



GST Compensation Cess in Light of the Recent Financial Developments 2023

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ABSTRACT

The Goods and Services Tax 2017, was implemented in India, replacing the taxes levied by the Centre and States to eradicate the cascading effect of taxes. It is a destination-based tax as compared to the previous taxes that were origin-based. Due to it being a destination-based tax, this impacts the revenue that was previously earned by the States. For this, the Government had introduced the Goods and Services (Compensation to States) Act 2017 to compensate the States. The authors have tried to analyse the Compensation Act with regard to the recent changes in relation to the 49th GST Council Meeting, Finance Bill 2023 and the notifications issued thereafter by the CBIC. The authors also analysed the impact of the withdrawal of the GST Compensation cess once the extended period up to 31st March 2026 gets over.

Keywords: *Compensation cess; Goods and Services (Compensation to States) Act 2017; GST council; Finance Bill 2023; Impact.*

1.0 Introduction

Goods and Services Tax (GST), implemented in India on 1 July 2017, is a comprehensive indirect tax for the entire country.¹ GST is charged at the time of supply and depends on the consumption destination. The GST subsumed the majority of taxes into a single tax that is primarily collected by the Centre and subsequently dispersed to the relevant States in accordance with the prescribed rates. As a result, the States are no longer able to levy their own taxes on the majority of goods and services. The Goods and Services Tax (Compensation to States) Act was enacted in 2017 to levy a compensation cess.

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The compensation cess is levied to compensate states, for the loss of revenue they have incurred on account of the introduction of the Goods and Services Tax by the government.² The aspect of state compensation, as the record suggests, was first pondered upon by the parliamentary standing committee which had examined the 115th Constitutional Amendment Bill, 2011. A renowned economist Dr. Vijay Kelkar floated the need to compensate states before the parliamentary committee, as a means of incentivizing States, when GST would be finally rolled out. Post the change in government at the centre and the consequent expiration of the 115th Constitutional Amendment Bill. The Constitutional 122nd Amendment Bill was introduced in 2014, which sought to amend various provisions in the Constitution, specifically those which affect the introduction of the GST. The recommendation of the parliamentary standing committee and Dr. Vijay Kelkar was accepted, and clause 19 of the bill was transformed into S. 18 of the Constitution (101st Amendment) Act, 2016, which reads as follows:

“18. Compensation to States for loss of revenue on account of introduction of goods and services tax. — Parliament shall, by law, on the recommendation of the Goods and Services Tax Council, provide for compensation to the States for loss of revenue arising on account of implementation of the goods and services tax for a period of five years.”³

The Compensation cess on imported goods is collected in accordance with S. 3 of the Customs Tariffs Act. This provision empowers the tax authorities to collect additional duties on imported goods.⁴ The Customs Tariff Act of 1975, governs the valuation of products for the compensatory cess. The exporter is entitled to a reimbursement of the input tax credit for the Compensation Cess related to the exported items, and Compensation Cess is not assessed on exported goods. Additionally, a taxable person who chooses to pay a composition levy is not subject to a compensation cess on the supplies they make. Both inter-state and intra-state supplies of goods or services would be subject to the GST cess.

As for payment to the State, as per section 7(1) of the Compensation Act, compensation is due to every State during the transition period. A period of five years starting on the transition date is called the “transition period.” The amount which the State may receive compensation is the Compensation Fund.

The aim of the study is to understand the implication of compensation cess under Goods and service tax (GST) on states, its constitutionality and the recent financial developments in the year 2023. Also the compensation cess was applicable for 5 years starting from 2017 and extended due to the coronavirus, what would be the impact in case of withdrawal of the compensation cess.

2.0 Important Provisions of the Goods and Services (Compensation to States) Act, 2017

The GST (Compensation to States) Act 2017 is a significant law that compensates states for revenue losses caused by the introduction of the Goods and Services Tax (GST). The State in which the consumption of goods and supply happen would be compensated. The following are some key sections of the Act:

2.1 Section 3 - projected growth rate

Section 3⁵ of the GST (Compensation to States) Act 2017 provides for imposing and collecting a compensation cess on certain goods and services, which will be used to compensate states for revenue losses caused by implementing the Goods and Services Tax (GST).

The key objective of this section is to ensure that states receive adequate compensation for revenue losses caused by the implementation of GST, a destination-based and consumption-based tax. The tax is charged at the place of consumption under the GST system, implying that the states where the goods and services are consumed may lose revenue compared to those where the goods and services are produced or supplied.

Section 3 compensation cess is levied in addition to the GST rate applicable to the goods or services. The GST Council, which comprises the Finance Ministers of the Centre and the States, determines the rate of compensation cess, which may vary based on the type of products or services. As per this section, the projected nominal growth rate of revenue subsumed for a State is kept at 14% p.a during the transition period.

Another important aspect of Section 3 is that it only applies to particular “luxury” or “sin” commodities, such as cigarettes, tobacco products, pan masala, aerated drinks, and automobiles. The rationale behind this is to ensure that the burden of compensation cess does not fall on the ordinary person but on those who purchase luxury or sin goods.

2.2 Section 4 - base year and Section 5 - base year revenue

Section 4⁶ of the GST (Compensation to States) Act 2017 sets the Financial Year 2015 – 16 as the base year for the purposes of calculating the Compensation Cess. Section 5⁶ of the Act states that the base year revenue shall be the total revenue accumulated by the state and its local bodies during that particular year. Thus, this revenue includes all of the taxes that states were entitled to collect but now are abolished by the GST, such as the Value Added Tax, Central Sales Tax, entry tax, octroi, taxes levied on luxuries, and taxes levied on advertisement. Additionally, pursuant to the former Article 268 of the

Constitution, the charges of excise on medical and toilet preparations are assessed by the Union but collected and held by the respective State Government.

It must be borne in mind that revenue earned by the states in the base year from taxes attracted from the supply of liquor for human consumption, petroleum products such as petroleum crude, high speed diesel, vehicular petrol, natural gas, aeroplane fuel shall be excluded from the base year revenue for the purposes of calculation.⁸

2.3 Section 6- projected revenue for any year

Section 6⁹ of the GST (Compensation to States) Act 2017 provides that the projected revenue shall be equal to the base year revenue multiplied by the Projected Growth Rate, which is deemed to be 14% compound interest.

2.4 Section 7 - calculation and release of compensation

Section 7¹⁰ of the GST (Compensation to States) Act 2017 specifies the amount of compensation given to states for revenue losses caused by implementing the Goods and Services Tax (GST). The main aim of this part is to provide a formula for calculating the compensation due to states and to ensure that compensation is computed transparently and objectively. The amount of compensation to which a State is entitled equals the difference between its projected revenue for the particular fiscal year and its actual revenue. The compensation to which the State is entitled will first be determined provisionally and released every two months. Thereafter, after receiving the final revenue data as audited by the Comptroller and Auditor-General of India, the compensation will be determined for each financial year. In addition, the projected revenue that the State would have received had the Goods and Services Tax not been in place during the final two months of the fiscal year is to be divided by the total projected revenue on a pro rata basis.

Section 7 is significant as it ensures that compensation is computed in a way that gives certainty and predictability to the states. This is essential for the State's financial stability and allows them to properly manage its budgets and expenditures. Section 7 also includes a provision for a review of the compensation formula five years after the implementation of GST. This ensures the formula is relevant and responsive to changing economic conditions and revenue patterns.

2.5 Section 8 - levy and collection of cess

Section 8¹¹ of the GST (Compensation to States) Act, 2017, provides for the levy and collection of cess, it provides that all taxpayers who supply prescribed goods and services, not including composition taxpayers, are to collect compensation cess including

compensation cess levied upon the imported goods. A compensation Cess is levied over and the above the GST leviable, particularly about a particular supply.

Tax determination of the compensation cess is similar to determining the Goods and Services Tax on a particular good or service. The stipulated tax rate is applied on the transaction value as prescribed under Section 15 of the Central Goods and Services Tax Act, 2017 for imported goods, the transaction value is that which is determined under the Customs Tariff Act, 1975, which is the transaction value plus the applicable customs duty.

2.6 Section 10 - crediting proceeds of cess to fund

Section 10¹² of the GST (Compensation to States) Act, 2017, the cess leviable under section 8 and any additional amounts the Council may recommend would be credited to a non-lapsable Fund known as the Goods and Services Tax Compensation Fund. This Fund would be used to pay the sum due to the States pursuant to section 7.

Section 10 also provides for the management of the fund. Whereby the Central Government is to reimburse the Comptroller and Auditor-General of India for any costs associated with the audit of the accounts relating to the Fund, which is conducted by the Comptroller and Auditor-General of India or any person appointed by him at such intervals as may be specified by him. The accounts of the Fund and the audit report must be given to each House of Parliament in order to ensure that the GST compensation mechanism continues to operate correctly. This guarantees that funds are distributed clearly and accountable and that compensation is paid in accordance with the Act's terms.

3.0 Input Tax Credit and Compensation Cess

As per Section 8 (2) of the GST (Compensation) Act, compensation cess is leviable upon the following only, in addition to normal GST:

- a) Pan Masala compensation cess leviable @ 204%
- b) Tobacco and manufactured tobacco substitutes and all kinds of tobacco products
- c) Coal and solid fuels generated from either coal, peat or lignite, compensation leviable @ Rupees 400 per ton
- d) Aerated drinks @ 12%
- e) Vehicles, cess to be charged @ 17% if the vehicle is less than 1500 cc, in other cases @ 20% and in cases of an SUV @ 22%

Thus, it must be borne in mind that suppliers engaged in the supply of the above-mentioned goods and services are liable to pay compensation cess and claim input tax credit on the same.

As per Section 2 (g)¹³ of the Act any compensation cess charged on the above-mentioned goods shall be deemed as input tax, thus the provisions related to credit of input tax under the Integrated Goods and Service Tax Act and the Central Goods and Services Tax Act is to apply in toto to the GST (Compensation) Act, as provided under Section 11 of the Act.¹⁴

Since Section 17 (5)¹⁵ of the Central Goods and Services Tax Act does not exclude credit on compensation cess, hence, Input Tax Credit can be availed on cess already paid. It is pertinent to note that input tax credit related to compensation cess can only be utilised against cess output on goods mentioned above only, if the final output is different from the scheduled goods, the input tax credit cannot be utilised, as per Section. 11 (2)¹⁶ of the GST (Compensation) Act.

3.1 Compensation cess and input tax credit on export

As per Section 16 (3) (a) of the Integrated Goods and Services Tax Act, an exporter is to always be entitled to a refund on account of unutilised compensation cess input tax credit related to export sale. Exporters are eligible for refund of input tax credit on the principle that “no taxes be exported and exports have to be zero rated only”. Thus, an exporter can claim Input tax credit subject to the following conditions:

- The input raw material on which compensation cess is payable is utilised to manufacture goods which shall be exported.
- Input tax credit against compensation cess is claimed as ITC in GSTR 3B.
- Final good is exported under a letter of undertaking without payment of GST. However, if the final good sought to be exported by the exporter is also a scheduled good and liable to compensation cess, then the good shall be exported on payment of IGST plus the compensation cess and then the exporter shall be entitled to refund of both IGST plus the compensation cess as laid down in Section 16 (3) (b) of the Integrated Goods and Services Tax Act.¹⁷

4.0 Constitutional Validity of the Compensation Cess

The case of *Union of India v. Mohit Mineral Pvt. Ltd.*'s¹⁸ challenges the validity of the new tax regime (GST) whereby it challenges the competency of the parliament to enact it in view of it being a colourable legislation.

Mohit Minerals is a private company engaged in the trade of imported and domestic coal, whereby they purchased coal from foreign countries and also purchased it domestically. The issue arose after Mohit Mineral Pvt. Ltd. received a notification from the Commissioner of Sales Tax requesting payment of compensation cess. They were

already paying the clean energy cess levied by the Finance Act of 2010, which is on the manufacture of coal and was levied on removing coal from the factory. With the introduction of the Goods and Services (Compensation to States) Act 2017, they were also required compensation cess. Therefore, they challenged the act's validity and demanded to set off clean energy cess against the compensation cess.

4.1 Analysis of the case

One of the most contentious issues that was issued before the Supreme Court in this case, was whether the parliament has the legislative competency to levy compensation cess in light of clean energy cess already being levied, thus leading to double taxation. The Court tackled this question by referring to Article 270 of the Constitution of India and held that post the 101st Constitutional Amendment, the parliament can levy any cess by passing suitable law. The court also held that the states were entitled by law to receive compensation, due to loss of revenue due to the introduction of the Goods and Services Tax Act, 2017. (Section 18 of the Amendment Act).

The Supreme Court also accepted the Government of India's contention that the compensation cess is in the nature of a special kind of tax and an exclusive component of the new Goods and Services regime. Thus on this premise, the parliament was completely within its competence to enact the GST and the compensation cess is the extension of it, hence by logic parliament is also competent to levy compensation cess by law. The Government of India also referred to Entry 97 of List 1 of the 7th schedule of the Constitution whereby by virtue of residuary powers, the parliament is competent and also Article 246A empowers parliament to make laws with respect to Goods and Services Tax.

By upholding the Compensation Act's legality, the Supreme Court has also upheld this crucial tenet of fiscal Center-State relations and advanced the cause of the change symbolised by the GST. It was also clear that there is no double taxation in this regard, as there is no agreement to implement GST together cooperatively, which is in accordance with the rationale for the Compensation Act.

5.0 The Demands of the State to Extend the Compensation Cess beyond 2022 after the Pandemic

In the pre – GST era, particularly in the financial years 2013 to 2017, the revenue growth of states ranged from 7.9% to 11%, while the average being 8.2%, despite this the centre guaranteed states as per the Goods and Services (Compensation to States) Act, 2017 a 14% growth rate for the next five years. Unfortunately, in light of the lockdown imposed in response of the COVID-19 pandemic, the loss of revenue to states was

estimated at Rs. 3 lakh crores. In contrast, the compensation cess paid to states was only to the tune of Rs. 65,000 crore. However, the centre borrowed Rupees 1.1 lakh crore from the Reserve Bank of India to make up for the deficit, but to completely address the deficit, the states have requested the centre to extend the payment of compensation cess, beyond 2022, contrary to the initially agreed period as per the act.¹⁹

According to the Goods and Services Tax (Period of Levy and Collection of Cess) Rules, 2022, the Finance Ministry extended the period of levy and collection of cess under sub-section (1) of section 8 of the Goods and Services Tax (Compensation to States) Act, 2017 from July 1, 2022, until March 31, 2026 (Notification No. 1/2022-Compensation Cess dated 24th June 2022).²⁰

6.0 49th Council Meeting- 2023

On February 18, 2023, the Union Minister for Finance and Corporate Affairs, Smt. Nirmala Sitharaman presided over the 49th GST Council meeting in New Delhi. Shri Pankaj Chaudhary, the Union Minister of State for Finance, the Finance Ministers of the States and UTs (with legislatures), and senior officials from the Ministry of Finance and the States and UTs also attended the meeting.

During this meeting, the Government of India decided to pay the total outstanding balance of Rs. 16,982 crores in June 2022 (Table 1). Due to the lack of funds in the GST compensation fund, the centre decided to release this money from its own funds, promising that it would be reimbursed through future compensation cess collections. The GST (Compensation to States) Act of 2017's provisions for the GST (Compensation to States) Act would be fully satisfied with this release by the Centre. Additionally, the Centre would approve the final GST compensation admissible to those States that have supplied the revenue data verified by the Accountant General of the States and a total Rs. 16,524 billion.²¹

GST Council has approved the recommendations of the GoM (the report of GoM chaired by Odisha's Finance Minister) on Capacity Based Taxation and Special Composition Scheme for certain sectors wherein it has been decided that capacity-based levy would not be prescribed on pan masala, gutkha, chewing tobacco, etc., but compliance and tracking measures shall be taken to plug leakages/evasions. Also, the compensation cess levied on such commodities shall be changed from ad valorem to a specific tax based levy to boost the first stage collection of the revenue.²²

Table 1: Clearance of Pending GST Compensation Balance for June 2022 by the Government of India

S. No.	Name of the State/UT	Balance GST compensation pending for June 2022 (Rs. in crore)
1.	Andhra Pradesh	689
2.	Bihar	92
3.	Chhattisgarh	505
4.	Delhi	1212
5.	Goa	120
6.	Gujarat	865
7.	Haryana	629
8.	Himachal Pradesh	229
9.	Jammu and Kashmir	210
10.	Jharkhand	342
11.	Karnataka	1934
12.	Kerala	780
13.	Madhya Pradesh	730
14.	Maharashtra	2102
15.	Odisha	529
16.	Puducherry	73
17.	Punjab	995
18.	Rajasthan	815
19.	Tamil Nadu	1201
20.	Telangana	548
21.	Uttar Pradesh	1215
22.	Uttarakhand	345
23.	West Bengal	823
	TOTAL	16982

Source: Recommendations of 49th GST Council Meeting by Ministry of Finance

7.0 Finance Bill 2023

On March 24, 2023, the Lok Sabha approved the Finance Bill, 2023²³ to change the levy of the GST compensation cess from ad valorem to a specific tax based levy on the retail sale price for the products like Pan Masala, Tobacco and manufactured tobacco substitutes, etc., it has been proposed to amend the Schedule of GST (Compensation to States) Act, 2017 via Finance Bill (Lok Sabha). The GST compensating cess is assessed on an ad valorem basis, which results in leakages at later levels of the supply chain because it is based on the value of the items.

An amendment was proposed in light of the GST Council's 49th meeting recommendations. As the Government wants to stop the leaks and improve the initial stage of revenue collection, therefore it changed the levy to a particular tax based on the retail sale price.

The aim is also to simplify the process of levying and collecting IGST and GST Compensation Cess on the subject products that are kept in warehouses that are bonded by customs and are being used for manufacturing or other processes. The government seeks to guarantee that the tax burden is calculated upfront and that the process of claiming Input Tax Credit (ITC) and refunds is expedited by applying IGST and GST Compensation Cess when products are removed from the warehouse. The proposed change is a step in the right direction towards streamlining the procedures for collecting the IGST and GST Compensation Cess, claiming ITCs, and requesting refunds for imported goods that are put through manufacturing or other processes in customs-bonded warehouses.

The CBIC issued two notifications dated 31.3.2023 regarding the compensation cess. They have been discussed below -

7.1 Notification no. 01/2023- compensation cess²⁴

Section 163 of the Finance Act of 2023, which deals with the levy of a compensation cess based on the Retail Sale Price (RSP), has been notified by the CBIC through a notification dated March 31, 2023. The maximum rate of the GST Compensation Cess is modified under Section 163 of the Goods and Services Tax (Compensation to States) Act, 2017. The maximum rate at which GST Compensation Cess may be levied/collected for items such as Pan Masala (from 135% ad valorem to 51% of the retail sale price/ unit), Tobacco and manufactured tobacco substitutes, including tobacco products (INR 4170/ 1000 sticks or 290% ad valorem or a combination thereof but not exceeding INR 4170/ 1000 sticks + 290% ad valorem or 100% of retail sale price/ unit).²⁵

7.2 Notification no. 02/2023- compensation cess (rate)²⁶

CBIC vide a notification dated 31.03.2023 to change the basis to levy compensation cess on Pan Masala and Tobacco Products from ad valorem to specified tax linked to the Retail Sale Price. The amendment that was made effective from 1st April 2023.

8.0 Impact of Withdrawal of GST Compensation Cess

The Goods and Services Tax (Period of Levy and Collection of Cess) Rules, 2022, as notified by the Finance Ministry, extended the levy and collection of the compensation

cess upto March 31, 2026. A report titled ‘State Finances: A Study of Budgets of 2022-23’²⁷ released by the Reserve Bank of India (RBI) on 16th January 2023 provides for analysis and assessment of state finance for the year 2022-2023. The report’s theme is “Capital Formation in India - The Role of States”.

The findings of the report of states on compensation cess:

- As per the report, the economies of half-a-dozen states were set to be “most severely affected” if the compensation cess would have been ended last year in 2022.
- The States’ non-tax revenue increased steadily even though it did so more slowly than in the previous year.
- Maharashtra, Karnataka, Gujarat, Tamil Nadu, and Punjab received the most compensation during the five-year transition period (July 2017 to June 2022). However, the States where the share of GST compensation in tax collection on an average exceeded 10% include Puducherry, Punjab, Delhi, Himachal Pradesh, Goa, and Uttarakhand, all of which are projected to be negatively impacted by the termination of the compensation regime.
- The north-eastern States have benefited the most from the GST system, with a compound annual GST revenue growth rate of 27.5% from the start of the GST (in 2017–18 to 202–23), compared to a state-wide percentage of 14.8%.
- Ten States are likely to fall short of a GST growth rate of 14%.

Therefore, the requirement for GST compensation has varied widely across States. A negative impact on the termination of the compensation cess is seen in 6 states, namely Puducherry, Punjab, Delhi, Himachal Pradesh, Goa, and Uttarakhand. These States will need to expand their tax bases, remove leaks, and boost compliance in the future to make up for lost GST reimbursement in the future. It’s high time for the states to start working on these leakages and compliances.

9.0 Conclusion

It has been time and again reiterated in this paper that the primary objective of the Goods and Services (Compensation to States) Act, 2017 was to compensate states for the loss in revenue on account of the rollout of the Goods and Services Tax, which subsumed many taxes which earlier formed a major chunk of state’s revenue.

The authors humbly believe that the Supreme Court’s judgement in *Mohit Mineral* is a very apt endorsement of the government’s policy of overhauling the indirect tax regime. By setting aside all the constitutional challenges to GST in general and the Compensation cess in particular, one can safely say that the Honourable Supreme Court

has given the green light to the legislature to bring any appropriate amendment in the future to execute the implementation of the Goods and Services Tax.

Further, through this legal battle, the policymakers might have also learnt valuable lessons to fine-tune the Goods and Services Tax and ensure its implementation in the best possible manner. Lastly, the author believes that the Indian polity is heading towards the coming-of-age cooperative federalism and thus, trust between the Union and the States is of utmost importance and the compensation act in a sense, seeks to ensure that, by allaying any fears of states on account of loss of revenue due to roll out of the GST. Thus, by upholding the validity of the Goods and Services (Compensation to States) Act, 2017, the Supreme Court has sustained the key pillar of the fiscal aspect of the Centre–State relations. Though the centre’s intention was good, as the compensation act was introduced to maintain the essence of cooperative federalism and fiscal relations between the centre and the states, many experts in the field of indirect taxation have criticised the implementation of the same.

With the country facing the COVID-19 pandemic, states had demanded an extension of the compensation scheme, which was extended by the Ministry of Finance vide a notification dated 24th June 2023. Although an extension is granted till 31st March 2026 but once this time period is over States like Delhi, Goa, etc., would have a negative impact on them. Therefore, it’s high time that states start planning ways to reduce the leakage of taxes and expand their tax bases.

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