

GST COMPENSATION OPTIONS

This paper describes the two options mentioned at the GST Council meeting on 27th August 2020, with a view to enabling the States to give their preference and views thereon within seven working days. Certain background information as furnished in the Council meeting is appended in Annex 1.

After the scheme is finalized, the states can chose either Option 1 or Option 2 and accordingly their compensation, borrowing , repayment etc will be dealt as per their individual choice. The options are applicable **only for the shortfall occurring in the current financial year.**

BACKGROUND AND LEGAL POSITION

Legal position

The Constitution (101st Amendment) Act 2016 contains the following provision:

*Parliament shall, by law, on the recommendation of the Goods and Services Tax Council, provide for compensation to the States **for loss of revenue arising on account of implementation of the goods and services tax** for a period of five years (emphasis added)*

In pursuance of this provision, Parliament enacted the Goods and Services Tax (Compensation to States) Act 2017. The preamble of this Act reads as follows:

*An Act to provide for compensation to the States **for the loss of revenue arising on account of implementation of the goods and services tax** in pursuance of the provisions of the Constitution (One Hundred and First Amendment) Act, 2016 (emphasis added).*

The said Act provides in Section 7 the detailed mechanism for calculation and payment of compensation to the States. In essence, the compensation payable is the projected revenue (at a compound growth rate of 14% from the base figure of 2015-16) minus the actual revenue in each period.

The Constitution and the preamble to the Act lay out the spirit and purpose of the GST compensation: namely that it is to compensate states for loss of revenue “**arising on account of implementation of GST**”. The wording of the Constitution and statutory preamble make it clear that the spirit of the

law is not to compensate states for all types of revenue losses, but rather for that loss arising from GST implementation.

This year the Indian economy, nay the global economy, is suffering from an exogenous shock, namely the Covid-19 pandemic, whose scope and scale is unprecedented in history.

Parliament obviously could not have contemplated a historically unprecedented situation of huge losses of revenue from the base—arising from an Act of God quite independently of GST implementation—affecting both Central and State revenues, direct and indirect.

Nevertheless, the operative sections of Section 7 do not make such a distinction. Compensation is payable for the entire shortfall (even if it is not on account of GST implementation). This position has been clarified by the Attorney General and **is accepted by the Central Government.**

The manner of payment of compensation is also prescribed under the Act in Section 10. Compensation is to be paid out of the non-lapsable GST Compensation Fund. As per Section 10(1), the inflows to the Fund are from the GST Compensation Cess levied under Section 8 of the Act and “such other amounts as may be **recommended by the Council**”. There is no provision for any amount other than Cess to be credited except based on recommendations of the Council. Section 10(2) provides that all compensation payable under Section 7 “shall be paid out of the Fund”.

It has been clarified by the Attorney General that the Act does not require the Government of India to bear the liability of making good the shortfall and that it is the GST Council which has to decide on making good the shortfall.

In short the correct legal position is that:

- (i) The states are entitled to compensation as per the method provided in Section 7 for the transition period, regardless of the cause of the shortfall
- (ii) However, compensation is to be paid only from the Compensation Fund and it is not an obligation of the Government of India in the event of a shortfall
- (iii) It is for the GST Council to decide on the mode of making good the shortfall.

- (iv) To the extent the shortfall is not made good, the States would still be eligible to get it in arrears after the transition period through extension of the Cess, if so decided by the Council.

EARLIER DISCUSSIONS ON RESPONSIBILITY FOR SHORTFALL IN GST COUNCIL & PARLIAMENT

The possibility of a shortfall was **anticipated even at the time of the contemplation and passing of the relevant legislation.**

During the discussions in the 5th GST Council meetings held on 2nd/3rd December, 2016, the 7th GST Council meeting held on 22nd /23rd December, 2016 and the 8th GST Council meeting held on 3rd /4th January 2017, the relationship between compensation and compensation cess was extensively discussed. Several states raised the point that the obligation to give compensation should not be restricted to the amount of compensation cess and in case of any shortfall, the shortfall should be made good by the Centre.

In the 7th Council Meeting held on 22-23 December, 2016, the then Chairperson Shri Arun Jaitley, while expressing the commitment to provide full compensation, stated that

“the demand for payment of compensation from the Consolidated Fund of India essentially meant funding compensation from Income Tax or non-tax revenues of the Central Government, which would be a challenge as the Central Government also had its own committed expenditure. He said that based on these considerations, certain principles had been agreed upon, namely that the compensation would be funded out of the cess mechanism, which would have a pool of revenue and if there was any shortfall in this pool, it could be supplemented by some mechanism that the Council might decide”[Para 21].

Therefore, it is very clear from the deliberations of the Council that the compensation had to be paid out of the Compensation Fund and not the Consolidated Fund of India. This issue was again raised in the 8th meeting held on 3-4 January, 2017, wherein the Chairperson stated that

“.....in case the amount in the GST Compensation Fund fell short of the compensation payable in any bimonthly period, the GST Council shall decide the mode of raising additional resources including borrowing from the market which could be repaid by collection of cess in the sixth year or further subsequent years”.
[Para 23 (iii)].

The Government of India (GOI) stands by the statement of Shri Jaitley and is actively working with the States to work out such an arrangement.

The issue of Government of India's responsibility for meeting any shortfall was also explicitly brought up in Parliament, where an amendment had been tabled seeking that compensation be paid from the Consolidated Fund of India. Hon'ble Member of Parliament Shri. K.C. Venugopal (Alappuzha) moved the following amendment:

"The compensation to the States for loss of revenue arising on account of implementation of the Goods and Service tax shall be paid from the Consolidated Fund of India"

The said amendment was **voted on and negated**. Hence this was a conscious decision of the legislature that compensation shall not be from the Consolidated Fund of India. There is no scope for ambiguity about the legislative intent.

In short:

- (i) The legal position as set out above regarding the role of the Government of India is not a new or fanciful interpretation of the law. It is the correct and proper interpretation which was **thoroughly discussed in the GST Council and in Parliament before the relevant legislation was passed.**
- (ii) The **Government of India is committed to implementation of the Act in letter and in spirit—in letter by adhering to the legal provisions and in spirit by honouring the commitment made by the former Chairperson in regard to the manner of meeting the shortfall.** In accordance with this commitment, certain options for borrowing are presented here. The Government of India **will support extension of the Compensation Cess for such period as may be necessary to completely discharge any arrears of compensation.**

Ways of Meeting the Shortfall:

The prevailing economic situation is such that Central revenues are under greater strain than GST revenue. While indirect taxes are linked to transactions, and recover in proportion to activity, direct taxes on profits are disproportionately reduced in the present situation. Direct taxes on wages and

salaries are also seriously affected. Customs revenues are also hit by the slowdown in imports. Central expenditures are stretched not only by the pandemic response but also by the needs of national security. This is a national problem not a Central Government problem alone.

As such the only practical way forward is based on the statement of the former Chairperson mentioned earlier, namely by borrowing and then repaying the borrowing by extension of cess beyond the fifth year.

The question arises of who should borrow. The notion of borrowing by the GST Council is not practically or legally feasible or desirable. This leaves the options of Central or state borrowing.

The Government of India faces a very large borrowing requirement this year. Additional borrowing by the Centre influences the yields on Central government securities (g-secs) and has other macro-economic repercussions. The yield on G-secs acts as a benchmark for State borrowing as well as private sector borrowing. Hence any rise in Central borrowing costs ipso facto drives up borrowing costs for all borrowers, including not only the States but also the entire private sector.

On the other hand, the yields on State Government securities do not directly influence other yields and do not have the same type of macro-economic repercussions. Hence it is in the collective interest of Centre and States, and in the interest of the nation and of all economic entities including the private sector, not to do any avoidable borrowing at the Central level when it could be done at the State level.

Borrowing by states typically incurs a higher interest cost than borrowing by the Centre. **The Government of India is conscious of this and has factored this below, with a view to protecting the states so that they are not adversely affected.**

Option 1

- I. The shortfall **arising out of GST implementation** (calculated at Rs. 97,000 crores approximately) will be borrowed by States through issue of debt under a Special Window coordinated by the Ministry of Finance.
- II. It will be the endeavour to ensure steady flow of resources similar to the flow under GST compensation on a bi-monthly basis.

- III. The GOI will endeavour to keep the cost at or close to the G-sec yield, and in the event of the cost being higher, will bear the margin between G-secs and average of State Development Loan yields up to 0.5% (50 basis points) through a subsidy.
- IV. A special borrowing permission will be given by the GOI under Article 293 for this amount, **over and above any other borrowing ceilings eligible under any other normal or special permission notified by Department of Expenditure.**
- V. In respect of Union Territories (including National Capital Territory), suitable arrangements to ensure flow of resources under the Special Window to them would be made by the Government of India
- VI. The interest on the borrowing under the Special Window will be paid from the Cess as and when it arises until the end of the transition period. After the transition period, principal and interest will also be paid from proceeds of the Cess, by extending the Cess beyond the transition period for such period as may be required. **The State will not be required to service the debt or to repay it from any other source.**
- VII. States will also be given permission to borrow the final instalment of 0.5% (originally intended as a bonus for completing at least three of the four specified reforms) allowed in para 4 of the Department of Expenditure's OM F.No. 40(06)/PF-S/2017-18 dated 17-5-20 (hereinafter referred to as DOE OM) even without meeting the pre-conditions. This will enable borrowing of approximately Rs. 1 lakh crores in aggregate.
- VIII. The first instalment of 0.5% unconditional borrowing permission granted vide para 4 of the DOE OM remains unaffected. The reform-linked tranches specified in paras 5 to 8 of that OM also remain unaffected.
- IX. In modification of para 9 of the DOE OM, States will be able to carry forward unutilised extra borrowing ceilings given under that OM to the next financial year; the instalments under para 4 (0.5 unconditional + another 0.5 as per para VII above) can be carried forward unconditionally; the reform-linked portions can be carried forward if the States meet the reform criteria within the dates already prescribed for this year.
- X. The borrowing under the Special Window **will not be treated as debt of the State** for any norms which may be prescribed by the Finance Commission etc.

- XI. The Compensation Cess will be continued after the transition period until such time as all arrears of compensation for the transition period are paid to the States. The first charge on the Compensation Cess each year would be the interest payable; the second charge would be the principal repayment. The remaining arrears of compensation accrued during the transition period would be paid after the interest and principal are paid.

Option 2

- I. The entire shortfall of Rs 235,000 crores (including the Covid-impact portion) may be borrowed by States through issue of market debt. The GOI will issue an OM committing to repayment of principal on such debt from Cess proceeds as per para IV below.
- II. Appropriate enhanced special borrowing permission will be given by the GOI under Article 293 based on the following methodology, in modification of scheme notified earlier under the DOE OM:
- a. Each state's borrowing limits for the year will be based on the following calculation:
- Basic eligibility (3 % of GSDP) + Amount allowed for shortfall as per Item I above of Option 2+ up to 1% of GSDP (reform-linked as per paras 5 to 8 of DOE OM)
- or
- Basic eligibility (3% of GSDP) + 1% of GSDP + up to 1% of GSDP (reform-linked as per paras 5 to 8 of DOE OM)
- whichever is higher.
- b. The additional unconditional borrowing limit of 0.5% and the final (bonus) tranche of 0.5% under para 4 of the DOE OM will not be separately available, being subsumed under the calculation above.
- c. States will remain eligible for the reform-linked tranches of borrowing under paras 5 to 8 of the DOE OM this year but shall not be eligible to carry them forward. The maximum amount which can be availed under that OM shall stand reduced to 1% of GSDP instead of 2% of GSDP.
- III. The interest shall be paid by the States from their resources.

- IV. The principal on the amount under Item I above will, after the transition period, be paid from proceeds of the Cess. **The States will not be required to repay the principal from any other source.**
- V. To the extent of the shortfall arising due to implementation of GST (i.e. Rs. 97,000 crores approximately in aggregate) the borrowing **will not be treated as debt of the State** for any norms which may be prescribed by the Finance Commission etc.
- VI. The Compensation Cess will be continued after the transition period until such time as all arrears of compensation for the transition period are paid to the states. The first charge on the future Cess would be the principal repayment. The remaining arrears of compensation accrued during the transition period would be paid after the principal is paid.

Annex 1: Background Information

1. As per Section 7 of the GST (Compensation to States) Act, 2017, the States are required to be compensated for loss of revenue due to implementation of GST (w.e.f. 01.07.2017) for 5 years' period. For the purpose of paying such compensation to States, as per section 8 of GST (Compensation to States) Act, 2017, there is provision for levy of cess on certain luxury items and demerit goods and this cess collected is to be credited into a Public Account known as GST Compensation Fund and bi-monthly payment of GST Compensation to States is released from Compensation Fund during transient period.
2. As per Section 10(2) of this Act all amounts payable to the States under Section 7 shall be paid out of GST Compensation Fund.
3. Taking into account the adequate Cess collection during FY 2017-18 & 2018-19, regular GST compensation has been released to the States and certain amount of Cess remained unutilized during these years. However, the cess collected during FY 2019-20 has not been sufficient for GST Compensation payable to States/UTs for the year. The total amount of compensation released provisionally for the year 2019-20 is ₹ 1,65,302 crore whereas the amount of cess collected during the year 2019-20 was ₹ 95,444 crore. To meet this excess release of ₹ 69,858 crore during the year 2019-20, Centre had transferred ₹ 33,412 crore from Consolidated Fund of India to the Compensation Fund as a part of an exercise to apportion balance of IGST pertaining to 2017-18 and the rest came from the unutilised cess balance during the FY 2017-18 & 2018-19 and current year cess collection as well.

Compensation Cess collected and compensation released

(Figures in ₹ Crore)

	2017-18	2018-19	2019-20	2020-21	Total
Compensation Cess Collected (Net)	62,612	95,081	95,444	21,355	2,74,492
				(till July'21)	
Compensation released	41,146	69,275	1,20,498	65,546	2,96,465
			(till Nov'19)	(till Mar'20)	

Balance	21,466	25,806	(-25,054)	(-44,191)	(-21,973) ¹
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4. Further, the likely monthly cess collection of less than ₹ 8,000 cr per month after 30th June, i.e. on opening of Economic Activities after Covid-19 pandemic, is not sufficient to meet the requirement of GST compensation liability and therefore, there is a need to discuss ways and means to fill the gap between the compensation requirement and compensation cess collection.

5. This issue was discussed in the 41st GST Council meeting held on 27th August 2020. The GST Council took note of the fact the projected shortfall for the current year would be of the order of ₹ 3 lakh crore. Against this shortfall, the compensation cess available during the year would be only ₹ 70,000 crore leaving an unmet shortfall of ₹ 2.3 lakh crore.

6. It was also presented before the Council that part of this shortfall can be attributed to **implementation of GST** and a part to COVID-19. To project the loss of revenue due to implementation of GST, it would be prudent to assume that in absence of impact of the pandemic, the post settlement GST revenues of the States would be an increase of about 10% over the post settlement GST revenues of 2019-20. The table shows the calculation of the revenue and compensation gap.

		₹ crore
1.	Protected Revenue (Apr-Jan)	6,38,339
2.	2019-20 SGST (Apr-Jan)	4,30,147
3.	2020-21 SGST (Apr-Jan projected) [10% over (2)]	4,73,161
4.	Revenue Gap [(1)-(3)]	1,65,178
5.	Estimated Compensation Cess available in 2020-21[(a)+(b)]	68,700
	(a) Balance as on 31.07.2020	11,438
	(b) Estimated collections till March	57,266
6.	Estimated Compensation Shortfall [(4)-(5)]	96,477

¹Taking into account the amount ₹ 33,412 crore transferred from the Consolidated Fund of India to Compensation Cess Fund as a part of an exercise to apportion balance of IGST pertaining to 2017-18, the cess balance available in CFI as on 31st July, 2020 is ₹ **11,438 crore**

Annex 2: Opinion of the Attorney General of India

Taking into account the shortage of cess collection during current FY, Central Government has sought the legal opinion of Ld. Attorney General of India on 5 points on the issue of release of GST compensation to States vide note dated 01.06.2020 and the point-wise summary of opinion given by Ld. Attorney General is as under:–

(i) In case the balance in the Goods and Services Tax Compensation Fund is not adequate to meet the compensation payable under Section 7, are the States still entitled to receive the full amount of compensation calculated as per the provisions of the Goods and Services Tax (Compensation to States) Act, 2017?

Opinion – The States are entitled to receive the full amount of compensation during the “transition period”, in accordance with the provisions of the Act, irrespective of shortfall.

(ii) In case the balance in the Goods and Services Tax Compensation Fund is not sufficient, is there an obligation on the Centre to meet the shortfall wholly or partly?

Opinion–There is no express provision in the Compensation Act for the Government of India to bear the liability of making good the shortfall. It is the GST Council which has to decide on making good the shortfall in the GST Compensation Fund, by providing for sufficient amounts to be credited to it.

(iii) What are the options before the GST Council, Union and States to meet the said shortfall? Can the GST Council recommend extension of period during which the compensation for the transition period can be paid to the States in terms of Section 8?

Opinion – No provision exists in the Compensation Act for extending the period of five years for payment of compensation to the States. Section 8(1) would only entitle an extension in regard to the period of the levy and collection of the Cess, beyond the period of five years, if the Council so recommends.

AG has further clarified that:

Where, on account of extraordinary circumstances causing a steep fall in GST revenues and a shortfall in the Fund, the states cannot be paid full compensation during the transition period, the shortfall in the payment of compensation could be made up even after the transition period of 5 years. Of course, a recommendation by the GST Council extending the levy and collection of the cess beyond 5 years under Section 8(1) of the Act, would require a decision by a three-fourth majority of the weighted votes.

(iv) Can the States borrow on the strength of the future receipts from the Compensation Fund to meet the compensation gap either fully or partially?

Opinion – Clause (2) of Article 292 authorizes Parliament to make loans to a State, subject to any limit which may have been fixed by law made by Parliament. The entitlement of a State to borrow is set out in Article 293(1). The limitation on such right is found in Clause (3), which prohibits a State from raising any loan, without the consent of the Government of India, “if there is still outstanding any part of a loan which has been made to the State by the Government of India.”

(v) Can the GST Council recommend or request the Centre to consider allowing States to borrow money to meet the compensation gap either fully or partially?

Opinion- The GST Council can, in the exercise of its duties under article 279A(4)(h) of the Constitution, recommend to the Central Government to permit the States to borrow money, as a measure for meeting the compensation gap. It would, however, be for the Central Government to take final decision in the matter, in exercise of its authority under article 293(3) of the Constitution.
