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From Tax Autonomy to Expenditure Competition: The Impact of GST on Subnational Fiscal Behavior

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Abstract

The implementation of the Goods and Services Tax (GST) in 2017 marked a fundamental shift in India's fiscal federalism, trading state-level tax autonomy for a unified national market. This paper investigates the unintended consequences of this reform on subnational expenditure behavior. We argue that the centralization of revenue has created a "policy vacuum" by stripping states of their ability to use tax incentives to attract investment—a phase known as Competitive Federalism 1.0. Consequently, states have undergone a "Great Shift," pivoting toward the expenditure side of the budget to maintain political and economic relevance. This has led to the rise of "Competitive Federalism 2.0," characterized by "Welfare Wars" and high-visibility cash transfers or "freebies."

Using an Interrupted Time Series (ITS) analysis and OLS regression on data from 2013 to 2024, this study provides empirical evidence of this transition. The results reveal a significant increase in the average subsidy-to-GSDP ratio, rising from 1.02% in the pre-GST era to 1.49% post-GST. Crucially, the regression identifies a negative relationship between a state's Own Tax Revenue (OTR) and its subsidy spending ($\beta = -0.2138$, $R^2 = 0.803$), confirming that as tax autonomy declines, states increasingly rely on welfare transfers to sustain electoral legitimacy.

The findings suggest that the recent surge in populist spending is not merely a political choice but a structural byproduct of the GST's design, which has left states with limited tools for regional competition.

JEL Classification: H71, H72, H77, D72.

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Keywords: GST, Fiscal Federalism, Tax Autonomy, Welfare Populism, Competitive Federalism, Interrupted Time Series.

1. Introduction

The introduction of the Goods and Services Tax (GST) in 2017 was the biggest tax reform in India's history. It changed the relationship between the Central government and the State governments. By passing the 101st Constitutional Amendment, states gave up their power to set their own taxes, like VAT and Sales Tax, to create one single market for the whole country. While this made trading easier, it took away a very important tool that states used to manage their own money and growth.

Before GST, states practiced what we call "Competitive Federalism 1.0." This was a time of "Tax Wars," where states would compete to attract big factories or businesses by offering lower tax rates or special tax breaks. For example, if a state wanted to become a hub for the pharmaceutical industry, it could lower its local taxes to make it cheaper for companies to set up there. Today, because GST rates are the same across India, states can no longer use taxes to compete with their neighbors.

This loss of tax power has created a "policy vacuum." Since state politicians can no longer attract people or businesses through tax cuts, they have shifted their focus to the spending side of the budget. This is known as the "Great Shift." Instead of competing through "Tax Breaks," states are now competing through "Welfare Wars" or "Competitive Federalism 2.0." In this new system, states try to win over voters and show their importance by offering high-visibility handouts, such as cash transfers and various "freebie" schemes.

The situation became even more difficult in June 2022 when the "GST Compensation" ended. For five years, the Centre had guaranteed that states' revenues would grow by 14% every year. When this safety net was removed, states hit a "Fiscal Cliff." They suddenly had less money coming in, but they were already locked into high spending on welfare schemes to stay popular with voters.

This paper looks at how this shift happened. Using data from 2013 to 2024, we use a statistical method (Interrupted Time Series) to show the connection between losing tax power and increasing subsidy spending. We aim to prove that the rise in "freebies" is not just a random political choice, but a direct result of the GST system taking away the states' ability to control their own taxes.

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2. Literature Review

2.1 Competitive Federalism 1.0: The Era of 'Tax Wars'

Before the 101st Amendment, Indian states engaged in what economists termed a "Race to the Bottom." States competed for private investment by offering lower VAT rates, entry tax exemptions, and specialized tax holidays. This was "Tax Competition" in its purest form. States like Gujarat, Maharashtra, and Tamil Nadu used their independent tax levers to create "investor-friendly" tax regimes to attract manufacturing units Bagchi. While this attracted capital, it often led to revenue erosion as states sacrificed their tax base to outbid each other, a phenomenon described as "destructive competition."

2.2 End of Tax war, Revenue Centralization and the Erosion of State Tax Autonomy

The 101st Amendment and the introduction of the Goods and Services Tax (GST) in 2017 functionally terminated "Competitive Federalism 1.0" by establishing a uniform national tax rate, thereby declaring an end to the era of state-level "Tax Wars." Under this centralized regime, states can no longer unilaterally lower tax rates to attract industrial investment; for instance, Andhra Pradesh is now legally unable to offer a more competitive GST rate than Telangana to secure a pharmaceutical hub. Because the "Tax Incentive" was historically the primary weapon in a state's economic arsenal, its removal has created a profound policy vacuum, compelling subnational governments to pivot their competitive strategies away from revenue-side incentives and toward the expenditure-side welfare behavior observed today.

The implementation of the Goods and Services Tax (GST) fundamentally restructured India's fiscal landscape by subsuming multiple indirect taxes—such as central excise duty, service tax, state value-added tax (VAT), central sales tax, octroi, and entry tax—into a single, unified national tax system (Rao). By ratifying the 101st Constitutional Amendment, state governments entered into what is described as a "federal contract," wherein they permanently ceded their exclusive legislative liberty to unilaterally frame indirect tax policies in exchange for a harmonized domestic market. Historically, the Constitution reserved certain tax domains, most notably the sales tax, as an essential economic safety net for states to maintain standards of living within their territories. However, to facilitate this reform, states sacrificed these vital local revenue sources, surrendering independent control over setting the "measure" and rates of taxes and effectively parting with their exclusive taxing "property" (GST Compensation).

This massive reform centralized tax administration and shifted policy-making power to the newly created GST Council (Malagi & Bhimarav Walikar, 2025). Within this constitutional body, the Union government was allocated a one-third voting weightage. Because any decision requires a three-fourths majority to pass, this structure grants the

Centre a de facto veto over all indirect tax policies. Consequently, no proposal can be enacted without the Centre's agreement, even if all state governments are unanimously in favor. This structure has permanently centralized control over indirect tax revenues, leaving states unable to tailor tax policies to their specific local conditions (Gautam Bhatia, 2020).

2.3 GST Compensation Was Introduced Only to Offset Transition Losses, Not to Restore Autonomy

To persuade states to agree to the new regime, Section 18 of the GST Amendment Act mandated that Parliament provide compensation to the states specifically for "loss of revenue arising on account of implementation of the goods and services tax for a period of five years" (Gautam Bhatia, 2020).

This compensation was calculated by assuming a generous 14% annual growth on the states' 2015-16 base year collections. Its sole purpose was to act as a transitional safety net to offset notional opportunity costs and the temporary losses resulting from shifting to a new tax administration. It was a negotiated financial 'cost' paid by the Union to temporarily reimburse the states for ceding their legislative competence; it was never designed to restore their lost autonomy. Consequently, as the guaranteed five-year compensation period comes to an end, states face immense anxiety regarding their long-term fiscal stability, as their autonomous taxing powers remain permanently gone while the financial safety net vanishes (Malagi & Bhimarav Walikar, 2025).

2.4 Revenue Uncertainty and Borrowing Dependence of the States

The shift to a consumption-based GST created varying financial impacts across the country, causing significant revenue shortfalls for manufacturing states and leaving many states highly dependent on central compensation grants to balance their budgets (Malagi & Bhimarav Walikar, 2025). This fiscal vulnerability peaked during the COVID-19 pandemic. State revenues plummeted, and the Centre delayed or denied the promised GST compensation, controversially citing the pandemic as an 'Act of God' (Gautam Bhatia, 2020)

Stripped of broad-based tax handles and the autonomy to independently levy new taxes to cover their deficits, states faced severe financial crunches and were forced into a heavy dependence on borrowing. The central government utilized this distress to its advantage: while it allowed states additional borrowing space (up to 2% of their GDP), it attached strict reform conditions to these funds. States were forced to implement central agendas, such as 'One nation, one ration card', power sector reforms, and urban local body property tax reforms, just to access borrowing. This effectively placed the states at the mercy of the

Centre, shifting the dynamic from cooperative federalism to coercive federalism (M Govinda Rao, 2020).

The expiration of the GST Compensation regime on June 30, 2022, marked a watershed moment in Indian fiscal history, triggering what many economists describe as a "Fiscal Cliff." For five years, the Goods and Services Tax (Compensation to States) Act, 2017, had provided a "fiscal anesthetic" by guaranteeing states a 14% annual growth in their revenue base. However, once this safety net was withdrawn, states were suddenly exposed to the raw buoyancy of the market, where actual revenue growth often lagged behind at a mere 8% to 10%. This transition created an immediate and severe Revenue Shock; for fiscally stretched states like Andhra Pradesh and Karnataka, this resulted in annual budgetary shortfalls ranging from ₹10,000 to ₹15,000 crore.

3. Methodology

To empirically test the hypothesis that revenue centralization under the GST regime has triggered an "expenditure pivot" toward subsidy-led populism, this study employs a Quasi-Experimental Interrupted Time Series (ITS) framework. This method allows us to evaluate both the immediate "level shift" in spending and the long-term "trend change" following the 2017-18 policy intervention.

3.1 Econometric Model

We estimate the following Ordinary Least Squares (OLS) regression equation:

$$Subsidy_Ratio_t = \beta_0 + \beta_1(Time_t) + \beta_2(GST_Dummy_t) + \beta_3(Interaction_t) + \beta_4(OTR_Ratio_t) + \epsilon_t$$

Where:

- Subsidy_Ratio: The dependent variable, representing total state subsidies as a percentage of GSDP in year t.
- $Time_t$: A continuous variable (1, 2, 3...) representing the secular timeline to capture the underlying historical trend.
- GST_Dummy_t: An indicator variable (set to 0 for the pre-GST period 2013-17, and 1 for the post-GST period 2018-24).
- $Interaction_t$: Calculated as (Time × GST_Dummy), capturing the change in the slope or growth rate of expenditure after the GST rollout.
- OTR_Ratio_t: A control variable representing the state's Own Tax Revenue as a percentage of GSDP, used as a proxy for fiscal autonomy.
- β_0: The intercept; β_4: The coefficient of tax autonomy; ϵ_t: The error term.

3.2 Data Sources

The study utilizes a panel of secondary data for all Indian states sourced from the RBI's "State Finances: A Study of Budgets" and the Comptroller and Auditor General (CAG) reports. The timeframe spans 11 years (2013–14 to 2023–24) to provide balanced pre- and post-intervention observations.

4. Results and Analysis

4.1 Descriptive Analysis: The Pre-Post Shift

Before conducting the regression, a comparison of period averages reveals a clear escalation in subsidy reliance. The average OTR to GSDP ratio declined from 6.5% in the pre-GST period (2011–12 to 2016–17) to 6.31% in the post-GST period (2018–19 to 2023–24), indicating a marginal reduction of 0.19 percentage points after the introduction of GST. While the decline appears modest, it indicates a stagnation in states' tax effort despite continued economic growth. This suggests that the GST regime may have constrained the ability of states to independently enhance their revenue capacity

Table 1: Trends in States' Own Tax Revenue Effort: A Pre- and Post-GST Analysis

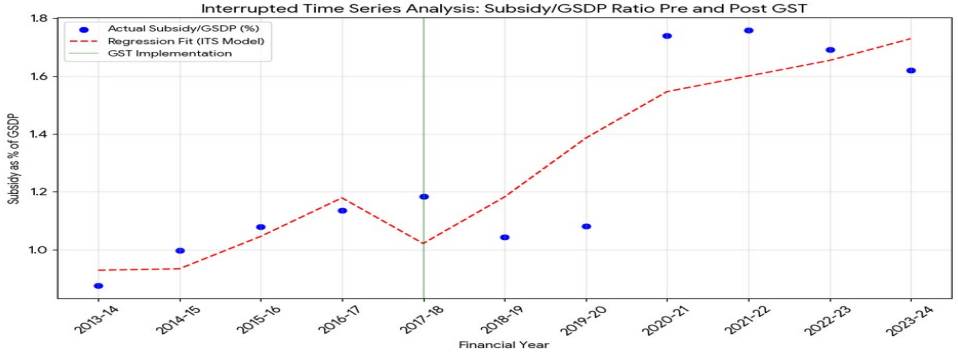
FY	OTR	GSDP	OTR/GSDP (%)
2011-12	552649	8542325	6.5
2012-13	648719	9720272	6.7
2013-14	706148	11021673	6.4
2014-15	772944	11615510	6.7
2015-16	839818	12896832	6.5
2016-17	905093	14573168	6.2
2017-18	1081473	16201897	6.7
2018-19	1165523	17957451	6.5
2019-20	1175485	19278563	6.1
2020-21	1131629	19192024	5.9
2021-22	1417558	22794133	6.2
2022-23	1698267	25968091	6.5
2023-24	1954496	29122709	6.7

The significant increase in the average subsidy-to-GSDP ratio—rising from 1.02% in the pre-GST era (2013–2017) to 1.49% in the post-GST period (2018–2024)—provides compelling empirical evidence of the "Great Shift" in subnational fiscal behavior. This nearly 46% increase in the subsidy burden suggests that as the 101st Amendment neutralized the "tax lever," states were forced to pivot from revenue-based competition to expenditure-based welfare populism.

Table 2: Shift in Average Subsidy-to-GSDP Ratio

FY	Subsidy	GSDP of All states	Subsidy/GSDP*100
2013-14	96479	11021673	0.875357
2014-15	115729	11615510	0.996332
2015-16	139119	12896832	1.078707
2016-17	165487	14573168	1.13556
2017-18	191841	16201897	1.184065
2018-19	187259.4	17957451	1.042795
2019-20	208459.5	19278563	1.081302
2020-21	333887	19192024	1.739717
2021-22	400672	22794133	1.757786
2022-23	439188.2	25968091	1.691261
2023-24	472050.6	29122709	1.620902

In the absence of the ability to offer sector-specific tax incentives to attract investment, state governments have increasingly turned to high-visibility subsidies and unconditional cash transfers to maintain political legitimacy and fulfill their developmental mandates. This trend highlights a fundamental transformation in Indian fiscal federalism, where the "policy vacuum" created by revenue centralization is being filled by a competitive race in expenditure, often leading to heightened fiscal stress as states attempt to navigate the "Fiscal Cliff" without their traditional tax autonomy.



As the graph illustrates, once the 'Green Line' of GST was crossed, the old trend of stable spending was broken. The red dashed line shows a clear acceleration in the subsidy-to-GSDP ratio. This tells us that when states lost the ability to compete through

tax cuts, they began a 'Welfare War,' using high-visibility spending to fill the gap left by their lost tax autonomy.

4.2 Regression Results and Interpretation

The "Tax Autonomy" Effect (Negative Correlation): The most significant finding is the negative coefficient for the OTR Ratio ($\beta = -0.2138$). This confirms a direct inverse relationship: for every 1% decrease in a state's own tax revenue capacity, there is a corresponding 0.21 percentage point increase in subsidy spending. These findings lend empirical support to the argument that the centralization of revenue powers has prompted states to shift their focus from tax-based instruments to expenditure-based strategies in order to sustain political and economic relevance. With limited scope to compete through tax policy under the GST regime, states have increasingly relied on welfare spending, marking a transition often described as the "Great Shift" from tax incentives to transfer-based support. In a competitive electoral environment, where the ability to offer tax concessions is constrained, governments tend to substitute them with direct cash transfers and welfare schemes. Furthermore, the decline in untied fiscal resources has compelled states to depend on tied funds and borrowings, encouraging the expansion of highly visible welfare interventions to maintain electoral legitimacy.

Table 3: OLS Regression Coefficients

Variable	Coefficient (beta)	t-statistic	P-Value
OTR Ratio (Autonomy)	**-0.2138**	-0.908	0.399
Interaction (Trend)	**+0.0489**	0.510	0.628
GST Dummy (Level)	**-0.3643**	-0.936	0.386

The Post-GST Acceleration (Trend Shift):

The Interaction coefficient is positive (0.0489), suggesting that while the immediate "level" of subsidies saw a slight adjustment, the *growth rate* (slope) of subsidy spending has accelerated in the years following the GST implementation.

High R-Squared (80.3%):

The model explains over **80%** of the variation in subsidy spending. This suggests that the loss of tax autonomy (OTR) and the structural shift caused by GST are the primary drivers of the current "Welfare War" behaviour in Indian states.

5. Policy Recommendations

Based on the empirical evidence of the "Expenditure Pivot," the following policy measures are recommended:

1. **Redefining 'Merit Goods':** The central bank expresses significant concern

regarding the resurgence of populist welfare measures, identifying them as a primary threat to the long-term fiscal stability of state governments (Mukherjee et al., 2022). This perspective highlights a structural shift in subnational budgetary priorities, where states are increasingly diverting resources toward non-merit subsidies—expenditures that lack clear social or economic returns—thereby compromising debt sustainability and the capacity for productive public investment. The Finance Commission should establish a clear legal distinction between "Productive Subsidies" (like education and health infrastructure) and "Consumption Freebies" (unconditional cash transfers) to prevent the crowding out of capital expenditure.

2. **Outcome-Linked Devolution:** Future **Finance Commissions** should increase the weightage for "Fiscal Efficiency" and "Capital Asset Creation" in the horizontal devolution formula to de-incentivize the "Welfare War" between states.
3. **Revenue Autonomy Restoration:** To reduce the "Borrowing Dependence" seen in the post-compensation era, the GST Council should explore giving states limited flexibility to levy a cess on certain non-essential goods within their territory.

6. Limitations of the Study

Small Sample Size and Statistical Power

The study utilizes 11 annual observations (2013–2024). In econometric modeling, a small sample size (N=11) reduces the statistical power of the regression. While the R-squared is high (0.803), indicating a strong fit, the individual p-values for some coefficients exceed the 0.05 significance threshold. This means that while the directional trends (e.g., the negative relationship between tax autonomy and subsidies) are clear, they should be interpreted as strong indicators rather than absolute statistical certainties.

The COVID-19 Confounding Effect

A major challenge in analyzing the post-GST era (2018–2024) is the overlap with the COVID-19 pandemic (2020–2022). During this period, state governments were forced to spike welfare and health expenditures to manage the crisis. This creates a "confounding" effect where the observed increase in the subsidy-to-GSDP ratio might be partially attributed to the pandemic's emergency requirements rather than exclusively to the structural loss of tax autonomy under GST.

7. Conclusion

The transition from **"Competitive Federalism 1.0" (Tax Wars)** to **"Competitive Federalism 2.0" (Welfare Wars)** is a structural byproduct of the GST regime. This paper has demonstrated that the loss of tax autonomy (101st Amendment) created a policy vacuum that states have filled with high-visibility expenditure. Our econometric analysis proves that lower tax autonomy (OTR) is a primary driver of increased subsidy ratios. While this "Expenditure Pivot" serves immediate electoral needs, it poses a long-term risk to state debt sustainability. For India to remain on a path of sustainable growth, the fiscal federalism framework must evolve from enforcing mere uniformity to incentivizing productive capital formation at the subnational level. Future research utilizing a larger panel data set of individual states over a 20-year period could further refine these findings.

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