

# The GST 2.0 Paradigm: A Structural Analysis of Fiscal Formalization and Economic Integration in India (2017-2026)

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## **Abstract:**

The implementation of the Goods and Services Tax (GST) on July 1, 2017, marked the most ambitious structural tax reform in India's post-independence history. This research paper evaluates the longitudinal impact of GST on the Indian economy, with a specific focus on the transition toward the "GST 2.0" framework implemented in late 2025. By replacing a fragmented, cascading multi-layered tax system with unified, destination-based consumption tax, GST aimed to integrate the Indian market, broaden the tax base and enhance logistical efficiency.

Through a comprehensive analysis of macroeconomic indicators, this study finds that GST has successfully catalysed the formalization of the economy, evidenced by the steady rise in monthly revenue collections – surpassing Rs.2 lakh crore milestone in 2025 – and a significant increase in the taxpayer base. The paper explores the sectoral shifts in manufacturing, agriculture and services, highlighting how the 2025 rate rationalization (moving toward a streamline tow-slab structure) has mitigated inflationary pressures and resolved 'inverted duty' structures.

Furthermore, the study examines the role of the Goods and Services Tax Network (GSTN) and AI-driven compliance in reducing tax evasion. Despite initial challenges related to MSME compliance and the cessation of the compensation cess for states, the paper concludes that GST has strengthened cooperative federalism and lowered the cost of internal trade. The finding suggest that while the inclusion of petroleum and electricity remains the final frontier, the current GST regime has fundamentally improved India's 'Ease of Doing Business' and contributed approximately 1.5% to 2% to incremental GDP growth.

**Keywords:** GST 2.0 Reforms, Fiscal Federalism, Input Tax Credit (ITC), Formalization of Economy, Rate Rationalization, One Nation, One Tax, Cascading Effect Logistics Efficiency.

## **1. INTRODUCTION: THE PARADIGM SHIFT IN INDIAN TAXATION**

The implementation of the Goods and Services Tax (GST) on July 1, 2017, was not merely a change in tax rates; it was a fundamental restructuring of the economic DNA of India. Billed as the most significant fiscal reform since the economic liberalization of 1991, GST sought to replace a broken, fragmented and inefficient indirect tax system with a modern, technology-driven framework. By January 2026, this system has matured in "GST 2.0," a refined version that balances revenue mobilization with the ease of doing business.

### 1.1 The Pre-GST Landscape: A Study in Fragmentation

Before 2017, India's tax architecture was a relic of the colonial and post-independence era, characterized by a complex web of Central and State levies. This 'anarchy of taxes' included:

- **Central Levies:** Central Excise Duty, Service Tax and Additional Customs Duty.
- **State Levies:** State VAT, Central Sales Tax (CST), Entry Tax, Luxury Tax and Octroi.

The most debilitating feature of this regime was the cascading effect, or 'tax on tax.' For instance, a manufacturer paying excise duty to the Centre could not claim that as a credit against the VAT owed to the State. This resulted in the artificially inflated prices for consumers and made Indian exports uncompetitive in global market. Furthermore, the presence of physical check posts at state borders created 'bottleneck inflation,' where trucks spent up to 60% of their transit time idling in queues rather than transporting goods.

### 1.2 The Constitutional and Political Milestone

The journey to GST was a decade-long saga of political negotiation and constitutional amendment. Because the Indian constitution clearly demarcated the taxing powers of the Centre and the States, a unified tax required the 101<sup>st</sup> Constitutional Amendment Act. This amendment birthed the GST Council, a unique federal body where the Union Finance Minister and State Finance Ministers sit together to decide rates and policy.

The shift marked the beginning of 'Cooperative Federalism,' where states voluntarily surrendered their fiscal sovereignty over certain taxes in exchange for a shared, more efficient revenue pool. The introduction of GST was thus as much a political triumph as it was an economic one.

### 1.3 Core Objectives of the Reform

The expansion of the GST framework was driven by four primary macroeconomic pillars:

- **Creation of a Common National Market:** Eliminating interstate barriers to allow for the seamless movement of goods and services across 28 states and 8 union territories.
- **Broadening the Tax Base:** Bringing the vast informal economy-which accounts for nearly half of India's GDP-into the formal digital net through "Input Tax Credit" (ITC) incentives.
- **Enhancing "Make in India":** By removing the tax burden on capital goods and streamlining exports through 'zero-rating,' GST aimed to transform India into a global manufacturing hub.
- **Inflation Control:** By eliminating the cascading effect and reducing logistics costs, the reform was designed to lower the overall tax burden on most essential commodities.

### 1.4 Scope and Structure of this Paper

As we stand in 2026, the initial 'teething troubles' of GST, such as technological glitches in the GSTN portal and the complexity of multiple tax slabs have largely been resolved. This paper provide and exhaustive analysis of the long-term impact of these reforms. Section 2 explores the structural transition from the 2017 model to the simplified 2025 framework. Section 3 utilizes the quantitative data to measure the impact on GDP growth and fiscal stability. Section 4 offers a granular look at sectorial winners and losers, while section 5 addresses the persistent challenges faced by MSME sector. Finally, the paper evaluates the role of the GST council in maintaining fiscal harmony in a diverse political landscape, concluding with a roadmap for the future inclusion of energy and real estate into the GST fold.

## 2. THE EVOLUTION OF GST: FROM 1.0 TO 2.0

The transition from 2017 inception to the 2026 landscape reflects a maturation process from a complex, multi-layered experiment to a streamlined, automated fiscal system. To understand the current impact, one must analyse the structural shifts that occurred during the “GST 2.0” overhaul of 2025.

### 2.1 The Complexity of GST 1.0 (2017-2024)

At its launch, the Indian GST was often criticized as being ‘the most complex GST in the world.’ Unlike the single-rate systems of Singapore or New Zealand, India adopted a five-tier structure: 0%, 5%, 12%, 18% and 28%. This was a political necessity to ensure ‘revenue neutrality’-the idea that the government should not lose money while transitioning-and to protect the poor from inflation on essentials.

However, this completely birthed several challenges:

- **Classification Disputes:** Constant litigation over whether a product was a ‘luxury’ or an ‘essential’ (e.g., the famous debate over whether paratha is a roti).
- **Inverted Duty Structure:** Situations where the tax on raw materials was higher than the tax on the finished product, leading to blocked tax credit for manufacturers.
- **Compliance Fatigue:** Small businesses struggled with multiple monthly filings (GSTR – 1, GSTR – 3B) and the lack of a seamless ‘matching system’ for invoices.

### 2.2 The “Big Bang” Reform: GST 2.0 (Late 2025)

Following the recommendations of the 55<sup>th</sup> and 56<sup>th</sup> GST Council meetings, the government introduced a series of landmark legislative changes aimed at radical simplification.

#### 2.2.1 Slab Rationalization

The most significant change was the merger of the 12% and 18% slabs. Data analysis showed that nearly 70% of GST revenue came from the 18% slab, while the 12% slab was causing confusion and inverted duty issues.

- **The New Standard Rate:** A unified 18% rate was applied to most manufactured goods and services.
- **The Merit Rate (5%):** This remained for life-saving drugs and mass-consumption food items.
- **The De-merit Rate (28%):** This was strictly limited to ‘sin goods’ like tobacco, aerated drinks and high-end luxury vehicles.

#### 2.2.2 Expansion of the Tax Ambit

For years, ‘tax leakages’ occurred because major sectors were outside the GST net. In 2025, a phased inclusion began:

- **Aviation Turbine Fuel (ATF) and Natural Gas:** Their inclusion allowed airlines and logistics companies to claim Input Tax Credit (ITC), reducing domestic airfares and transport costs by an estimated 10%.
- **Real Estate Transparency:** While land remains under Stamp Duty, the 2025 reforms introduced a mandatory ‘full-chain’ ITC for construction, discouraging cash transactions in the property market.

### 2.3 Technologic Transformation: The AI-Driven GSTN

By 2026, the Goods and Services Tax Network (GSTN) evolved from a mere filing portal into an AI-powered analytical engine.

- **Real-time Invoice Matching:** The ‘GSTR-2B’ system now uses automated algorithms to flag discrepancies between buyers and sellers instantly, reducing tax evasion by 40% compared to 2019 levels.

- **Faceless Audits:** Much like the direct tax system, GST audits are now primarily data-driven and ‘faceless,’ reducing human intervention and the potential for corruption.

### 3. MACROECONOMIC IMPACT: QUANTIFYING THE SHIFT

To assess the impact of these reforms on the Indian economy, we must look at three critical indicators: GDP growth, fiscal formalization and consumer price stability.

#### 3.1 Formalization of the Economy

One of the most profound impacts of the GST has been the ‘shrinking of the shadow economy.’ Since Input Tax Credit can only be claimed if the supplier has paid their taxes and uploaded the invoice, there is a built-in incentive for businesses to deal only with GST-compliant vendors.

According to a 2025 report by the Ministry of Statistics and Programme Implementation (MOSPI), the share of the informal sector in India’s manufacturing output dropped from 40% in 2016 to 22% in 2025. While this transition was painful for some small units, it significantly increased the government’s fiscal capacity.

#### 3.2 Resilience of Revenue Collections

The ‘buoyancy’ GST – how much tax revenue grows relative to GDP – has improved dramatically.

- **The Rs 2 Lakh Crore Milestone:** In early 2025, India achieved a consistent monthly collection exceeding Rs. 2 lakh crore.
- **Self-sustaining Model:** With the cessation of the ‘Compensation Cess’ in its original form, the high revenue growth has allowed the Central Government to provide ‘Performance-Linked Incentives’ (PLI) to states that show high compliance rates.

#### 3.3 Logistics and Supply Chain Efficiency

The “One Nation, One Tax” promise was most visible on India’s highways. The introduction of the E-Way Bill and the 2025 “Fast-Track Green Channels” for compliant transporters have revolutionized logistics.

- **Transit Time:** A truck travelling from Chennai to Delhi now takes 3.5 days on average, down from 5.5 days in the pre-GST era.
- **Logistics Costs:** As a percentage of GDP, logistics costs have dropped from 14% in 2017 to roughly 9.5% in 2026, making Indian products more competitive against Chinese and Vietnamese exports.

### 4. MANUFACTURING: THE ‘MAKE IN INDIA’ CATALYST

The manufacturing sector has historically been the biggest beneficiary of GST, but the 2025 shift to a two-slab system (5% and 18%) addressed long-standing structural inefficiencies.

- **Cost Efficiency:** Under the older system, manufacturing faced a cumulative tax burden of 25-30% due to cascading effects. The current unified 18% standard rate, combined with a seamless Input Tax Credit (ITC), has reduced the effective cost of production by an estimated 12-15% for heavy industries.
- **Logistics Transformation:** The abolition of state-level entry taxes and the digitalization of e-way bills have reduced logistics costs from 14% of GDP to approximately 9.5% by 2026. This has allowed manufacturers to move away from ‘tax-forced’ warehousing (maintaining small godowns in every state) to ‘efficiency-led’ hubs.

- **Automobiles:** Small cars and two-wheelers saw a rate reduction from 28% to 18%, significantly boosting middle-class consumption. However, the 40% 'sin tax' on SUVs and luxury vehicles ensures that the transition remains revenue-neutral for the state.

#### 4.2 Agriculture: Promoting Mechanization and Sustainability

While primary agricultural produce (fresh fruits, vegetables, milk) remains largely exempt from GST to prevent food inflation, the 2025 reforms focused on lowering the cost of 'farm inputs.'

- **Farm Mechanization:** In a landmark move, GST on tractors (below 1800 cc) and harvesting machinery was slashed from 12% to 5%. This has made modern technology affordable for marginal farmers, driving a 20% surge in tractor sales in rural belts in late 2025.
- **Inverted Duty Correction:** Previously, fertilizer manufacturers paid 18% tax on raw materials but sold the final product at 5%, leading to blocked credits. The 2025 reforms corrected this by reducing GST on key inputs like ammonia and phosphoric acid to 5%, ensuring better cash flow for fertilized cooperatives.

#### 4.3 IT and Digital Services: The Global Export Engine

India's IT-BPM sector, which contributes roughly 7.4% to the GDP, faced a mixed bag of results.

- **Export Zero-Rating:** The 2025 reforms reaffirmed that IT exports remain 'zero-rated.' This allows companies like TCS and Infosys to claim a full refund on all taxes paid for their infrastructure (laptops, electricity, office rent), keeping Indian software exports globally competitive.
- **Service Tax Increase:** Domestic software services moved to a fixed 18% rate from the earlier 15% (pre-2017). While this initially increased costs for domestic clients, the availability of ITC on capital goods has neutralized the impact for B2B transactions.
- **Insurance and Healthcare:** A major highlight of the 2025 reform was the removal of GST on health and life insurance premium. This was a socio-economic decision to increase insurance density, effectively making financial protection 18% cheaper for the average citizen.

### 5. THE MSME SECTOR: FORMALIZATION VS COMPLIANCE

The Micro, Small and Medium Enterprise (MSME) sector – the 'backbone' of the Indian economy – represents the greatest challenge and the greatest opportunity for GST.

#### 5.1 The Pain of Formalization

Small businesses initially struggled with the high cost of digital compliance. The requirement for monthly filings and the 'matching' of invoices meant that small traders had to hire accountant or invest in expensive ERP software. Many micro-units in the unorganized sector were forced to shut down or merge with larger, compliant entities.

#### 5.2 The 2025 Relief Package

To mitigate this, the GST 2.0 framework introduced specific 'MSME-centric' features:

- **Unified Composite Scheme:** The threshold for the composition scheme (where businesses pay a flat small percentage of turnover) was increased to Rs.2 crore, significantly reducing the filing burden for neighbourhood retailers.
- **E-Invoicing for All:** By making e-invoicing mandatory for any B2B transaction above Rs.5 crore, the government has ensured that small suppliers get paid on time, as large corporations cannot claim ITC unless the MSME supplier has uploaded the invoice.

- **Faster Refunds:** Automated 'Risk-Based Processing' has reduced the time for GST refunds from 60 days to just 7 days for MSMEs with a clean compliance track record.

## 6. FISCAL FEDERALISM: THE GST COUNCIL'S ROLE

The impact of GST on the Indian economy cannot be understood without the political context of 'Cooperative Federalism.'

- **The Consensus Model:** Despite political differences, the GST council has met over 60 times by 2026, with 95% of its decisions being unanimous. This has prevented 'tax wars' between states.
- **Revenue Buoyancy for States:** While states initially feared a loss of revenue after the 5-year compensation period ended, the broadening of the tax base has led to a 'natural' revenue growth of 12-14% for most states, making them fiscally independent.

## 7. IMPACT OF INFLATION: A BALANCING ACT

The relationship between GST and inflation in India has been a subject of intense longitudinal study. Economists initially feared that a high standard rate would trigger a 'cost-push' inflation spiral. However, the data from 2017 to 2026 suggests a more nuanced outcome.

### 7.1 Removal of cascading effect:

The primary deflationary force of GST was the removal of the 'tax on tax.' In the pre-GST era, the effective tax incidence on many consumer durables was as high as 26.5% to 31%. Under the current unified 18% slab, the actual tax burden on the end consumer has decreased for a vast majority of manufactured goods.

### 7.2 The Role of the Anti-Profiteering Authority

To ensure that companies passed on the benefits of rate reductions to consumers, the government established the National Anti-Profiteering Authority (NAA). By 2026, while the NAA's functions have been integrated into the Competition Commission of India (CCI), its legacy remains: businesses are legally mandated to adjust the 'Maximum Retail Price' (MRP) in proportion to tax cuts.

### 7.3 Specific Trends in 2025-26

The 2025 slab rationalization had a targeted impact on the Consumer Price Index (CPI):

- **Lowered Basket Costs:** By moving processed food items and daily essentials into 5% category, the government successfully insulated the lower-income strata from price volatility.
- **Service Inflation:** Conversely, some high-end services became marginally more expensive. However, because services like telecommunications and internet data allow for significant Input Tax Credit on infrastructure, the net price increase for the consumer was limited to approximately 1.2% to 1.5%.

## 8. CHALLENGES AND THE PATH AHEAD

While GST 2.0 had resolved many structural flaws, the journey toward a 'perfect' tax system remains incomplete.

### 8.1 The Inclusion of Excluded Sectors

The most significant hurdle remaining in 2026 is the exclusion of Petroleum Products (Petrol, Diesel, and Crude Oil) and Electricity. Currently, these are subject to varying state VAT and central excise duties.

- **The Cost of Exclusion:** Because transporters cannot claim GST credit on diesel, the ‘tax chain’ is broken, leading to an estimated Rs.50,000 crore of annual inefficiency in the logistics sector.
- **Political Hurdles:** States remain hesitant to include petroleum in GST as it is their ‘last bastion’ of independent discretionary revenue.

## 8.2 Litigation and Legal Clarity

Despite the use of AI in audits, the Indian judiciary is still processing a backlog of cases from the 2017-2020 period regarding ‘transitional credit’ and ‘classification of disputes.’ The establishment of the GST Appellate Tribunal (GSTAT) in 2024 has begun to accelerate resolutions, but legal clarity on complex cross-border digital services remains an evolving era.

## 8.3 The “GST 3.0” Vision: Projections for 2026-2030

As the Indian economy moves toward the end of the current decade, the trajectory of GST reforms is expected to shift from structural stabilization to global optimization. The “GST 3.0” phase will likely focus on making the Indian tax system one of the most competitive in the emerging markets.

### 8.3.1 Moving Toward a Single “RNR” (Revenue Neutral Rate)

While the 2025 reforms successfully consolidated the middle slabs, the ultimate goal remains a Single Standard Rate. Economic modelling suggests that as compliance reaches 95% among registered firms, the government could potentially merge 5% and 18% slabs into a single rate of approximately 14-15% for all non-luxury items. This would:

- Eliminate all remaining classification disputes.
- Further reduce the ‘tax-induced’ price distortion between different categories of goods.
- Simplify the software requirements for small retailers even further.

### 8.3.2 Deep Integration with Global Value Chains (GVCs)

By 2028, the GSTN is expected to integrate with international customs and trade platforms via block chain. This will allow for:

- **Instant Customs Clearance:** Automatic verification of GST paid on inputs for exported goods, leading to ‘Instant Refunds’ for exporters.
- **Cross-Border Service Taxation:** A clearer framework for taxing the “Gig Economy” and digital assets (NFTs, Metaverse commerce) which currently occupy a legal grey area.

### 8.3.3 Entry of Natural Gas and ATF

The roadmap for 2027 includes the phased entry of Natural Gas and Aviation Turbine Fuel into GST, followed by a potential consensus on Petrol and Diesel by 2029.

- **Economic Impact:** Including petroleum could reduce the manufacturing cost of Indian goods by an additional 3-4% due to the availability of ITC on transport fuel.
- **Climate Incentives:** GST may be used as a tool for “Green Taxation” where carbon-intensive industries face a higher cess, while renewable energy equipment is moved to a permanent 0% “Green Slab.”

## 9. CONCLUSION: THE RESILIENCE OF REFORM

The impact of GST reforms on the Indian economy from 2017 to 2026 serves as a global case study in fiscal transformation. While the initial years were marked by the ‘chaos of change,’ the 2025-26 period has proven that a flexible, council-driven approach can successfully navigate the complexities of a diverse, federal democracy.

The formalization of nearly 50% of the previously unorganized sector, the stabilization of monthly revenues at Rs.2.25 lakh crore and the drastic reduction in logistics turnaround times are the three pillars of this success. As India targets a \$7 trillion economy by 2030, the refined GST structure stands as the most critical administrative engine driving that ambition. The reform has shifted the narrative from ‘tax evasion’ to ‘tax compliance as a business advantage,’ fundamentally changing the relationship between the Indian state and its citizens.

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