GST Compensation: Centre's bizarre stand*

Prabhat Patnaik

When the Goods and Services Tax was introduced, and the states virtually gave up the power to levy indirect taxes which they had enjoyed under the constitution, the centre had solemnly promised that it would compensate them for a period of five years for any revenue shortfall arising from the shift to GST. The shortfall was to be assessed relative to what revenue should have been, assuming a 14 per cent rate of growth. It is this promise which had persuaded many states to fall in line behind the GST. And parliament had enacted the GST (Compensation to states) Act 2017 to legalise this promise.

The GST however has been singularly unsuccessful in garnering revenue, partly because of its own infirmities and partly because of the slowing down of GDP growth. Likewise the GST cess which is supposed to finance the compensation payment to states has also failed to garner adequate revenue. While the states' revenue growth therefore has been sluggish and hence the need for compensation particularly large and urgent, the fund out of which such compensation is to be paid has also shown sluggish growth. The logical course for the centre to tide over this shortfall would have been to borrow, or to raise taxes from other sources, and then transfer these additional resources to state governments as its compensation payment.

But, instead of keeping its promise, the centre has simply reneged on its compensation payment. The problem began in August 2019, but has assumed serious proportions in the current fiscal year, owing to the pandemic. The pandemic has drastically reduced GST revenue, and with it the states' share, while greatly increasing their expenditure requirements. The compensation amount for 2020-21 is estimated at Rs 3 lakh crores of which only Rs 65,000 crores would be paid out of the cess levied by the centre. As for the remaining Rs 2.35 lakh crores, the centre simply refuses to pay this amount; at the August 27 meeting of the GST Council it just asked the states to borrow this amount. It has offered two different options to the state governments, but they both amount to making the states borrow.

This is an utterly bizarre stand for two very obvious reasons: first, it violates not just a solemn promise given by the centre, but an Act of parliament. It is on this basis that the states had given up their constitutional rights and agreed to enact constitutional amendments paving the way for the introduction of the GST; the centre is now reneging on an obligation that underlies the entire new constitutional arrangement. Second, there is not an iota of economic logic behind the centre's stand.

Whatever "harm" larger borrowing by the centre can do to the economy will be done equally if the states do the borrowing instead. In fact, by asking the states to do the borrowing, the centre has already conceded that Rs 2.35 lakh crores of borrowing on this score can be safely done and the proceeds injected into the economy as additional expenditure. But then why can't the centre do this borrowing and hand over the proceeds as GST compensation to the states?

This will have two obvious advantages: first, and most important, constitutional proprieties would have been observed with no question of any reneging involved. And secondly, with the extensive taxation powers that the centre has, its debt is perfectly safe, where no fears of default need arise. The centre in short can borrow with impunity unlike the states.

The centre however has put forward two arguments in favour of its suggestion, both of which are baseless. The first is that the pandemic that has caused a massive shortfall in GST revenue is an “Act of God”, for which the centre cannot be held responsible. Now, such provisions regarding lack of responsibility in the event of the occurrence of an Act of God characterise private contracts, where each party to the contract, in a typical capitalist manner, attempts to maximise its gains. It cannot characterise the contract between two tiers of popularly-elected government in a democratic society. Finance minister Nirmala Sitaraman’s invoking an Act of God therefore reduces relations between different tiers of government in a federal polity to the level of a contract between two private parties. This is not only bizarre, but constitutes an act of supreme irony on the part of a government that keeps talking of “cooperative federalism”.

The second argument of the central government is that if it borrowed to pay GST compensation to the states, then the cost of its borrowing will go up, which would be harmful for the economy as a whole; on the other hand if the states borrowed, then such an increase in the cost of borrowing presumably would not happen. This argument however is completely without any basis.

Besides, there is absolutely no reason why the central government should go to the market to raise this loan. Since by its own reckoning this borrowing has been necessitated by “an Act of God”, it can easily ask the Reserve Bank of India to lend this amount to it at the repo rate, i.e., the rate at which the RBI lends to the banking system.

If the entire sum of Rs 2.35 lakh crores is borrowed at the repo rate from the RBI, then this would not even entail an increase in the amount of reserve money, i.e., currency in the economy, which is the monetary liability of the Reserve Bank of India, by this amount.

A simple example will clarify the point. Suppose for simplicity that at the margin, the people at large hold no currency but only bank deposits. When the centre gives the states Rs 100, say, as GST compensation, then all of it will come back to the banks as deposits. The banks can extend loans with this additional resource. Now suppose the cash-reserve ratio of banks is 10 per cent, and the “worthwhile” demand for credit (from the point of view of banks) is Rs 300, then the banks will give out Rs 300 as credit, for which they would need to hold Rs 40 as cash reserves (10 per cent of total liabilities of Rs 400); the remaining Rs 60 of cash which they possess will be used by them for buying government securities from the RBI. So the reserve money in the economy would have increased by only Rs 40, even when the central government has borrowed Rs 100 from the RBI.

The centre’s borrowing from the RBI at the repo rate would have two further advantages. First, by putting additional resources in the hands of the banks (who do not have to borrow these resources from the RBI) it enlarges bank credit in the economy compared to what it would otherwise have been; and second, the interest rate in the economy would be lower because of this injection of liquidity. Since the

Indian economy is currently faced with a serious recession, both these should be considered desirable developments.

In other words, the centre's borrowing from the RBI at the repo rate to meet its GST compensation obligations, kills several birds with one stone. First, it enables the centre to fulfil its constitutional obligations enshrined in the 2017 Act. Second, it does not subject the state governments to any strain and hence strengthens the federal structure; and third, it helps the economy to overcome the recession better, by nudging it towards a lower interest rate and an easier state of liquidity. But, the Modi government, with its limited understanding of economics, and even more limited sympathy towards the states, cannot see these obvious points.

At the GST Council meeting, all major states, with the exception of two BJP-ruled ones, rejected the centre's proposal that the states should borrow to make good the shortfall in their GST compensation. The government of Kerala in particular has come out strongly against this proposal. It is imperative that the states are paid what is their due if the federal structure of the polity is to be preserved.

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