International Journal of
Law, Politics and Governance
ISSN: 3143-7028 | https://www.ioro.org/ijlpg

Federalism and Fiscal Autonomy: Rethinking Centre-State Relations in India after GST

Shataxi Uma Jaiswal

LL.M. in Criminal Law, ICFAI University, Ranchi, India

Abstract

The Goods and Services Tax was introduced as a symbol of cooperative federalism, but the States had to give away their biggest tax weapon to get a common tax and a place at the GST Council and a five-year compensation guarantee. This article assesses the fiscal autonomy of the States post-GST, having lost its guarantee, the compensation cess was discontinued, rates were slashed into two major slabs and the Sixteenth Finance Commission kept the fiscal power of the States at 41 per cent. It sees the issue as not with the imposition of GST on goods, but with a lack of institutions to recover, in voice and in rules, what it gives up in power, and it suggests measures how to make pooled sovereignty truly shared. Tracing the arc from the pre-GST sales tax regime through the Constitution (One Hundred and First Amendment) Act, 2016, the article examines the working of the GST Council, the compensation crisis of 2020, the rate rationalisation of 2025 and the shrinking divisible pool. It draws on the decision in Union of India v. Mohit Minerals and on comparative experience from Canada, Australia and Brazil. It argues that the States surrendered rate-setting power in exchange for voice and protection, but that the institutions meant to secure that exchange, above all the dispute resolution mechanism under Article 279A(11), were never fully built. It concludes with reforms, including a standing dispute resolution body, a narrow band of rate flexibility, limits on cesses and a rule-based revenue stabilisation fund.

Keywords: Fiscal Federalism; Goods and Services Tax; GST Council; Cooperative Federalism; Finance Commission; State Fiscal Autonomy

I. Introduction

Federalism in India has been from the beginning about money as well as power. The Constitution assigns matters to the jurisdiction of the Union, the States and the concurrent sphere, but if a State is unable to muster the means to do so, the lists are of little consequence. A State that depends upon police, public health, agriculture, school education and many other aspects of welfare to be provided by others but has no control over their cost is a junior partner in the government, irrespective of what the Seventh Schedule states on paper.[1]

The Goods and Services Tax (GST) roll-out on 1st July 2017[2] made it far more transformational than any other reform since the Constitution was adopted. Prior to GST, in place were two separate and exclusive taxing fields, one at the Union level and one at the States level. The Union levied a tax on manufacture and services; the States levied a tax on the sale of goods. Each could set the rates, offer

[1] The Constitution of India, 1950, Art. 246 read with the Seventh Schedule, Lists I, II and III. See generally M.P. Jain, *Indian Constitutional Law* (8th edn., LexisNexis, 2018).

[2] The Central Goods and Services Tax Act, 2017 (Act 12 of 2017); the Integrated Goods and Services Tax Act, 2017 (Act 13 of 2017); the Union Territory Goods and Services Tax Act, 2017 (Act 14 of 2017); and the Goods and Services Tax (Compensation to States) Act, 2017 (Act 15 of 2017), together with the corresponding State Goods and Services Tax Acts, all operative from 1 July 2017.

International Journal of Law, Politics and Governance (IJLPG)
Volume 1 | Issue 2 | 2026 | Article ID: 9312-7545-1493 | https://doi.org/10.64823/ijlpg.2602005
IORO Publications · Texas, USA · www.ioro.org

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exemptions and develop incentives as they saw fit. Much of this separation was eliminated by the implementation of GST. It gave a concurrent and simultaneous power to tax supplies of goods and services, and it transferred the control over this power to a new constitutional body known as the GST Council, which is neither under the control of the Union nor any single State.[3]

Supporters felt this arrangement was the best "cooperative federalism" the Republic had to offer. The transfer of fiscal sovereignty from the States, in the guise of partnership, was seen as an insidious loss by critics.[4] Both perspectives are correct. It is not the words in the contract itself that are the key to the deal but the trust that sustains it. This trust was tested in 2020 when the Union initially asked whether it would be bound to make good the compensation shortfall[5], and again in 2025 when the Council made some simplifications in rates without obtaining a new compensation guarantee[6], and now, as the compensation cess is scheduled to come to an end and the Sixteenth Finance Commission has announced its award which restructures transfers from 2026 to 2031.[7]

This article explores what the fiscal autonomy of Indian States is left with after the introduction of the Goods and Services Tax (GST) and how the Centre-State relationship should be redesigned based on this analysis. In other words, the argument is that pooled sovereignty functions as long as it is accompanied by shared institutions the States can trust and that India has created the former, but not the latter.

II. The Constitutional Design of Fiscal Federalism

People who drafted the Indian Constitution saw the Indian subcontinent divide in 1947 and were concerned about its unity. The outcome is a federation that is pro-Centre with residuary power in Parliament, emergency powers and the power of the Union to alter the boundaries of the States.[8] It has been termed a "holding together" federation, instead of a "coming together" federation.[9]

This leaning is more evident than in other powers of government in taxing powers. The taxes the framers considered the most buoyant were introduced in the Union List: income tax, corporation tax, customs and most excise duties. The States were given taxes that were narrower, less elastic: land taxes, agricultural income taxes, stamp taxes, excise taxes on alcohol, vehicle taxes, and, most importantly, sales taxes.[10] But the States had a heavier burden of spending, such as law and order, public health, agriculture, irrigation and local government.

[3] The Constitution of India, 1950, Art. 279A, inserted by s. 12 of the Constitution (One Hundred and First Amendment) Act, 2016.

[4] For the competing assessments, see Y.V. Reddy and G.R. Reddy, *Indian Fiscal Federalism* (Oxford University Press, 2019).

[5] GST Council, Minutes of the 41st Meeting of the GST Council (27 August 2020), at which the Union placed before the States two borrowing options to meet the compensation shortfall for 2020-21.

[6] GST Council, 56th Meeting of the GST Council, New Delhi (3 September 2025); Press Information Bureau, Ministry of Finance, "Recommendations of the 56th Meeting of the GST Council" (3 September 2025).

[7] Finance Commission of India, *Report of the Sixteenth Finance Commission for 2026-31* (submitted to the President on 17 November 2025; laid before Parliament on 1 February 2026 under Art. 281 of the Constitution); Ministry of Finance, *Explanatory Memorandum as to the Action Taken on the Recommendations Made by the Sixteenth Finance Commission* (February 2026).

[8] The Constitution of India, 1950, Arts. 3, 248 and 352-360. See Granville Austin, *The Indian Constitution: Cornerstone of a Nation* (Oxford University Press, 1966).

[9] Alfred Stepan, "Federalism and Democracy: Beyond the U.S. Model", 10(4) *Journal of Democracy* 19 (1999).

[10] The Constitution of India, 1950, Seventh Schedule, List I, Entries 82-85 and List II, Entries 45-63, as they stood before the Constitution (One Hundred and First Amendment) Act, 2016.

The framers filled this void by transferring, not redistributing taxes. Article 270 of the Constitution allocates most Union taxes to the States as proceeds of the net taxes. The legal base of centrally sponsored schemes is in Article 275 (grants-in-aid) and Article 282 (grants for any public purpose). Article 293 regulates State borrowing. The Finance Commission is located in the centre of the structure and is found under Article 280 that recommends the division of divisible pool amongst the Union and amongst the States.[11]

This was based on two tacit assumptions. The first was that the States would have a meaningful and independent tax base of their own, such that transfers would be complementary, not a replacement for, that source of tax revenue. The second was that the Finance Commission, being a neutral constitutional organisation, would serve as a safeguard against arbitrary action by the central government. Over the past sixty-seven years or so the sales tax was the mainstay of the first assumption. It represented the largest source of own tax revenue for almost all the States. It provided State governments with a means to raise revenue, to attract investment via exemptions or to safeguard local industries. It was not a good tax; it was theirs.[12]

III. Before GST: Fragmentation and Its Discontents

So one has to remember the messiness of the pre-GST system for these States to accept the loss of this weapon. Until 2016, indirect taxation in India was a web of overlapping levies by various tiers of government at various stages of the value chain. Excise duty was imposed on the manufacture of goods and service tax on service by the Union. The States imposed sales tax (followed by value added tax) on the sale of goods in their domain. Inter-State sales were subject to Central Sales Tax which was collected from the buyer and retained by the seller. In addition to these were entry tax, octroi tax, luxury tax, entertainment tax, purchase tax and a variety of local taxation.[13]

Some of the costs to the economy were familiar. The origin of cascading was due to the fact that there were no cross-overs between the two taxes, and that the excise tax was included in the manufacturer's price and then applied again as sales tax in the hands of the retailer. The origin-based Central Sales Tax (CST) which was not eligible for credit at the destination, disrupted the national market. Trucks were stopped at checkpoints and the number of classification battles was endless.[14]

The States were not blind to these issues, and a great deal of early reform momentum sprang from them. The Empowered Committee of State Finance Ministers was an amazing horizontal co-ordinating exercise on uniform floor rates of sales tax and the eventual implementation of State-level VAT without any constitutional amendments from April 2005.[15] It demonstrated that States were able to exert some constraint on their own discretion for collective advantage and the tax phase-down of Central Sales Tax that followed the deal in advance.[16]

[11] The Constitution of India, 1950, Arts. 270, 275, 280, 282 and 293.

[12] Reserve Bank of India, *State Finances: A Study of Budgets* (various years), which consistently records sales tax/VAT as the largest component of the States' own tax revenue before 2017.

[13] The Central Sales Tax Act, 1956 (Act 74 of 1956); the Constitution of India, 1950, Seventh Schedule, List II, Entries 52, 55 and 62 (pre-2016).

[14] Thirteenth Finance Commission, *Report of the Task Force on Goods and Services Tax* (December 2009).

[15] Empowered Committee of State Finance Ministers, *A White Paper on State-Level Value Added Tax* (17 January 2005).

[16] Empowered Committee of State Finance Ministers, *First Discussion Paper on Goods and Services Tax in India* (10 November 2009).

The idea of a comprehensive GST was floated by the Kelkar Task Force in 2004.[17] In 2011, the Constitution Amendment Bill was introduced and lapsed owing to the fear of the States over loss of autonomy and also their apprehensions about the Union providing them compensation commitment that it could not be kept during the phase out of Central Sales Tax.[18] After years of negotiating the compensation and the voting, a new Bill which was introduced in 2014 was passed as the Constitution (One Hundred and First Amendment) Act, 2016.[19] GST is not a coincidence or an accident of the States. They went inside it, and they got the things they were most afraid of losing: They were given a guaranteed compensation, a strong voice in the Council and the exclusion of petroleum and alcohol.[20]

IV. The 101st Amendment and the New Fiscal Bargain

The 101st Amendment did a number of things simultaneously. Its main feature is the provisions of Article 246A, which confer upon Parliament and the State Legislatures the powers to enact laws pertaining to goods and services tax levied by the Union and the State respectively.[21] The power is concurrent, but it would be more aptly described as simultaneous as it does not come into existence in a manner consistent with the rule of Union supremacy which exists for the Concurrent List under Article 254.[22] A dual tax on the same transaction imposed at the same time by both levels of government. Central GST is collected by the Union and State GST is collected by the States on intra-State supplies.[23]

In the case of inter-State supplies, Article 269A gives the Union the power to impose Integrated GST, which would be distributed between the Union and destination State as prescribed by the Parliament on the recommendation of the Council.[24] The change from origin-based to destination-based system was itself a significant redistribution. It was beneficial for those countries who are consuming states, which are usually the more populous states and also the least industrialised countries. The manufacturing regions of the west and south, the so-called Producing States, would lose revenue generated by Central Sales Tax. For this reason, the compensation guarantee was significant for them.

The Amendment also paved the way. It eliminated the entries in the State List for entry taxes and advertisement taxes and shortened the entries on luxuries and entertainment. The State List previously included the entire field of sales tax, but now only petroleum crude, high speed diesel,

[17] Ministry of Finance, Government of India, *Report of the Task Force on Implementation of the Fiscal Responsibility and Budget Management Act, 2003* (Chair: Vijay L. Kelkar, July 2004).

[18] The Constitution (One Hundred and Fifteenth Amendment) Bill, 2011, which lapsed with the dissolution of the Fifteenth Lok Sabha; see Standing Committee on Finance (2012-13), *Seventy-Third Report on the Constitution (One Hundred and Fifteenth Amendment) Bill, 2011* (Lok Sabha Secretariat, August 2013).

[19] The Constitution (One Hundred and Twenty-Second Amendment) Bill, 2014, enacted as the Constitution (One Hundred and First Amendment) Act, 2016, which received Presidential assent on 8 September 2016.

[20] The Constitution of India, 1950, Art. 366(12A) (excluding alcoholic liquor for human consumption from "goods and services tax") and Art. 279A(5) (deferring GST on specified petroleum products until a date recommended by the Council).

[21] The Constitution of India, 1950, Art. 246A(1).

[22] Article 246A(1) opens with a non obstante clause: "Notwithstanding anything contained in articles 246 and 254".

[23] The Central Goods and Services Tax Act, 2017, s. 9; see, for instance, the West Bengal Goods and Services Tax Act, 2017, s. 9.

[24] The Constitution of India, 1950, Art. 269A(1); the Integrated Goods and Services Tax Act, 2017, ss. 5 and 17.

motor spirit, natural gas, aviation turbine fuel and alcoholic liquor for human consumption are included.[25] Article 270 has been amended to include CGST and Union's contribution of IGST in the divisible pool.[26]

The GST Council is a structure created in the new system that is embodied in Article 279A. It consists of the Union Minister of State as Chairperson, Union Minister of State having charge of revenue or finance and Finance Minister or other designated Minister of State of each State. The Council shall make recommendations regarding the taxes to be absorbed, the goods and services to be exempted, model laws, principles of levy and place of supply, threshold limits, rates including floor rates and bands, additional resources to be raised during disaster through special rates and special provisions for certain States.[27]

The real politics is in the voting rule. The majority of at least three-fourths of the weighted votes of those members present and voting shall be the standard for the decision on each question. One-third of the total vote is the Union's, and two-thirds is the States'.[28] No decision can, therefore, be made without the Union, and even a United bloc of all the States cannot meet three-fourths. In turn the Union must have the support of a large majority of the States present.

Lastly, Section 18 of the Amendment Act provided for compensation of the States for loss of revenue if GST was implemented for five years as recommended by the Council.[29] This was implemented by the GST (Compensation to States) Act, 2017, which assumed each State's revenue will increase by 14 per cent a year based on the base of 2015-16 and will compensate for any deficit by a separate compensation cess on demerit and luxury goods.[30]

When viewed as a whole, they constitute a fresh fiscal contract. The States gave up their autonomy in imposing taxes on goods and the power to fix the rate as needed. They were promised three in return – constitutional entitlement to a larger tax base (which now covered services), a collective representation in a body that was empowered to decide on key issues and a time-limited guarantee of non-loss. What has been left to deciper over the years has been whether or not the second and third parts have been sufficient to warrant the first.

V. The GST Council and Managed Consensus

In its current form, the GST Council is the boldest attempt at intergovernmental decision-making that the Indian Constitution has ever witnessed. Bodies like the Inter-State Council (under Article 263)[31] or the National Development Council were advisory in nature and held meetings infrequently, if at all. The GST council, on the other hand, convenes regularly, decides on parameters with immediate implications for revenue and has got a full secretariat. During its first years, it convened

[25] The Constitution (One Hundred and First Amendment) Act, 2016, s. 17, omitting Entries 52 and 55 and substituting Entries 54 and 62 of List II of the Seventh Schedule.

[26] The Constitution of India, 1950, Art. 270(1), (1A) and (1B), as amended by s. 10 of the Constitution (One Hundred and First Amendment) Act, 2016.

[27] The Constitution of India, 1950, Art. 279A(2) and (4).

[28] The Constitution of India, 1950, Art. 279A(9).

[29] The Constitution (One Hundred and First Amendment) Act, 2016, s. 18.

[30] The Goods and Services Tax (Compensation to States) Act, 2017, ss. 3, 7 and 8.

[31] The Constitution of India, 1950, Art. 263; see also the Presidential Order dated 28 May 1990 constituting the Inter-State Council.

more frequently than almost any other intergovernmental body in the country and its actions influenced the economic lives of millions of businesses.

The Council also has a very impressive culture of consensus. Most of its life it has refrained from formal votes and worked things out by negotiation. A decision on lotteries has a few times been referred for a vote, such as in 2019.[32] This is cited as an example of the effectiveness of cooperative federalism: States and Union, no matter who's in power, are sitting at the table making common sense decisions.

There is another way of reading the same record. Consensus can be true or it can be forced. It is essential that the Union votes, or that is a veto. But the agenda is determined by a secretariat which closely liaises with the Union Ministry of Finance, and the committees that draft proposals are largely central dominated. A State Finance Minister who does not like it will have to choose between isolation in a body which values consensus and acceptance of a decision she does not like. Many have opted for the latter, and noted their objections in the minutes but not by formal vote.

There are institutional barriers that exacerbate this imbalance. The Council shall, pursuant to Article 279A(11), set up a mechanism to settle disputes between the Union and the States or between the States related to the recommendations of the Council or the implementation thereof.[33] This mechanism has not been meaningfully established, despite being in place for almost a decade since the implementation of GST. The absence matters. In case a State does not agree with the way the IGST is being apportioned, or on a decision which impacts its revenue, it has no dedicated mechanism to turn to. It has no other option but to go to Supreme Court, via Article 131, which is a slow and political path.[34]

This case has been clarified in 2022 by the Supreme Court in *Union of India v. Mohit Minerals*.[35] The Council's recommendations were meant to be binding on the Union and the States, or not? The Court ruled that they did not. Under Article 246A, Parliament and State Legislatures have concurrent power to make laws on GST and Article 279A does not place any restrictions on that power of Parliament or the State Legislatures. The recommendations are not binding mandates, the Court explained, but they are "persuasive" and "the result of collaborative dialogue. While reaching this decision, the Court noted that Indian federalism is a conversation with cooperative and contestatory or uncooperative aspects and that the States should have access to the means of contestation they have at their disposal.[36]

States welcomed the judgment as a reaffirmation of their legislative sovereignty, but in practice, the impact has been limited. Where the rates and the rules are uniform, a State which acts contrary to the recommendation of the Council risks disuniting the common market agreed to be created. It did move the conversation, though, in that if the Council's authority is to be won by persuasion and not command, fairness of its procedures becomes vitally important. Here this record is split. States have

[32] GST Council, Minutes of the 38th Meeting of the GST Council (18 December 2019), at which the rate on lotteries was decided by vote for the first time.

[33] The Constitution of India, 1950, Art. 279A(11).

[34] The Constitution of India, 1950, Art. 131; see *State of Karnataka v. Union of India*, (1977) 4 SCC 608.

[35] *Union of India v. Mohit Minerals (P) Ltd.*, (2022) 10 SCC 700 (decided on 19 May 2022).

[36] *Ibid.*

expressed that agenda papers are late, that they are not provided with enough detail of revenue impact, and that decisions on important issues are sometimes made before the Council meets. This is not unconstitutional but it does point to a forum of managed consensus, as opposed to a forum of equals.

VI. The Compensation Saga: Promise, Shortfall and Trust.

The voting episode is the formal history of the balance of power in GST federalism; the compensation episode is the emotional history of the balance of power in GST federalism. The potential for fourteen per cent annual revenue growth over five years was a good offer – it may have been an exaggerated offer.[37] The cost the Union paid to win reluctant States, especially manufacturing States, into the system. For the first 2 years the arrangement seemed to function more or less as intended, though some States experienced shortfalls in their revenues, with some relying on compensation payments for routine expenditure.

In 2020, the crisis came! The COVID-19 pandemic and the nationwide lockdown led to a significant decline in economic activity and tax revenues. The compensation cess, which was to be used to pay for the guarantee, crashed along with all the other ones. The loss of compensation fund was in lakhs of crores of rupees. In this case, the Union, with the aid of an opinion of the Attorney General, contended that it was not required to pay compensation from the Consolidated Fund of India where the collections of cess were not made up.[38] If this is the case, the obligation was limited to the amount that the compensation fund could cover.

The States were shocked. The guarantee was all their business was about, and now it seemed that it was dependent on something out of their reach. A compromise was finally achieved in which the Union borrowed from a special window, then transferred the money to the States, and repaid it from the compensation cess which was extended to cover the need to March 2026.[39]

The compromise addressed the pressing need for cash. It was no balm to the broken confidence. The episode imparted two lessons to the States. 1st, that the interpretations given by the Union under the framework of the GST might be different when the situation turned sour. Second, in a crisis situation, all they had to work with was pressure from the public and politics, rather than any institutional enforceable mechanism. Whereas the dispute resolution mechanism envisioned by Article 279A(11) would have been the logical place for such a clash of views. Without it there would have been a constitutional dispute over the meaning of a constitutional promise that would have been resolved through negotiation in the context of fiscal stress. The guaranteed compensation period ran until June 2022, but was not renewed, even as several States had requested it be extended.[40] In September 2025, the rate structure was changed, with the compensation cess on most goods removed and it was removed entirely at the beginning of 2026 when the loans were paid

[37] The Goods and Services Tax (Compensation to States) Act, 2017, ss. 3, 5 and 7, which fixed 2015-16 as the base year and a projected growth rate of fourteen per cent per annum.

[38] Supra note 5. The Union relied on the opinion of the Attorney General for India that the shortfall was not payable out of the Consolidated Fund of India.

[39] Ministry of Finance, Press Release, "Special Window to Meet GST Compensation Shortfall" (October 2020); the Goods and Services Tax (Period of Levy and Collection of Cess) Rules, 2022, notified on 24 June 2022, extending the levy of compensation cess to 31 March 2026.

back.[41] Subsequently, Parliament passed a new Health Security and National Security Cess on some demerit goods and amended the central excise on tobacco.[42] The Union has offered to pass on a portion of the new cess to the States for health-related uses. But this is a Union cess, which by its nature is not part of the divisible fund, and whatever comes to the States, comes to them at the pleasure of the central government.[43] The Union's defenders are right in pointing out that the compensation was always supposed to be short-term, and that GST revenues have increased in strength.

VII. GST 2.0 and the Rate Rationalisation of 2025

The second great test of the GST bargain came with what has been called GST 2.0. For years, economists and businesses had criticised the multiplicity of rates under GST: slabs of five, twelve, eighteen and twenty-eight per cent, with a compensation cess on top for certain goods, and special rates for gold and a few other items. The complexity bred classification disputes and undermined the promise of a simple tax.[44]

During its fifty-sixth meeting in September 2025, the GST Council took a comprehensive step towards rationalisation. The 12% and 28% slabs were phased out apart from a few distinct rates of 5% and 18% and a special rate of 40% for a small base of luxury and demerit goods. The new structure will be effective as of 22 September 2025.[45] Numerous items of mass consumption saw lower rates, and the reform was touted as a kick for consumption and for small businesses.

From the onset, there was a federal tinge to the reform. The finance ministers of eight Opposition-led States like Jharkhand, Karnataka, Kerala, Himachal Pradesh, Punjab, Tamil Nadu, Telangana and West Bengal - got in sync before the Council meeting. They were not against the principle of simplification per se. They wanted to be compensated for the loss of revenue in each State and a transitional compensation system. Some suggested that the revenues generated from any levy exceeding forty per cent be distributed exclusively to the States and one southern State recommended to review the equal sharing of GST in favor of the States.[46]

The Union rebutted that if they lowered the rates they would encourage consumption and over time that growth would offset the diminished revenue. Other States, including those controlled by the

[40] GST Council, 47th Meeting of the GST Council, Chandigarh (28-29 June 2022), at which several States sought extension of the compensation period beyond 30 June 2022.

[41] Compensation cess ceased to be levied with effect from 1 February 2026, upon discharge of the back-to-back loans of about Rs. 2.69 lakh crore.

[42] The Health Security se National Security Cess Act, 2025 (Act 35 of 2025); the Central Excise (Amendment) Act, 2025 (Act 34 of 2025), both brought into force on 1 February 2026.

[43] The Constitution of India, 1950, Art. 270(1), which excludes from the divisible pool the surcharges referred to in Art. 271 and any cess levied for specific purposes under any law made by Parliament.

[44] Ministry of Finance, Government of India, *Report on the Revenue Neutral Rate and Structure of Rates for the Goods and Services Tax* (Chair: Arvind Subramanian, December 2015).

[45] Supra note 6; Notification No. 9/2025-Central Tax (Rate), dated 17 September 2025, effective from 22 September 2025.

[46] "Opposition-Ruled States Demand Compensation for Revenue Losses Due to GST Rate Cuts", *The Wire* (30 August 2025); "Oppn States Demand Compensation for Revenue Loss Due to GST Reform Proposal", *Business Standard* (29 August 2025).

Union's political allies, endorsed the reform, unconditionally. Eventually, the rationalisation was agreed upon and no new compensation guarantee was provided.[47]

This is an interesting result. The States that requested protection had a say; they attended, synchronized and presented the case openly. The Council's structure put persuading as their only solution and once they were unable to persuade they took the outcome as it came and did not defy the consensus.

The initial aftermath lent credence to their fears. GST collections grew at a gradual pace during the first few months following the introduction of the new rates and in some months of late 2025, there was a large number of States showing negative growth in their GST receipts.[48] Judging by the longer-term impact is still premature and there may still be an impact as the Union would expect. However, the episode demonstrated that a collective decision could have very uneven consequences to individual States and that there was nothing to absorb these. Where GST would be in place, if it was implemented, the States could only argue at the Council, and wait, whereas under the old sales tax they could hike the rates on certain items if they were short of funds.

VIII. Vertical Imbalance, Cesses and the Shrinking Divisible Pool

GST was not the reason behind the vertical fiscal imbalance of Indian federalism. It deepened it. The States had a higher proportion of general government expenditure and a lower proportion of revenue even in 2016. The States' own tax base was also constricted, as the most significant tax that they administered became a shared tax, and their expenditure obligations were unchanged or increased. This heightened the significance of the system of transfers and the rules surrounding it.[49]

A development outside GST has had a big impact. Article 270 says that cesses and surcharges are not part of the divisible pool.[50] Designed to be unique, these levies have become a frequent and increasingly large portion of Union revenue, at times accounting for as much as one-fifth of gross tax revenue.[51] It is true that all money collected by a cess is regarded as money unrecoverable by the States, and that the headline forty-one per cent is a much less impressive share of the Union's total collections.

The Sixteenth Finance Commission was headed by Dr Arvind Panagariya and presented its report to the Union Budget on 1 February 2026, which was laid before Parliament in November 2025. It did not budge on the States' 41 per cent share of the divisible pool during the period 2026-27 to 2030-31, despite offers from many States for a higher share. It also introduced a number of changes in horizontal distribution, with the income distance now accounting for 42.5 per cent, compared to the 30 per cent applied to tax and fiscal effort in earlier versions; population 17.5 per cent; demographic performance 10 per cent; area 10 per cent; forest cover 10 per cent; and, for the first time, a State's

[47] "How Consensus Was Struck on GST 2.0", *The Tribune* (September 2025).

[48] "GST Collections Dip in 20 of 36 States and Union Territories in October", *Business Standard* (4 November 2025); "In Second Full Month of GST 2.0, Net Collections Increase 2.2%", *Business Standard* (1 January 2026).

[49] M. Govinda Rao and Nirvikar Singh, *Political Economy of Federalism in India* (Oxford University Press, 2005).

[50] Supra note 43.

[51] Fifteenth Finance Commission, *Finance Commission in Covid Times: Report for 2021-26*, Vol. I (October 2020).

contribution to national GDP 10 per cent, replacing the earlier criterion of tax and fiscal effort.[52] The Commission has also ended revenue deficit and State specific and sector specific grants and suggested significant grants to local bodies and to disaster management. It suggested that the fiscal deficit of States should not exceed three per cent of the Gross State Domestic Product and all off-budget borrowings should be transferred to their budgets.[53]

These recommendations cut in different directions. The GDP criterion answers a long-standing grievance of prosperous States that equalisation penalised their success. The end of revenue deficit grants removes a lifeline for several smaller and hill States. And holding the vertical share at forty-one per cent, just as compensation ends and cesses continue to erode the pool, has been read by many as a missed opportunity to rebalance the system.

The other side of the imbalance lies in how the Union spends. A substantial portion of transfers flows through centrally sponsored schemes under Article 282, carrying conditions: matching contributions, prescribed designs, branding and, at times, policy conditions unrelated to the scheme itself.[54] Recent disputes over the release of education funds linked to acceptance of particular central initiatives show how conditional transfers can steer State policy.[55] As a State's own tax base narrows, its dependence on such transfers, and the Union's leverage, grows.

Borrowing is the final piece. Article 293(3) requires a State indebted to the Union to obtain its consent before raising a loan[56], and since virtually every State owes money to the Union, this gives the Union an effective say over State borrowing. The Union's decision to count off-budget borrowings of State entities against borrowing limits was challenged by Kerala in an original suit; in 2024 the Supreme Court declined interim relief and referred the questions on Article 293 to a Constitution Bench.[57] The pattern is familiar: a State whose revenue autonomy has shrunk turns to borrowing, and finds that this avenue too is controlled from the Centre.

IX. The Residual Space of State Fiscal Autonomy

To suggest that the States are today only agents of the Union would be an error. They have a few important taxes that they keep. Petroleum products are excluded from GST and motor spirit and diesel taxes are one of the largest sources of State revenue. Also excluded from GST is alcohol for human consumption and State excise on liquor is a significant source of revenue. The States retain property stamp duties and registration fees on property transactions, vehicle taxes, land revenue, electricity duties and taxes. A number of States have actively employed the taxes with increases or decreases in the tax rates, for example, as related to fuel.[58]

[52] Supra note 7; PRS Legislative Research, *Report Summary: Report of the 16th Finance Commission for 2026-31* (1 February 2026).

[53] Supra note 7.

[54] The Constitution of India, 1950, Art. 282.

[55] *State of Tamil Nadu v. Union of India*, Original Suit under Art. 131 instituted in the Supreme Court in May 2025, challenging the withholding of Samagra Shiksha funds linked to implementation of the National Education Policy, 2020 and the PM SHRI Schools scheme.

[56] The Constitution of India, 1950, Art. 293(3).

[57] *State of Kerala v. Union of India*, 2024 INSC 253 (Original Suit No. 1 of 2024, order dated 1 April 2024).

[58] The Constitution of India, 1950, Seventh Schedule, List II, Entries 45, 51, 53, 54, 56, 57 and 63; Art. 279A(5).

However, the makeup of this residual base is telling. Much of it is in the form of taxes on goods with high social costs and/or taxes on transactions the States has every incentive to keep moderate. Liquor excise is bound by the politics of prohibition, fuel taxes are limited by inflation and popular resentment and stamp duty has an impact on housing markets. These are the spoils of the GST deal that have not been swallowed up, and there's continuing pressure to bring petrol into GST.

The loss of rate-setting power has an additional aspect. Sales tax exemptions and deferrals were originally part of states' industrial policy tools. These were frequently exploitative and led to downward pressure for wages, but reflected a State's own development plan. The incentives can only be passed through to the budgetary reimbursement mechanism under GST, which is more transparent but is also more expensive and less flexible.[59]

Local government has suffered even more. The 73rd and 74th Amendments had envisioned panchayats and municipalities having their own revenue sources[60] but GST rolled the octroi and entry tax and a large part of entertainment and advertisement taxes which were the additional revenue sources of urban local bodies. This is acknowledged in part by the large local body grants for the Sixteenth Finance Commission[61], but the grants do not tax the power of the grantees; and a city that cannot raise its own money cannot be held fully responsible to its own citizens.

Another form of autonomy is the autonomy of voice, which is still mentioned. In the pre-GST period, a State did not have any say in central excise or service tax. Today, each State Finance Minister is seated at the table where the rates of the country's biggest indirect tax are determined. GST has turned a lot of States' autonomy into a collective influence over a broader area. But the issue is whether that influence is powerful enough and well enough established to make up for that loss.

X. Comparative Glimpses

India is not the only country to face the federal ramifications of a common consumption tax. There are some other federations to look at to give perspective to its choices.

Flexible harmonisation is a model that can be found in Canada. Goods and Services Tax is being imposed throughout the country by the federal government. Some provinces have decided to align their provincial sales taxes to it, resulting in a single Harmonized Sales Tax implemented on a federal level, while others have opted to maintain their own separate provincial sales taxes, and at least one has not implemented a provincial sales tax at all.[62] Importantly, the participating provinces have the authority to determine the amount of the provincial rate. Harmonisation in Canada is therefore voluntary and partial, and maintains an important provincial autonomy regarding rates.

The attitude of Australia is the reverse of this. The Commonwealth collects the GST but all the net revenue is passed to the States. Distributed on the basis of horizontal fiscal equalisation (HFE) in

[59] See, for instance, Department of Industrial Policy and Promotion, *Scheme of Budgetary Support under Goods and Services Tax Regime to the Units Located in States of Jammu and Kashmir, Uttarakhand, Himachal Pradesh and North East including Sikkim* (5 October 2017).

[60] The Constitution of India, 1950, Arts. 243H and 243X, inserted by the Constitution (Seventy-third Amendment) Act, 1992 and the Constitution (Seventy-fourth Amendment) Act, 1992 respectively.

[61] Supra note 7.

[62] Excise Tax Act, R.S.C. 1985, c. E-15, Part IX; the Harmonized Sales Tax applies in Ontario, New Brunswick, Nova Scotia, Newfoundland and Labrador and Prince Edward Island, while Alberta levies no provincial sales tax.

accordance with a formula set by an independent Commonwealth Grants Commission, but modified in recent years in dispute with richer States.[63] Australian States have no input into rates and only the States can agree on their change and any federal legislation will be required to do so; States get 100% of the revenue and a rules based distribution of revenue.[64]

In 2023 Brazil implemented a significant change in its consumption tax, with the States historically being embroiled in fiscal conflict. It would have been replacing a complex system of federal and sub-national taxes with a dual value added tax, consisting of a federal tax and a sub-national (state and municipal) tax, with a managing committee shared between them.[65] Brazil's reform also includes a region development fund to offset the loss of a policy instrument, namely tax incentives, and a clear recognition that harmonisation removes a policy instrument and that this needs to be substituted.[66]

A federal consumption tax does not have a "right" design. There is a clear decision on the sacrifice of sub-national units and the gains they receive, with stable institutions, which is a characteristic of successful systems. The rate is maintained under country autonomy in Canada. Australia offers it for free but assures the revenue and even a neutral distribution. Brazil provides incentive powers, but establishes a special fund. India had demanded that States not have any discretion at all on rates; it even had offered a compensation of a fixed amount with a time cap and this had expired; India had also given them a seat in a Council that has never been equipped with a mechanism for dispute resolution. In this respect, the Indian bargain is quite incomplete.

XI. The Bargain Redone: Ways to reform.

So the only way to solve the problem is not to give up on GST if the above diagnosis is broadly true. The benefits of market integration, compliance and transparency are tangible and it would not be realistic or desirable to return to the past, where markets are disjointed. The task is rather to complete the bargain, by building the institutions and rules that would allow the States to trust a system in which they have pooled their sovereignty. A number of changes deserve to be considered.

The first and most obvious is to give life to Article 279A(11).[67] A Standing Dispute Resolution Mechanism consisting of members who have judicial or fiscal expertise and agreed upon by both the Union and States would give a platform to disagreement amongst them on the apportionment of IGST, implementation of Council decisions, and interpretation of commitments. The mere existence of this would keep everyone in check. If this body had been in existence in 2020, the compensation issue could have been settled on principle instead of through ad hoc negotiations.

Second, the working of the GST Council needs to be made more transparent and more equal. All members should be notified in advance of meetings about agenda papers and the impact of the revenue. Minutes (with any dissent notes recorded should be published as soon as possible). Council

[63] A New Tax System (Goods and Services Tax) Act 1999 (Cth); Federal Financial Relations Act 2009 (Cth); Treasury Laws Amendment (Making Sure Every State and Territory Gets Their Fair Share of GST) Act 2018 (Cth).

[64] Intergovernmental Agreement on Federal Financial Relations (Council of Australian Governments, 2008, as amended), which requires the unanimous agreement of the States and Territories for any change to the GST rate or base.

[65] Constitutional Amendment No. 132 of 20 December 2023 (Brazil), inserting Arts. 156-A and 156-B and amending Art. 195, V of the Federal Constitution of 1988.

[66] *Ibid.*, Art. 159-A (Fundo Nacional de Desenvolvimento Regional).

[67] Supra note 33.

secretariat may be institutionalized apart from the Union Ministry of Finance and officers may be appointed from both Union and State and serve the Council as a whole. But a slight change in the voting arithmetic such as reducing the weight of the Union a little or requiring that a specific number of States be in majority, would also (with the necessary constitutional amendment and wide political support) make the Council more truly federal.

Third, the States could be given a "narrow band" of rate flexibility. An alternative might be a small band, say one or two percentage points, around the rate set by the Council for certain categories of goods for each State to determine the SGST. This would keep the overall uniformity of this system intact and give the States a little more fiscal flexibility. In Canada, this flexibility has coexisted with a common tax base.[68] With digital architecture of the GST Network, the administrative cost would be real but manageable.

Fourth, the issue of cesses and surcharges need to be dealt directly with. A constitutional / statutory cap on the proportion of the Union's gross tax revenues that can be levied as cesses and surcharges will preserve the purity of the divisible pool. Or, any continuing beyond a specific time of any cess or surcharge might automatically be put on the divisible stock. This would make the Finance Commission's recommendation of vertical devolution flexible and not like a stone of stone. The revenue that was previously allocated to the States via the compensation fund is clearly up for grabs by way of statutory sharing formula instead of discretionary transfers in the form of new health and security cess on demerit goods.

Fifth, India must have a permanent and rule-based revenue stabilisation mechanism instead of the ended compensation guarantee. Based on clear conditions that are linked to a significant drop in revenue, a fund could be established during good years with a portion of the GST and drawn from during bad years. It wouldn't offer the same certain growth rate as the old compensation, but it would buffer States from sudden shocks, such as the one in 2020, and from the uneven impact of major compensation shifts, such as the one in 2025. Being rule-based, it would eliminate the need for political horse trading at crisis time.

6th, the GST Council and the Finance Commission need to work in tandem. Future terms of reference might include an evaluation of the impact of the Council's decisions on the State's finances and the recommendation of corrective grants if the impact is significant; the Council might be required to take the Commission's recommendations into account before undertaking major structural change.

Finally, petroleum products, which is always touted as the inevitable next step in the reform, should not be considered a foregone conclusion. The States deserve a significant counter to their willingness to surrender their remaining primary tax source: they are entitled to a greater vertical share, a fixed amount of revenue for a limited amount of time, or a constitutional amendment to protect their divisible tax base from further cuts. It would be be better to brook no delay without such a concession, because it would aggravate the mistrust that has been present from the beginning in the scheme of GST.

[68] Supra note 62.

Eighth, there should be a direct representation of local governments in GST. The panchayats and municipalities may by law receive a fixed percentage of the collections under SGST, as recommended by the State Finance Commissions. This would at least bring the revenue base back where it has been since octroi, entry tax and local entertainment tax were merged, and provide the third tier with a reliable source of funds, instead of relying on grants completely.

Last but not least, the Inter-State Council under Article 263 – which has met rather infrequently[69] – may be the regular platform for broader considerations of fiscal federalism: on conditional transfers, borrowing limits and the design of centrally-sponsored schemes. GST has demonstrated that the Indian governments can work together intensively if there is an institution to facilitate such cooperation.

XII. Conclusion

In many aspects, the Goods and Services Tax is a tribute to the possibilities of Indian federalism. It demanded that the Union and all the States agree on a single tax, that they give up part of their sovereignty, and that they submit themselves to collective decision-making in an area where they each used to make decisions for themselves. Only a handful of federations have dared to try it and even fewer have succeeded.

However, a monument is not a house. The States came to the GST deal because of three promises: A share in a bigger tax base, A say in the decision-making rules of the tax and protection during the transition to GST. The first one is preserved. The second has been kept in form but not substance: the Council's voting procedures and arithmetic leaves the Union with the winning hand and the proposed dispute resolution mechanism goes unbuilt. The third has been exhausted, and cesses, conditional transfers and control of borrowing have reduced the fiscal space of the States from other sources.

The Supreme Court in *Mohit Minerals*[70] took India's people to task for forgetting that Indian federalism is a two-way street where both cooperation and competition can exist. The job is to make that conversation fair: institutions that the States can trust, open access to data, rules, not the whims of the political moment, and some of the fiscal tools handed back to the States. Fiscal autonomy following GST cannot involve coexistence of separate and competitive tax systems. It should signify that the States are real owners of the common system and not tenants of it. Cooperative federalism, as it should be, and not as a mere slogan, must rest on that ground.

Funding

This research received no external funding.

Conflict of Interest

The author declares no conflict of interest.

[69] The Inter-State Council last met, for its eleventh meeting, on 16 July 2016. See also Commission on Centre-State Relations, *Report* (Chair: R.S. Sarkaria, 1988); Commission on Centre-State Relations, *Report* (Chair: M.M. Punchhi, 2010).

[70] Supra note 35.

Data Availability Statement

Not applicable. No new data were created or analysed in this study.

AI Usage Disclosure

The author used Claude (Anthropic) to format the manuscript to the journal template and to prepare citation footnotes; all content was reviewed and verified by the author.

Author Contributions

Shataxi Uma Jaiswal is the sole author and was responsible for conceptualization, research, analysis and writing of the manuscript.

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