How can Centre fund compensation to States with GST rate at RNR?

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The Constitutional Amendment Bill to roll out the Goods and Services Tax (GST) [GST Bill] will perhaps be the main agenda of the Rajya Sabha in the ensuing Monsoon Session of Parliament. The Bill has already been passed by the Lok Sabha.

GST will be a destination based consumption tax wherein the State where the goods (similarly for services) are consumed gets the right to get the tax rather than the State in which the goods are produced. This paradigm is different from the current regime wherein the producer or origin State gets the revenues. So the consumer States (i.e. where the aggregate production is lesser than aggregate consumption) such as Bihar, West Bengal, Orissa, etc. are likely to get additional revenues with the roll out of GST, whereas the producer States such as Maharashtra, Gujarat and Tamil Nadu are likely to lose revenue. This is essentially a zero-sum game with the gain by consumer States due to this shift being equal to the loss of producer States. While the consumer States will naturally seek to retain their gains, the producer States are seeking their losses to be compensated by the Centre. Though Maharashtra and Gujarat have now fallen in line, Tamil Nadu still has a serious concern about this revenue loss. Tamil Nadu even submitted a dissent note to the Select Committee of the Rajya Sabha on the GST Bill seeking 100% compensation for the loss for not less than five years.

However, we need to keep in mind that there will be significant revenue gain to the States from taxation of services (only Centre has been taxing services so far) and this gain needs to be netted against the revenue loss from the aforesaid shift from origin to destination based taxation of goods to arrive at the compensation figures. The producer States are also the highest consumers of services, in general.

The Select Committee has recommended compensation for a period of five years (earlier the provision read that the compensation may be for such period which may extend upto five years). Accordingly, the GST Bill *inter alia* seeks to empower Parliament to make law to provide for compensation to the States for the loss of revenue arising from implementation of the GST for a period of five years, on the recommendation of the GST Council.

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So in the first five years of implementation of GST, the Central Government will not only need to raise revenues for its own requirements, but also to compensate the producer States for the loss of revenue on account of agreeing to implement GST. Has any firm estimate been worked out of the amount of compensation which may be required to be paid by the Centre? Unfortunately, no! Not so far. Apparently the Think Tanks do not think they should give such inputs! Or is it because they think that the figure involved will be high enough to be a dampener?

If we gross up for the devolution (currently at 42%) based on the Finance Commission recommendations, the actual revenue requirement of the Centre for paying the compensation would be significantly higher (by 2.38 times for current devolution rate). So if the actual revenue loss to be compensated to the States is say INR 17,000 crore, the additional revenue requirement of the Centre will be about INR 40,000 crore!

Where will this additional Rs. 40,000 crore of revenue come from? The discussion as of now is only to levy GST at a Revenue Neutral Rate (RNR) which will preserve the current revenues (both Centre and States) generated from the existing levies which are to be subsumed in the GST. Strictly speaking, the compensation to be paid to the States will be an additional outgo for the Centre and hence will not be covered by the RNR.

Of course, the vanilla route to funding the compensation would be either of the two options - either reduction in Centre's own expenditure or deficit financing to be funded through additional borrowings! Neither of these options may be good from the public finances perspective. But this will take us to the fiscal responsibility and budget management (FRBM) issues which we shall discuss elsewhere!

However, I see that the Centre may not even have to resort to any of these two options. Let us not forget that the Centre will actually be getting a big revenue gain in the form of the countervailing duty (CVD) imposed on imports into India!

CVD is levied to counter-balance the excise duty paid on manufacture of like goods in India. No CVD is leviable on imported goods if like domestic goods are exempt from excise duty. Moreover, there are also several cases of standalone CVD exemptions, i.e. where no excise duty exemption is available for like domestic goods. Both these kind of CVD exemptions give rise to negative protection to domestic manufacturing industry. Imported goods are generally zero-rated in the source country and hence are not burdened by any embedded input taxes, whereas the domestic manufacturers are not eligible for input tax credit in view of the exemption for their final products. The negative protection gets accentuated further if we take into account the similar dispensation prevailing in respect of the sales tax and other taxes suffered by domestic goods.

The negative protection on account of CVD exemptions has been quantified at 6% or Rs. 40,000 crore in the Economic Survey 2014-15 (Box 1.4). According to the Survey, an exemptions-free GST is the solution to overcome this burden both on the Fisc as well as the domestic manufacturers. The Arvind Subramanian Committee on RNR has also stressed on this aspect in paras 2.18 to 2.27 of its Report.

So the introduction of GST should in effect result in about Rs. 40,000 crore additional CVD revenue to the Centre without in any way impacting the RNR! Of course, some part of such CVD may be taken as input tax credit and hence the net impact on the Central revenues may still need to be worked out.

But what we see is that in one stroke, GST will both give significant extra revenue to the Centre to compensate the States as well as give a big boost to the make-in-India campaign. Perhaps one more strong reason for the Indian manufacturing industry to welcome GST! A real win-win situation for both the Government and the industry!

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