

GST Unlocks Strong Revenue Potential of India's North Eastern States

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Abstract

The north eastern (NE) states have largely benefitted from the introduction of the goods and services tax (GST) in the country. Arunachal Pradesh witnessed the highest increase in tax collections in the country, while the performance of Manipur, Mizoram and Nagaland was well above the national average. This can be attributed to three distinct reasons. First, with the shift from origin-based levy to destination-based taxation in inter-state sales of goods and services, these states collected much more revenues as they are predominantly consuming states. Second, GST being a value added tax has an inbuilt mechanism for higher tax compliance. All the NE states have witnessed higher revenues from SGST, a component of GST representing taxes collected within the state. Third, the central and the state governments have also encouraged tax payments indirectly by disseminating information on the new tax system. With economic growth picking up in the NE states, GST is likely to register a strong revenue performance in the future and help in much-needed resource mobilisation for the development of the region.

Keywords: Goods and Services Tax, Sales Tax, Revenue, Cascading effect, Tax compliance

JEL: H25, H26, H71

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I Introduction

Goods and Services Tax or GST was introduced in India on July 1, 2017, after decades of planning. It has removed many of the disadvantages associated with the earlier domestic consumption tax system. It is now levied on value addition at every stage of production and distribution of goods and services, providing more comprehensive input tax credit to remove the cascading effect. It is also a tax formed by merging several central and state taxes, including CENVAT/UED, state VAT, CST, Octroi, etc. thus reducing the multiplicity of taxes levied on goods. The tax rates applied to goods at present are also the same throughout the country, reducing tax competition prevailing in the erstwhile sales tax system.

As the tax has subsumed many of the central and state taxes, a new arrangement has been made for collecting and sharing the tax proceeds by the GST Council. The decision-making body comprises of representatives from the Centre and each of the States and Union Territories to take all decisions relating to the structure and operational details of the tax. The Union Finance Minister is the Chairperson of the Council. With central goods and services tax (CGST) and the state goods and services tax (SGST) levied at identical rates, half of the tax is credited to the central government towards CGST, and the other half is credited to the state where the final consumption occurs towards SGST. In case of inter-state sales of goods and services, IGST or integrated goods and services tax is levied whereby the proceeds are allocated equally to the centre and the concerned destination state.¹

To insure against any revenue loss to the states, the GST Council decided to compensate the states for any shortfall in revenues, estimated at 14% increase over the base year revenue from the state taxes subsumed in SGST every year. The compensation was decided upon for 5 years until the tax system stabilises. All decisions regarding the structure and operation of the tax are taken by the GST Council, and thus, individual states have agreed to forgo tax autonomy.²

Four years have passed since GST was introduced and many states had to be compensated for the loss of estimated revenue. However, the NE states have reported an upsurge in tax collections leading to an improvement in their tax-GSDP ratios. This paper attempts to analyse the reasons for the high buoyancy in the GST revenue in NE states. It focuses on the time period before the onset of the COVID-19 pandemic, after which there has been a significant decline in trade and tax revenues. The paper is divided into five sections. Section two analyses the reasons for low tax revenues in the north eastern states. The third section deals with the enhanced buoyancy of tax collections and the reasons for the same, in terms of destination-based nature of the tax and improved tax compliance. The fourth section discusses the reasons why some of the states in the region are getting GST compensation even after witnessing higher tax revenues. The last section summarises the conclusions.

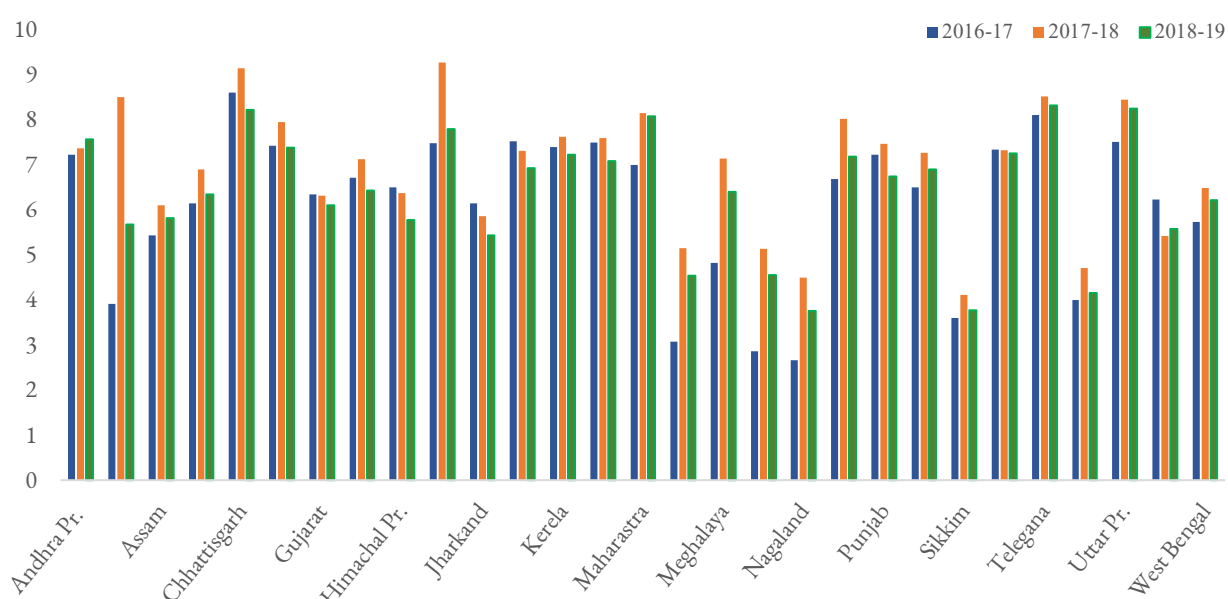
II NE states and low tax collections

The NE states comprise of the states of Arunachal Pradesh, Assam, Manipur, Meghalaya, Mizoram, Nagaland and Tripura. With the exception of Assam, the remaining states have many

similar characteristics. They are basically small states sharing international boundaries; they are geographically mountainous in character; and they are relatively poor states. Because of these reasons, they have not been able to garner large tax revenues on their own and depend on central transfers to finance a large part of their expenditures. They have all been included in the list of 'special category states' which were given development funds on 90:10 grants-to-loans ratio by the erstwhile Planning Commission of India. In their non-plan revenue accounts, they used to have perennial deficits, and as a result they received the so-called gap-filling grants recommended by the Finance Commission of India. With higher devolution they are expected to get more centrally-sponsored schemes, which are often given to states on a matching basis.

The tax ratios of these states have remained low for a long time. This is seen in Figure 1 where the ratio hovered around 3% of their respective incomes for states like Manipur, Mizoram, and Nagaland, and a little higher for the remaining states in the year 2016-17. On the other hand, many big states in the country had tax ratios at around 8% of their state incomes. Low own tax ratio could be due to several factors like low per capita income, higher contribution of the agricultural sector to state income, constraints on production-distribution activities, and small population. State taxes being a state subject, the states' effort in tax collection also cannot be neglected. A brief discussion on low tax revenues in the region can also be found in Nepram (2009).

Figure 1: Tax ratios of states in the country (%)

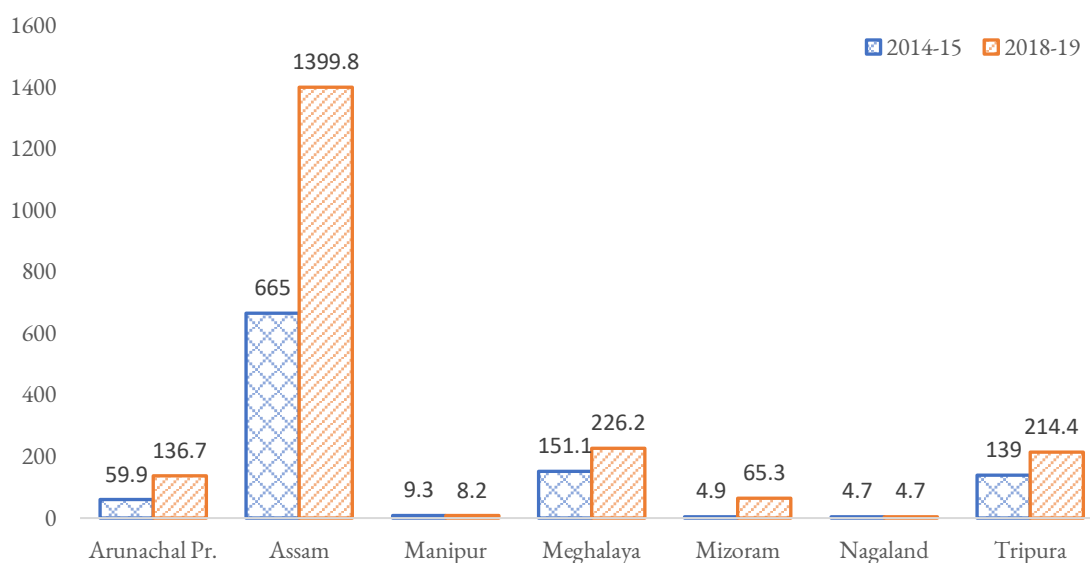


Source: Estimated using Reserve Bank of India (RBI) data on tax collections and net state domestic product (NSDP) data from Economic Survey

Another important point for the low tax collections is the implementation of prohibition. Some state governments have imposed prohibition due to strong pressure from civil society or religious organisations. Bhaumik (2009) narrated how the Church in Mizoram was very much against alcohol consumption; given its enormous influence over the electorate, no political party was willing to risk losing an election and, therefore, adopted the prohibition policy. In the brief

three-year period that Mizoram lifted prohibition (2015-18), the state earned more than Rs. 60 crores annually (Telegraph, 2021). Arunachal Pradesh, Assam, Meghalaya, Mizoram, and Tripura earned Rs. 136.73 crores, Rs. 1399.84 crores, Rs. 226.21 crores, Rs. 65.34 crores, and Rs. 214.35 crores respectively from state excise in the year 2018-19 (Figure 2). Manipur and Nagaland which have prohibition collected just Rs. 8.18 crores and Rs. 4.65 crores respectively from the tax in the same year. Meanwhile, Punjab could collect Rs. 5072.40 crores, which was as high as 15.95 % of its own tax revenues. Tamil Nadu collected Rs. 6863.12 crores or 6.47 % of its own tax revenues from taxes on alcohol. The merits and demerits of prohibition is a highly debated topic in the region.

Figure 2: Revenue from state excise (Rs.cr.)



Source: RBI, State Finances, A study of state budgets

The second reason for low tax effort could be larger central transfers. The Finance Commission estimates the gaps in the revenue account of each state in the country for the ensuing five years, and these are filled by the 'gap-filling grants'. The basic logic is that states should not suffer from lack of funds, and all the NE states have been receiving these grants. However, this transfer creates a soft budget constraint on spending, resulting in less urgency for states to collect more taxes. There are a number of studies that support the resource constraint hypothesis. Panda (2009) observed that per capita transfers reduce per capita tax and non-tax revenues of the states. Nepram (2011) in a study on determinants of tax ratio also found that higher central transfers reduce the tax ratio of the states. Garg *et al*(2016), based on a study using data from fourteen major states in the country, also observed negative association between per capita tax revenue and central transfers. In a more detailed study, Debnath and Battacharjee (2019) found that tax ratio is inversely related to unconditional central transfers, while conditional transfers seem to have a positive effect on it. Coming to studies based on the NE states, Dutta and Dutta (2015) said Assam received liberal central transfers but own revenue mobilisation effort has not been satisfactory and needs to increase tax ratio.

Another reason for the lower tax ratio has been the high contribution of public services in the state income. Many of the NE states depend on central transfers and these funds are channelled in providing healthcare, education, administration, development of infrastructure facilities, etc. As many of the states are very small with very little production-distribution activity, in part due to proximity to international borders and poor security situation, the government is the most important source of organised employment. For example, in a relatively large state like Assam, the expenditure on public administration is 6.32% of the state income; it is over 10% for the other NE states, with Nagaland going over 18%. A large expenditure on public administration adds to the state income but does not yield much tax revenue to the state governments directly as compared to other services. Government employees do pay the tax on profession, trade, callings and employment, but it has been capped at a maximum of Rs. 2500 per person per year, while Arunachal Pradesh does not levy it. Opinions have been expressed for raising the upper limit for employees exempted from paying income tax in the region. The potential can be enormous (Sen, 2018).

Table 1. Expenditure on public administration and collection of professional tax (2018-19)
(Rs.cr.)

State	NSVD	Public administration	Gross central transfers	Professional tax
Arunachal Pradesh	21478	2901(13.51)	14313.6	0
Assam	261984	16565 (6.32)	38925.5	186.35
Manipur	24410	3603(14.76)	9245.9	33.78
Meghalaya	30729	3697(12.03)	7423.8	3.88
Mizoram	16993	2239(13.18)	7805.2	14.49
Nagaland	23993	4439(18.50)	10265.0	35.33
Tripura	47938	6703(13.98)	9809.5	43.88

Source: RBI, Handbook of Statistics on Indian Economy

RBI, State Finances, A study of state budgets

Note: The figures in the brackets represent percentages of net state value added at basic prices (NSVD).

III Buoyant tax revenues from GST

Own tax collections in these states have seen sudden improvement after the implementation of GST, with Arunachal Pradesh achieving the highest growth rate in the country. Manipur, Meghalaya, and Mizoram all witnessed higher tax revenue, and GST indeed has proved to be a money machine. A review of data hints that higher tax collections in these states could be due to two reasons. The first one is transformation from the origin-based levy to the destination-based levy by abolishing the central sales tax, while the other is better tax compliance. These shall be studied in the following two sub-sections.

1 Central Sales Tax

Central sales tax on inter-state sale of goods was levied by the central government but collected and appropriated by the state of origin. In fact, it was an export of the sales tax burden levied by the state of origin on the people in the state of destination. With the levy of GST, this tax has been abolished. Rao (2003) narrated the inequity aspects of the previous central sales tax in detail. Sales tax in the country was entirely destination based initially but the origin aspect was incorporated later on because of widespread tax evasion by reporting intra-state sales as inter-state sales. It was introduced in the year 1956 on inter-state sales with an objective to track the movement of goods. The tax rate was initially levied at 1% which was increased gradually to 4% and became an important source of revenue for many states. This enabled the rich producing states to export the tax burden to the residents of poor consuming states. It also added to the distortion due to the cascading effect (where prices increase due to a good being taxed more than once). In addition to the inequity aspects of it, Purohit (2001) stated that it created hindrance to the smooth movement of goods across the country, thereby, preventing creation of a nation-wide common market.

CST was to be abolished completely when state VAT was introduced in 2005, with the plan being to reduce it in stages from the prevailing 4%. The planned reduction in the tax rate stopped at 2% when many of the states simply refused to abolish it totally. In fact, CST was a very good source of revenue for many states and their hesitancy could be understood. Maharashtra and Karnataka collected Rs. 6543.05 crores and Rs. 4783.29 crores respectively as proceeds from the tax in the year 2016-17.

With the GST reform, inter-state supply of goods and services are now taxed as IGST where the tax proceeds are credited to the centre and the state where the final consumption of the supply takes place. This makes it a destination-based tax. As a result, the state of origin may lose revenue, to the gain of the states of destination. But all states are likely to get more revenue from it as every state consumes manufactured goods produced outside the state. Secondly, the GST rate could be much more in inter-state sales than just the 2 % which the producing states were getting.

The NE states with the exception of Assam, Meghalaya, and Tripura did not receive any CST revenue prior to the GST implementation, as they are largely consuming states with hardly any manufacturing activity. Public sector dominates the services sector while the secondary sector is dominated by the construction industry (which again is consumed where it is produced). Table 2 shows that Manipur was getting no revenue from CST in 2016-17 and all of a sudden received Rs. 210.92 crores as IGST in the subsequent year, which further increased to Rs. 589.75 crores in the year 2019-20. The IGST figure is very large for Assam, touching Rs. 4309.07 crores in the year 2019-20. While big states still gained more in terms of absolute amounts, NE states gained the maximum in terms of percentage increase.

Besides the NE states, the table also gives data of bigger states, namely, Bihar, Kerala, Gujarat, Maharashtra and UP, three rich income states and two relatively poor states. A big, populated state like UP which collected just Rs. 1995.08 crores in 2016-17 from CST, got Rs. 13,485.44 crores in the subsequent year from inter-state sales, CST and IGST added together, while for

Kerala the rise was from Rs. 336.85 crores to Rs. 6214.67 crores. The big producing state like Maharashtra also gained and collected Rs. 11,832.15 crores from IGST alone in the year 2017-18, which comes to Rs. 14,942.64 crores when CST revenue was added. The total gain from inter-state sales tax was Rs. 8399.59 crores over the previous year's figure. Thus, the earlier notion that consuming states will gain at the cost of producing states may not be totally true.

2 Higher tax compliance

Another important point for the increase in tax compliance may be due to the self-policing mechanism associated with the method of calculating GST. A value-added tax has two methods of collecting tax in practice, one is the subtraction method while the other is the tax credit system. In the latter, which is in practice in the country, a person has to pay tax on the full value of the good at any stage of transactions, but a refund will be given later on of any tax paid in earlier transactions (making it a tax on value added). This makes the system inherently tax-compliant, as refunds will not be available in case of tax evasion. Further, payment of taxes can be easily checked as every transaction has been done online.

From 2017-18 onwards, the Reserve Bank of India (RBI) classified SGST separately from sales tax (which includes state sales tax/VAT, CST, etc.). Column 6 in Table 3 is the addition of these two taxes, done to compare with the previous data of sales tax.³ It is seen that in the year 2016-17 the amount of sales tax collected by Arunachal Pradesh was Rs. 282.54 crores which jumped to Rs. 1440.42 crores in the subsequent year. The state witnessed an increase in revenue by over five times while Manipur, Mizoram, and Nagaland observed growth by more than two times. The lowest increase was observed in Tripura, followed by that of Assam and Meghalaya. Even after subtracting IGST data from column 6, the improvement in revenue collection is significant (column 7).

Arunachal Pradesh has been a star performer in GST collections and the effort as reported in the media included taxpayer outreach programme and market surveys (The Sentinel, 2019). The State Taxation Department of Manipur said surprise checks in markets and highways along with awareness programme had yielded results (The People's Chronicles, n.d). The awareness programmes taken up by the central and state governments while implementing the new tax indeed helps in increasing tax compliance. GST is a popular term now among the general public.

Table 2: Collection of CST/ IGST by states (Rs.in cr.)

	2016-17	2017-18	2017-18	2017-18	Gain/Loss in	2018-19	2018-19	2018-19	2019-20
	CST	CST	IGST	CST+IGST	2017-18 over 2016-17	CST	IGST	IGST+CST	IGST
Arunachal Pr.	0	0	152.53	152.53	152.53	0	357.96	357.96	502.33
Assam	558.26	338.40	1977.90	2316.30	1758.04	206.44	3867.32	4073.76	4309.07
Manipur	0	0	210.92	210.92	210.92	0	457.47	457.47	589.75
Meghalaya	25.14	7.25	206.59	213.84	188.7	1.65	417.85	419.50	548.68
Mizoram	0	0	123.51	123.51	123.51	0	316.02	316.02	389.13
Nagaland	0	0	133.27	133.27	133.27	0	331.41	331.41	457.98
Tripura	4.21	1.16	281.44	282.60	278.39	0	553.82	553.82	629.18
Bihar	41.21	53.90	3831.96	3885.86	3844.65	743.06	8368.06	9111.12	9458.70
Gujarat	4783.29	3462.74	5042.45	8505.19	3721.90	2785.80	6805.21	9591.01	7449.73
Kerala	336.85	149.68	6064.99	6214.67	5877.82	29.71	10114.96	10144.67	9933.42
Maharashtra	6543.05	3110.49	11832.15	14942.64	8399.59	1216.07	19063.70	20279.77	20690.79
UP	1995.08	989.53	12495.91	13485.44	11490.36	483.09	21231.13	21714.22	24363.18

Source: Reserve Bank of India, State Finances, A study of state budgets

<https://www.gst.gov.in/download/gststatistics>

Table 3: Collection of sales tax/SGST (Rs.cr.)

States	2015-16	2016-17	2017-18		2017-18	2018-19	
	Sales tax	Sales tax	Sales tax	SGST	Sales tax +SGST	Minus IGST	Sales tax +SGST
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Arunachal Pr.	190.22	282.54	285.13	1155.29	1440.42	1287.89	1075.24
Assam	7493.72	8751.63	6373.00	6329.07	12702.07	10724.17	13588.48
Manipur	466.51	499.65	385.58	721.09	1106.67	895.75	1040.32
Meghalaya	811.79	931.06	766.63	812.56	1579.19	1372.6	1529.76
Mizoram	247.04	307.81	242.85	482.56	725.41	601.9	659.66
Nagaland	328.58	400.12	287.55	526.21	813.76	680.49	731.03
Tripura	1058.48	1112.89	611.88	916.27	1528.15	1246.71	1435.69

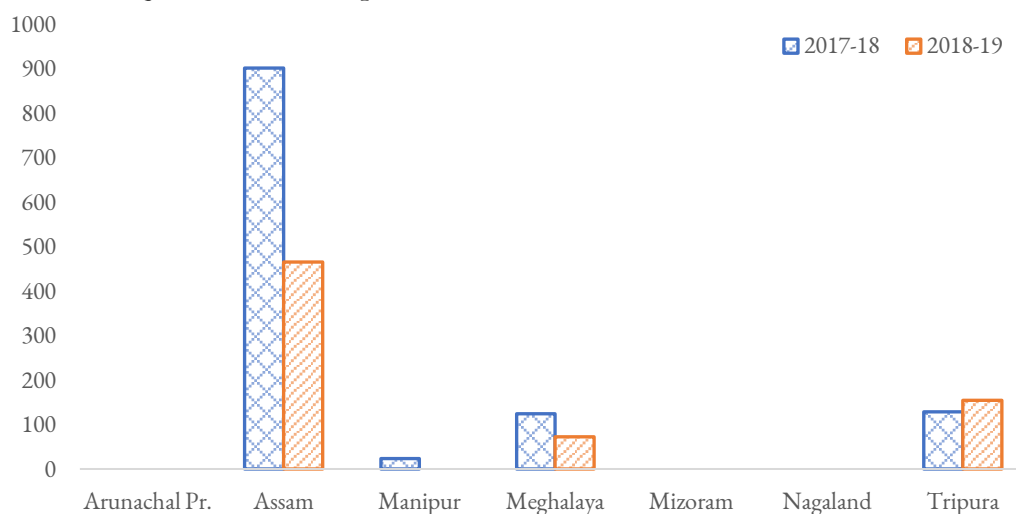
Source: Reserve Bank of India, State Finances, A study of state budgets

<https://www.gst.gov.in/download/gststatistics>

Note: Sales tax includes sales tax/VAT and other taxes like CST. SGST includes IGST.

IV GST compensation

Despite the strong revenue performance of the NE states, some of the states have been receiving GST compensation even before the constraints on economic activities caused by the surge in corona cases in 2020-21 (Figure 3). Only the three states of Arunachal Pradesh, Mizoram, and Nagaland did not receive any GST compensation. Assam, Manipur, Meghalaya and Tripura were given compensation in the year 2017-18. In the subsequent year, lower compensation was given to Assam and Meghalaya while no compensation was given to Manipur. Only the state of Tripura received higher compensation. To understand the reasons behind giving of compensation, we need to comprehend the mechanism of how GST compensation given to states is estimated.

Figure 3: GST compensation to the north eastern states (Rs.cr.)

Source: Reserve Bank of India, State Finances, A study of state budgets

As mentioned earlier, the states were persuaded to join the GST reform by assuring them compensation for any loss of revenue if the actual revenue collections differ from the estimated revenue. To finance the compensation, the GST Act enables the levy of GST cess on certain goods like chewing tobacco, cigarettes, and automobiles. In order to estimate the loss, the revenue from the taxes subsumed in GST in 2015-16 was to be taken as the base year and projected to grow at 14% every year. The shortfall in the actual revenue from the projected revenue was to be compensated. In the year 2017-18, many states were given GST compensation, the maximum amount going to Karnataka with a sum of Rs. 6246 crores.⁴

The adoption of 14% growth rate for all the states was arrived at after considerable deliberations.⁵ The rate of growth adopted was generous, mainly to incentivise the states to join the reform programme. There are, however, two important shortcomings in the compensation scheme besides the generous compensation package. First is the adoption of uniform growth rate for estimating potential revenue although the actual revenues from the subsumed taxes varied widely across the states. Second, the growth rate adopted to estimate potential revenue was delinked from the growth of the economy. The Fifteenth Finance Commission (2021-26) also commented that many states in the pre-GST period did not witness a 14% tax growth rate and said that the guarantee of an assured revenue “has created another significant complication in federal finance” (GOI, 2020, p. 54).

Shah (2020) raises two points regarding the compensation issue. First, the compensation was paid to states like Meghalaya, Tripura, Bihar and Assam, which benefitted much more from the new destination-based tax system. It should have been confined to producing states. Second, this kind of generous package can also encourage tax complacency. A similar view on the latter point was echoed by Gupta and Rajaraman (2020). They estimated the average growth rate of the subsumed taxes by using three different methods during the period 2012-13 to 2015-16. The state annual average growth rate varied between 7.59% to 7.67% while the growth rate of the GSDP ranged between 10.89% and 11.09%. Only a few states achieved the 14% growth rate during the period, while the number of states witnessing less than 8% growth rate estimated by using trend growth rate was 9. The number rose to 16 if the rate of growth is less than 10%. They observed that such a generous guarantee to all the states may in fact reduce tax effort.

The data of subsumed tax collections were given for the period 2012-13 to 2016-17. Using this data, we estimated the trend growth rate of the NE states (with the exception of Arunachal Pradesh, for which only the data of 2015-16 was given). We find only Meghalaya and Mizoram had growth rate over 14%, while the remaining four states achieved less. In any case, in a reform involving the agreement from all the states, differentiating the compensation principle among the states may not be feasible.

Table 4: Proceeds of taxes subsumed in GST (Rs.cr)

	2012-13	2013-14	2014-15	2015-16	TGR (%)
Assam	4467.12	4878.21	5244.91	5985.5	9.50
Manipur	263.71	386.57	432.78	347.06	9.37
Meghalaya	379.27	309.89	448.26	636.17	19.21
Mizoram	109.098	135.563	148.898	188.91	17.41
Nagaland	195.51	178.43	215.94	256.10	10.01
Tripura	572.88	628.20	667.90	788.73	10.21

Source: <https://www.gst.gov.in/download/gststatistics>

The states can collect more revenue from GST by improving the tax compliance. The states have done it before and can do it again. Ebrill *et al*(2001) said tax revenue from VAT increases with the age of the tax and literacy rate of the country. Thus, as the economy picks up and social development indicators improve over the years, the tax compliance is likely to be better. Further, the efficiency of the administrative machinery may also improve over time. For example, the technical glitches and other problems associated with the GST system as mentioned in CAG Report may be done away with in due course of time.⁶ What we can do now is to reduce the time lag by special measures and make eligible taxpayers pay, instead of waiting for increasing compliance in a natural manner.

Mukherjee (2020) has stated that, based on his study, many states including the NE states have seen higher GST compliance gap and lower filing of GST returns. Even in Figure 1, the tax ratios of the states are seen declining in the year 2018-19 from the previous year's figure. Bringing more small traders into the tax net could increase tax revenues of the states, as many of them seem to be unaware of the tax or avoided it intentionally, suggesting room for growth. As per the data released by GSTN on 3 years of GST, Arunachal has more active taxpayers than Manipur and Nagaland, even though its population is lower than theirs. More checks and awareness programmes should be held.

V Conclusion

GST has been rightly called 'One nation, One tax' not only from the point of streamlining the tax system but also from the point of revenue generation as well. The tax ratio of the NE states has increased, so much so that they are no longer low tax effort states. This transformation can be credited to three factors. The phasing out of the central sales tax resulting in the transfer of tax proceeds from the state of origin to the consuming state. Tax collections for states have also seen a phenomenal increase, with a state like Arunachal Pradesh witnessing a jump in own tax collections by over 100%. This has also been due to the tax design which results in higher tax compliance. The effort of the governments, both central and states, in disseminating information about the tax cannot be neglected. It created more awareness about the new tax.

There are factors like prohibition, low production base, large central transfers, etc. which have reduced tax ratio of the NE states. But there are possible ways of increasing tax revenues, such as greater effort on the part of the government to increase tax compliance and raising the tax limit for taxes on profession, trade, callings and employment. Ultimately, the long-term means is faster

economic growth and reduction in the inequality of income distribution. These measures will widen the tax base and improve tax collections in the future. The NE states lack industrialisation and the governments should give special focus on infrastructural development for the purpose. The 'Look East Policy' initiated by the central government has opened a number of opportunities on this front.

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Notes

¹ See The Empowered Committee (2009) and Government of India (GOI) (2017) for more details on the tax.

² See Joseph and Ramalingam (2020) on why states should be compensated even after five years.

³ In 2017-18 the amount of sales tax includes state VAT levied in the months of April, May and June on all goods. It continued to be levied on certain items like petrol and alcohol.

⁴ The RBI data differs from the data published by the Ministry of Finance which puts the figure at Rs. 7535 crores (See <https://pib.gov.in/PressReleasePage.aspx?PRID=1542747>)

⁵ See the deliberations of GST council meeting on the theme (GOI, 2016).

⁶ See Dhasmana (2019) on CAG report.