

## GST Strengthened or Strained Federal Fiscal Relations?

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### INTRODUCTION

The introduction of the Goods and Services Tax (GST) on July 1, 2017, marked a **transformative shift** in India's indirect tax framework. Prior to GST, the Indian tax system was highly fragmented, with the Centre and States levying **multiple indirect taxes** such as excise duty, service tax, VAT, CST, luxury tax, entry tax, and others. These overlapping taxes created complexities, cascading tax effects, and significant **compliance burdens** for businesses.

The lack of a common tax base and **uniform structure** also led to inefficiencies in the supply chain and made inter-State commerce cumbersome. Different States had different rates and tax procedures, which increased the cost of compliance and often resulted in **double taxation**. This fragmentation was a key hurdle in establishing a common national market.

By replacing this multitude of Central and State taxes with a unified levy, GST was envisioned as a move towards "**One Nation, One Tax**." While it brought about uniformity and simplified compliance, GST also significantly reshaped India's fiscal federal architecture, altering the financial dynamics between the Centre and the States. This article examines how GST has both fortified and tested Centre-State fiscal relations over time.

### HISTORICAL BACKGROUND AND THE RATIONALE FOR GST

Prior to the introduction of GST, India's indirect tax system was riddled with a complex web of Central and State taxes. The Centre administered taxes such as central excise duty, service tax, and customs duty, while States imposed their own taxes like value-added tax (VAT), entry tax, entertainment tax, and luxury tax. Each tax had its own compliance framework, rate structure, and jurisdictional authority. This led to **overlapping tax burdens, cascading effects** (tax on tax), and barriers to seamless trade across State boundaries.

The Central Sales Tax (CST), levied on inter-State sales, discouraged inter-State trade due to its non-creditable nature. **Input tax credits** were restricted within the same tax jurisdiction, causing inefficiencies in **supply chains** and encouraging tax avoidance. As a result, the overall system stifled competitiveness, hampered economic growth, and increased compliance costs for businesses. Recognizing these challenges, the idea of a unified GST was mooted as early as 2000 by the Vajpayee government and was finally

brought into effect after a long process of negotiation, consensus-building, and constitutional amendment.

The primary motivation behind GST was to **consolidate multiple indirect taxes** into a single structure that facilitates smoother movement of goods and services, increases revenue efficiency, and establishes a **unified economic ecosystem** across the country. The eventual rollout of GST was therefore not merely a tax reform but also a structural reform aimed at realigning Centre-State fiscal responsibilities in a modern economic framework.

### **Institutional Mechanism: GST Council (Article 279A of the Constitution)**

One of the most important outcomes of GST has been the **institutionalisation of cooperative federalism** through the GST Council. Constituted under Article 279A of the Constitution, the Council comprises the Union Finance Minister (as Chairperson) and the State Finance Ministers. Decisions are taken by a **three-fourths majority**, with the Centre holding one-third of the voting power and all States collectively holding two-thirds. This framework has enabled structured, consensus-driven decision-making. From rate fixation to procedural norms and exemptions, the Council has provided a collaborative platform where States have a meaningful role, reinforcing the spirit of **cooperative federalism**.

### **Compensation Mechanism**

When GST was introduced, States were worried they might lose revenue because many of their earlier taxes were now merged into GST. To ease these concerns, **Section 18 of the Compensation Act** promised that the Central Government would compensate States for any **revenue loss** for five years (from July 1, 2017 to June 30, 2022), stating that:

*"The compensation payable to a State shall be calculated for every financial year after taking into account the base year revenue of that State and the projected revenue for any year shall be calculated by applying the projected growth rate of 14% per annum over the base year revenue."*

As stated above, the compensation was calculated based on a guaranteed **14% annual growth** in the State's tax revenue, using the financial year 2015-16 as the base year. If actual GST revenue fell short of this expected growth, the Centre would pay the difference from the GST **Compensation Cess**. This provision provided fiscal security to States and incentivized their support for GST. The Centre's commitment to compensate States during the initial years strengthened trust in the new tax regime.

Additionally, the Compensation Fund helped shield the finances of States from unexpected shortfalls during the early transition period, especially those that relied heavily on indirect taxes like **VAT** or **entertainment tax**. The mechanism helped maintain a sense of **equilibrium**, even as States navigated a radically new tax structure and adapted their administrative mechanisms accordingly.

### **Removal of Cascading Taxes and Uniformity**

Prior to the implementation of GST, States levied a range of indirect taxes such as VAT, Entry Tax, and Luxury Tax, resulting in a **fragmented and non-uniform tax regime**. This multiplicity of taxes often led to tax cascading, compliance challenges, and restricted interstate trade. The advent of GST consolidated these diverse levies into a unified

structure comprising CGST, SGST, and IGST, thereby streamlining the overall tax framework.

This reform enhanced the ease of doing business by reducing **tax-related bottlenecks**- for instance, earlier, a manufacturer shipping goods interstate had to navigate multiple taxes and checkpoints, which GST replaced with a **single streamlined levy**, expanding the tax base through better compliance incentives, and improving tax transparency. Consequently, States witnessed more consistent revenue tracking and benefited from a stable and predictable fiscal environment. The removal of **inter-state tax barriers** and **standardization of tax rates** has also contributed to better logistics and operational efficiency across sectors. Businesses have responded positively to the single-tax system, citing it as a **key factor** in improved production planning, warehouse consolidation, and faster delivery timelines.

The unified market approach also enabled **optimal resource allocation**, eliminated supply chain inefficiencies, and encouraged formalization of the economy- objectives that are central to long-term fiscal strengthening for both Centre and States.

### **Revenue Growth and Data Sharing**

The implementation of the GST Network (GSTN) has facilitated **advanced data analytics** and better compliance monitoring. With access to pan-India data, States are better equipped to detect tax evasion, conduct targeted audits, and plug revenue leakages.

Several States reported **higher tax collections** post-GST, aided significantly by the **credit matching system**. This technology-driven mechanism ensures that input tax credit (ITC) is availed only when a corresponding invoice has been uploaded by the supplier, thereby establishing a robust system of verification and accountability. It has played a pivotal role in reducing **fraudulent ITC claims**, strengthening the credibility of tax filings, and creating a digital trail that enhances **transparency** in the entire supply chain. Additionally, it has encouraged timely and accurate return filing by businesses, as buyers are incentivized to ensure that their suppliers comply with GST requirements in order to claim ITC themselves. This **interconnected compliance environment** has helped States plug revenue leakages, broaden the tax base, and improve overall fiscal performance. It has also promoted **digitalization** and standardization of compliance processes across India, contributing to long-term revenue efficiency.

The common **IT backbone** has empowered States with real-time dashboards, comparative analytics, and inter-jurisdictional collaboration, thus enabling a more proactive, data-driven, and transparent approach to tax administration that supports both compliance and enforcement functions effectively.

### **Delayed Compensation and Trust Deficit**

Despite the statutory commitment under **Section 18** of the Compensation Act to ensure timely disbursement of compensation to States, the Central Government delayed these payments during the period from 2019 to 2021, primarily due to the **economic slowdown** and the **fiscal strain** caused by the COVID-19 pandemic. In 2019-20, the delay in payment was observed due to insufficient funds with the Centre for providing compensation to States. These funds are raised by levying a compensation cess on the sale of certain goods, some of which were affected by the economic slowdown. In a **controversial move** during FY 2020-21, the Centre recommended that States borrow funds against anticipated **future**

**cess collections**, a suggestion that many States viewed as a departure from the spirit of **cooperative federalism** and a breach of the original assurance, thereby intensifying the trust deficit between the Centre and the States.

States expressed concern that the burden of **debt servicing** would ultimately fall upon them, despite having no control over GST collections or cess management. This situation highlighted the need for clearer guidelines and contingency planning for similar fiscal emergencies under shared tax regimes.

### **Central Dominance in GST Council**

While the GST Council was established as a consensus-based decision-making body, numerous States have consistently voiced concerns that the Centre tends to exercise a **disproportionate influence**, particularly in decisions related to rate structures, exemption policies, and compliance frameworks. Proposals from various States such as the **zero-rating** of essential commodities or requests for sector-specific reliefs have frequently been overruled or delayed without adequate justification.

Moreover, the irregular scheduling and **postponement of Council meetings**, especially during crucial phases like the post-COVID economic recovery, have further **marginalized State governments** from timely and meaningful participation in policy formulation. This has led to growing apprehensions among States regarding the erosion of their **fiscal autonomy** within the GST framework.

Over time, concerns have been raised about whether the cooperative model is drifting toward a more centralized decision-making approach, wherein States are relegated to a consultative rather than participatory role. This imbalance must be addressed to preserve the federal intent of the GST Council.

### **CONCLUSION**

GST continues to stand as one of the most significant tax reforms in independent India, introduced with the objective of achieving **economic integration** through a **unified tax framework**. It has undeniably contributed to enhanced tax compliance, reduced inefficiencies in the indirect tax structure, and **institutionalized cooperative federalism** through mechanisms such as the GST Council.

However, the implementation of GST has also underscored structural and operational challenges in Centre-State fiscal relations. Issues such as delayed compensation, central dominance in decision-making, and limited fiscal autonomy for States have revealed underlying tensions in the federal fabric.

To unlock the full potential of GST and reinforce the **federal character** of India's fiscal framework, there is a pressing need for reforms that ensure timely disbursement of compensation, institutional transparency, equitable participation of States in decision-making, and greater decentralization in tax administration. Strengthening these pillars will be critical to evolving GST into a truly inclusive and balanced model of fiscal federalism that serves the interests of **both** the Centre and the States.