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MAGAZINE NOTES

# GST 2.0 and the Arithmetic of Fiscal Federalism

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# GST 2.0 and the Arithmetic of Fiscal Federalism

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**Analytical digest** for EPW July 2026, built from verified data and public debate.

The most consequential tax reform of the decade quietly took effect on **September 22, 2025**, and by mid-2026 its distributional consequences had become a live debate in EPW's pages. The **GST Council, at its 56th meeting on September 3, 2025**, collapsed the old four-tier structure into a leaner design: two principal slabs of **5 percent and 18 percent**, with a **40 percent** rate reserved for luxury and sin goods, and the **12 percent and 28 percent** slabs abolished. The reform, marketed as GST 2.0, simplified compliance and cut rates on a swathe of mass-consumption goods. It also reopened a question the original GST bargain had deferred: who bears the fiscal risk when the Union rationalises a shared tax?

## WHAT CHANGED

Most goods previously taxed at 12 percent moved down to 5 percent, while items at 28 percent moved either down to 18 percent or up to the new 40 percent tier. The stated aim was threefold: **structural simplification, rate rationalisation, and ease of living and doing business**. For households, the immediate effect was cheaper essentials and consumer durables. For the exchequer, the effect was more ambiguous.

| FEATURE | OLD GST (PRE-SEPT 2025) | GST 2.0 (FROM SEPT 22, 2025) |
|---|---|---|
| Number of principal slabs | Four (5, 12, 18, 28) | Two (5, 18) plus 40 for luxury and sin goods |
| Essentials and mass goods | Mostly 12 percent | Mostly 5 percent |
| High-end and demerit goods | 28 percent plus cess | 18 or 40 percent |
| Compliance complexity | Higher, with classification disputes | Lower, fewer classification margins |
| Revenue predictability for states | Cushioned by compensation cess | Reopened as a live concern |

## THE FEDERAL QUESTION

GST is the constitutional expression of **cooperative federalism**. Under **Article 279A**, the GST Council pools the sovereign taxing power of the Union and the states into a single forum where the Centre holds one-third and the states collectively hold two-thirds of the weighted vote, with decisions needing a three-fourths majority. The design assumes that rate changes are negotiated, not imposed. GST 2.0 was recommended by the Council, so the process was constitutionally sound. The dispute is about consequences, not procedure.

Because the states surrendered independent indirect-taxation powers in 2017 in exchange for a compensation guarantee that expired, a rate cut on high-buoyancy goods directly narrows the base from which states draw. Opposition-governed states such as **Kerala, West Bengal and Tamil Nadu** publicly flagged the risk of revenue loss, arguing that the gains to consumers are financed partly by the fiscal space of subnational governments that must still fund health, education and policing.

## BUOYANCY VERSUS NEUTRALITY

The central economic claim for GST 2.0 is that lower rates on mass goods will lift **consumption**, widen the base, and make the reform broadly **revenue-neutral** over time through higher volumes and better compliance. Early signals were favourable: GST collections in FY 2025-26 were expected to exceed budget estimates, suggesting healthy **buoyancy**. But neutrality at the aggregate national level can still mask **horizontal imbalance**. Consuming states with large retail bases gain relatively more than producing or resource-dependent states, and states with weaker own-tax capacity are more exposed to any shortfall. EPW's analytical concern was precisely this gap between a reform that looks neutral in national accounts and one that is uneven across the federation.

## THE EFFICIENCY CASE AGAINST OVER-SIMPLIFICATION

A two-rate GST is closer to the textbook ideal of a broad-based, low-rate consumption tax with minimal exemptions. It reduces classification litigation, shrinks the incentive to misdeclare goods into a lower slab, and lowers the compliance burden on small firms. The trade-off is that a 40 percent luxury tier reintroduces a high-margin category that invites the same classification games GST was meant to end, and the continued exclusion of petroleum, electricity and real estate from the GST net leaves the reform structurally incomplete.

## WAY FORWARD

- **A rules-based revenue-sharing floor** or a successor to the compensation mechanism, so that states facing structural shortfalls are cushioned during transition.
- **Bringing petroleum and electricity into GST**, which would broaden the base, restore input-tax credit chains, and reduce cascading in energy-intensive sectors.

- **Strengthening the GST Council as a deliberative institution**, with transparent revenue-impact assessments published before rate decisions.
- **Independent fiscal analysis** of horizontal effects, so that consuming and producing states can negotiate on shared evidence rather than political assertion.

## UPSC ANGLE

- **GS3 (Economy):** indirect taxation, rate rationalisation, revenue buoyancy and neutrality, consumption effects of tax reform.
- **GS2 (Polity and Governance):** cooperative federalism, the GST Council under Article 279A, Union-state fiscal relations.
- **GS3 (Fiscal policy):** tax base broadening, compliance design, and the political economy of reform.

**Likely Mains question:** “The move to a two-slab GST simplifies the tax but complicates fiscal federalism. Critically evaluate.” (GS3, 15 marks)

### FACTS CORNER

GST Council 56th meeting: September 3, 2025; recommended two principal slabs (5 and 18 percent) plus 40 percent for luxury and sin goods.

Effective date of GST 2.0: September 22, 2025; the 12 and 28 percent slabs were abolished.

Article 279A: constitutional basis of the GST Council; Union holds one-third and states two-thirds of weighted votes; decisions need a three-fourths majority.

GST introduced: July 1, 2017, via the 101st Constitutional Amendment Act, 2016.

Still outside GST: petroleum products, electricity, alcohol for human consumption and real estate remain outside the GST base.

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