Indian Economy · GS - III

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?

EXAM YEAR	PAPER	SUBJECT
2020	GS - III	Indian Economy

MARKS	WORD LIMIT
15	~250 words

Answer Hint

GST implementation; revenue protection for states; 14% projected growth; compensation cess; COVID-19 revenue shortfall; compensation borrowing; fiscal federalism; Centre-state relations

Model Answer

Introduction

The Goods and Services Tax (Compensation to States) Act, 2017, was enacted to address states' concerns about potential revenue losses following the introduction of GST. It provided a transition mechanism to support state finances during the initial years of the new tax regime.

Rationale behind the Act

- **Revenue assurance:** States were promised compensation for eligible GST revenue shortfalls compared with a protected revenue base.
- **Growth assumption:** Protected revenue was calculated using a 14% annual growth assumption over the 2015–16 base year.
- **Compensation mechanism:** Compensation was funded through a cess on specified goods and services.
- **Cooperative federalism:** The arrangement helped secure state participation in a major restructuring of indirect taxation.

Impact of COVID-19

- **Revenue contraction:** Lockdowns and economic disruption reduced consumption and tax collections, widening compensation requirements.
- **Cess shortfall:** Compensation cess collections were insufficient to cover the resulting gap.
- **Borrowing dispute:** The Union proposed borrowing options to address the shortfall. Differences emerged over whether the revenue gap was attributable to the pandemic or reflected a broader compensation liability.
- **Fiscal pressures:** States faced increased expenditure on healthcare, welfare and economic relief while their own revenues weakened.
- **Federal tensions:** Disagreement over the timing, source and responsibility for compensation strained Centre-state relations and raised concerns about fiscal autonomy.

Way forward

Improve predictability in intergovernmental transfers, strengthen fiscal consultation through the GST Council and establish transparent borrowing and repayment arrangements. States also need sustainable revenue capacity and improved expenditure efficiency.

Conclusion

The compensation mechanism was essential to building trust during GST implementation. The pandemic exposed weaknesses in fiscal shock-sharing and demonstrated the need for predictable, cooperative and transparent federal financial arrangements.

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