

The Role of GST 2.0 in Expanding India's Formal Economy

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Abstract

India's Goods and Services Tax (GST) reform of 2017 represented a watershed moment in the country's fiscal architecture, replacing a fragmented indirect tax system with a unified national framework. While GST has delivered significant gains in tax buoyancy, logistics efficiency, and taxpayer inclusion, structural challenges persist—particularly in compliance complexity, digital disparities, and sectoral informality. As India advances toward a \$5 trillion economy, the conceptualization of GST 2.0 has emerged as a critical policy discourse. GST 2.0 refers to a technologically enhanced, compliance-friendly, and institutionally robust second-generation reform aimed at deepening formalization, strengthening transparency, and improving ease of doing business. This provides a comprehensive analysis of GST 2.0's potential role in expanding India's formal economy. Through a multidisciplinary lens, the paper examines the limitations of GST 1.0, outlines the structural and technological pillars of GST 2.0, and evaluates its implications for MSMEs, supply chains, tax administration, and fiscal stability. The study concludes that GST 2.0 can serve as a transformative catalyst for formalization, provided it is accompanied by institutional coordination, digital capacity building, and inclusive policy design.

Keywords: GST 2.0; Formal Economy; Tax Reform; Digital Governance; MSMEs; Informal Sector; Fiscal Policy; India; Blockchain; Artificial Intelligence; Compliance Architecture

1. Introduction

The introduction of the Goods and Services Tax (GST) in India marked one of the most ambitious fiscal reforms in the country's post-independence history. By subsuming multiple indirect taxes—such as VAT, excise duty, service tax, and entry tax—GST aimed to create a unified national market, reduce cascading effects, and enhance tax transparency. Over the past years, GST has expanded the taxpayer base (**Ministry of Finance, 2018, p. 32**)¹, improved logistics efficiency through the elimination of interstate checkpoints (**NCAER 2023**)² and strengthened digital governance through the GST Network (**GSTN**) (**NITI Aayog, 2020**)³.

However, despite these achievements, GST 1.0 continues to face structural and operational challenges. These include complex rate structures, frequent policy changes, invoice mismatches, compliance burdens for small enterprises, and uneven digital adoption across states. Moreover, India's informal sector—constituting nearly 85% of the workforce (**NITI Aayog, 2018**)⁴—remains deeply entrenched, limiting the full potential of GST as a formalization tool.

Against this backdrop, scholars, policymakers, and industry bodies had begun articulating the need for GST 2.0, a second-generation reform that builds upon the existing framework but integrates advanced technologies, rationalized structures, and inclusive compliance mechanisms. GST 2.0 is envisioned as a future-ready tax ecosystem capable of accelerating formalization, enhancing transparency, and supporting India's long-term developmental aspirations.

2. Conceptualizing GST 2.0: A Second-Generation Tax Reform

GST 2.0 is not intended to replace the existing GST framework; rather, it represents an evolutionary upgrade that builds upon the foundational architecture of GST 1.0. The shift from the current compliance-heavy, document-centric system toward a more data-driven, technology-enabled, and user-friendly tax ecosystem lies at the heart of this reform. GST 2.0 envisions a future in which tax administration is seamless, automated, and transparent, reducing friction for taxpayers while strengthening the government's ability to monitor, analyze, and respond to economic activity. The conceptual foundation of GST 2.0 rests on four interlinked pillars: digital deepening and automation, structural rationalization, institutional strengthening, and inclusion with accessibility (GST Council, 2021⁵; Ministry of Finance, 2023⁶). Together, these pillars aim to create a tax system that is efficient, equitable, and capable of accelerating India's transition toward a fully formalized economy.

2.1 Digital Deepening and Automation

A defining feature of GST 2.0 is its emphasis on deep digital integration across all layers of tax administration. The reform envisions the widespread use of advanced technologies such as Artificial Intelligence (AI), Blockchain, Machine Learning (ML), and API-based interoperability to transform the GST ecosystem into a real-time, automated compliance environment. AI is expected to play a central role by enabling anomaly detection, predictive compliance monitoring, and automated reconciliation of invoices and returns. This reduces human intervention and minimizes the scope for manual errors or manipulation. Blockchain technology further strengthens the system by creating tamper-proof invoice trails and enhancing supply chain transparency, ensuring that every transaction is recorded securely and can be verified without ambiguity. Machine Learning algorithms add another layer of sophistication by identifying fraud patterns, supporting risk-based auditing, and enabling targeted enforcement rather than broad, intrusive inspections. Additionally, API-based interoperability allows seamless integration between GSTN and external systems such as

banks, e-commerce platforms, and enterprise resource planning (ERP) software. This interconnected digital ecosystem ensures that data flows smoothly across platforms, enabling real-time compliance, faster processing, and improved taxpayer experience. Collectively, these technologies aim to reduce compliance burdens, enhance accuracy, and create a robust digital backbone for GST 2.0.

2.2 Structural Rationalization

Another critical pillar of GST 2.0 is structural rationalization, which seeks to simplify the tax framework and reduce the complexities that have emerged under GST 1.0. The current system's multiple tax slabs have often resulted in classification disputes, interpretational ambiguities, and compliance confusion among businesses. GST 2.0 advocates a more streamlined rate structure, ideally converging toward a three-tier system that balances revenue needs with simplicity. Simplifying exemptions is also a key priority, as the existing exemption list has grown increasingly complex and difficult to administer. Rationalizing exemptions would reduce distortions and improve tax neutrality (Mirrlees et al., 2011)⁷. Furthermore, GST 2.0 emphasizes the importance of harmonized coordination between the Centre and the States, ensuring that policy decisions are consistent, predictable, and aligned with broader economic objectives. Reducing the frequency of policy amendments is equally important, as constant changes in rules and procedures have created uncertainty for businesses and increased compliance burdens. A more stable and predictable tax environment enhances ease of doing business and encourages voluntary compliance. Structural rationalization, therefore, is essential for reducing friction, improving clarity, and strengthening the overall efficiency of the GST system.

2.3 Institutional Strengthening

GST 2.0 also underscores the need for robust institutional mechanisms that can support a modern, technology-driven tax system. One of the major challenges under GST 1.0

has been the slow and often cumbersome dispute resolution process. GST 2.0 proposes the establishment of fast-track GST tribunals equipped with digital case management systems to ensure timely and transparent adjudication. Transparent audit systems are another crucial component, as they help build trust between taxpayers and authorities by ensuring that audits are conducted fairly, consistently, and based on objective criteria. Strengthening cooperative federalism is equally important, as GST is fundamentally a shared tax between the Centre and the States **(Rao, 2019)⁸**. Effective coordination, clear communication, and consensus-based decision-making are essential for maintaining the integrity of the GST framework. Streamlined dispute resolution mechanisms further enhance institutional stability by reducing litigation and enabling smoother interactions between taxpayers and authorities. Overall, institutional strengthening is vital for building confidence in the tax system, ensuring accountability, and supporting the long-term sustainability of GST 2.0.

2.4 Inclusion and Accessibility

The final pillar of GST 2.0 focuses on inclusion and accessibility, particularly for MSMEs, small traders, and micro-entrepreneurs who form the backbone of India's economy. GST 2.0 recognizes that formalization cannot be achieved without making compliance processes accessible to all segments of society. To this end, the reform prioritizes the development of vernacular digital interfaces that allow taxpayers to interact with the GST system in their preferred regional languages, thereby reducing linguistic barriers. Simplified return filing processes are also central to this pillar, ensuring that small businesses can comply with GST requirements without needing extensive professional assistance. Providing subsidized digital tools—such as accounting software, mobile-based GST applications, and automated invoicing systems—can further ease compliance for resource-constrained enterprises. Additionally, GST 2.0 aims to lower entry barriers for new taxpayers by simplifying registration procedures, reducing documentation requirements, and offering

supportive onboarding mechanisms. These measures collectively ensure that the benefits of formalization are accessible to all, making the GST system more inclusive, equitable, and supportive of India's diverse economic landscape.

3. India's Formal Economy: Structural Context

Understanding the role of GST 2.0 in expanding India's formal economy requires a clear appreciation of the structural realities that define the country's economic landscape. India's economy is characterized by a dual structure in which formal and informal sectors coexist, often with blurred boundaries. Despite steady economic growth, informality remains deeply entrenched. Nearly 85 percent of India's workforce is employed in informal sectors, ranging from small retail shops and household enterprises to construction labor and unregistered manufacturing units. These entities typically operate outside the purview of formal taxation, social security systems, and regulatory oversight. The persistence of informality is driven by multiple factors, including low financial literacy, limited access to institutional credit, cultural reliance on cash transactions, and the perceived complexity of formal compliance procedures.

MSMEs, which contribute significantly to India's GDP and employment, often straddle the line between formality and informality. Many MSMEs maintain partial compliance—registering under GST but continuing to conduct a portion of their transactions informally to avoid tax liabilities or reduce administrative burdens (Mukherjee & Rao, 2019)⁹. This hybrid behavior limits the effectiveness of GST as a formalization tool. Additionally, sectoral variations in informality are pronounced. Industries such as construction, small manufacturing, logistics, and retail exhibit high levels of unregistered activity, making tax penetration uneven across the economy. GST 1.0 has succeeded in widening the taxpayer base, but the pace of formalization has been inconsistent due to infrastructural gaps, compliance challenges, and limited awareness. GST 2.0 aims to address

these structural constraints by creating a more accessible, predictable, and technologically empowered tax ecosystem that encourages voluntary compliance and reduces the incentives for informal operations.

India's formal economy is undergoing a structural transformation, influenced not only by tax reforms but also by broader shifts in fiscal governance. It has started a significant phase in India's economic development. This perspective aligns closely with the objectives of GST 2.0, which seeks to position taxation as an instrument of economic modernization rather than merely a mechanism for collecting revenue.

4. How GST 2.0 Can Expand India's Formal Economy

GST 2.0 has the potential to significantly accelerate India's transition toward a more formalized economic structure by addressing the systemic barriers that currently discourage compliance. One of the most important contributions of GST 2.0 lies in strengthening taxpayer onboarding. By simplifying registration procedures through single-step digital KYC, Aadhaar-based authentication, and automated PAN–GSTN integration, GST 2.0 reduces the administrative hurdles that often deter micro-entrepreneurs and small traders from entering the formal tax system. Mobile-first registration platforms further democratize access, enabling individuals in remote or underserved regions to register without relying on intermediaries.

Transparency is another critical driver of formalization. GST 2.0's emphasis on real-time invoice matching and blockchain-based supply chain verification enhances trust in the system by reducing fake invoicing, input tax credit fraud, and shadow transactions. When businesses perceive the tax system as fair, predictable, and transparent, they are more likely to comply voluntarily (Hofmann et al. 2008)¹⁰. Lowering compliance costs is equally important. Automation of return filing, reconciliation, and record-keeping reduces the need for professional assistance, thereby making compliance more affordable for small

enterprises. This shift encourages businesses to remain within the formal system rather than reverting to informal practices.

GST 2.0 also enhances MSME competitiveness by enabling access to institutional credit, participation in e-commerce platforms, and integration into global value chains. Formalization becomes a strategic advantage rather than a regulatory burden. As more enterprises formalize, the tax base expands, leading to higher GST collections and improved fiscal stability. This creates a virtuous cycle in which increased revenue enables greater public investment, which in turn supports economic growth and further formalization. In this way, GST 2.0 serves not merely as a tax reform but as a structural catalyst for transforming India's economic landscape.

5. Technological Innovations Driving GST 2.0

Technological innovation forms the backbone of GST 2.0, enabling a shift from manual, document-centric processes to automated, data-driven governance. Artificial Intelligence (AI) and Machine Learning (ML) are central to this transformation. AI systems can analyze vast volumes of transactional data to detect anomalies, identify suspicious patterns, and flag potential cases of tax evasion. Predictive compliance tools can alert taxpayers to errors before they escalate into penalties, thereby improving compliance behavior. Machine Learning algorithms enhance risk-based auditing by identifying sectors or entities with higher probabilities of non-compliance, allowing authorities to focus resources more efficiently.

Blockchain technology adds another layer of integrity to the GST ecosystem. By creating immutable, tamper-proof records of invoices and supply chain transactions, blockchain reduces opportunities for fraud and enhances trust among stakeholders. This is particularly valuable in industries with complex supply chains, where verification of transactions is often challenging. API-based interoperability further strengthens the digital

infrastructure by enabling seamless communication between GSTN and external systems such as banks, e-commerce platforms, and ERP software. This integration ensures that data flows smoothly across platforms, reducing duplication, improving accuracy, and enabling real-time compliance monitoring.

Advanced data analytics also play a crucial role in GST 2.0. By analyzing sector-wise compliance patterns, regional variations, and behavioral trends, policymakers can design targeted interventions that address specific challenges. Data-driven governance enhances the responsiveness and effectiveness of tax administration, making GST 2.0 a dynamic and adaptive system capable of evolving with the economy.

6. Challenges in Implementing GST 2.0

Despite its transformative potential, GST 2.0 faces several implementation challenges that must be addressed to ensure its success. The digital divide remains one of the most significant obstacles. Many rural and small enterprises lack access to reliable internet connectivity, digital devices, and technical skills required to navigate a technology-driven tax system. Without targeted support, these entities may struggle to adopt GST 2.0's digital tools, leading to uneven compliance and widening disparities.

Cybersecurity risks also pose a serious challenge (Rao, M. G., 2019)¹¹. As GST 2.0 relies heavily on digital infrastructure, the system becomes vulnerable to data breaches, hacking attempts, and identity theft. Ensuring robust cybersecurity protocols, encryption standards, and data protection frameworks is essential to maintaining trust in the system. Coordination between the Centre and the States is another critical challenge. GST is a shared tax, and effective implementation requires strong cooperative federalism, consensus-based decision-making, and clear communication. Divergent priorities or political differences can hinder policy harmonization and slow down reforms.

Resistance to change is an additional barrier. Many businesses accustomed to informal practices may resist formalization due to fear of taxation, lack of awareness, or cultural inertia. Overcoming this resistance requires sustained outreach, education, and incentives that demonstrate the tangible benefits of formalization. Addressing these challenges is essential for ensuring that GST 2.0 achieves its intended objectives.

Although GST 2.0 rate rationalization is expected to spur long-term consumer demand, it poses immediate revenue trade-offs and fiscal stress for state governments (NIPFP, 2025; Mukherjee, 2026)¹².

7. Policy Recommendations

To realize the full potential of GST 2.0, a comprehensive set of policy interventions is required. Simplifying the rate structure is a crucial first step. Moving toward a three-tier GST structure reduces classification disputes, enhances clarity, and improves ease of doing business. Strengthening digital infrastructure is equally important. Providing subsidized digital tools, training programs, and mobile-based applications can help MSMEs adopt GST 2.0's digital features more effectively.

Enhancing dispute resolution mechanisms is another priority. Establishing fast-track GST tribunals equipped with digital case management systems ensures timely adjudication and reduces litigation burdens. Incentivizing voluntary compliance through tax credits, reduced penalties, or onboarding support can encourage informal enterprises to transition into the formal sector. Public awareness campaigns in multiple languages can further educate taxpayers about the benefits of GST 2.0, reducing misconceptions and building trust.

Encouraging innovation in tax technology is also essential. Supporting startups and fintech companies that develop GST-related tools can create a vibrant ecosystem of digital solutions tailored to diverse business needs. These policy recommendations collectively

strengthen the foundation of GST 2.0 and enhance its ability to expand India's formal economy.

8. Conclusion

GST 2.0 represents a pivotal opportunity to reshape India's fiscal landscape and accelerate the transition toward a more formalized economy. By integrating advanced technologies, simplifying compliance structures, and strengthening institutional mechanisms, GST 2.0 addresses the limitations of GST 1.0 and lays the groundwork for a more efficient, transparent, and inclusive tax system. The reform's emphasis on digital deepening, structural rationalization, institutional strengthening, and accessibility ensures that formalization is not merely a regulatory requirement but a strategic advantage for businesses.

As India aspires to become a \$5 trillion economy, GST 2.0 emerges as a critical reform capable of enhancing tax buoyancy, improving ease of doing business, and fostering economic resilience. Its success, however, depends on addressing implementation challenges, building digital capacity, and ensuring cooperative federalism. With thoughtful policy design and sustained institutional commitment, GST 2.0 can serve as a transformative catalyst for expanding India's formal economy and strengthening its long-term developmental trajectory.

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