Q12

Explain the rationale behind the Goods and Services Tax (Compensation to States) Act of 2017. How has COVID-19 impacted the GST compensation fund and created new federal tensions?

UPSC Civil Services Mains 2020 · GS III · 15 marks · Government Budgeting

Government Budgeting.

Core demand of the question

- Explain the rationale behind the Goods and Services Tax (Compensation to States) Act of 2017. How has COVID-19 impacted the GST compensation fund and created new federal tensions?
- The assurance was 14 per cent CAGR on a 2015-16 base for a five-year window, funded by compensation cess - not an open Consolidated Fund guarantee. Treat the 2020 fight as cess shortfall plus borrowing options
- Keep the explanation within a 15-mark length

Revision summary

GST compensation was the political insurance for States that subsumed VAT and related taxes.

The 2017 Act promised a 14 per cent CAGR over a 2015-16 base for about five years, funded by cess.

COVID crashed GST and cess inflows, so the fund could not meet the formula from current cess.

The 2020 conflict was borrowing windows versus a Union Consolidated Fund bailout.

The 14 per cent figure was a time-bound statutory compact, not a permanent constitutional grant.

Introduction

GST asked States to give up origin-based taxes (VAT, entry tax, a slice of excise) for a destination-based dual GST. The **GST (Compensation to States) Act, 2017 was the political insurance: a time-bound, formula-based top-up so no State would lose revenue in the transition. COVID then smashed collections. The fight of 2020 was over who borrows when the compensation cess** no longer fills the promised gap - not over whether the 14 per cent figure had been secretly repealed.

Body

Rationale of the 2017 Act

- States feared a **permanent loss of fiscal autonomy** and of origin-tax buoyancy after subsuming VAT and related levies.

• The Act promised **compensation for five years** (broadly July 2017 to June 2022) if a State's GST revenue fell short of a **14 per cent compounded annual growth** over the **2015-16** tax base specified in the law.

• Funding was not meant to be a routine Union Budget grant. A **GST compensation cess** on specified luxury and sin goods (plus some others) was to flow into a **compensation fund** and then to States.

• **The design bought a** GST Council consensus**:** one tax, two levies, with a sunset insurance so reform was not a leap in the dark.

• **It also created a** moral-hazard and forecast problem**:** 14 per cent was a political ceiling-as-floor from a high pre-GST base year, generous in a slowdown even before COVID.

How COVID hit the compensation fund

• Lockdowns in 2020 crushed GST collections. Cess collections, tied to autos, coal, tobacco, and similar bases, also fell just when the **compensation gap** exploded.

• The fund therefore could not, in 2020-21, pay the full statutory formula from **in-year cess** the way a normal year might.

• **Two shortfalls got argued:** a **GST implementation/structural shortfall** versus a **COVID-period shortfall**. The Union's 2020 line was that the Act never made the Consolidated Fund of India a residual guarantor; it made the **cess** the source.

• **GST Council (around the 41st meeting, 2020)** offered States **borrowing options:** a special window to borrow the cess-shortfall amount, with later cess extension to repay, versus a larger borrow covering a wider gap. That was the operational 'impact' - delay, options, and interest, not a silent repeal of 14 per cent.

New federal tensions

• **States heard a** compact**:** we ceded tax handles; you make us whole at 14 per cent CAGR. They wanted the **Union to borrow** (cheaper G-Sec, no State fiscal-deficit stain) and on-lend or grant.

• **The Union heard a** statute**:** compensation is cess-funded; a pandemic is an Act of God not written as a Centre overdraft; States should share the extraordinary borrowing.

• **Finance Commissions, FRBM headroom, and market borrowings** of States became the battlefield. Opposition-ruled States turned it into a trust issue about cooperative federalism.

• Extending cess **beyond June 2022** to repay COVID-window loans was the later compromise logic: the insurance period ends, the debt tail remains.

• **The tension is structural:** GST centralised rate politics in the Council while leaving States fiscally hung on a **temporary formula**. COVID pulled the formula's funding assumption apart.

What the answer must not do

• Do not say the Centre 'abolished' compensation in 2020. The fight was **how to finance a cess shortfall**.

• Do not treat 14 per cent as a constitutional forever-right. It was a **five-year statutory assurance**.

Flow diagram

GST 2017 compact 2017 compact -> Compensation Act
Compensation Act -> 14 percent CAGR five years
Compensation Act -> Compensation cess fund
COVID collections crash collections crash -> Cess shortfall
Cess shortfall -> State borrowing options
Cess shortfall -> Federal tension

Conclusion

- **The 2017 Act was the price of GST:** a five-year, 14 per cent CAGR top-up funded by compensation cess so States would surrender VAT. COVID emptied that cess just as the gap peaked, and the 2020 quarrel was who borrows. Federal trust cracked because States thought they had a Union guarantee and the Union pointed at the cess clause.

Facts & figures

GST (Compensation to States) Act, 2017

Statute that created the compensation fund and the 14 per cent CAGR formula for a five-year transition.

14 per cent CAGR

Assured annual growth over the specified 2015-16 State tax base - the political number of the compact.

Compensation cess

Levy on specified goods whose proceeds were meant to pay compensation; the actual source in the Act.

2020 borrowing options

GST Council path under which States could borrow against cess shortfall, with later cess extension to repay.

Five-year window

Compensation designed to sunset around June 2022, not to run as a perpetual Union subsidy.