

## **A Damaged Federal Structure\***

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The office of the Comptroller and Auditor General (CAG) of India, in its Report 4 of 2020 relating to Union finances, has criticized the Centre's handling of funds collected from various cesses levied for specified purposes. Cesses collected for designated purposes have to be transferred to specially created funds and not retained in the Consolidated Fund of India (CFI). Once transferred, they must then be deployed to further the identified purpose.

The Centre's violations are many. According to the CAG's report, in practice, there are cesses with no special reserve fund associated with them, such as a 'social welfare surcharge' on customs duty. There are others where collections have been held in the Consolidated Fund of India and not transferred to the designated reserve fund. And yet others, collections from which have been transferred to the associated fund after much delay. The sums involved are not small. Thus, Rs. 1.24-lakh crores collected through a cess on crude oil over the past ten years have not been transferred as mandated to the Oil Industry Development Board, but were instead retained in the consolidated fund. In 2018-19 alone, of the Rs. 2.74-lakh crore garnered from 35 different cesses, only a sum of Rs. 1.64 lakh crore was transferred to reserve funds. The difference amounted to 17 per cent of the fiscal deficit actually recorded in that year.

Cesses and surcharges have always been a bone of contention between the Centre and the states. Based on the argument that these are imposed for specific purposes, the revenue from these imposts have been kept out of the divisible pool of taxes, from which states receive a 42 per cent share. Exploiting this exclusion, the Centre has increasingly relied on cesses and surcharges to mobilise additional resources, since the revenue from these imposts need not be shared with the states. This process of depriving the states of a share of tax revenues has gone quite far. By 2016-17, before the imposition of the GST compensation cess to cover shortfalls in the GST revenues of the states from levels reflecting a 14 per cent annual growth, cesses contributed almost 10 per cent of the Centre's net tax revenue.

Having deprived the states of a share in these taxes, the Centre has worked to dissociate these revenue sources from the commitment to deploy them for specified purposes. In the case of some surcharges no specific purpose is identified. In others the revenue collected is diverted to uses that do not correspond to the stated objective for which the cess was imposed. This has been routinely flagged by the CAG in its audits of the financial accounts of the union government. For example, in its report on the accounts for 2017-18 the CAG had noted that the Secondary and Higher Education Cess which was levied as of 2006-07 had contributed a sum of Rs. 94,306 crore between 2006-07 and 2017-18, all of which had been retained in the Consolidated Fund of India. In fact, a special reserve fund (the Madhyamik and Uchchar Shiksha Kosh) was created for the purpose only in August 2017. But the accumulated revenue had not been transferred to this fund even after that. According to a Finance Ministry statement of December 2019, the aggregate shortfall in transfers of cess revenues to the designated accounts amounted to Rs. 31,384 crore in 2014-15,

Rs. 62,664 crore in 2015-16, Rs. 72,941 crore in 2016-17 and Rs. 61,372 crore in 2017-18.

This blatant violation of procedure corroborates the allegation made by the states that the Centre is exploiting the cess and surcharge option only to deprive them of a legitimate share of the revenues collected and not to further specific and exceptional developmental objectives. It is one of the many egregious ways in which rules governing the constitutionally mandated sharing of financial resources between the Centre and the states have been subverted.

Given this history, the violations recorded in the recent audit by the CAG of union accounts for 2018-19 would seem routine. But there is an added element in the most recent assessment that is proving even more controversial. According to the CAG, in 2018-19, around Rs. 40,806 crore of the total of Rs. 95,028 crore collected through the GST compensation cess was not credited to the cess fund but was retained in the Consolidated Fund of India. The CAG implicitly identified this as a diversion that violates the GST Compensation Cess Act which requires the government to hold the receipts from this cess in a non-lapsable fund to be used for compensating the states to cover shortfalls in their GST revenue receipts relative to a promised annual expansion of 14 per cent.

To quote the CAG report: “The short-crediting was a violation of the GST Compensation Cess Act, 2017. The amount by which the cess was short credited was also retained in the CFI and became available for use for purposes other than what was provided in the act. Ministry accepted the audit observation and stated (February 2020) that the proceeds of cess collected and not transferred to Public Account would be transferred in subsequent year. Short crediting of cess collected during the year led to overstatement of revenue receipts and understatement of fiscal deficit for the year. Further, any transfer in the subsequent year would become an appropriation from the resources of that year and would require Parliamentary authorisation.”

The Centre as expected has denied any diversion, claiming that the retention in the CFI was only temporary pending reconciliation of compensation receipts and that till financial year 2019-20 all compensation due to state governments had been settled. That denial misses a number of points. Even if the retention is temporary, the Centre which receives its own revenues across the year could have during that interim period used the funds for purposes other than compensating the states. Further, states have been constantly complaining that there was undue delay in releasing compensation funds, creating cash flow problems for them and forcing some of them to borrow to meet committed expenditures. This does suggest that the states are being short-changed by the Centre.

Moreover, this evidence of “diversion” comes at a point in time when the Centre has declared that it cannot compensate the states in full for the severe shortfall in GST collections expected in Covid-year 2020-21, as receipts from the compensation cess would be inadequate for the purpose. This has stirred a major controversy with states claiming that the Centre is renegeing on a Constitutional obligation. The Centre’s claim is that it is not responsible for ensuring full compensation, which according to the GST Act has to be financed with receipts from the compensation cess levied for the purpose. If resources in the cess fund fall short of what the states must receive, it is up to the states and the GST council to resolve the problem.

The states are clear that they had ceded the right to collect a dominant proportion of their erstwhile revenues to a central body only because they had been promised a reasonable rate of growth of revenues, failing which they would be compensated. The compensation fund was only the modality agreed upon at the GST Council to mobilise the resources needed for the purpose. If that proved inadequate, it was the responsibility of the Centre as well to find ways of making up the difference. The understanding of the states was that the Centre had agreed that, in the case of any such eventuality, it would borrow the required resources and extend the tenure of the compensation cess to cover the costs of that borrowing.

If the Centre is at present collecting receipts from the compensation cess, parking it for long periods of time in the CFI and putting it to temporary use, it clearly does accept responsibility for organizing the compensation due to the states. It also benefits from taking on that responsibility. Moreover, paradoxically, while trying to wash its hands of the problem, the Centre not only offered the states two options through which they can part- or full-finance the GST revenue shortfall with borrowing, but decided to decompose the short fall into that due to “GST implementation” and that due to the “Covid-19 pandemic”, and accepted some responsibility only for the former. The absurdity of this decomposition should be obvious. To start with, the pandemic was not imposed by the states. Moreover, even if the Covid-19 pandemic had not struck, the recession that was overcoming the economy before its onset would have substantially curtailed revenue receipts, as the estimates for receipts in financial year 2019-20 make clear. The Centre would then have hardly been in a position to separate out the fall in revenues due to “GST implementation” and that due to the “recession” and accept joint responsibility only for the latter.

In sum, the process of centralization of financial resources at the expense of the states that had been underway for long has taken on a new intensity under the current government. The transition to the GST was an element of that intensification. The Centre’s response to the revenue shortfall of the states in the wake of the Covid-19 pandemic is another major step. The traverse along this trajectory suggests that this government places its own interests above the unifying social contract implicit in the prevailing federal financial structure.

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