

State Compensation Mechanism:

- There was uncertainty about gains in revenue after implementation of GST.
- GST is a destination based consumption tax. Under destination based taxation, tax accrues to the destination place where consumption of the goods or services takes place.
- The existing VAT regime was based on origin principle where Central Sales Tax was assigned to the State of origin where production or sale happened and not to the State where consumption happened.
- Many manufacturing States expressed concerns over the loss of revenue on account of shift from origin based taxation to destination based taxation.
- An argument put forward on behalf of producing states in support of origin based taxation is that they need to collect at least some tax from inter-State sales in order to recover the cost of infrastructure and public services provided by the State Governments to the industries producing the goods which are consumed in other states.
- This line of reasoning is based on the assumption that in the absence of a tax on inter-State sales, the location of export industries within their jurisdiction would not contribute to the tax revenues of the exporting state.
- This view was missing the fact that any value addition in a jurisdiction necessarily means extra income in the hands of the residents of that jurisdiction.
- Spending of this income on consumer goods expands the sales tax base of the producing states and thereby contributes to their revenues.
- However, states asked for compensation during the first five years of implementation of GST.
- A provision has been made under GST to compensate the States/UTs for the reported revenue deficit on account of implementation of Goods and Services Tax (GST).
- As per provisions in Section 7 of the GST (Compensation to States) Act, 2017 loss of revenue to the States on account of implementation of Goods and Services Tax shall be payable during transition period and compensation payable to a State shall be provisionally calculated and released at the end of every two months during transition period of 5 years.
- As per Section 4 of the said Act, financial year 2015-16 has been taken as the base year for calculating compensation amount payable to States for loss of revenue during transition period.
- The projected nominal growth rate of revenue subsumed for a state during the transition period shall be 14% per annum.
- As per section 7(c) of the said Act, the total compensation payable in any financial year shall be difference between the projected

revenue for any financial year and the actual revenue collected by a State.

- The base year tax revenue consists of the states' tax revenues from: (i) State Value Added Tax (VAT), (ii) central sales tax, (iii) entry tax, octroi, local body tax, (iv) taxes on luxuries, (v) taxes on advertisements, etc.
- However, any revenue among these taxes arising related to supply of alcohol for human consumption, and five specified petroleum products, will not be accounted as part of the base year revenue.
- A GST Compensation Cess is levied on the supply of certain goods and services, as recommended by the GST Council to finance the compensation cess.
- Compensation cess is levied on products considered to be 'sin' or luxury goods such as pan masala, cigarettes, coal, aerated water and motor vehicles.
- For example, SUV vehicles are charged 50 per cent GST, of which the GST tax rate is 28 per cent and the compensation cess is 22 per cent.
- The receipts from the cess will be deposited in a GST Compensation Fund.
- Fifty percent of such amount, as may be recommended by the Council, which remains unutilized in the Compensation Fund, at any point of time in any financial year during the transition period shall be transferred to the Consolidated Fund of India as the share of Centre, and the balance fifty percent shall be distributed amongst the States in the ratio of their base year revenue.
- In case of shortfall in the amount collected in the Fund against the requirement of compensation to be released for any two months' period, fifty percent of the same, but not exceeding the total amount transferred to the Centre and the States as recommended by the Council, shall be recovered from the Centre and the balance fifty percent from the States in the ratio of their base year revenue.