GST Reform and State Compensation

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GST Reform and State Compensation: Fiscal Responsibility vs Fairness

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Context:

The Union government has proposed rationalising the **Goods and Services Tax (GST)** into a **two-tier structure of 5% and 18%**. The objective is to **simplify taxation** and enhance **competitiveness** in the economy. However, this reform is expected to result in a **short-term revenue loss of ₹60,000–1,00,000 crore annually**. With the **five-year GST compensation scheme (2017–22) concluded**, the issue of whether **States should receive compensation** has resurfaced.

Body:

1. Proposal Overview

- The Centre proposes **two main GST slabs: 5% and 18%**, while retaining a **~40% rate for sin and luxury goods**.
- **Average GST rate** is expected to fall from **11.5% to ~10%**, aligning India with **advanced economies** and improving **competitiveness**.
- **Short-term revenue loss:** Estimated at **₹60,000–1,00,000 crore annually (~0.2–0.3% of GDP)**; for **FY2025-26**, projected loss is around **₹45,000 crore**.
- **State impact:**
  - Industrialised States (Maharashtra, Karnataka, Tamil Nadu) may see declines in **appliances and electronics revenue**.
  - Agrarian States (Bihar, Uttar Pradesh), dominated by essentials, face **minimal impact**.

- **No automatic compensation** mechanism exists post the **2017–22 GST compensation scheme**.

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2. Significance of the Reform

- **Unequal fiscal impact:** In 2018 GST rate cuts, **Maharashtra and Karnataka** saw **3–4% dip in monthly collections**, while **north-eastern States** experienced little effect.
- **Federal trust:** GST was adopted with the Centre's promise of **14% annual revenue growth compensation**; breaking this precedent may **weaken GST Council confidence**.
- **Developmental consequences:** Revenue shortfalls may reduce State spending on **health, education, and infrastructure**. Example: **Karnataka's urban tax dependence** increases vulnerability.
- **Competitiveness boost:** At **~10%**, India's average GST rate is comparable with **developed economies**, promoting **Make in India** and attracting **global manufacturing investments**.
- **Political backing: Prime Minister's Independence Day announcement** signals strong support; timing and product classification debates may arise, but reforms are likely to proceed.

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3. State Compensation Debate

Case for Compensation:

- **Fairness:** Industrialised States like **Tamil Nadu and Maharashtra** should not bear **disproportionate costs** while smaller States remain insulated.
- **Fiscal stability:** FY2026 losses (**~₹45,000 crore**) could undermine State budgets without support.
- **Asymmetric exposure:** Manufacturing-heavy States depend on **higher-tax slabs** (e.g., appliances at 28% moving to 18%).
- **Global precedent:** Advanced economies often combine **GST-linked compensation** with **central support** to ease transitions.

- **Reform acceptance:** Compensation was the **“political glue”** for GST adoption in 2017; repeating it ensures smoother acceptance of slab rationalisation.

Case against Compensation:

- **Fiscal unsustainability:** Annual shortfalls (**₹60,000–1,00,000 crore**) make permanent compensation **unviable**.
- **Moral hazard:** Guaranteed revenue may discourage States from **plugging GST leakages**, despite **digital compliance improvements**.
- **Transition window over:** The **five-year scheme** was intended as a **one-time cushion**; extension risks **permanent bailouts**.
- **Growth dividend:** Lower rates on essentials/durables may **increase consumption** and shift transactions into the **formal economy**.
- **Alternative models:** State-specific stabilisation tools, e.g., **Kerala’s flood cess (2019)**, reduce reliance on Centre-led compensation.

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4. Policy Recommendations

- **Time-bound support:** Provide **short-duration relief** in FY2026 for the estimated **₹45,000 crore revenue dip**.
- **Selective assistance:** Aid **industrialised States** facing sharper shocks; avoid uniform distribution.
- **Stabilisation fund:** Allocate a portion of GST into a **flexible contingency pool** under the **GST Council**.
- **Performance-linked aid:** Link assistance to **e-invoicing, compliance, and tax base expansion**, reducing moral hazard.
- **Strengthening GST Council dialogue:** Ensure **transparency in revenue projections** and **product reclassification debates** for consensus-based decisions.

Conclusion:

GST rationalisation promises **simplicity, competitiveness, and long-term revenue buoyancy**, but its **short-term revenue shocks** could strain State finances. While **permanent compensation is fiscally unsustainable**, **targeted, transitional, and reform-linked support** can balance **fiscal responsibility** with **cooperative federalism**, ensuring reforms succeed without destabilising **State stability**.

Source : The Hindu