India's GST reform: Balancing consumer benefits with state revenue concerns

Simplified GST slabs aim to relieve consumers but pose significant challenges for state finances and federal harmony in India. States anticipate substantial revenue losses, raising concerns about fiscal sustainability and their ability to fund development

By Lekha Chakraborty

Issue Date: September 21, 2025

Updated: September 14, 2025 07:15 IST

A mine in Dhanbad in Jharkhand | AFP

THE GOODS AND Services Tax Council's recent decisions have sparked intense debate among states, with many expressing concerns about potential revenue losses thanks to new tax slabs. States fear they could lose a significant portion of their receipts: estimates suggest the rate rationalisation could cost around Rs48,000 crore. Revenue Secretary Arvind Shrivastava noted the new tax regime would result in tax buoyancy. Yet several state finance ministers have voiced deep concerns about the long-term fiscal sustainability of the structure. Questions have also been raised about the timing of indirect-tax reforms and their efficacy in neutralising the effects of Donald Trump's tariff hikes.

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Since its implementation in 2017, the GST has been a game-changer for India's economy. It replaced a complex labyrinth of central and state levies, aiming to create a unified national market and boost growth. It sought to preempt the cascading effects of taxation by avoiding tax at multiple intermediate stages and taxing a commodity only at the final stage.

The GST Council, comprising representatives from the Centre and the states, was tasked with deciding tax rates, exemptions and related matters. To put the issue into perspective: when GST was introduced it had four slabs—5 per cent, 12 per cent, 18 per cent and 28 per cent. The structure was designed to be revenue-neutral so that neither the Centre nor the states lost out because of the transition. States were provided GST compensation at a 14 per cent revenue-neutral rate during the transitory phase to make up for shortfalls.

However, the multiplicity of tax rates persisted and affected ease of doing business. Many countries operate a single GST rate; Union Finance Minister Nirmala Sitharaman has, however, ruled this out for India, noting that "hawai chappal and Benz car cannot have the same GST rate."

The GST Council recently arrived at a “dual GST regime”, simplifying slabs to 5 per cent and 18 per cent with a special 40 per cent rate for luxury and sin goods, effective from September 22.

While the aim of the new regime is to boost consumption and reduce compliance burden, its impact on state revenues remains a worry. Lower tax rates will increase disposable income, but if the propensity to save is high that increase may not translate into higher growth. Tax policy alone is not the optimal route to stimulate aggregate demand; rising wages and salaries can be a more direct lever. Announcements by the eighth Pay Commission are therefore likely to be important for demand.

Tough balance: A government hospital in Jammu | PTI

States rely heavily on GST receipts to finance growth and development; any reduction in rates could strain their finances. They are seeking measures to ensure fiscal sustainability and minimise revenue losses. Fiscal consolidation amid reduced collections would likely mean expenditure compression: it is plausible that states will protect their fiscal targets by curtailing capital spending. There is no clear articulation yet on how the 16th Finance Commission will analyse the new GST regime in its tax-transfer award forecasting and related decisions.

Uncertainty also surrounds the compensation cess. Although it was extended until March 2026, there are indications it could be discontinued as early as October 31, 2025—and questions remain over whether any surplus will be retained by the Centre or shared with the states. Own-tax bases and non-tax revenue sources at the state level may not be as buoyant as GST, further constraining subnational fiscal space.

The sectoral impacts of the new rates will be uneven across states—affecting food, health care, medicines, housing, automobiles and education in different ways. While reductions on essentials such as food and health care will benefit consumers, the hit to state revenues is real. Kerala's Finance Minister K.N. Balagopal has said the state would face losses in cement, automobiles, electronics and insurance; he also warned that raising GST on lottery to 40 per cent will hurt Kerala, since lottery revenue is an important state resource. The sin-goods slab includes gambling and casinos.

A lottery seller in Kollam, Kerala | Rinkuraj Mattancheriyil

There is ambiguity over mining royalties—a source of non-tax revenue for many states—and over the GST treatment of mineral products. Mining royalties affect states differently; mineral-rich states stand to lose more. A Supreme Court ruling has held that royalties paid by mining lessees for mineral rights are not a tax but a consideration for land use and therefore outside the GST's scope. Nevertheless, under the new regime, GST on coal, lignite and peat has been raised from 5 per cent to 18 per cent.

If there is a significant deviation between projected and actual GST collections, states are likely to pursue fiscal consolidation by cutting expenditure, which in turn would affect their growth recovery. Small deviations reflect the government's fiscal "marksmanship"; large deviations would indicate poorer marksmanship given the uncertainties around revenue buoyancy under the new GST.

The discretionary fiscal space available to support growth will be constrained by potential revenue loss from GST reductions. It remains unclear whether the debt-deficit dynamics of state governments will be redesigned in light of the new regime. As Diwali and Navaratri arrive with tax reductions, fiscal-federal relations must be amicably resolved to preserve long-term fiscal sustainability.

There are no direct links between tax reduction and economic growth—much depends on the macroeconomic channels through which effects operate. States are equal partners with the Centre on the path to macroeconomic stabilisation. Sitharaman will need to address these issues in co-ordination with state governments; she has written to all state finance ministers thanking them for their support. The Centre and the states must undertake a careful, detailed analysis of the dual GST regime's impact on long-term fiscal sustainability and chart the way ahead.

Chakraborty is professor at National Institute of Public Finance and Policy and board member of International Institute of Public Finance, Munich.