GST reform needs a new grand bargain

Context:

- 40th GST Council meeting and growing voices about compensation to states.

Background:

- Before GST, States had the power to levy some indirect taxes on economic activity.
- Therefore, after GST regime was introduced (in 2017), the Centre promised guaranteed compensation to the States for the first five years, for the revenues they lost after the shift from the earlier system.
- The compensation is calculated at a growth rate of 14% keeping 2015-16 as the base year.

What are the challenges for GST during the times of pandemic?

- The tax collection has dropped significantly, while expenditure needs are sharply higher, especially at the frontline of the battle, at the State level.
- Using an equivalent of the Force Majeure clause in commercial contracts, the Centre is abdicating its responsibility of making up for the shortfall in 14% growth in GST revenues to the states (compensation amount).
- It seems that the States have been told that they are on their own to meet the shortfall in revenues.

Why is Centre putting onus on States to finance themselves considered wrong?

- States do not have recourse to multiple options that the Centre has, such as issue of a sovereign bond (in dollars or rupees) or a loan against public sector unit shares from the RBI.
- The Centre can anyway command much lower rates of borrowing from the markets as compared to the States.
- **I**n terms of aggregate public sector borrowing, it does not matter for the debt markets, nor the rating agencies, whether it is the States or the Centre that is increasing their indebtedness.
- Fighting this recession through increased fiscal stimulus is basically the job of macroeconomic stabilization, which is the Centre's domain.
- Most importantly, breaking the important promise of compensation, using the alibi of the COVID-19 pandemic causes a serious dent in the trust built up between the Centre and States.

Way Forward – GST 2.0

- GST is a destination-based consumption tax, which must include all goods and services with very few exceptions, such as food and medicine
- Widening of the tax base itself will allow us to go back to the original recommendation of a standard rate of 12%, to be fixed for at least a five-year period.
- **Some extra elbow room for the States' revenue autonomy** can be obtained by allowing the States non-Vatable surcharges on a small list of "sin" goods such as liquor, tobacco, polluting goods such as SUVs, and industrial fuels such as diesel, aviation turbine fuel and coal.

- Of the 12% GST, 10% can be equally shared between the States and the Centre, and 2% must be earmarked exclusively for the urban and rural local bodies, which ensures some basic revenue autonomy to them. The actual distribution across panchayats, districts and cities would be given by respective State Finance Commissions.

Conclusion:

GST is a crucial and long-term structural reform which can address the fiscal needs of the future, strike the right and desired balance to achieve co-operative federalism and also lead to enhanced economic growth.