore)

	Scenario 1: Growth rate of 14 percent		Scenario 2: Growth Rate of 20 percent	
	Estimated Revenue	**Shortfall**	**Estimated Revenue**	**Shortfall**
Andhra Pradesh	28632	1819	29682	769
Arunachal Pradesh	1242	0	1307	0
Assam	12357	781	12810	328
Bihar	23479	4223	24299	3403
Chhattisgarh	12192	3957	12591	3557
Delhi	29058	7782	30035	6806
Goa	3631	1158	3750	1038
Gujrat	56692	6647	58726	4613
Haryana	29814	3617	30881	2550
Himachal Pradesh	6047	1930	6246	1732
Jharkhand	11845	2226	12258	1813
Karnataka	66044	13292	68330	11006
Kerala	29774	7148	30788	6135

	Scenario 1: Growth rate of 14 percent		Scenario 2: Growth Rate of 20 percent	
	Estimated Revenue	Shortfall	Estimated Revenue	Shortfall
Madhya Pradesh	27918	5730	28882	4765
Maharashtra	122925	9881	127403	5403
Manipur	1242	0	1307	0
Meghalaya	1330	67	1379	18
Mizoram	796	0	838	0
Nagaland	941	0	990	0
Odisha	20675	3578	21400	2853
Puducherry	1423	981	1462	943
Punjab	22320	9445	23018	8747
Rajasthan	33845	3818	35061	2602
Sikkim	715	0	752	0
Tamil Nadu	57520	7860	59567	5813
Telangana	34740	618	36038	0
Tripura	1528	203	1582	149
Uttar Pradesh	66528	6757	68930	4355
Uttarakhand	7984	2905	8241	2649
West Bengal	38381	5733	39740	4374

Source: Own estimates.

This is a challenging situation that needs to be addressed. States experiencing a fall in the revenue collections would be forced to curtail some of their expenses to make ends meet.

3. Options for Correcting this Situation

Broadly there are four kinds of options available to deal with the above challenge. These can be classified into short term and long term solutions. Some of these implications are discussed in this section.

a. ***Long term solutions***: Improving the revenue productivity of GST can be thought of as having three components – rationalizing the rates of tax to increase the weighted average tax rate, expanding the base for the tax by bringing within the tax base, activities which were hitherto excluded and improving administration to expand the coverage of the tax. There have been references to improved collections attributable to administrative measures by the central and state tax administrations in the current financial year.[1] These measures would contribute to improvements in revenue collection but the extent of improvement in revenue is not predictable.

i. Recalibration of GST rates: Increase in GST collections through recalibration of the tax rates and improvement in compliance through effective administration are required for the long term sustainability of the regime. As shown in a comparison of scenario 1 and scenario 2 in Table 3, if the growth of revenue increases, the

[1] https://indianexpress.com/article/explained/november-gst-collection-surge-explained-7650750/

number of states which would experience a decline in revenue would be smaller. The Report of the Fifteenth Finance Commission in its chapter on Resource Mobilisation highlights the observation that the weighted average tax rate under GST has declined from 14.4 percent at the time of introduction of GST to about 11.6 percent.[2] The GST Council has set up a Group of Ministers headed by the Chief Minister of Karnataka to "simplify rate structures, reduce classification related disputes and raise revenues".[3] Academic studies too have provided some opinions on this front.[4] A quick and ready calculation of the impact of increase in the weighted average tax rate from 11.6 percent to say 13 percent suggests a 12 percent increase in revenue. This in turn would leave only 6 states with revenue less than in the 2021-22. Raising rates of tax however could be a faced with political and economic challenges, especially given the context of a nascent recovery in the economy. For this reason, it can be considered a long term solution implemented in a phased or gradual manner. In implementing such a restructuring, increase in rate of tax can be moderated by keeping the CGST rate unchanged and allowing for increase of SGST alone, if the purpose is to provide some additional space to the states.

ii. Expanding the base for GST: While this is a very commonly discussed option in the debate on rationalizing the GST regime, there are limitations to this approach from the point of view of raising additional revenue. Briefly put, the major segments remaining outside the base for GST are certain petro products like petrol, diesel, crude and natural gas and alcoholic beverages for human consumption. Historically both the Union government and state governments have been dependent on the revenues raised from these sectors. At present, the rates of tax on these sectors are quite high. Bringing these goods within the ambit of GST can be visualized in two ways: first, only GST is applicable on these goods or second, a two- part tariff is put in place, like the present regime for tobacco products. Since the effective tax on these products is higher than the peak rate available within the GST regime, bringing them within the ambit of GST would result in a lower tax incidence and therefore reduction in the revenue collection. Electricity is one other activity which continues to remain outside the base of GST. While the tax rate on electricity is not very high, it is largely used as an input for many sectors in the economy. This feature of the sector underlines the need to bring it into the base for GST for reasons of improving efficiency of the GST regime, not to raise additional resources. In other words, expansion in the base through changes in the tax design does not offer much scope for raising the revenue productivity of GST.

b. ***Short term solutions:*** An alternative option can be to consider an extension in the compensation regime by a few more years. The purpose of the extension could be to safeguard the fiscal position of the states from being witness to a decline in revenue. Given the volatility in economic growth, assurances of high rate of growth of protected revenue

---

[2] https://www.rbi.org.in/Scripts/PublicationsView.aspx?id=19240, https://fincomindia.nic.in/ShowContentOne.aspx?id=9&Section=1

[3] https://gstcouncil.gov.in/sites/default/files/GoM-Dynamic/OM-GoM-on-Rate-Rationalization.pdf

[4] https://nipfp.org.in/publications/working-papers/1956/

might be considered unsustainable. An acceptable compromise in growth of protected revenue needs to be arrived at. This could protect the concerns of the states which face a decline in revenue or a very slow rate of growth of revenue. One such benchmark can be protecting the revenue to the extent of rate of inflation, i.e., if the expected rate of inflation is 5 percent, this could in turn be the rate of growth of protected revenue. Alternatively, the GST Council could seek to protect revenues with a moderately higher growth of say 8%. Table 4 below shows the number of states which would require compensation and the amounts of compensation payout for a period of five years, under alternative assumptions about revenue growth – 14 percent and 20 percent and growth in revenue to be compensated of 5 and 8 percent against the present rate of 14 percent. These estimates are presented as an aid to a discussion on the feasibility of such an alternative scenario. It is clear from the table, that the number of years for which the compensation would be required as well as the amount of compensation and the number of states requiring compensation falls quite sharply in most scenarios, expect scenario 3 which refers to the higher rate of compensation with a lower rate of growth of revenue.

Table 4: Estimated Consequences of Alternative Compensation Schemes (Revenue in Rs Crore)

	Last Year		2022-23	2023-24	2024-25	2025-26	2026-27
Scenario 1:	2029-30	Revenue	251885	204250	146729	85226	44771
ROGR 14 percent		No. of States	25	25	24	20	13
ROGC 5 percent							
Scenario 2:	2026-27	Revenue	216663	123551	44254	13716	3787
ROGR 20 percent		No. of States	25	24	14	7	2
ROGC 5 percent							
Scenario 3:	2029-30	Revenue	271209	252753	227199	193191	152042
ROGR 14 percent		No. of States	25	25	25	25	23
ROGC 8 percent							
Scenario 4:	2026-27	Revenue	235987	170333	91686	40187	16445
ROGR 20 percent		No. of States	25	25	20	13	7
ROGC 8 percent							

Notes: ROGR: ROG of Revenue,
ROGC: ROG of Compensation.
Source: *Ibid.*

Given that the timeline for the imposition of the Compensation Cess has been extended by another five years, for servicing the back to back debt to honour the compensation commitments, it is useful to examine whether this time period would be adequate eliminating the need for compensation. Table 5 shows evolution of net outstanding debt from back to back loans, assuming at 7 percent rate of interest on such loans. It should be noted that if the timeline for imposition of the compensation cess is extended to 2029-30, most of the scenarios discussed in here can be financed fully. This could be one alternative way to protect the revenues of the states. Further, this time frame is sensitive to the rate of growth of revenue. Work on the long term solutions alongside can provide the necessary boost to revenue, to ensure that the time period for extended compensation can be kept low.

Table 5: Net Outstanding Debt from Back to Back Loans (Rs crore)

	2021-22	2022-23	2023-24	2024-25	2025-26	2026-27	2027-28	2028-29	2029-30
Revenue from Cess	90442	103104	117538	133994	152753	174138	198518	226310	257993
Scenario 1	269208	436834	554124	605648	580516	491785	349377	158684	
Scenario 2	269208	382768	388780	299040	160003				
Scenario 3	269208	437313	572528	665733	706171	684075	511484	298566	46991
Scenario 4	269208	402091	454886	412580	300014	142321			

Note: Revenue from cess assumed to increase by 14 percent per annum.
Source: *Ibid.*

If the extension of compensation regime is not found to be suitable, a final option can be to explore alternative ways for states to raise revenues. While exploring beyond the scope of GST is outside the purview of this paper, it might be worth raising the possibility of allowing for a degree of flexibility in the rates of tax within the GST regime. While flexibility does bring in an element of complexity into the regime, it could relieve the Union government of its responsibility to ensure a minimum rate of growth of revenue to the states from GST.

MORE IN THE SERIES

- Datta, P., Dubey, J., and Choudhury, M., (2022). Progressivity of Public Spending on Health care at the Sub-state Level in India: An Empirical Investigation in Tamil Nadu and Bihar, W.P. No. 375 (March).

- Nayak, D.K., and Hazarika, B., (2022). Linkage between Income and Government Expenditure at Indian Sub-nationals: A Second-Generation Panel Co-integration Techniques, W.P. No. 374 (March).

- Banerjee, S., Sane, R., Sharma, S., and Suresh, K., (2022). History of disinvestment in India: 1991-2020, W.P. No. 373 (March).

R. Kavita Rao, is Professor, NIPFP
Email: kavita.rao@nipfp.org.in

NIPFP
National Institute of Public Finance and Policy,
18/2, Satsang Vihar Marg, Special Institutional
Area (Near JNU), New Delhi 110067

Tel. No. 26569303, 26569780, 26569784
Fax: 91-11-26852548
www.nipfp.org.in