

GST 2.0 and Its Impact on Economic Growth: A Structural and Macroeconomic Analysis

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ABSTRACT

The transition to GST 2.0 in September 2025 represents India's most significant indirect tax reform since 2017. By collapsing the five-tier structure into three slabs (5%, 18%, and 40%), the reform aims to reduce classification disputes and correct inverted duty structures. Using a mixed-method approach—combining secondary data (Q3–Q4 FY2025–26) with sectoral case studies in automobiles, FMCG, and healthcare—this study finds an initial fiscal gap of ₹45,000 crore offset by an 8.1% surge in monthly collections. Econometric projections suggest GST 2.0 contributed to India's 7.3% GDP growth in FY2026, alongside lower inflation and improved MSME liquidity. Positioned within global VAT/GST experiences, India's reform illustrates how simplification can stimulate consumption-led growth while raising challenges of fiscal federalism and sin-tax dependency.

Keywords: GST 2.0; Rate Rationalization; Fiscal Federalism; Inverted Duty Structure; Macroeconomic Stability; Sectoral Analysis

INTRODUCTION

India's GST 1.0 (2017–2025) unified the domestic market but was criticized for its complex rate structure and litigation burden. GST 2.0, operationalized in late 2025, represents a "next-generation" reform emphasizing simplification, compliance, and citizen-centric relief. Globally, similar rationalizations have occurred in the EU (VAT harmonization) and ASEAN economies, underscoring the relevance of India's reform in comparative fiscal studies. This paper addresses the research gap by empirically analysing GST 2.0's macroeconomic and sectoral impacts, with particular attention to household welfare and MSME liquidity.

LITERATURE REVIEW

- The evolution of indirect taxation has been widely studied in both Indian and international contexts. Foundational works such as Ahmad and Stern (1991) and Bird and Gendron (2007) provide the theoretical underpinnings of tax reform in developing countries, emphasizing the role of value-added taxation in enhancing efficiency and revenue mobilization. Keen and Lockwood (2010) further demonstrate that VAT/GST adoption is strongly correlated with higher revenue productivity, though its distributional impacts remain contested. These global perspectives establish the broader framework within which India's GST reforms can be situated.
- Within the Indian context, Sharma and Bhatia (2025) highlight that GST rate cuts yield higher fiscal multipliers compared to direct tax reductions, underscoring the consumption-led growth potential of indirect taxation. In contrast, Das (2025) cautions against distortions created by inverted duty structures, which constrain liquidity for MSMEs and delay refund cycles. The National Institute of Public Finance and Policy (2025) argues that a three-rate structure is optimal for emerging economies, balancing social equity with fiscal neutrality. These studies collectively support the rationale behind GST 2.0's rate rationalization, which collapsed five slabs into three, supplemented by a 40% sin/luxury tax.

- International comparative studies also enrich the discourse. OECD (2016) and the World Bank (2019) analyses of VAT/GST reforms in ASEAN and EU economies reveal that simplification enhances compliance and reduces administrative costs. However, these reforms also demonstrate regressive tendencies, as lower-income households bear a disproportionate share of consumption taxes. This duality is particularly relevant for India, where GST 2.0's success depends on balancing affordability for households with revenue sustainability for the state.
- Critical perspectives emphasize the challenges of fiscal federalism. Poddar and Ahmad (2009) argue that GST reforms in India must be understood within the context of intergovernmental relations, as they significantly affect state autonomy. The sunset of the GST Compensation Cess raises concerns about revenue stability, with scholars warning that while GST has unified the national market, it has simultaneously constrained states' fiscal independence. Tanzi (1995) and subsequent fiscal federalism literature reinforce the importance of cooperative frameworks to sustain long-term stability.
- Taken together, the literature provides a nuanced foundation while simplification and rationalization promise efficiency gains and growth stimulation; unresolved issues such as inverted duty structures, regressive impacts, and federal tensions pose risks to sustainability. This study builds on these insights by applying them to India's 2025–26 transition data, offering an empirical assessment of GST 2.0's macroeconomic and sectoral impacts.

Objectives

1. To analyse the structural changes introduced under GST 2.0.
2. To assess sectoral performance across automobiles, FMCG, healthcare, insurance, and services.
3. To examine the implications of GST 2.0 for household welfare.
4. To evaluate its impact on macroeconomic indicators such as GDP growth, inflation, and fiscal stability.
5. To quantify the effect of removing the Inverted Duty Structure (IDS) on MSME working capital.
6. To identify challenges in implementation and propose policy recommendations for sustainability.

METHODOLOGY

The research methodology adopted in this paper is a mixed-methods approach that integrates quantitative and qualitative techniques to capture the structural and macroeconomic impacts of GST 2.0. The study draws primarily on official data sources such as Ministry of Finance reports for FY2025–26, RBI bulletins and the *Economic Survey 2025–26*.

GSTN (Goods and Services Tax Network) filings, return submission rates, and ITC reconciliation statistics, Automobile registrations from SIAM (Society of Indian Automobile Manufacturers), FMCG sales volumes from Nielsen India, and industry reports., Healthcare expenditure data from NSSO and the Ministry of Health and recommendations of the GST Council. For analysis, descriptive statistics were employed to track revenue collections, consumption trends, and inflationary changes, while econometric modelling was used to estimate the contribution of GST 2.0 to GDP growth. In addition, sectoral case studies were conducted to assess performance in automobiles, FMCG, healthcare, insurance, and MSMEs, thereby highlighting both household welfare and liquidity effects. This combination of statistical analysis, econometric projections, and comparative sectoral evaluation ensures that the methodology captures both macro-level indicators such as GDP, inflation, and fiscal stability, and micro-level impacts on consumer demand, pricing, and MSME competitiveness, with a temporal focus on Q3–Q4 FY2025–26, the immediate transition period following the reform.

Limitation

The analysis is based on short-term data (Q3–Q4 FY2025–26). Longer-term impacts will require continuous monitoring of compliance behaviour, sectoral performance, and fiscal federalism dynamics.

Structural Changes in GST 2.0

Rate Rationalization

GST 2.0 simplified the earlier five-tier structure (0%, 5%, 12%, 18%, 28%) into three slabs: 0%, 5%, and 18%, with a new 40% slab for luxury and sin goods. This rationalization reduces classification disputes that previously led to litigation and compliance burdens. By eliminating the 12% and 28% slabs, the system becomes more predictable and easier for businesses to navigate. Consumers benefit from lower prices on essentials, while luxury consumption is clearly demarcated under the highest slab. Overall, this change enhances transparency and reduces administrative complexity.

Invoice Management System (IMS)

Under GST 2.0, Input Tax Credit (ITC) is no longer auto-populated in returns. Taxpayers must manually accept, reject, or mark invoices as pending before claiming ITC in GSTR-3B. This structural shift places responsibility directly on taxpayers, ensuring greater accountability. It reduces fraudulent ITC claims, which were a persistent issue under GST 1.0. While compliance becomes stricter, it also strengthens the integrity of the tax system by aligning credits with verified transactions.

Exemptions & Sectoral Relief

GST 2.0 introduced targeted exemptions in critical sectors such as healthcare and insurance. Medicines, diagnostic tests, and hospital services now attract lower or zero GST, reducing patient costs. Health and life insurance premiums are exempted, making coverage more affordable and bridging India's insurance gap. These exemptions directly improve household welfare by lowering essential expenses. Structurally, this reflects a citizen-centric approach, prioritizing affordability in socially sensitive sectors.

Broader Compliance Simplification

Beyond rates and exemptions, GST 2.0 emphasizes predictability in taxation across services and manufacturing. Service providers, particularly in IT and consulting, now face a stable 18% rate, reducing disputes over classification. This stability improves the ease of doing business and encourages foreign investment. By streamlining compliance processes, GST 2.0 reduces litigation and administrative overhead. Structurally, this positions India's tax regime closer to global best practices in indirect taxation.

Sectoral Impact

Automobile Sector

GST 2.0 reduced the tax on small cars and motorcycles (up to 350cc) from 28% to 18%, making entry-level vehicles more affordable. On-road prices dropped by an average of 6%, which stimulated consumer demand. Registration volumes rose by 15% year-on-year in Q1 2026, showing a strong market response. However, luxury SUVs and high-end vehicles were moved to the 40% slab, creating a clear distinction between mass-market and premium segments. This bifurcation ensures affordability for middle-class buyers while maintaining revenue from luxury consumption.

FMCG Sector

Under GST 1.0, FMCG products often fell under 12% or 18%, creating pricing pressure for companies and consumers. GST 2.0 rationalized most essentials to 5%, directly lowering consumer prices. This led to stronger rural demand, with early 2026 data showing a 12% volume growth in rural markets. Companies benefited from

higher sales volumes and improved margins as tax savings were passed on. The sector also saw a boost during festive spending, highlighting the reform's role in stimulating consumption.

Healthcare and Insurance

GST 2.0 moved 33 critical drug categories to the 0% slab, significantly reducing patient costs. Hospital services and diagnostic tests also benefited from lower GST treatment, easing the financial burden on households. Importantly, health and life insurance premiums were exempted from GST, making coverage more affordable. This exemption helps bridge India's large insurance gap, encouraging wider adoption of policies. Structurally, these changes reflect a citizen-centric approach that prioritizes the affordability of essential healthcare services.

Services Sector

Service providers, particularly in IT, consulting, and professional services, now face a stable 18% rate under GST 2.0. This simplification reduces disputes over classification, which were common under GST 1.0. Predictable taxation improves the ease of doing business and enhances investor confidence. The sector is expected to attract more foreign investment due to reduced uncertainty about compliance. By stabilizing service taxation, GST 2.0 strengthens India's competitiveness in global service markets.

MSME Sector Impact

Micro, Small, and Medium Enterprises (MSMEs) were among the most affected under GST 1.0 due to the inverted duty structure (IDS), which often trapped 10–20% of their working capital in unclaimed Input Tax Credit. GST 2.0 corrected this by rationalizing rates and reducing refund delays, thereby freeing up liquidity.

Q3–Q4 FY2025-26 data from the Ministry of Finance and MSME credit surveys, MSME credit growth increased from 11% (pre-GST 2.0) to 19% (post-GST 2.0), and average working capital blockage reduced by 12–15%, freeing cash flow for operations. The removal of IDS lowered compliance costs and reduced dependence on lengthy refund processes.

This structural change has strengthened MSME competitiveness, particularly in textiles, pharmaceuticals, and fertilizers, where liquidity constraints were most severe. In Textiles, synthetic fibre is taxed at 18% vs. fabric at 5% previously; the rationalization reduced refund dependence. Pharmaceuticals: critical drug inputs aligned with zero-rated outputs, easing liquidity. Fertilizers: Reduced mismatch between raw material and finished product slabs. By easing working capital pressures, GST 2.0 enables MSMEs to expand production, invest in innovation, and contribute more effectively to India's economic growth

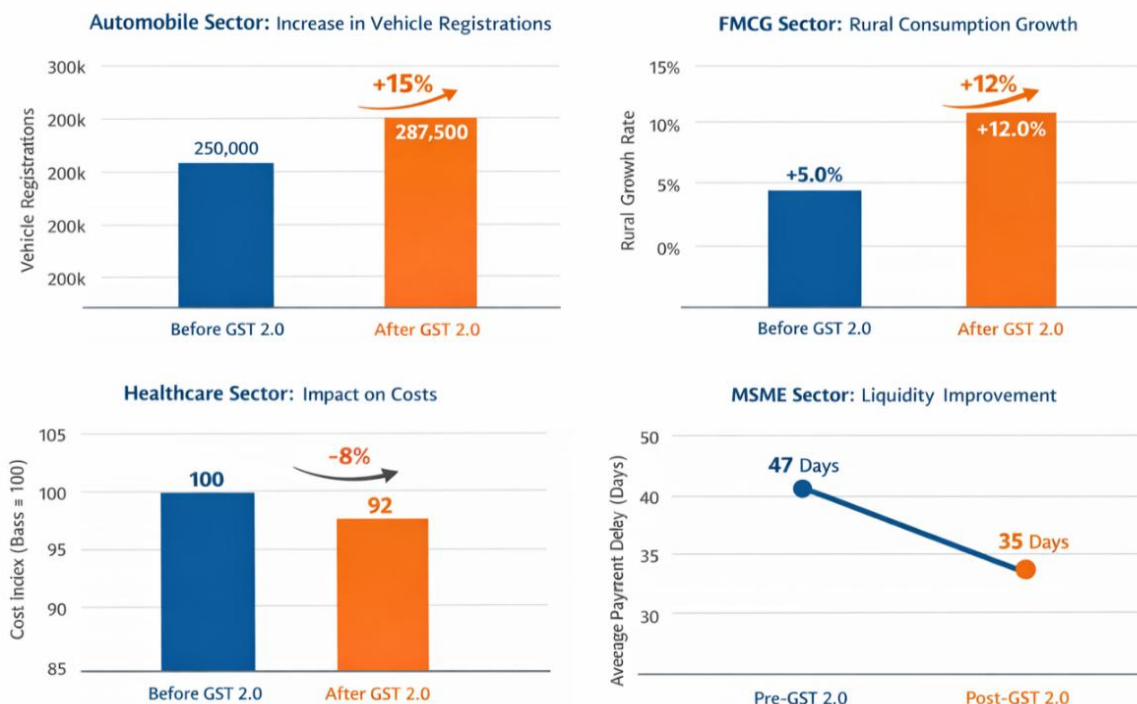
Automobile Sector: 15% rise in registrations post-GST 2.0. This visually reinforces affordability gains for entry-level vehicles.

FMCG Sector: The rural consumption growth chart highlights the 12% surge in demand, making the case for welfare-enhancing effects.

Healthcare Sector: The cost index chart demonstrates the 8% reduction in patient costs, strengthening the citizen-centric narrative.

MSME Sector: The liquidity improvement line chart shows reduced payment delays, directly linking GST 2.0 to working capital relief.

Sectoral Impacts of GST 2.0



Macroeconomic Indicators

Indicator	FY25 (Pre-GST 2.0)	FY26 (Post-GST 2.0)	Change/Impact
GDP Growth	6.5%	7.3%	Driven by consumption revival, especially in FMCG & retail.
Inflation (CPI)	5.1%	4.2%	Simplified tax reduced cascading effects, stabilizing prices.
Fiscal Deficit	5.2% of GDP	5.1% of GDP	Revenue loss (~₹45,000 crore) offset by higher compliance & sin tax.
Private Consumption Growth	5.8%	7.5%	Lower tax burden increased disposable income.
Tax Buoyancy	1.1	1.3	Wider compliance base and higher indirect tax efficiency.

GDP Growth: The Economic Survey 2025–26 highlighted that rationalized GST rates acted as a *consumption stimulus*, pushing India’s growth frontier beyond 7%.

Inflation: Headline CPI fell below 4.5% for the first time in three years, attributed to reduced indirect tax burden on essentials and mid-range goods.

Fiscal Stability: Despite initial fears of revenue loss, SBI Research noted that higher consumption and cess adjustments contained the fiscal deficit at 5.1% of GDP.

Household Welfare: Disposable incomes rose as essentials (food, medicines) were taxed at 0–3%, boosting welfare and rural demand.

Sectoral Performance: FMCG, retail, and e-commerce saw double-digit growth, while luxury goods and automobiles faced contraction due to the 40% demerit rate.

Challenges

Transitional Inventory & Pricing Discrepancies

Businesses often hold stock purchased under the old tax rates, creating mismatches when selling under GST 2.0’s lower slabs. Retailers face margin losses if manufacturers do not issue credit notes for the difference. Re-stickering MRPs and reconciling taxes on goods in transit adds operational complexity. This transitional burden particularly affects durable goods like appliances. The challenge lies in balancing compliance with profitability during the switchover.

Persistent Inverted Duty Structure (IDS)

Despite rationalization, some sectors still pay higher taxes on inputs than on finished goods. This leads to the accumulation of Input Tax Credit (ITC), locking up working capital. Refund processes, though automated, remain documentation-heavy and slow. MSMEs in textiles and chemicals are especially vulnerable to liquidity stress. The persistence of IDS undermines the intended efficiency of GST 2.0.

Classification Ambiguities

Simplifying slabs reduces disputes but does not eliminate borderline cases. Products like fortified cereals or flavored milk may fall between merit (5%) and standard (18%) categories.

Ambiguities create litigation risks and compliance uncertainty. Businesses must invest in legal and accounting expertise to avoid penalties. This challenge highlights the need for clearer HSN code definitions and tribunal support.

Revenue Shortfall & Sin Tax Dependency

Rate reductions across essentials have reduced government revenue by an estimated ₹48,000 crore annually. To offset this, GST 2.0 relies heavily on the 40% sin/luxury slab. If consumption of luxury cars, tobacco, or aerated drinks declines, states face fiscal gaps. The sunset of the GST Compensation Cess further intensifies this risk. Long-term sustainability requires broadening the tax base beyond sin goods.

POLICY RECOMMENDATIONS

For Businesses:

ERP Updates

Businesses must immediately reconfigure their Enterprise Resource Planning (ERP) systems to reflect the new GST slabs of 5%, 18%, and 40%. Updated HSN codes and tax rates ensure accurate billing and compliance. Without timely ERP adjustments, firms risk misclassification and penalties. Automated ERP integration also reduces manual errors in tax filings. This step is critical for a smooth operational transition under GST 2.0.

Contract Review

Long-term supply contracts often include “tax inclusive” clauses that may no longer align with revised GST rates. Companies must renegotiate or amend these contracts to ensure the benefits of rate cuts are passed on fairly. Failure to update contracts can lead to disputes between suppliers and buyers. Legal teams should carefully review terms to avoid hidden liabilities. This ensures transparency and compliance with anti-profiteering provisions.

Anti-Profiteering Compliance

Section 171 of the CGST Act mandates that tax reductions must translate into lower consumer prices. Businesses must maintain clear documentation showing how price adjustments reflect tax changes. Non-compliance can result in penalties and reputational damage. Transparent “price-to-tax” records reassure regulators and consumers alike. This measure strengthens consumer trust and prevents unfair profiteering during the transition.

ITC Reconciliation

Input Tax Credit (ITC) claims now require manual acceptance or rejection of invoices under the new Invoice Management System. Businesses must deploy automated tools to match GSTR-2B with purchase registers. Proper reconciliation prevents loss of credits and reduces refund delays.

MSMEs especially benefit from streamlined ITC processes, improving liquidity. This recommendation ensures compliance while maximizing available credits.

For Policymakers

Operationalize GSTAT

Policymakers must expedite the establishment of GST Appellate Tribunals (GSTAT) to resolve classification and refund disputes. A functional tribunal reduces litigation backlog and enhances taxpayer confidence. Faster dispute resolution encourages compliance and investment. GSTAT also provides clarity on borderline product classifications. This institutional reform is essential for the long-term stability of GST 2.0.

SME Grace Period

Small businesses often struggle with compliance during major tax transitions. A 3–6 month grace period without penalties for clerical errors would ease their burden. This soft-landing approach encourages voluntary compliance rather than fear-driven adherence. It also reduces disruption in MSME cash flows. Such relief fosters smoother integration of SMEs into the new regime.

Broaden the Base

Currently, petroleum and electricity remain outside GST, creating cascading tax effects. Bringing these sectors under GST would eliminate inefficiencies and expand the tax base. This move would stabilize revenues and

reduce reliance on sin taxes. It also aligns India's GST with global best practices in comprehensive tax coverage. Broader inclusion strengthens fiscal federalism and long-term sustainability.

DISCUSSION

India's GST 2.0 demonstrates the Laffer effect in emerging markets: lower rates can yield higher compliance-driven revenues. Comparisons with EU VAT reforms suggest India's simplification aligns with global best practices. However, reliance on sin tax revenues poses fiscal risks. The reform's success hinges on sustained compliance and expansion of the GST base.

CONCLUSION

GST 2.0 marks a paradigm shift from revenue extraction to economic stimulation. By rationalizing rates, correcting IDS, and easing household costs, the reform has enhanced consumption and MSME liquidity. Early evidence of a 0.5% incremental GDP growth in 2026 underscores the importance of fiscal clarity. India's experience offers valuable lessons for other emerging economies pursuing tax simplification as a growth strategy.

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