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Reimagining Fiscal Federalism: Policy Challenges under India's GST Regime

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Abstract:

India's transition to the Goods and Services Tax (GST) marks one of the most significant fiscal reforms in its post-independence economic history, fundamentally reshaping the contours of fiscal federalism. Introduced through the 101st Constitutional Amendment Act, GST sought to unify a fragmented indirect tax system into a harmonised national framework under the guiding principle of "One Nation, One Tax." While the reform has improved tax efficiency, broadened the tax base, and facilitated ease of doing business, it has simultaneously generated complex policy challenges that call for a re-examination of Centre–State fiscal relations. This paper critically analyses how GST has redefined the balance between cooperative federalism and fiscal autonomy in India.

The study argues that the institutional mechanism of the GST Council represents a novel experiment in collaborative governance, bringing together the Union and State governments in joint decision-making. However, this cooperative framework is not devoid of structural asymmetries. The centralisation of tax powers, limitations on states' independent revenue-raising capacity, and increasing dependence on shared revenues have raised concerns regarding the erosion of fiscal sovereignty. The issue of GST compensation, particularly in the aftermath of economic disruptions such as the COVID-19 pandemic, has further intensified tensions, exposing vulnerabilities in the design of intergovernmental fiscal transfers.

Methodologically, the paper adopts a qualitative and analytical approach, drawing upon secondary data from government reports, Finance Commission recommendations, and scholarly literature. A comparative perspective is also incorporated to situate India's GST within broader global experiences of value-added tax systems in federal polities. The analysis reveals that while GST has strengthened formal

mechanisms of cooperation, it has also deepened vertical imbalances and constrained policy flexibility for states, especially those with weaker fiscal capacities. The paper concludes that reimagining fiscal federalism in India requires recalibrating the GST framework to ensure a more equitable distribution of fiscal powers and responsibilities. Strengthening institutional transparency, redesigning compensation mechanisms, and enhancing the role of states in decision-making are essential to sustaining the legitimacy and effectiveness of the GST regime. Ultimately, the success of GST depends not merely on tax efficiency, but on its ability to uphold the federal spirit enshrined in the Constitution.

Keywords: Fiscal Federalism; Goods and Services Tax (GST); Cooperative Federalism; Fiscal Autonomy; Centre–State Relations

Introduction:

Fiscal federalism constitutes a foundational pillar of India's constitutional and economic architecture, defining the distribution of financial powers and responsibilities between the Union and the States. Historically, India has maintained a quasi-federal structure characterised by a strong Centre, particularly in matters of taxation and resource allocation. Before the introduction of the Goods and Services Tax (GST), the country's indirect tax system was highly fragmented, with multiple levies such as Value Added Tax (VAT), central excise duty, service tax, and entry taxes imposed by different levels of government. This multiplicity not only created inefficiencies and cascading tax burdens but also hindered the creation of a unified national market. In response to these structural limitations, GST emerged as a transformative reform aimed at streamlining indirect taxation and enhancing economic integration.

The enactment of GST through the 101st Constitutional Amendment Act marked a watershed moment in India's fiscal evolution. By subsuming a wide range of central and state taxes into a single tax regime, GST sought to simplify compliance, increase transparency, and promote ease of doing business. More importantly, it introduced a novel institutional framework in the form of the GST Council, which embodies the principle of cooperative federalism by enabling joint decision-making between the Union and State governments. This mechanism was envisioned as a platform for consensus-building, where both levels of government could participate in shaping tax policies in a collaborative manner.

However, the implementation of GST has also triggered significant debates regarding its implications for fiscal federalism in India. While the reform hasstrengthened formal mechanisms of intergovernmental cooperation, it has simultaneously constrained the fiscal autonomy of states by limiting their independent taxation powers. States are now largely dependent on the GST Council for decisions related to tax rates, exemptions, and structural changes, thereby reducing their flexibility to respond to region-specific economic needs. Additionally, the issue of revenue uncertainty, particularly in the context of the GST compensation mechanism, has emerged as a critical concern. The promise of assured compensation for revenue losses, though intended to facilitate a smooth transition, has led to disputes and fiscal stress, especially during periods of economic slowdown.

The evolving dynamics of Centre–State relations under GST reflect a complex interplay between efficiency and autonomy, cooperation and control. The centralisation of tax administration, coupled with the asymmetrical voting structure within the GST Council, has raised questions about the balance of power in India's federal framework. Furthermore, disparities in revenue generation capacities among states have accentuated horizontal imbalances, posing challenges to equitable fiscal governance. These developments necessitate a critical re-examination of the GST regime not merely as a tax reform, but as a transformative shift like Indian federalism.

Against this backdrop, the present study seeks to analyse the policy challenges arising from GST and their implications for fiscal federalism in India. It aims to explore whether GST has truly strengthened cooperative federalism or whether it has inadvertently led to a re-centralisation of fiscal authority. By situating the Indian experience within broader theoretical and comparative perspectives, the paper contributes to the ongoing discourse on reimagining fiscal federalism in an era of economic integration and institutional reform.

Conceptual and Theoretical Framework

The conceptual and theoretical framework of this study is grounded in the theory of fiscal federalism, which examines how taxation powers, expenditure responsibilities, and intergovernmental transfers are distributed across different levels of government to achieve efficiency, equity, and macroeconomic stability. Classical (first-generation) fiscal federalism theories, associated with scholars like Musgrave and Oates, emphasize decentralization as a means to enhance allocative efficiency by allowing subnational governments to respond to local preferences, while assigning stabilization and redistribution functions to the central government. In contrast, second-generation theories of fiscal federalism incorporate political economy considerations, highlighting

the role of institutional design, incentives, and intergovernmental bargaining in shaping fiscal outcomes. Within this broader theoretical context, India's Goods and Services Tax (GST), introduced through the 101st Constitutional Amendment Act, represents a structural shift toward tax harmonisation and shared governance. The GST Council serves as a key institutional mechanism embodying cooperative federalism, wherein both the Union and States participate in decision-making. However, this arrangement also raises concerns regarding fiscal autonomy, vertical and horizontal fiscal imbalances, and the centralisation of revenue authority. Thus, the GST regime can be understood as an institutional experiment that attempts to balance efficiency with federal equity, while simultaneously transforming the traditional dynamics of Centre–State fiscal relations in India.

Evolution of GST in India

The evolution of the Goods and Services Tax (GST) in India represents a gradual and complex process of fiscal reform aimed at unifying the country's fragmented indirect tax system. Prior to GST, India operated a multi-layered taxation structure comprising central taxes such as excise duty and service tax, and state-level taxes like Value Added Tax (VAT), entry tax, and luxury tax. This system led to cascading taxes, compliance complexities, and inefficiencies in the movement of goods and services across states. The need for a comprehensive indirect tax reform was widely acknowledged as essential for creating a unified national market and improving economic efficiency.

The conceptual origins of GST in India can be traced back to the early 2000s when the Government began exploring options for indirect tax reform. The first significant institutional step was the formation of the Empowered Committee of State Finance Ministers in 2004, which was tasked with designing a roadmap for a national VAT and eventually GST. A landmark milestone came in 2006 when the Union Finance Minister formally proposed the introduction of GST in the Union Budget. Following extensive consultations between the Centre and the States, a dual GST model was envisioned to accommodate India's federal structure, ensuring that both levels of government retained the power to levy taxes.

The constitutional foundation for GST was laid through the enactment of the 101st Constitutional Amendment Act in 2016. This amendment introduced Articles246A, 269A, and 279A, which collectively empowered both the Union and the States to levy GST and established the framework for intergovernmental coordination. The amendment also paved the way for the creation of the GST Council, a constitutional body responsible for recommending tax rates, exemptions, and administrative procedures, thereby institutionalizing cooperative federalism in tax governance.

GST was officially implemented on July 1, 2017, marking a historic transition from a fragmented tax regime to a unified indirect tax system. The structure of GST in India follows a dual model comprising Central GST (CGST), State GST (SGST), and Integrated GST (IGST) for inter-state transactions. This design was intended to balance the fiscal interests of both the Centre and the States while maintaining a seamless credit mechanism across jurisdictions. The initial phase of GST implementation involved multiple tax slabs, transitional provisions, and the introduction of the GST Network (GSTN) as the digital backbone for tax administration.

Since its rollout, GST has undergone continuous evolution through periodic rate rationalisations, procedural simplifications, and policy adjustments based on the recommendations of the GST Council. Amendments have been made to address issues related to compliance, classification disputes, input tax credit mechanisms, and revenue compensation to states. The COVID-19 pandemic further tested the resilience of the GST framework, particularly with respect to revenue shortfalls and compensation disputes, highlighting the need for structural refinements.

Overall, the evolution of GST in India reflects a phased and negotiated reform process shaped by constitutional amendments, institutional innovation, and intergovernmental consensus. While GST has succeeded in creating a more integrated tax system, its ongoing evolution continues to reflect the dynamic interplay between economic efficiency and federal balance within India's fiscal architecture.

Literature Review

The existing literature on Goods and Services Tax (GST) and fiscal federalism in India highlights both the transformative potential and the structural challenges associated with the reform. Scholars broadly agree that GST has contributed to the creation of a unified national market, improved tax compliance, and reduced cascading effects of multiple indirect taxes. Studies drawing on the theoretical perspectives of fiscal federalism emphasize that GST aligns with the principles of tax harmonisation and economic efficiency, as outlined in classical frameworks associated with Musgrave and Oates, while also reflecting second-generation concerns related to institutional design and intergovernmental coordination. Empirical analyses by policy institutions such as the Reserve Bank of India and various academic researchers suggest that GST has enhanced revenue buoyancy over time, although initial implementation phases witnessed disruptions and transitional costs.

At the same time, a significant body of literature critically examines the implications of GST for state fiscal autonomy, arguing that the consolidation of indirect taxes has reduced

the independent taxation powers of states and increased their dependence on the GST Council for revenue-related decisions. Issues such as revenue-sharing disputes, compensation delays, compliance burdens, and administrative complexities have also been widely documented, particularly during economic shocks like the COVID-19 pandemic. Comparative studies of federal GST systems in countries such as Canada and Australia further indicate that while GST-like systems can enhance efficiency and transparency, their success depends heavily on robust institutional mechanisms and balanced intergovernmental relations. However, the literature also reveals a gap in comprehensive, policy-oriented analyses that integrate efficiency gains with the evolving challenges of cooperative federalism in the Indian context, thereby necessitating further research on reimagining fiscal federalism under GST.

Research Questions and Hypotheses

This study is guided by a set of research questions aimed at examining the impact of the Goods and Services Tax (GST) on India's fiscal federal structure and assessing the evolving balance between cooperative federalism and fiscal autonomy. The primary research question explores how the implementation of GST has transformed Centre–State fiscal relations in India. It further investigates whether GST has strengthened institutional cooperation among governments or led to a subtle re-centralisation of fiscal authority. A second line of inquiry focuses on the extent to which the GST framework has affected the fiscal autonomy of states, particularly in terms of their ability to generate independent revenues and respond to region-specific economic needs. Additionally, the study seeks to examine the role of the GST Council in mediating intergovernmental coordination and whether its decision-making structure ensures equitable representation and outcomes for all states. Another important research question addresses the challenges associated with revenue sharing, compensation mechanisms, and horizontal fiscal disparities among states under the GST regime.

Based on these research questions, the study formulates the following hypotheses. First, it is hypothesised that GST has contributed to a relative centralisation of fiscal powers by limiting the independent taxation authority of states. Second, it is posited that while the GST framework promotes cooperative federalism through institutional mechanisms, the asymmetry in decision-making power within the GST Council constrains the fiscal discretion of states. Third, the study hypothesises that the GST compensation mechanism, though designed to protect state revenues, has led to periodic fiscal tensions and uncertainties, particularly during economic downturns. Finally, it is hypothesised that disparities in economic development across states continue

to result in horizontal fiscal imbalances, which are not fully addressed by the current GST framework. These hypotheses collectively guide the analytical framework of the study in evaluating the effectiveness and limitations of GST in reshaping India's fiscal federalism.

Methodology

This study adopts a qualitative and analytical research design to examine the implications of the Goods and Services Tax (GST) on fiscal federalism in India. The research is primarily based on secondary data sources, including official government publications, reports of constitutional and statutory bodies, academic journal articles, and policy documents. Key sources include publications from the Reserve Bank of India, reports of the Finance Commission of India, GST Council notifications and reports issued by the GST Council, as well as relevant working papers, books, and peer-reviewed articles on fiscal federalism and tax reforms.

The study employs a descriptive and comparative analytical approach to evaluate how GST has altered Centre–State fiscal relations. It systematically reviews the institutional design of GST, its constitutional provisions under the 101st Constitutional Amendment Act, and the functioning of the GST Council as a decision-making body. A comparative perspective is also incorporated by examining selected international GST/VAT models in federal systems such as Canada and Australia, in order to contextualize India's experience within broader global practices of fiscal federalism.

Data analysis is carried out through thematic interpretation, focusing on key dimensions such as fiscal autonomy, revenue adequacy, intergovernmental coordination, and vertical and horizontal fiscal imbalances. The study identifies recurring themes and patterns in the literature and policy reports to assess the strengths and limitations of the GST regime. Particular attention is given to issues such as revenue-sharing mechanisms, compensation to states, compliance challenges, and administrative coordination between different levels of government.

Since the research is exploratory and policy-oriented in nature, no primary data collection or statistical modelling is undertaken. Instead, the methodology relies on critical evaluation and synthesis of existing evidence to draw informed conclusions about the evolving nature of fiscal federalism under GST. This approach enables a comprehensive understanding of both the institutional dynamics and policy challenges associated with GST, while also highlighting areas for potential reform and future research.

Structure and Functioning of the GST Council

The Goods and Services Tax (GST) Council serves as the central institutional mechanism for coordinating tax policy between the Union and the States in India,

embodying the principle of cooperative federalism. It was established under Article 279A of the Constitution through the 101st Constitutional Amendment Act. The Council is chaired by the Union Finance Minister and includes the Union Minister of State for Finance, along with the Finance Ministers or nominated representatives of all States and Union Territories with legislatures. This composition ensures representation of both levels of government in a structured decision-making forum.

The voting structure of the GST Council is designed to balance the interests of the Centre and the States. The Union Government holds one-third of the total voting weight, while the States collectively hold two-thirds. Decisions are taken by a three-fourths majority of the weighted votes of members present and voting. This arrangement is intended to encourage consensus-building; however, it also ensures that neither the Centre nor the States can unilaterally dominate decisions, thereby promoting a collaborative approach to fiscal governance.

Functionally, the GST Council is responsible for making recommendations on a wide range of issues related to GST, including tax rates, exemptions, threshold limits, model laws, procedures, and principles of levy and apportionment of GST. It also plays a crucial role in addressing disputes and recommending mechanisms for revenue compensation and administrative coordination. Although the Council's recommendations are not legally binding in a strict sense, they carry significant persuasive authority and are generally followed by both the Union and State governments in practice.

In terms of functioning, the GST Council meets periodically to deliberate on policy changes, rate rationalisation, and administrative reforms. Its decision-making process is largely consensus-driven, reflecting the need to accommodate diverse fiscal interests across states with varying economic capacities. Over time, the Council has emerged as a key platform for intergovernmental dialogue, enabling the resolution of complex issues such as rate structures, input tax credit rules, and compliance mechanisms.

Despite its cooperative design, the functioning of the GST Council has also revealed certain challenges, including differences in priorities between the Centre and States, delays in consensus on contentious issues, and concerns over the dominance of the Union in agenda-setting. Nevertheless, the Council remains a unique institutional innovation in India's fiscal federal framework, playing a pivotal role in shaping the implementation and evolution of GST while attempting to maintain a balance between unity in taxation and diversity in fiscal interests.

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Policy Challenges under the GST Regime

The implementation of the Goods and Services Tax (GST) in India represents a landmark reform in indirect taxation; however, its operation has revealed several policy challenges that impact fiscal federalism, administrative efficiency, and economic equity. One of the primary concerns is the erosion of the fiscal autonomy of states. Under the GST framework, states have relinquished significant taxation powers, particularly over indirect taxes, and now depend heavily on the recommendations of the GST Council for decisions related to tax rates, exemptions, and structural changes. This limits the ability of states to independently design tax policies tailored to their specific economic conditions.

Another critical challenge relates to revenue uncertainty and the issue of compensation. The GST regime initially guaranteed states compensation for revenue losses arising from the transition to GST, as mandated under the provisions of the 101st Constitutional Amendment Act. However, delays and disputes in compensation payments—particularly during periods of economic stress such as the COVID-19 pandemic—have led to tensions between the Centre and the States. This has raised concerns about the reliability of revenue flows and the sustainability of the compensation mechanism.

Vertical and horizontal fiscal imbalances also persist under GST. While GST has streamlined indirect taxation, disparities in revenue generation capacities across states remain significant. Economically advanced states tend to generate higher GST revenues, whereas less developed states depend more on transfers and compensation, exacerbating horizontal inequalities. At the same time, the Centre continues to have greater control over revenue-raising instruments, contributing to vertical imbalance in fiscal power distribution.

Administrative and compliance-related challenges further complicate the GST regime. The complexity of return filing, frequent changes in rules, and the need for robust digital infrastructure through systems such as GSTN have created operational difficulties for businesses, particularly small and medium enterprises. Issues related to the classification of goods and services, input tax credit reconciliation, and anti-profiteering provisions have also posed challenges in implementation.

Additionally, political economy considerations influence GST governance. Differences in priorities between the Centre and States, coupled with asymmetries in decision-making within the GST Council, sometimes lead to delays in consensus-building on critical policy matters. The centralisation of agenda-setting and coordination functions has also raised questions about the balance of power in India's federal system.

Overall, while GST has improved tax efficiency and created a unified market,

these policy challenges highlight the need for continuous institutional reforms, greater transparency, and improved intergovernmental coordination to ensure that the system remains both economically efficient and consistent with the principles of cooperative federalism.

Comparative Analysis

A comparative analysis of Goods and Services Tax (GST) systems in federal countries provides valuable insights into how different institutional designs balance efficiency, revenue generation, and fiscal federalism. India's GST, governed by the GST Council, follows a dual model in which both the Centre and the States simultaneously levy taxes on a common base. This model reflects India's unique constitutional structure, where fiscal powers are shared, and cooperative decision-making is institutionalised through a constitutional body created under the 101st Constitutional Amendment Act. While this arrangement promotes coordination, it also introduces complexities in decision-making and limits the fiscal autonomy of subnational governments.

In contrast, countries like Canada adopt a more flexible federal VAT system where both federal and provincial governments can levy their own taxes, often with varying degrees of harmonisation. Canada operates a combination of federal GST and provincial sales taxes (PST) or harmonised sales taxes (HST) in some provinces. This allows provinces to retain a higher degree of fiscal autonomy, as they can choose whether to align with the federal tax system or maintain separate structures. The Canadian model demonstrates a balance between coordination and autonomy, where provinces have significant discretion in tax policy while still benefiting from administrative simplification in harmonised systems.

Similarly, Australia follows a centralised GST model where the federal government collects GST and redistributes the revenue to states based on recommendations from an independent body such as the Commonwealth Grants Commission. In this system, states do not have independent taxation authority over GST but receive assured revenue allocations. This model emphasises horizontal fiscal equalisation, ensuring that less developed regions receive adequate transfers to maintain fiscal balance. Compared to India, Australia's system is more centralised in terms of tax collection but provides a structured and transparent mechanism for revenue redistribution.

India's GST model occupies a middle ground between these two approaches. While it incorporates elements of cooperative federalism through shared decision-making in the GST Council, it also restricts the independent taxation powers of states more than Canada's system, yet does not provide as robust a redistribution mechanism as

Australia's equalization framework. Furthermore, the asymmetry in voting power within the GST Council and the dependence of states on compensation transfers highlight ongoing tensions between central coordination and state-level fiscal autonomy.

In summary, the comparative analysis reveals that while India's GST framework is innovative in institutional design, it faces challenges in achieving an optimal balance between efficiency, equity, and autonomy. Lessons from Canada and Australia suggest that greater flexibility for subnational governments, combined with transparent and rule-based revenue-sharing mechanisms, can strengthen fiscal federalism. These international experiences provide useful benchmarks for reimagining and refining India's GST regime to better align with the principles of cooperative federalism.

Policy Recommendations

To address the emerging challenges under India's GST regime and strengthen fiscal federalism, a set of targeted policy reforms is necessary to enhance efficiency, equity, and cooperative governance. First, there is a need to reinforce the fiscal autonomy of states by allowing greater flexibility within the GST framework. While uniformity of tax rates is essential for market integration, states could be provided limited discretionary powers in specific tax bands or through surcharge mechanisms, enabling them to respond to region-specific economic conditions without undermining the overall structure of GST.

Second, the functioning of the GST Council should be further democratized and made more transparent. Although the Council embodies cooperative federalism, concerns regarding asymmetry in influence between the Centre and States persist. Introducing more structured consultation mechanisms, publishing detailed deliberation records, and strengthe

ning consensus-building processes would enhance trust and accountability in decision-making. Additionally, reforms in the voting process or the introduction of weighted regional considerations could help ensure a more balanced representation of diverse state interests.

Third, the GST compensation mechanism requires long-term restructuring. Rather than relying on ad hoc arrangements, a stable and predictable formula-based system should be developed to ensure timely and adequate compensation to states facing revenue shortfalls. This mechanism could be institutionalized with clearer fiscal rules, possibly involving an independent oversight framework to monitor compliance and disbursement, thereby reducing Centre–State tensions during periods of fiscal stress.

Fourth, simplification of GST compliance procedures is essential to reduce administrative burdens, particularly for small and medium enterprises. Streamlining

return filing processes, minimizing frequent changes in tax rules, and improving the functionality of digital platforms such as GSTN can significantly enhance compliance efficiency. Capacity-building initiatives for state tax administrations should also be strengthened to ensure uniform implementation across jurisdictions.

Fifth, addressing horizontal fiscal imbalances among states should be a priority. While GST has created a unified tax base, disparities in economic development continue to influence revenue generation capacity. Strengthening the role of the Finance Commission of India in recommending equitable revenue-sharing arrangements and integrating GST-related considerations into fiscal transfers can help mitigate these disparities. Lessons from global
federal systems such as Australia, which employs structured equalization transfers, may offer useful insights for India.

Finally, enhancing dispute resolution mechanisms within the GST framework is crucial. Establishing a more robust and time-bound institutional mechanism for resolving Centre–State and inter-state disputes would improve policy coherence and reduce litigation. Regular policy reviews, data-driven decision-making, and stakeholder consultations should be institutionalised to ensure that GST remains adaptive to changing economic conditions.

In conclusion, these policy recommendations aim to strengthen the GST regime by improving institutional design, ensuring fiscal balance, and reinforcing the principles of cooperative federalism, thereby enabling a more resilient and equitable fiscal framework in India.

Conclusion

The Goods and Services Tax (GST), introduced through the 101st Constitutional Amendment Act, represents a landmark reform that has significantly reshaped India's fiscal federal structure by promoting tax uniformity, improving compliance, and fostering the creation of a common national market. The institutional mechanism of the GST Council has strengthened cooperative federalism by enabling joint decision-making between the Union and the States; however, it has also highlighted inherent tensions between fiscal efficiency and state-level autonomy. While GST has streamlined indirect taxation and enhanced economic integration, it has simultaneously constrained the independent revenue-raising capacity of states, leading to concerns over fiscal autonomy, revenue uncertainty, compensation delays, and vertical and horizontal imbalances. These challenges indicate that although GST has improved coordination in fiscal governance, it has also redefined Centre–State relations in ways that require continuous institutional adjustments. Moving forward, a balanced approach that ensures equitable revenue

sharing, strengthens intergovernmental trust, and preserves the federal spirit is essential for sustaining the effectiveness and legitimacy of the GST regime within India's evolving fiscal federal framework.

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