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EVALUATING THE ECONOMIC CONSEQUENCES OF GST COMPENSATION WITHDRAWAL ON STATE BUDGETS

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Abstract

The elimination of GST (Goods and Services Tax) compensation has substantial ramifications for Indian state income. This article evaluates the impact of compensation withdrawal on state budgets using data from 2017-18 through 2020-21. The findings show that many states heavily depend on GST compensation to bridge the income gap, and that removing compensation will result in revenue deficits, fiscal imbalances, and developmental setbacks. Furthermore, the withholding of compensation contradicts cooperative federalism and may result in a slowing of economic progress. To address the possible negative consequences, mitigation measures such as finding other income sources, improving tax administration, and rationalising spending are required. In the absence of GST compensation, collaborative efforts between the central government and states, as well as wise financial management, are critical to ensuring a balanced and thriving economic environment.

Index Term – GST, Tax System, VAT, GST Revenue, GST Compensation, Indirect Tax, VAT

Introduction:

The Goods and Services Tax (GST) is an all-inclusive indirect tax system that was implemented in India on July 1, 2017. It replaced a number of state and national levies, streamlining the tax system and creating a single and harmonised market across the country. GST is founded on the "One Nation, One Tax" philosophy and strives to create a common tax framework that promotes ease of doing business, simplifies tax administration, and reduces the cascading impact of taxes.

Prior to the adoption of GST, India had a complicated tax system with several indirect taxes levied at various points of the supply chain, such as Central Excise Duty, Service Tax, Value Added Tax (VAT), and Central Sales Tax. Because of the fragmented tax structure, several taxes were charged on the same goods or services, resulting in a cascading effect and higher pricing for customers.

With the implementation of GST, India's taxation regime underwent a fundamental shift. GST is a destination-based tax that is levied at every level of the supply chain, from manufacture through ultimate sale to the end customer. It is a broad tax that applies to the provision of goods and services, as well as certain intangible products and digital transactions.

Background:

Manufacturing states were concerned about revenue loss as the country transitioned to the Goods and Services Tax. The new system replaced a production-based taxing system with a consumption-based taxation structure. To alleviate this concern, a five-year compensation process was put in place. According to Section 18 of the Constitution (101st) Act of 2016, Parliament shall, by law, compensate states for revenue loss resulting from the implementation of the Goods and Services Tax for a period of five years from the date of implementation.

During the transition phase, states' revenue was guaranteed to grow at a rate of 14% per year above the base year revenue of 2015-16. There was a compensation system in place even before the implementation of Value Added Tax (VAT) in early 2000. It worked well, but after a few years, as states' revenue increased, it was discontinued.

A cess on particular commodities is charged to provide compensation to states, and the money collected is credited to the Compensation Fund. States' compensation is being paid out of the Compensation Fund as of July 1, 2017.

Objective of the study

The objective of this study is to explore the possible impact of the withdrawal of GST compensation on the revenues of states, fiscal stability, and the overall economic landscape.

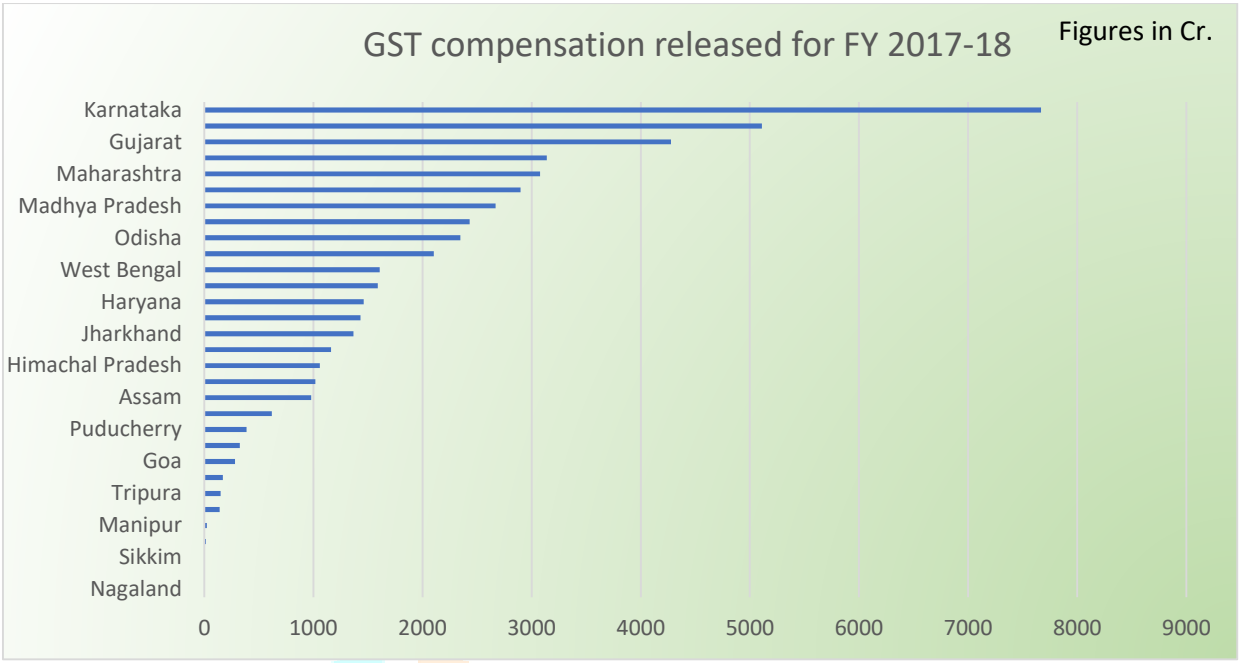
Research Methodology

Relevant data will be collected from official government reports, publications, and financial statements related to GST compensation, state revenues, and budgetary allocations that provide insights into the topic.

Importance of GST Compensation for States

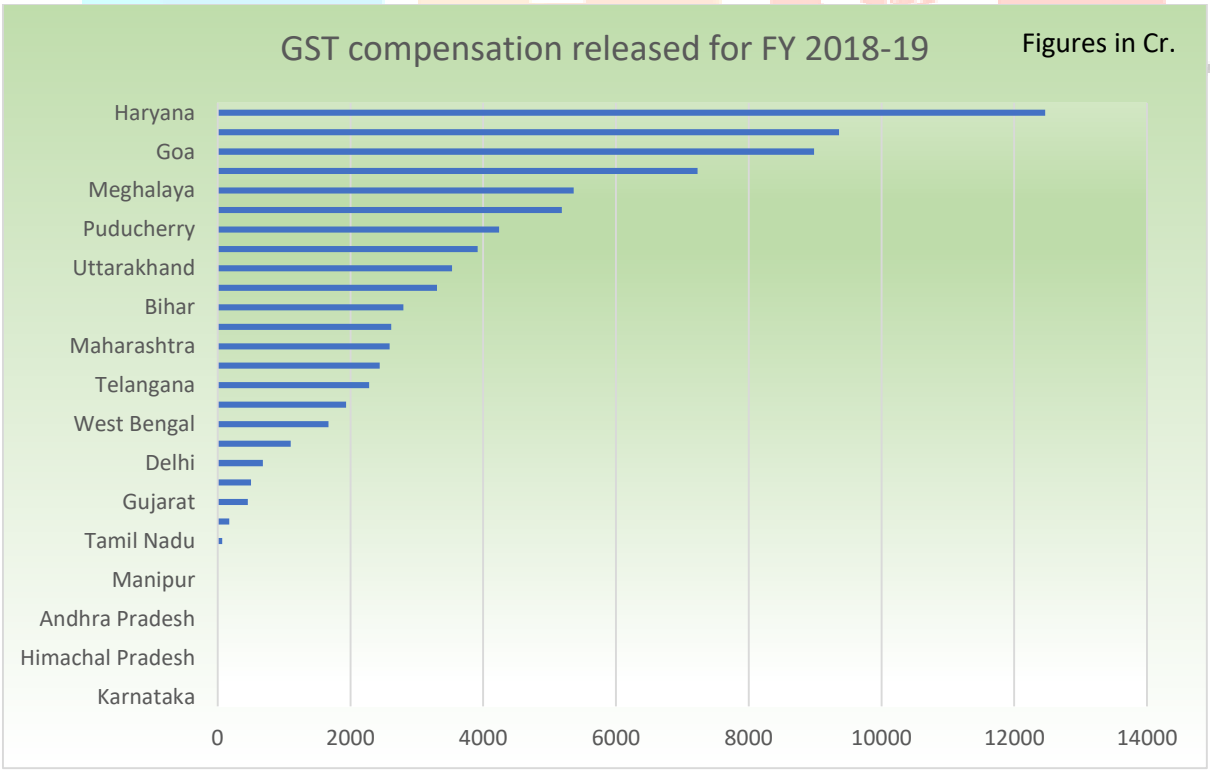
- **Revenue Stability**: GST compensation is critical in preserving state income stability. Some states had difficulties during the changeover, particularly those that relied mostly on the taxes that had been replaced by GST. The compensation system acts as a financial buffer for states, ensuring that they do not face severe income deficits during the early period of GST implementation.
- **Fiscal Autonomy**: GST compensation provides governments with greater budgetary autonomy. States have the freedom to impose and enforce GST without excessive financial pressure by offering compensation for revenue losses. It enables states to focus on growth-oriented efforts, infrastructure projects, and social programmes, boosting their ability to effectively address the needs of their citizens.
- **Economic Stability**: GST compensation helps to state-level economic stability. The presence of compensation funds aided governments in maintaining their financial stability during covid-19, when revenue collection was minimal. This stability encouraged long-term economic development, investment, and job creation, creating a favourable business climate.
- **Incentive for Tax Reform:** GST compensation functions as an incentive for states to implement and comply with GST laws. Compensation encourages states to actively engage in the GST framework and match their taxes policy with national objectives.

gst compensation distributed over the years



source: open government data platform (ogd) india

States such as Karnataka and Punjab, which received substantial compensation amounts of 7,670 crore rupees and 5,109 crore rupees, respectively, and states such as Kerala, Odisha, Uttar Pradesh, and Maharashtra, which received compensation amounts ranging from 2,102 crore rupees to 3,077 crore rupees, demonstrate the critical role of GST compensation in assisting states in maintaining fiscal stability and effectively addressing revenue shortfalls.



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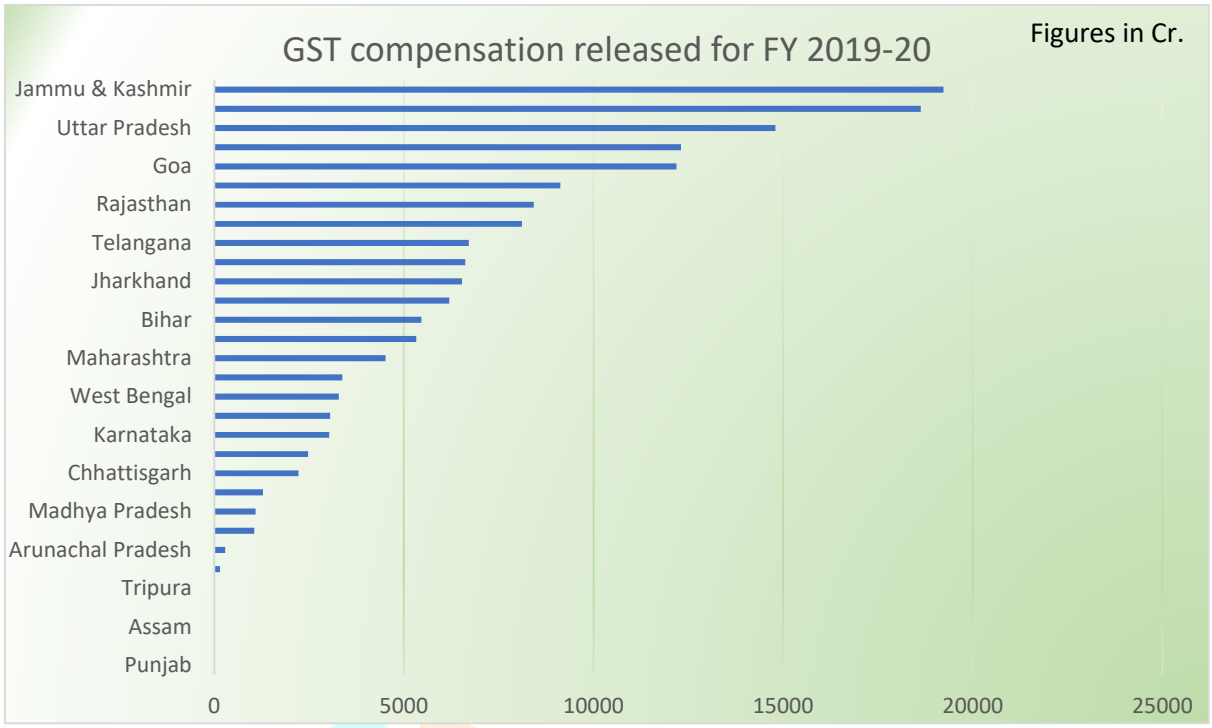
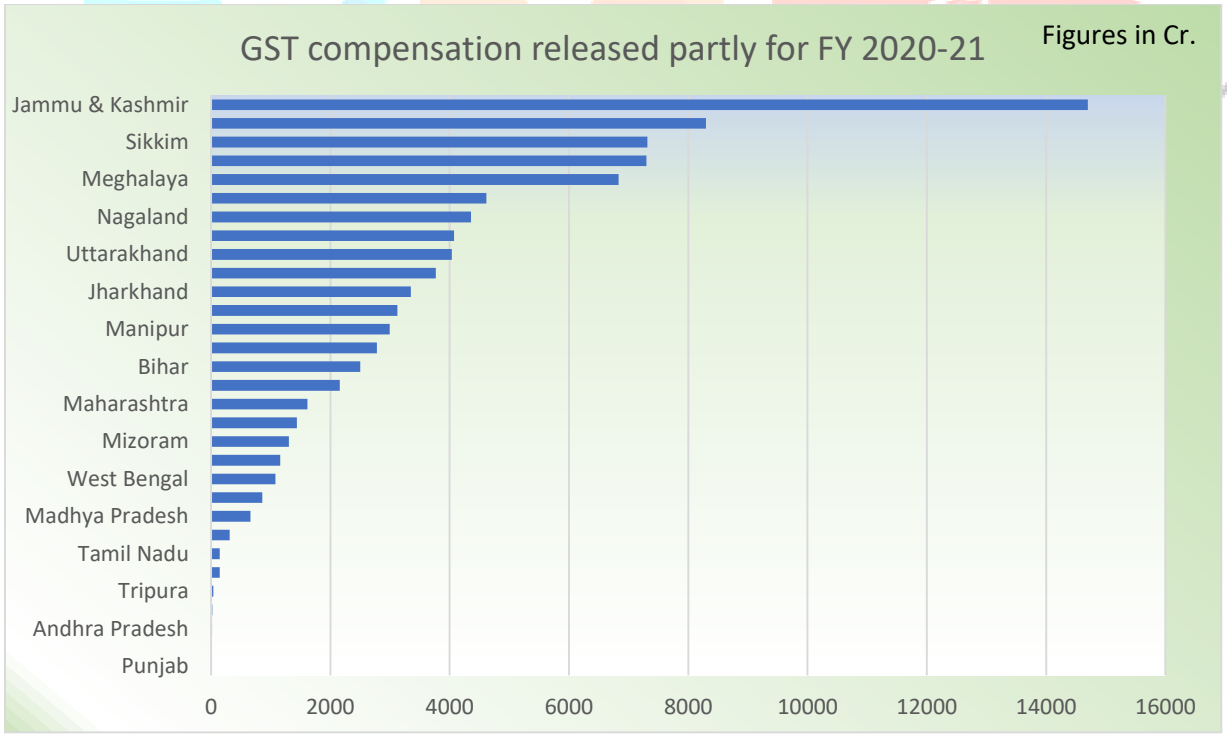
Haryana, Jammu and Kashmir, Goa, Uttar Pradesh, Meghalaya, Rajasthan, Puducherry, Odisha, Uttarakhand, Jharkhand, and Bihar all got significant GST compensation. Haryana received the most compensation (12,465 crore rupees), followed by Jammu and Kashmir (9,363 crore rupees), and Goa (8,985 crore rupees). These states had major income shortfalls and were heavily reliant on GST compensation.



Source: Open Government Data Platform (OGD) India

GST compensation was distributed to states such as Jammu and Kashmir, Haryana, Uttar Pradesh, Meghalaya, Goa, Rajasthan, Uttarakhand, Telangana, Odisha, Jharkhand, and Nagaland. These numbers demonstrate the enduring importance of compensation in assisting states with revenue deficits and assisting them in maintaining budgetary stability.



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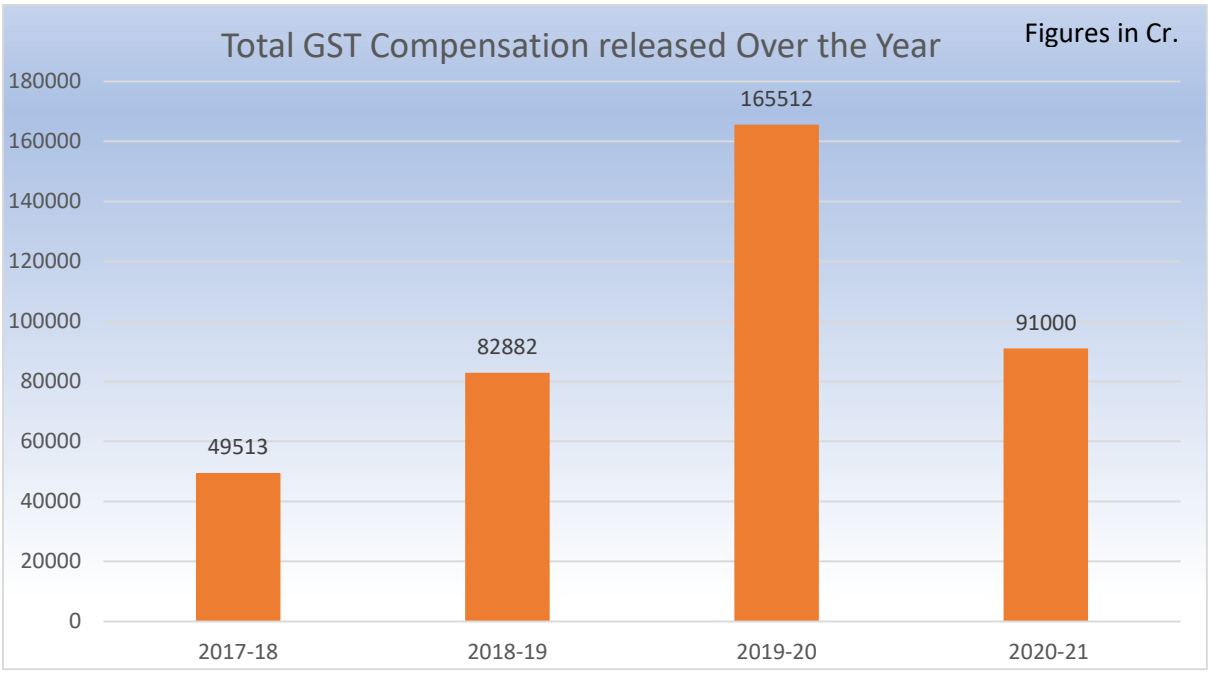
Jammu and Kashmir received the most partial compensation (14,699 crore rupees), followed by Haryana (8,298 crore rupees), Uttar Pradesh (7,300 crore rupees), Sikkim (7,312 crore rupees), and Meghalaya (6,833 crore rupees).



source: open government data platform (ogd) india

The entire GST compensation given from 2017-18 to 2020-21 was 379,907 crore rupees. This huge sum reflects the size of the central government's financial support offered to remedy revenue shortages and guarantee the seamless implementation of the GST system across the country.

The analysis of four years of data on GST compensation granted to Indian states and union territories (2017-18 to 2020-21) gives significant insights into the shifting environment of fiscal transfers and revenue stabilisation effort.

- **Distribution of Compensation:** Compensation Distribution: The data show that the distribution of GST compensation varies between states and UTs. While some states received more substantial compensation sums over time (for example, Goa, Haryana, and Jammu and Kashmir), others had volatility in their compensation levels. This demonstrates variances in income shortages and highlights the necessity for customised compensation solutions based on particular state conditions.
- **Revenue Shortfalls:** Several states experienced income deficits during the transition period, as demonstrated by their receipt of GST compensation, according to the statistics. The compensation provided a critical lifeline, filling gaps and mitigating the impact of lower income. It emphasises the significance of compensation in sustaining financial stability and allowing nations to satisfy their fiscal responsibilities.
- **Economic Disparities:** The differing amounts of GST compensation received by different states reflect regional economic inequalities and budgetary concerns. States with greater compensation tend to have larger economies and larger tax bases, whereas states with lesser compensation tend to have smaller economies and lower revenue bases. It is necessary to bridge these economic imbalances through targeted fiscal policies and support measures.

Consequence of GST compensation withdrawal

If GST compensation is withdrawn, it will have a huge impact on state income in India. The removal of compensation might have numerous significant consequences:

- **Revenue Shortfalls:** Several states, including Jammu and Kashmir, Sikkim, Uttar Pradesh, Goa, Haryana, Karnataka, and Gujarat, got significant compensation over the course of one or more years. This suggests that these states had revenue deficiencies and depended on compensation to make up the difference. If compensation were completely removed, many states would face severe revenue shortfalls, making it difficult for them to satisfy financial responsibilities.
- **Impact on Infrastructure Development:** States such as Goa, Jammu and Kashmir, Meghalaya, and Uttar Pradesh got significant compensation, allowing them to invest in infrastructure, social welfare programmes, and other critical areas. Withdrawing payments would hinder their development activities and delay growth in these areas.

- **Fiscal Stability Concerns:** The elimination of GST compensation will cause fiscal instability in states. Compensation was crucial in balancing state budgets and guaranteeing financial stability. States would struggle to achieve their expenditure needs and maintain fiscal discipline without this crucial help.

Mitigation Measures

Given the possible impact on state revenues of the withdrawal of GST compensation, many mitigating measures might be adopted to address the issues that may develop. These policies are intended to assist governments, maintain fiscal stability, and minimise the negative impacts of compensation withdrawal.

- **Alternative Revenue Sources:** States should look at alternative revenue streams to make up for the loss of GST compensation. This might involve identifying industries with high development potential and executing methods to increase tax revenue in such areas. Diversifying income streams can help minimise reliance on GST compensation while also improving fiscal resilience.
- **Enhanced Tax Administration:** Improving GST administration and compliance methods can assist states in collecting more taxes. Increasing the generation of income and mitigating the impact of compensation withdrawal may be accomplished by strengthening tax assessment procedures, building strong technological systems, and performing regular audits.
- **Inter-Governmental Coordination:** To meet the issues posed by compensation withdrawal, the central government and states must improve their coordination and collaboration. Constructive conversation, sharing best practises, and giving policy direction can assist governments in navigating the shift and mitigating the negative consequences on their revenues.
- **Expenditure Rationalization:** States may need to rationalise their spending habits in order to match available resources. Prioritising important services, implementing cost-cutting measures, and optimising public expenditure can assist state budgets cope with the impact of compensation withdrawal.

Conclusion

The elimination of GST compensation will have a severe impact on state income in India. Many states rely largely on GST compensation to bridge the income gap between their actual tax collections and what they would have earned under the pre-GST system. Withdrawing compensation would result in financial deficits, affecting governments' capacity to meet budgetary commitments and support key services and development initiatives. As governments confront income constraints and cut back on expenditure, aggregate demand may decline, slowing economic development. This slowdown in economic activity may have a detrimental influence on job creation, investment, and consumer confidence.

Certain states' compensation payments have supported investments in infrastructure, social welfare programmes, and other important areas. Withdrawing compensation will stymie the progress of various development endeavours, perhaps leading to project delays or cancellations and negatively hurting individuals' well-being.

The compensation system was created to promote fair and equal resource allocation and to preserve financial solidarity between the federal government and the states. Compensation withdrawal might put a strain on the ideas of cooperative federalism, perhaps leading to tensions and disputes between different levels of government. Revenue deficits, budgetary imbalances, developmental setbacks, difficulties to cooperative federalism, and a downturn in economic growth would result if proper mitigating measures were not implemented.

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