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GST 2.0: Emerging Reforms, Digital Compliance and Future of Indirect Taxation in India

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Abstract- The Goods and Services Tax (GST) system in India has witnessed a paradigm shift since the September 2025 rate rationalization, referred to as GST 2.0. In this research paper, the structural reforms initiated via the recommendations of the 56th GST Council have been examined, namely rate consolidation, the discontinuation of the compensation cess on selected goods and the increase in digital compliance architecture. The study is based on a mixed method analysis of government documents and economic survey findings, and draws on the recent literature and academic discourse on the matter. The results of the research reveal that the rationalization process has led to the narrowing of the tax slab structure, to reduced inflationary effects on mass consumption goods, and to an incentive-compatible equilibrium in the interaction of taxpayers and administration via automatic ITC matching and e-invoicing system. It is also concluded that certain problems, such as inverted duty structure distortion, still exist and need to be addressed. The final part of the paper asserts that in the future the evolution of the Indian indirect taxation system should be based on trust-based compliance, dispute resolution effectiveness, and on achieving refund neutrality for capital goods and input services.

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I. Introduction

The rollout of the GST on 1 July 2017 marked the largest ever reform of indirect taxes in independent India where a fragmented system of central and state taxes was brought under one unified destination-based consumption tax. However, the original design of the GST featuring four main rate brackets, classification controversies, and cesses overhangs led to inefficiencies which became all too obvious as the GST evolved over time [1][3]. The GST 2.0 reform program, finalized in the 56th GST Council meeting and effective from 22 September 2025, marks a crucial second-generation reform that seeks to streamline the rate structure, rebase the taxation and utilize digital technology for greater ease of compliance and revenue resilience [1][3].

The core of the reform revolves around the rationalisation of the rate structure. In what is an elimination of the former 12 per cent slab rate, about 276 items were taken off the 12 per cent slab and have either been shifted to the 5 per cent slab or exempted from taxation entirely [1][3]. While the 28 per cent slab was removed for all items save tobacco and pan masala, these two items were brought under the ambit of a new 40 per cent slab where the former tax and cess were rolled into a unified statutory rate [1]. While the compensation cess that had been created for the payment of the debt accrued during the GST transition period has been reduced for most goods, the same has been done away with completely in respect of a few specific tobacco products insofar as the cess has been amalgamated into the higher headline rate [1][3].

Alongside the reforms in rates, the digital compliance environment has also been significantly bolstered. Thresholds for e-invoicing have gradually decreased and the link between the Invoice Registration Portal and returns submission, e-way bill creation, and input tax credit reconciliation has resulted in near real-time compliance verification system [2][8]. The GST Network uses machine learning and data analytics for risk-based compliance check and this allows the government to focus on high-risk

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taxpayers while decreasing the compliance load on compliant taxpayers [2]. Creation of the Electronic Credit Reversal and Reclaimed Statement, together with RCM Liability/ITC Statement, is a part of the granular ledger management approach that helps address ambiguities in credit reversal and reclamation [7].

The macroeconomic environment within which such rationalizations have been made is also positive. The collections for GST have proved to be resilient, crossing the level of ₹2.36 lakh crore in April 2025, sustaining high levels thereafter [3]. Indicators like e-way bill generation, Purchasing Managers' Index (PMI), festive season auto sales, and Unified Payments Interface (UPI) transactions all suggest a positive movement in the direction of strengthening of demand momentum in the period post-rationalization [3]. In October 2025, retail inflation stood at a record low of 0.25 percent, with the Ministry of Finance's Monthly Economic Review having specifically mentioned the pass-through effect of reduced GST rates for essential goods as one of the reasons for lower inflation [1].

However, several problems still remain. The inverted duty structure with higher tax on inputs than outputs has continued to pose working capital problems in industries such as textiles and fertilisers despite the introduction of the automated refund system for the unused input tax credit of inputs [1][9]. Input services and capital goods being exempted from the inverted duty structure refund scheme constitutes an anomaly in a service-based economy [9]. Removal of the compensation cess without any arrangement to utilize the credits has made some industries such as automobiles and coal to have stranded balances which undermine the investors' confidence [9][10]. Moreover, the mid-year change of rates has caused compliance issues as the taxpayers had to calculate both the old and new rates within one return cycle [7][10].

The purpose of this paper is to conduct a systematic analysis of GST 2.0 as a case study of second-generation indirect tax reform. Three related questions will be considered in the analysis: first, what are the features of the rationalisation of the rates and cesses, and how do they affect the change in tax incidence depending on the category of goods? Second, how has the digital infrastructure of the compliance system changed to accommodate this reform of the rates structure, and what are its consequences for taxpayers and oversight? Finally, what distortions and unfinished

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business are left to deal with in the next stage of reforms? In answering these questions, this paper aims to contribute to the expanding body of literature on incentive-based tax governance and digital compliance technology as an instrument of overcoming the tradeoff between compliance and compliance.

II. Literature Survey

The literature on GST in India has undergone different stages, which have reflected the development of the regime over time. The early literature paid attention to the federal bargain embedded in the 101st Constitutional Amendment, the structure of the GST Council as an institution for cooperative federalism, and the difficulties faced during the process of migrating to input tax credit [1]. The second round of research was devoted to such issues as compliance behaviour, productivity of revenues, and rate classification disputes [3][5]. The emergence of GST 2.0 has already generated a separate stream of literature that pays attention to incentive compatibility, digitization, and rate rationalization [1][6].

One of the most empirically rigorous studies of GST compliance behavior within the Indian context is conducted by Garg, Narwal, and Kumar [5]. Using the theory of planned behavior and a sample of 503 taxpayers, they show that attitude, subjective norm, and perceived behavioral control significantly predict the variance of compliance intention [5]. Their study has practical implications for the GST 2.0 reform because its emphasis on a simplified rate structure and elimination of discretionary interpretation lowers the taxpayer's cognitive load, which increases perceived behavioral control and, consequently, compliance [1][5]. According to their conclusions, compliance is not simply related to the level of enforcement but rather is contingent upon the psychological and informational environment of the taxpayer [5].

The approach taken by Baghla et al. in analyzing the effects of GST 2.0 is that of game theory to determine the effect of GST 2.0 on the game played between the firm and the revenue authority [6]. Their key finding is that GST 2.0 results in the reduction in the number of unstable equilibria in the compliance game, resulting in a convergence to a high compliance equilibrium via a combination of rationalization of the rate,

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digitalization, and a reduction in opportunities for evasion [6]. GST 2.0 is conceptualized by Baghla et al. as an incentive compatible governance mechanism, which brings the interests of the firms into alignment with those of the revenue authority [6].

Formal policy analysis, specifically the Economic Survey chapter on GST 2.0, offers the most holistic view of the underlying rationale of the reform [1]. The Economic Survey highlights the inverted duty regime as one of the main distortions and rationalises it as a carefully thought-out process of its rectification through taxation of inputs and intermediate goods at relatively lower levels and of final consumption goods at relatively higher levels [1]. Another interesting idea that has been introduced is the rethinking of the e-way bill scheme as a tool not for enforcement but rather as a logistic device with the introduction of a "trusted dealer" model where a taxpayer who does not have any issues with their compliance receives minimal physical examinations [1].

The use of digital infrastructure in tax administration has been analyzed by official sources as well as independent scholars [2][8]. The replies of the Ministry of Finance to questions in Parliament indicate the gradual reduction of the threshold for e-invoicing, the use of Aadhaar authentication for registration, the use of risk-based ratings in the processing of refunds, and the use of artificial intelligence and machine learning in identifying cases of circular trading and fraudulent input tax credit [2]. Such official documents, even though self-assessing in nature, have the detailed information about the workings of digital compliance mechanisms which tend to be missing from academic analysis. The newsletter of the GST Council provides technical information regarding the rate changes and functionalities of the ledgers, including the introduction of the Electronic Credit Reversal and Re-claimed Statement in 2023 [7].

These aspects have been discussed in the industry and professional literature due to the difficulties brought about by the reform. The Indian Institute of Chartered Accountants' analysis of the journal provides an in-depth examination of the effects of the mid-year change in rate in terms of tax return filing, the double rate system in case of September 2025 supply, the proportional reversal of credit in section 17(2) and rules 42/43, and the questionable accounting of finished goods inventory at the time of rate reduction [7][10]. In its turn, the Grant Thornton Bharat points out the stranded

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compensation cess credit and the absence of inverted duty structure refunds in cases of input services and capital goods as the key reform items that require finishing [9].

The constant theme in literature on the subject is the dichotomy of simplification and revenue adequacy [1], [3]. The net negative impact of rationalization in terms of revenue generation during the initial year and subsequent consumption-induced gains is an outcome of the traditional fiscal rationale for tax rate reduction, as pointed out by SBI Research [3]. The focus of the Monthly Economic Review published by the Ministry of Finance on the demand-side stimulus and base broadening as a result of compliance is more to do with differences in approach than content [1].

III. Proposed Methodology

Research Design

The current paper uses the mixed-methods approach to research that entails a combination of qualitative policy documents analysis and quantitative trends analysis. The former is based on the thorough examination of primary policy documents such as GST Council Notifications, CBIC Circulars and chapters from the Economic Survey, alongside scholarly sources and professional literature between 2021 and 2026. The latter utilizes publicly available high-frequency data in order to provide the description of the economic dynamics after the reform. This type of methodology is adequate for a policy analysis that is performed at an early implementation stage.

Data Sources and Selection Criteria

Sources of primary data are:

- GST Council notifications from September 2025 to January 2026, especially those pertaining to rates changes and cess removal
- Ministry of Finance replies to parliament in relation to digital compliance mechanisms
- The chapter on GST 2.0 in the Economic Survey, which represents the most authoritative statement of the logic of the reform
- GSTN portal announcements on thresholds for e-invoicing and ledger capabilities

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The secondary sources will be academic journal articles from 2024-2025, analysis by professional organizations, and reports from financial services research. The sources have been chosen based on their currency, institutional authority, and pertinence to the rate rationalization, digital compliance, and fiscal effects aspects of GST 2.0.

Analytical Framework

The analysis is conducted from three interrelated perspectives. Firstly, the structural perspective studies the modifications in the rate structure, cess structure, and exemption limits, showing how categories of commodities move between slabs. Secondly, the behavioral perspective utilizes the incentive-compatibility model of Baghla et al. along with the compliance behavior results of Garg et al. to evaluate the impact of the reforms on the payoff matrix for taxpayers of varying compliance sophistication. Thirdly, the fiscal perspective analyses the fiscal and inflationary effects of the reforms based on the figures provided by SBI Research and the Ministry of Finance.

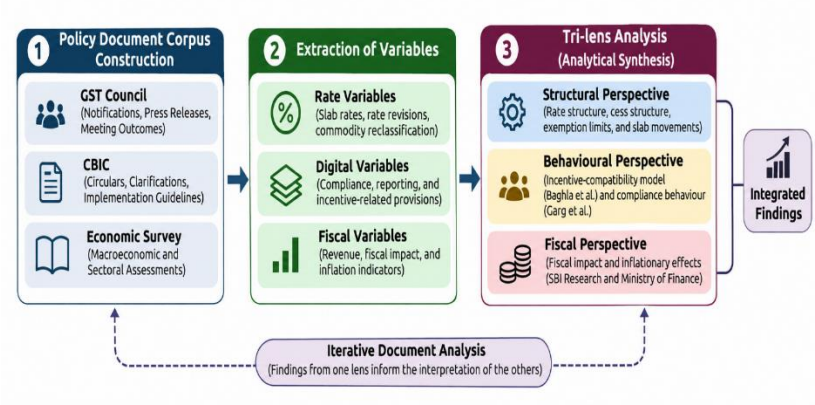


Figure 1. Methodological Flow Diagram

The diagram below demonstrates the sequence of the research design, starting from identifying the sources, and moving on through extracting the variables, to the three-lens analysis synthesis process. Arrows denote the iterative nature of analyzing the documents, where the results of the one analysis affect the other two.

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Variables and Indicators

The structural indicators will include the movement of goods from the slabs of 12 percent and 28 percent, which is the new slab rate for tobacco and pan masala; compensation cess withdrawal extent. The technology compliance indicators include the trend in e-invoicing threshold levels from ₹20 crore to ₹10 crore to ₹5 crore, electronic credit reversal ledger functionalities, and the use of AI and ML for risk assessment. The fiscal indicators include GST collection figures, trends in e-way bill generation, retail inflation, and the net revenue impact estimate of SBI Research. These indicators have been selected based on availability, policy relevance, and their ability to shed light on the multidimensional effects of the reform.

Limitations

The following limitations need to be taken into account. First, the period for observation after the reforms is rather small, which makes it impossible to draw strong conclusions in terms of causes and effects concerning revenues and compliance. Official information on GST collections and e-way bills can be revised in the future. The assumptions made by the SBI Research concerning consumption elasticities and pass-through rates can be incorrect for some industries. However, the limitations mentioned above should not undermine the results obtained during the research.

Research Question (RQ)	Primary Sources (Policy and Official Documents)			Secondary Sources (Analytical and Empirical Evidence)			Triangulation (Minimum Sources)	Inference Strength
	GST Council Documents	CBIC Circulars & Guidelines	Economic Survey (GoI)	SBI Research Reports	Ministry of Finance Publications	Academic Studies (Baghla et al.; Garg et al.)		
RQ1 What are the structural changes in GST rates, cess structure, and exemption limits, and how do commodities move across slabs?	✓	✓	✓	–	–	✓	≥ 2	Strong
RQ2 How do the reforms alter taxpayer payoffs and compliance behaviour across different levels of compliance sophistication?	–	✓	–	–	–	✓	≥ 2	Moderate
RQ3 What are the fiscal and inflationary effects of the GST reforms?	–	✓	✓	✓	✓	–	≥ 2	Strong

Legend: ✓ = Source used (evidential basis) – = Source not used | Strong = High confidence (multiple, independent sources) | Moderate = Reasonable confidence (two sources, with some inference)

Figure 2. Data Integration and Triangulation Strategy

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IV. Analysis and Discussion

Structural Transformation of the Rate Schedule

A prominent aspect of GST 2.0 is the compression of the rate structure. The removal of the slab of 12 per cent implies simplification as around 276 goods, which were taxed under this slab, have been brought under the slab of 5 per cent or completely exempted. The slab of 28 per cent, which applied to around 36 goods, has been done away with, except for tobacco products, where a new slab of 40 per cent has been introduced instead, which includes the tax and cess. The compensation cess on all goods, except some selected tobacco products, has been discontinued with the cess rate being 0 per cent for the relevant tariff entries as on 1 February 2026. The overall impact of the above amendments is that there are now only three slabs, which include 5 per cent, 18 per cent, and 40 per cent (demerit goods).

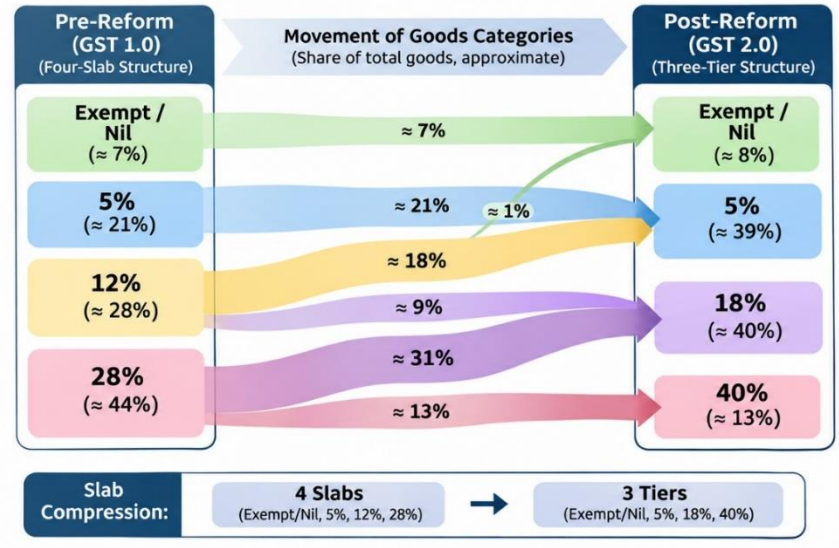


Figure 3. Rate Slab Migration Under GST 2.0

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The distribution effects of this structural shift are evident. The move of mass consumption products from 12% to 5% or zero is a step in the right direction as far as progressivism goes because it lowers the tax burden on goods that account for a bigger portion of the budget of low-income families. SBI Research expects that the effect of rate cuts on essential goods inflation alone would amount to 25–30 basis points in FY26 and 65–75 basis points in FY26-27, including service rationalization. The Finance Ministry's figures that indicate retail inflation was 0.25% in October 2025 with GST rate cuts being one of the contributing factors are evidence of the same.

Digital Compliance Architecture and Behavioural Effects

While the digital facet of GST 2.0 may be seen as merely an infrastructural aid, it plays a much deeper role in determining the behavioral logic of the reform. The gradual lowering of the threshold of e-invoicing to ₹5 crore, along with the linking of data from the Invoice Registration Portal to the filing of GSTR-1 and GSTR-3B returns, means that near-real-time verification of invoice data is possible now. The Electronic Credit Reversal and Reclaimed Statement, on the other hand, is designed to fill a gap in compliance by making it possible to track any temporary reversal and reclamation of input tax credit through a ledger mechanism and generate alerts in case of overreclamations against available reversal balances.

Such digital instruments have operationalized the logic of incentive compatibility as propounded by Baghla et al. In making the compliance status of an individual measurable and the costs of non-compliance calculable in real-time, the system has been able to remove the information asymmetry that had previously favored tax evasion. In addition, the employment of artificial intelligence and machine learning algorithms for assessing risks—specifically in terms of registration verifications, refunds and circular trading—has led to greater concentration of efforts on risky individuals while letting compliant taxpayers remain untouched. As per the recommendations of the Economic Survey, this logic can further be extended to what can be termed a “trusted dealer” model for e-way bill checks.

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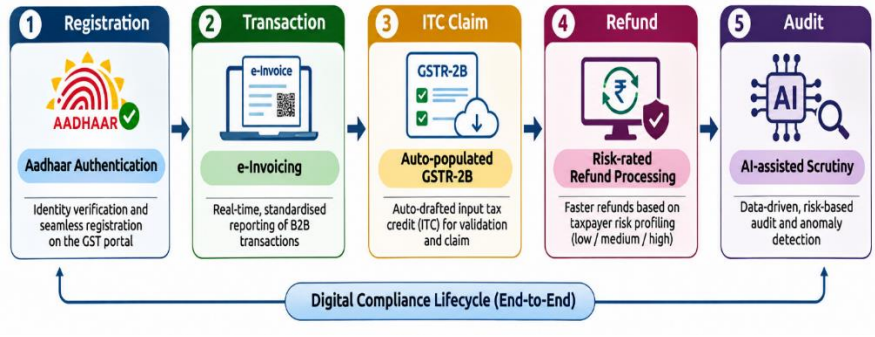


Figure 4. Digital Compliance Touchpoints Across the Taxpayer Lifecycle

Fiscal Outcomes and the Revenue–Simplicity Trade-off

The fiscal effect of GST 2.0 has been more complex than what both the official accounts of the scheme as well as the revenue estimates have suggested. An estimate made by SBI Research that the scheme will result in net revenue loss of ₹25,794 crore on the FY26 consumption base and hence a GDP impact of about 1 basis point on the fiscal deficit is relatively small in absolute numbers. The very same study expects an increase in consumption worth ₹3.35 lakh crore, leading to an increase in tax revenues worth about ₹31,806 crore and largely offsetting the gross loss due to reduced rates.

The key issue here is whether the dynamic effects, which include better compliance, base broadening, and demand stimulation, will prove correct the assumption made by the reform that simplicity and growth are more potent sources of revenue than a high tax rate. According to the Monthly Economic Review by the Finance Ministry, the rationalization process has provided a “measurable boost” to consumption in terms of greater generation of e-way bills, highest-ever festive season vehicle sales, strong UPI transactions, and more tractor sales. These measures may not be direct indicators but they seem to suggest that there has been an improvement in demand. Past reductions in tax rates have yielded extra revenue of ₹1 trillion, as mentioned in the Economic Survey.

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Table I. Comparative Analysis of Pre- and Post-GST 2.0 Parameters

Parameter	Pre-GST 2.0 (Before Sept 2025)	Post-GST 2.0 (From Sept 2025)	Analytical Significance
Primary rate slabs	5%, 12%, 18%, 28% (+cess)	5%, 18%, 40% (demerit goods)	Structural simplification; reduced classification discretion
Goods in 12% slab	Approximately 276	Relocated to 5% or exempt	Progressive incidence reduction on mass consumption
Goods in 28% slab	Approximately 36	Relocated to 18% (except tobacco at 40%)	Elimination of peak rate for general goods
Compensation cess	Applicable to multiple goods	Nil for all except specified tobacco	Reduced cascading; stranded credit transition issues

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Parameter	Pre-GST 2.0 (Before Sept 2025)	Post-GST 2.0 (From Sept 2025)	Analytical Significance
E-invoicing threshold	₹5 crore (from Aug 2023)	₹5 crore (threshold stable; reporting window tightened)	Mature digital capture; focus shifts to data utilisation
ITC reversal mechanism	Manual/interpretive	Electronic Credit Reversal Ledger with warnings	Real-time validation; reduced retrospective disputes
Refund of accumulated ITC	Inputs only; IDS refunds for goods	Inputs only; IDS refunds extended to some sectors	Persistent exclusion of services and capital goods
Risk assessment	Limited analytics	AI/ML-driven risk rating for refunds and registration	Targeted enforcement; reduced burden on compliant taxpayers

The comparative table presented above encapsulates the key changes that have occurred. The change in the number of slabs from four to three, the virtual extinction

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of the compensation cess, and the integration of risk analysis within the compliance process can be termed as a coherent set of changes which simplify the tax regime and improve its information base. The continuing exclusion of input services and capital goods from inverted duty structure refunds continues to remain a major distortion that needs to be rectified in the next phase of reforms.

Residual Distortions and Unfinished Agenda

Incompleteness in three areas merits special focus. First, the inverted duty structure, despite being partially resolved by means of rate rationalization and automation of refunding on inputs, results in working capital inefficiencies in those industries where the output rates are still below input rates. This point is recognized in the Economic Survey, which recommends that "policy options such as permitting IDS refunds on capital goods and input services may be examined". According to Grant Thornton Bharat, however, expanding the scope of eligible inputs for refunding back would "restore tax neutrality and directly reduce the cost of doing business". Given that the contribution of services to gross value added exceeds 50%, the non-neutrality of input services becomes a matter of the past.

Second, removal of the compensation cess without a means of absorption of existing credits has resulted in stranded credits in automotive and coal sectors. They are not any form of tax concessions but rather legitimate credits earned under the previous regime. This windfall gain to the government has deprived the relevant sectors from their benefits without any obvious reason. It also poses questions about the confidence of investors in future reform.

Finally, the mid-year adoption of rate adjustments led to temporary yet significant transitional compliance challenges. Pre-revision rates had to be used in respect of supplies made between 1 and 21 September 2025 with the application of post-revision rates to subsequent transactions along with credit adjustment under section 18(4) and rule 44. There is ambiguity surrounding the treatment of finished goods inventory on the date of the rate reduction, which has been resolved by High Court decisions in a manner less strict than the circulars. This problem is one of the transitional difficulties arising from the reform; however, this does not question its general logic.

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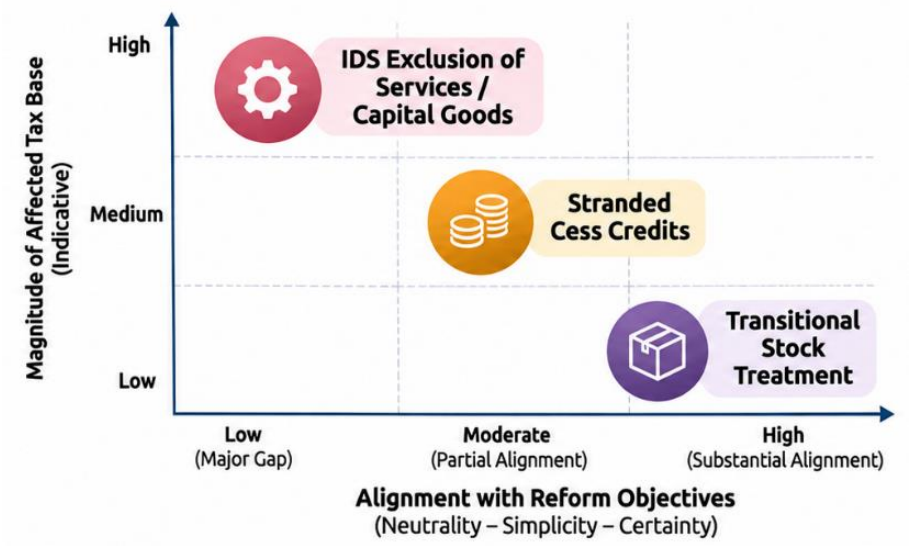


Figure 5. Residual Distortions and Proposed Reform Trajectory

Discussion: Toward a Trust-Based Indirect Tax Regime

The combination of these strands of analysis suggests a wider conclusion that can be drawn from GST 2.0: GST 2.0 is an indication of a shift from a compliance and enforcement system of tax administration to one of trust and facilitation. Rationalization of the rates minimizes the instances of interpretation-related problems. The digital infrastructure ensures transparency and low costs of compliance to those that opt for compliance. The risk-based enforcement focuses on those that do not. The discussion of the concept of "trusted dealers" in Economic Survey and the concept of "Paper-Free Customs 2028" by CII show the same way: future of the indirect taxes in India does not lie in increased surveillance but in creation of a frictionless and data-rich environment.

The transformation process in no way is a complete and irreversible one. The distortions described above serve as evidence that there are still aspects where the trust-

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facilitation rationale has not been fulfilled. First, the existence of the stranded cess credits sends a message that the credits issued under the reform are vulnerable to policy changes and thus undermines trust, which is the very essence of the transformation. Second, the absence of services in IDS refunds makes the reform biased towards goods in an economy where services dominate.

The preliminary fiscal data is, however, in line with the theory implicit in the reform. The low net revenue cost, along with the observed increase in consumption and the disinflationary pass-through effect, implies that the dynamic impacts of the reform are being felt in the expected direction. Whether the base expansion and compliance improvement effects will manage to compensate the static revenue loss in the medium term is unclear, but the early signs are not discouraging. The political economy behind the reform—the unanimity among GST Council members, its compatibility with the Viksit Bharat mission, and its coherence with industry calls for simplification—are factors justifying optimism about the continuity of the reform path.

V. Conclusion

GST 2.0 marks a significant maturing of India's indirect tax system through consolidation of rates from four main slabs to three, removing the compensation cess from all other than specifically designated tobacco products and integrating high-level digital authentication within every phase of the compliance cycle. The analysis in this paper reveals three main findings regarding the impact of the GST reform.

Firstly, the rationalization of the rates reflects a progressive policy measure that has a definite disinflationary impact on mass consumption goods. The shifting of about 276 items from the 12% slab to either the 5% or the exempt category and the removal of the 28% slab for general goods decreases the effective tax burden on goods whose consumption takes a disproportionate share in the budget of poor households. The record-low retail inflation rate in October 2025, noted by the Finance Ministry and partly credited to the GST pass-through, proves the positive effect expected from the reform. The estimated reduction of 65–75 basis points in the CPI inflation forecast by

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SBI Research, despite all the typical risks of pass-through, reflects a noticeable increase in household incomes under the current low wage growth conditions.

Second, the compliance architecture of the digital revolution has itself shifted from being a supportive one to being a constituent component of the reform's behavioral logic. The convergence of the system of e-invoicing and return filings with ITC matching; the adoption of a ledger-based system for ITC reversal and reclaiming; and the use of artificial intelligence/machine learning systems for risk assessment create a context where compliance is visible, cheap, and increasingly becomes the preferred option for those taxpayers who have something to lose by being detected. In such a scenario, the game theoretical prediction of convergence to a high-compliance equilibrium is quite conceivable; although empirical confirmation of the same would only be possible when enough longitudinal data become available. The "trusted dealer" approach advocated in the Economic Survey takes the logic even further and incorporates physical movement of goods in the process as well.

Thirdly, substantial distortionary effects persist, which should be addressed in the next phase of reforms. The refusal to reimburse inverted duties for inputs and capital goods is an anomaly in a service-driven, capital-intensive economy. The stranded credit on account of compensation cess in areas like automobiles and coal reflects more of a credibility cost than a fiscal gain. The transition costs associated with the mid-fiscal year introduction of the rates are indeed temporary but illustrate why future major reforms should be timed to fiscal year demarcations. These issues could be sorted out without any major changes to the basic design of the reform.

The wider importance of GST 2.0 lies in its showcasing of how a large, federal, and developing economy could carry out an elaborate tax reform through collaboration and through technological means. The consensus of the GST Council on the rationalization of rates, the implementation capabilities of GSTN on technological changes, and the administrative capabilities of managing the change without any disruptions would form a reform governance model that is beyond taxation issues. For India to achieve the dream of Viksit Bharat 2047 of having a globally competitive economy, the indirect taxation system needs to help and not hinder the economy from investments, consumptions, and formalizations. GST 2.0 is important as it marks a great deal of

progress in this direction, but it is a milestone and not the end. There are still tasks of extending refund neutrality, fixing the problem of stranded credits, and enhancing the enforcement approach to trust facilitation.

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