Honour Jaitley's grand bargain on GST compensation for states

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The Centre should uphold its end of the deal with states as it would not only be more efficient but also help foster federalism

The last thing India needed at this time, when it is already facing crises on multiple fronts, is friction in Centre-state relations. Yet, relations between the Centre and states, especially those ruled by non-National Democratic Alliance political parties, are under severe stress. An impression has formed that the Centre is trying to wriggle out of its responsibility to compensate states for the shortfall in their goods and services tax (GST) revenues as per legally specified norms. A serious trust deficit has emerged.

The GST compensation scheme that India's then finance minister Arun Jaitley had negotiated gave an assurance to states—enshrined in the GST Compensation Act—that for a transition period of five years, the Centre would compensate states for GST revenues that fell short of the collections they would have got had the state taxes that GST subsumed grown at an annual 14%, starting with the base year. This offer was overly generous, since revenues from the taxes subsumed had not been growing at 14%. Jaitley, nevertheless, made that offer to bring states on board and roll out the GST. Arguably, it would be the most significant economic reform since the liberalization reforms of 1991. No less important, it would lay the foundation for an altogether new paradigm of Centre-state relations based on trust and cooperation.

The GST Compensation Act specified that the shortfall, if any, would be paid out of a GST compensation cess, which the Centre was authorized to levy. During the 7th and 8th meetings of the GST Council, it was decided that in the event of the cess proving inadequate to cover the shortfall, the council would decide on ways to raise additional resources, including borrowing from the market, to make up for the difference. It was also decided that such debt would be paid back from the proceeds of the compensation cess. The cess could be extended beyond the five-year transition period under clause 8(1) of the Act.

Following the lockdown in late March, states were hit by a double whammy. As frontline state governments battled the pandemic while also having to provide humanitarian relief to cushion the impact of an economic contraction, their expenditure requirements went up significantly. At the same time, their resources shrank dramatically on three counts: a decline in central tax receipts that reduced transfers to states from this divisible pool; a fall in the states' own tax revenues; and, most importantly, a slide in their state GST receipts.The shortfall to be compensated have shot up to an estimated ₹3 trillion. Meanwhile, receipts from the compensation cess have fallen to a mere ₹65,000 crore, leaving a large gap of ₹2.35 trillion.

Such an eventuality had been anticipated as a possibility. The Centre has now proposed two options. Splitting the shortfall into two parts; it claims that only ₹97,000 crore is attributable to GST implementation problems and the balance ₹1.38 trillion is attributable to the economic contraction. Hence, under Option I, the Centre proposes a special Reserve Bank of India window to provide concessional loans to states of up to ₹97,000 crore, for which the principal and interest will be paid out of the compensation cess. The borrowing limits of states will also be relaxed by an additional 0.5% of gross state domestic product for this purpose. Under option II, the Centre will facilitate market borrowings by individual states to immediately cover their entire share out of the ₹2.35 trillion. However, apart from the higher cost of market loans, under this option, the compensation cess will only be usable to repay the principal, not the interest.

The partition of the shortfall into two parts and the unequal treatment of the financing of the two may not be legally sustainable, since the Compensation Act only refers to the total shortfall. Further, it is inexplicable why the central government is nudging states towards option I by making it more attractive. Option I would minimize present borrowing and spending by the states, though it is now that they need to urgently raise spending to fight the pandemic and provide humanitarian relief. Such spending will also help stimulate demand and thus an economic recovery. It is equally inexplicable why the Union government is pushing states to borrow, rather than doing so itself, since ultimately it will be taxpayers who will foot the bill through an extended compensation cess. As Vijay Kelkar and Ajit Ranade have argued, there are compelling reasons for the Centre to do the borrowing (Indian Express, 1 September 2020). Unlike states, the Centre has multiple options to raise domestic or foreign loans, including multilateral loans. Second, it can borrow at a lower cost than states can. Third, it was the central government which had imposed the lockdown that triggered the severe contraction of India's economy. The Centre, therefore, must bear the moral responsibility of dealing with its consequences, especially since it is constitutionally responsible for maintaining macroeconomic stability. Fourth, and most importantly, reneging on a legally-mandated commitment will have the effect of destroying the grand bargain forged by Jaitley that enabled the GST roll-out to begin with. It could also destroy the foundation of trust between the Centre and states that underlies the new paradigm of cooperative federalism he sought to institute.

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