



## STATE GOVERNMENT FINANCES - UPDATE MAY 2020

**GST compensation  
requirement of states  
to surge to Rs. 4.1  
trillion in FY2021,  
sharply outweighing  
likely compensation  
cess collections**



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*The Covid-19 pandemic is expected to have a lingering impact on the consumption of several non-essential goods and services, on which the state governments in India levy State Goods and Services Tax (SGST), which is a key source of their own tax revenues. ICRA expects the SGST collections to contract by 30% to Rs. 3.5 trillion in FY2021 from Rs. 5.0 trillion in FY2020. This is less than half of ICRA's estimate of the aggregate protected revenues of the state governments of Rs. 7.7 trillion and implies that the GST compensation requirement would surge to Rs. 4.1 trillion in FY2021 from Rs. 1.7 trillion in FY2020. The estimated GST compensation requirement would be equivalent to 2.1% of ICRA's estimated Gross Domestic Product (GDP) of India for FY2021, more than double the level of 0.8% of GDP estimated for FY2020.*

*Moreover, we anticipate that the GST compensation cess, which is levied on some specific items including automobiles and coal, for compensating the states' shortfall in their SGST collections relative to their protected SGST revenues, would halve to Rs. 494 billion in FY2021 from Rs. 1.0 trillion in FY2020. This mainly reflects the expectation of muted demand for discretionary items, including automobiles, in the light of the ongoing Covid-19 crisis.*

*Additionally, out of the total required GST compensation of Rs. 1.7 trillion in FY2020, the Government of India (GoI) had released Rs. 1.2 trillion to the state governments in that year, leaving an unpaid balance of Rs. 505 billion for FY2020. Moreover, we estimate that the closing balance of the GST Compensation Fund was a modest Rs. 255 billion at end-March 2020, which comprises the unreleased cess balance of the prior years. Accordingly, the gap between the resources that are likely to be available to the GoI in FY2021 (Rs. 494 billion plus Rs. 255 billion) for disbursing the pending GST compensation requirement for FY2020 (Rs. 505 billion) and the substantial requirement for FY2021 (Rs. 4.1 trillion) would enlarge to Rs. 3.9 trillion or 1.9% of ICRA's estimate of India's GDP for FY2021.*

*While the GoI recently increased the net borrowing ceiling of the state governments to 5% of Gross State Domestic Product (GSDP) in FY2021 from 3% of GSDP, to address the expected shortfall in their revenues because of the Covid-19 crisis, the increase in unconditional borrowings is limited to 0.5% of GSDP only. We estimate the additional unconditional net borrowing of the states for FY2021 at Rs. 1.0 trillion<sup>1</sup>, which would be adequate to offset only a fourth of the aforementioned gap of Rs. 3.9 trillion between the GST compensation required and available cess collections.*

*We estimate the conditional borrowing of 1.5% of GSDP permitted to the state governments for FY2021 at Rs. 3.0 trillion. However, this is linked to the achievement by the state governments of the targets related to four reform areas prescribed by the GoI in FY2021. If the states are unable to achieve these targets and therefore not eligible to borrow the additional 1.5% of GSDP, any mismatches in the magnitude and timing of the release of the GST compensation by the GoI to the state governments will considerably exacerbate the fiscal and liquidity stress that the states are experiencing in the aftermath of the Covid-19 crisis.*

<sup>1</sup> Refers to total borrowing of all the 28 state governments (excluding borrowing of Union Territory (UT) of Puducherry and Jammu and Kashmir), as a percentage of ICRA's estimate of GDP of Rs. 200.3 trillion for FY2021. This may be slightly different from the GoI's estimate of additional net unconditional borrowing of 0.5% of GSDP (as well as 1.5% of GSDP as conditional borrowing) as the same would be calculated as a percentage of the states' combined GSDP for FY2021, which would be slightly different from the estimate of GDP.

**Exhibit 1: Estimated balances in GST Compensation Fund, SGST collections and GST compensation requirement of all states and 3 UTs**

Amount in Rs. Billion	FY2020	FY2021 SGST collections – ICRA estimates		
		20% lower than FY2020	30% lower than FY2020	40% lower than FY2020
SGST collections (A)	5,007	4,006	3,505	3,004
Protected revenues (B)	6,711	7,650		
GST compensation requirement (C=B-A)	1,704	3,645	4,145	4,646
GST Compensation Fund opening balance (D)	466	255		
GST compensation cess collections (E)	987	494		
GST compensation paid (F)	1,199			
GST Compensation Fund closing balance (G)= (D+E-F)	255			
Unpaid GST compensation for FY2020 (H) = (C-F)	505*			
Gap between GST compensation requirement and cess collections for FY2021 (I) =(C-D-E)		2,896	3,397	3,897
Total estimated gap at end-FY2021 (J)= (H+I)		3,401	3,901	4,402
J as a percentage of ICRA's estimated FY2021 GDP		1.7%	1.9%	2.2%

Note: \* The calculated GST compensation requirement of Rs. 1,704 billion is for the period April 2019-March 2020. GST compensation of Rs. 1,199 billion was released during FY2020, which covered the months of February-September 2019, and a portion of the requirement for October-November 2019. Subsequently, the remaining GST compensation of Rs. 141 billion for October-November 2019, was transferred to the states in April 2020.

Source: GST portal; Press Information Bureau releases; ICRA research

A 21-day nationwide lockdown was initially imposed by the GoI from March 24, 2020 to contain the spread of the Covid-19 pandemic, which has been extended thrice (albeit with some graded relaxations) and is now expected to end on May 31, 2020. This limited the consumption in the economy largely to essential items, curtailing the revenues of the state governments and the GoI.

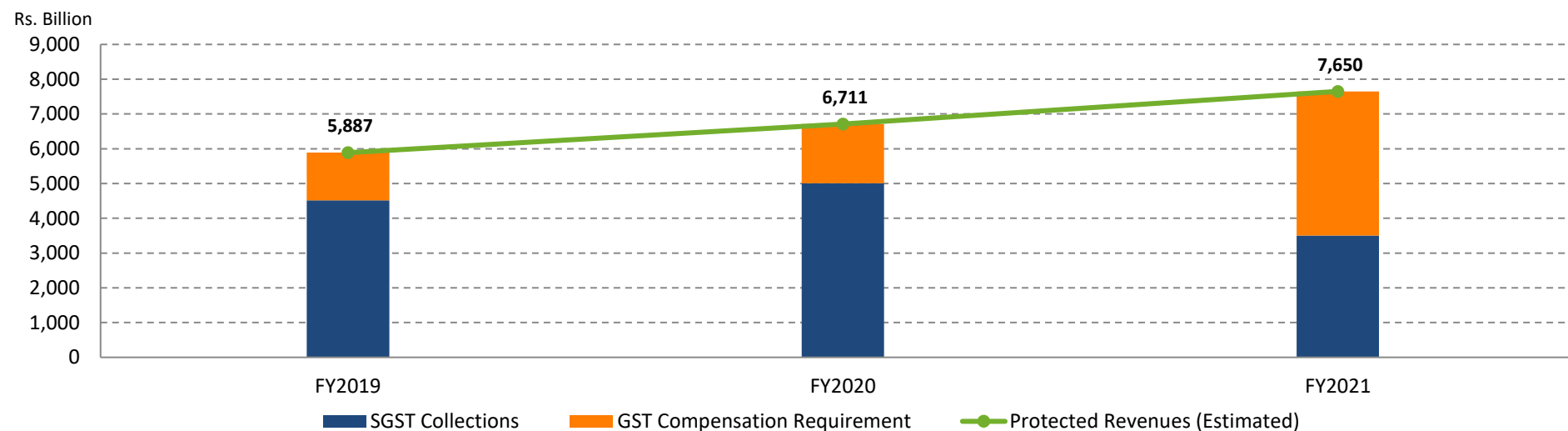
The SGST collections form a sizable 40% of the aggregate own tax revenues of the state governments. Under the provisions laid down in the GST (Compensation to States) Act, 2017, a shortfall in the SGST collections below the protected level, is to be compensated by the GoI to the state governments for the first five years after the transition to the GST regime. The protected revenues of the state governments are arrived at by expanding the revenues subsumed into GST in FY2016, at an annual rate of 14%.

The GST compensation is meant to be funded by levying a cess on the supply of specified products, including sin products (pan masala and tobacco), luxury goods (motor vehicles), coal and aerated water. In our assessment, the GST compensation cess levied on motor vehicles is the chief contributor to the GST Compensation Cess Fund.

The aggregate SGST collections of the 28 state governments and three UTs (Jammu and Kashmir, Puducherry and Delhi) rose by 11.0% to Rs. 5.0 trillion in FY2020 from Rs. 4.5 trillion in FY2019. However, they were substantially lower than the estimated combined protected revenues of these states and UTs of Rs. 6.7 trillion for FY2020. This implies that the GST compensation requirement of the 28 state governments and 3 UTs for FY2020 was Rs. 1.7 trillion in FY2020.

We estimate that the unutilized balance of the previous years in the GST Compensation Fund was around Rs. 466 billion at the beginning of FY2020, to which Rs. 987 billion of GST cess collections were added during FY2020 (Source: Press Information Bureau releases). Out of this total available cess of Rs. 1.45 trillion, the GoI released GST compensation of Rs. 1.2 trillion to the state governments in FY2020, leaving a balance in the GST compensation fund at the end of FY2020 of a modest Rs. 255 billion. This also left an unpaid compensation of Rs. 505 billion (refer Exhibit 1) for FY2020.

**Exhibit 2: Estimated protected revenues, SGST collections and GST compensation required by the state governments**



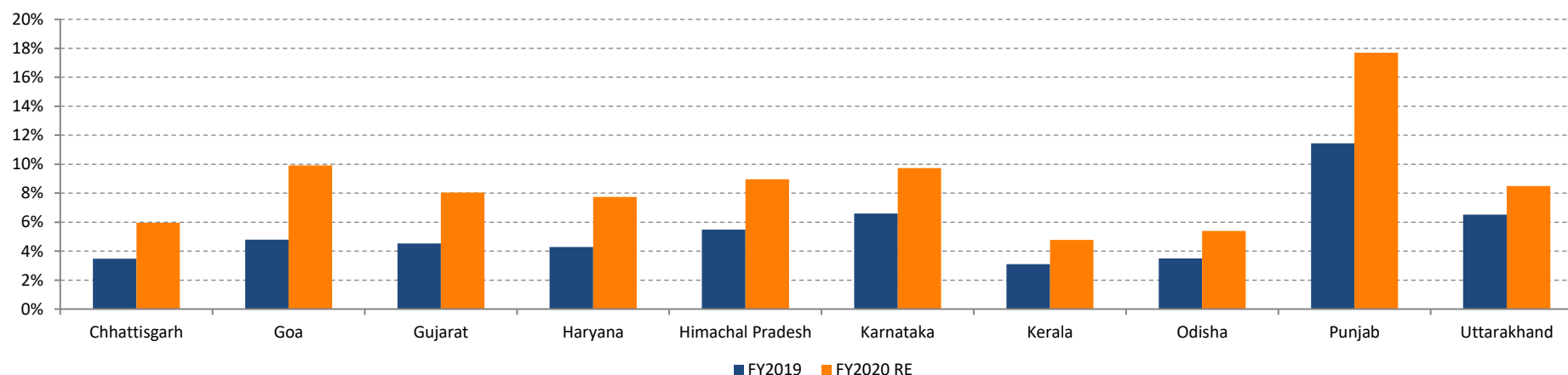
*Note: Estimates of FY2019 and FY2020 SGST collections are from GST portal and FY2021 SGST collections is estimated by ICRA*  
*Source: GST Portal; State Budgets; ICRA research*

For estimating the SGST collections for FY2021, we have evaluated three scenarios, factoring in a contraction of (a) 20% (b) 30% and (c) 40% in the aggregate SGST collections of the state governments from the level in FY2020. ***Our base case is that the SGST collections will contract by 30% to Rs. 3.5 trillion in the ongoing fiscal from Rs. 5.0 trillion in FY2020. ICRA estimates the aggregate protected revenues of the 28 states and 3 UTs at Rs. 7.7 trillion for FY2021. This implies a substantial GST compensation requirement of Rs. 4.1 trillion in FY2021 (refer Exhibit 2).***

*Since the GST cess is levied primarily on luxury and sin items, its collections may undergo a sharper drop in FY2021 than the contraction of 30% estimated by ICRA for the SGST revenues. We have estimated the GST cess collections in FY2021 may decline to around half of the Rs. 987 billion collected in FY2020. Utilising this, and the unspent balance of Rs. 255 billion in the GST Compensation Fund, ICRA estimates a large gap of Rs. 3.4 trillion between the GST compensation requirement of the states in FY2021 and the available cess collections. Moreover, if we add the unpaid GST compensation of FY2020 (Rs. 505 billion), the total GST compensation that the GoI needs to disburse to the states in FY2021 would enlarge to Rs. 3.9 trillion or 1.9% of GDP from the actual payment of Rs 1.2 trillion or 0.6% of GDP made in FY2020.*

*Accordingly, the risk associated with the magnitude and timing of the release of the GST compensation by the GoI to the state governments has escalated sharply and would exacerbate the fiscal and liquidity stress that the states are experiencing due to the Covid-19 crisis. This may pose a larger revenue and liquidity risk to those state governments, which have derived a substantial proportion of their revenue receipts from GST compensation in the recent years (refer Exhibit 3).*

**Exhibit 3: GST compensation as a proportion of revenue receipts in FY2019 and FY2020 Revised Estimates (RE)**



Source: Lok Sabha, State Budgets; ICRA research



To address the expected large shortfall in the revenues of the state governments in FY2021 following the Covid-19 pandemic, including SGST collections, the GoI recently permitted state governments to borrow a net amount of 5% of GSDP in FY2021 as compared to the earlier limit of 3% of GSDP. However, the increase in the unconditional borrowing limit of the state governments is limited to 0.5% of GSDP, ***which translates into Rs. 1.0 trillion (based on ICRA's estimate of FY2021 GDP of Rs. 200.3 trillion) additional borrowing over and above Rs. 6.4 trillion of borrowing earlier permitted by the GoI to the states for FY2021. We therefore estimate the total unconditional net borrowing of the state governments for FY2021 at Rs. 7.4 trillion (Rs. 6.4 trillion plus Rs. 1.0 trillion), 49.5% higher than the Rs. 5.0 trillion of net SDLs issued in FY2020.***

***In our assessment, the additional unconditional net borrowing of Rs. 1.0 trillion would be adequate to offset only a fourth of the gap of Rs. 3.9 trillion between the GST compensation required and available cess collections. There would be significant revenue shortfalls from other sources as well, which would create the pressure for additional state borrowing.***

In addition to the unconditional borrowing mentioned above, the GoI has permitted the net borrowing limit of the states for FY2021 to be augmented by an extra 1% of GSDP in four tranches of 0.25% of GSDP each, subject to the state governments executing reforms pertaining to four areas in their states. The four areas for which the GoI will notify specific, measurable and feasible reform actions, are (a) universalization of the scheme announced by the GoI, 'One Nation One Ration card' (b) Ease of Doing Business (c) Power distribution and (d) Urban Local Body revenues. This implies that upon fulfilment of the each of the outlined four reforms by the state governments, they would be entitled to an additional aggregate net borrowing of Rs. 0.5 trillion per reform, or Rs. 2.0 trillion if all the four are successfully executed in FY2021. Moreover, if the state governments accomplish the targets set for three out of the aforementioned four reforms, they would be eligible for an additional 0.5% of GSDP of net borrowing in FY2021, or Rs. 1 trillion.

***We estimate the conditional borrowing of 1.5% of GSDP permitted to the states for FY2021 at Rs. 3.0 trillion. However, this is linked to the achievement by the state governments of the targets related to four reform areas prescribed by the GoI in FY2021, which remains contingent on several factors. If the states are unable to achieve these targets and therefore not eligible to borrow the additional 1.5% of GSDP, any mismatches in the magnitude and timing of the release of the GST compensation by the GoI to the state governments will considerably exacerbate the fiscal and liquidity stress that the states are experiencing in the aftermath of the Covid-19 crisis.***



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