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GST 2.0 — TWO SLABS TODAY, ONE RATE TOMORROW

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I. INTRODUCTION

WHY THIS PAPER?

India's proposed **GST 2.0** is being framed as the biggest reform to the indirect tax system since 2017: India's upcoming **GST 2.0** announcement, slated for implementation by Diwali, is being widely promoted in the media as a "**Diwali gift**"—a measure to reduce burdens on everyday consumers. Prime Minister Modi's Independence Day speech has already prompted headlines calling it "a brighter gift of simpler taxes" and a "game-changer" for GST.^{1|2|3}

Media reports indicate that the reform architecture may not stop at two slabs. Instead, a **third slab at 40% for sin and luxury goods**—such as tobacco, pan masala, luxury vehicles, and online gaming—has emerged as a key proposal, even though the government has yet to explicitly frame the reform in terms of **revenue neutrality**.

Instead, the narrative remains focused on the symbolic "festival gift" aspect, with little public detail on how state finances will be protected.⁴

This paper explores whether GST 2.0—amid external trade headwinds and strong political symbolism—can deliver meaningful simplification, uplift consumption, and preserve fiscal integrity, or whether it risks replicating structural complexity under a festive banner.



Proposed architecture:

Two slabs (5%, 18%) + 40% slab for sin / luxury goods + high-rate/specific-cess treatment; 12% & 28% to be retired (pending Council approval)



COUNCIL TIMELINE:

Early-September 2025 session to take up the rate rejig.



Consumption impact (SBI Research):

₹1.98 lakh crore boost; annual revenue hit modeled at ~₹85,000 crore



GEOPOLITICAL BACKDROP:

New U.S. tariffs up to 50% on Indian goods; cautious improvement with China (direct flights, trade links).

II. HISTORICAL PERSPECTIVE

WHAT WAS THE VISION WHEN GST WAS FIRST INTRODUCED?

When GST launched in **July 2017**, India sought to replace a patchwork of central and state levies with a **destination-based value-added tax** that would **minimize cascading**, stabilize rates, **improve logistics**, and raise compliance. The legislative design included **multiple slabs (5%, 12%, 18%, 28%)** to reflect India's socio-economic diversity, plus a **compensation cess** on specified luxury/demerit goods to protect state revenues during transition. The promise was a **common market** with fewer frictions and **predictable tax incidence**.¹⁰

Notably, the cess was envisaged as **temporary**—its remit: compensate states for revenue shortfalls in the first five years of GST. That clock has been extended in practice to enable repayment of borrowings raised during the pandemic shortfall years.¹¹



Initial slab design: 5%, 12%, 18%, 28%; special lower rates for precious metals (3%) and 0.25% for certain stones, plus a compensation cess over 28% for demerits.



Documented logistics dividend (e.g., checkpoint removal) was an early gain from unification.



Legal basis for cess and temporariness were framed in the Compensation to States law & circulars.

III. CURRENT SITUATION

DID WE DELIVER ON THE ORIGINAL VISION OF A SIMPLIFIED, NATIONWIDE SYSTEM OF TAXATION?

Eight years on, **complexity persists**. Four slabs, frequent classification disputes, and a substantial overlay of **compensation cess** (especially on autos and tobacco) have kept **effective rates high** in several categories and **compliance friction** alive for businesses. Independent reporting routinely characterizes the system as **complex**, while the very existence of cess has required **continuous updates/clarifications** to resolve category-specific ambiguities (e.g., SUVs).^{14|15}

On the macro side, GST has delivered **buoyancy**, but the system has not yet become the **simple, low-friction, low-dispute VAT** originally envisioned. The need to **extend compensation cess collections to 31 March 2026** underscores the fragility of state finances under the current configuration.^{14|15}



Four active slabs plus cess (status quo prior to 2.0).



SUVs: 28% GST + 22% cess (clarified in Jan 2023 circular) ⇒ ~50% effective rate.



Tobacco products: 28% GST + product-specific cess; Ex - for cigarettes there is 36% compensation cess or ₹4,170 per thousand sticks whichever is higher; for chewing tobacco and pan masala blended with tobacco, compensation cess can go up to 290%



Cess extension: levy to continue till 31/03/2026 (to service compensation loans)

IV. NEED FOR A RELOOK

THE SUNSET OF GST CESS, AND AN OPPORTUNITY TO OVERHAUL THE TAX

The **cess sunset** (now 31 March 2026) creates a **policy window** to rationalize rates while devising a **transparent, narrow, and targeted** approach for exceptional items. In the present structure, **too many slabs** and **ad hoc cess** generate disputes, working-capital strain (via refunds), and uncertainty. The **Center-State compact** also needs a durable formula that **shields state revenues** without constantly extending “temporary” levies.¹²

GST 2.0 proposes to **retire 12% and 28% slabs**, migrate most items respectively into **5% and 18%**, and keep **special treatment** only for a **small set of sin/luxury goods**—through a single high rate (proposed at 40%) and with **specific cess** so that **complexity is contained** and **state revenue is protected**. The heavy lifting now lies in clarifying **where a “high rate” stops** and **where a specific cess starts**, and how **indexation** works over time.¹²



Cess sunset date: 31 Mar 2026 (current legal horizon).



Reform architecture under discussion: two slabs 5%/18% + a small basket of sin/luxury at 40%/specific cess; Council meet Sept 3-4.



Projected macro effects (SBI): ~₹1.98 lakh crore consumption impulse; ~₹85,000 crore annual revenue shortfall to offset.

V. GREAT VISION, BUT NEED CAREFUL DETAILING

The **vision to simplify and support the common citizen** is unmistakable: push **mass-consumption items** into the **5% slab**, compress the standard rate to **18%**, and rationalize anomalies (e.g., duty inversions, confusing rate differentials). But **global headwinds** complicate the calculus: **U.S. tariffs up to 50%** raise cost pressures and import-substitution debates; India’s **cautious re-engagement with China** could simultaneously ease input costs and create competitive pressures. Tax policy is not made in a vacuum: **rate shocks**—even when well-intentioned—can ripple through supply chains already under **external stress**.¹⁸

For the vision to translate into outcomes, **transparency and predictability** must guide: (i) **clear mapping** of what goes to 5% vs. 18%, (ii) **tight containment** of any high rate/cess to truly **exceptional items**, (iii) **explicit guardrails** to avoid backdoor instruments to recover the shortfall (e.g., removing ITC on zero-rated outcomes) and (iv) **time-bound impact reviews** so unintended effects can be corrected.⁹



POLICY DIRECTION:

5% & 18% as anchors; food/textiles likely at 5%; cement/insurance also under review



GEOPOLITICAL CONTEXT:

tariffs on Indian exports; tentative normalization with China (direct flights resuming)



INSURANCE GST:

proposals to cut to 5% or Nil, with ITC loss risk if fully exempted (could push base premiums up)

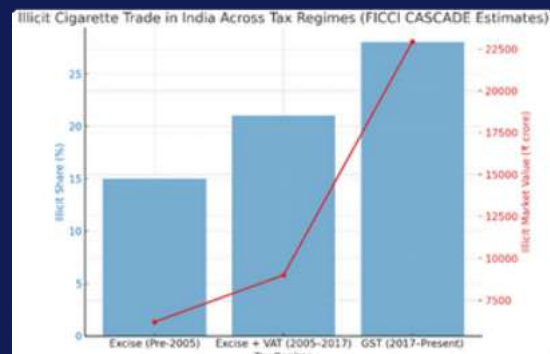
VI. SOME CHALLENGES

(a) A 40% “SIN” SLAB — SIMPLIFICATION, OR A NEW LAYER OF COMPLEXITY?

A headline **40% slab** for “sin/luxury” goods risks being read as a **third slab**, potentially **re-creating classification** that simplification attempts to end. Where an ad valorem high rate is applied to **heterogeneous categories** (e.g., tobacco, SUVs, aerated beverages), it may blur key differences in **illicit market risk** (tobacco for example is a subject of high smuggling and illicit), elasticity, and social **externalities**. **Uniform “high” rates** can under- or over-tax sub-segments, prompting arbitrage and possibly grey-market growth—especially for high-smuggling products.²³

Specific Duties Contain Illicit Trade Better - The Tobacco Case

The case of the tobacco sector shows that specific duties are more effective in containing illicit trade and smuggling. Under the Excise-only regime (pre-2005), when cigarettes were taxed mainly through specific duties, illicit trade was significant but relatively contained at around 15% of the market (~₹6,200 crore). With the rollout of State VAT in 2005, coupled with central excise, price arbitrage between states widened, and the illicit share climbed to about 20-21% (~₹9,000 crore) by the mid-2010s.



After the introduction of GST in 2017, which imposed both a 28% GST and a Compensation Cess, the effective tax incidence rose above 50%, creating large price gaps with illicit supply. As a result, illicit trade has surged further, reaching nearly ₹23,000 crore by 2022 and accounting for roughly 25-30% of the market. The data underscores how higher ad valorem rates and layered levies have steadily incentivized smuggling and black-market activity, weakening the objectives of each reform. [Based on FICCI-CASCADE estimates]

(b) SPECIAL CESS / SPECIFIC DUTY NECESSARY - MAKE IT TRANSPARENT

A **targeted specific duty/cess** is often **superior** to a high ad-valorem rate for a few reasons: it **recognizes product-specific risks**, can be **indexed** and **calibrated** more precisely, and **protects state revenues** without unnecessarily distorting large swathes of the market. In practice India already relies on cess for **tobacco** (quantum-linked and ad valorem caps) and **motor vehicles** (differentiated by engine size/length/ground clearance). **Acknowledging this openly—and codifying principles** for its use—would improve **predictability**.²⁴

Why Specific Additional Levies Outperform High Ad Valorem Taxes: Lessons from Past Evasions

An NIPFP (National Institute of Public Finance and Policy) study titled “Evasion of Excise Duties in India: Study of Copper, Plastics, and Cotton Textiles”, commissioned by the Central Board of Excise and Customs in 2013 on ad valorem regimes in India, notes that undervaluation—through misclassified high-value items, showing lower invoices, or fluffing post-manufacturing costs—was a widespread tactic to reduce tax liabilities. Further, the Golden Tobacco Company case (1980s-1990s, under the pure excise regime) starkly revealed how ad valorem or value-based taxation enables manipulation—companies understated wholesale prices

and MRPs to evade duty, a practice the courts ultimately penalized. Together, these cases build a consistent argument: a higher base level of ad valorem duty like a 40% slab will incentivize price manipulation. In contrast, specific additional duties (per unit/quantity) combined with a lower base ad valorem rate on a narrow set of goods provide far less scope for manipulation, thereby strengthening revenue integrity and compliance clarity.

(c) “CREATIVE” FIXES TO ARREST REVENUE DECLINE CAN BACKFIRE

Some ideas which have surfaced in the public debate that warrant caution:

- i. **Reclassification of Goods & Services:** A quick way to raise revenue is by reclassifying more goods and services as “luxury” or “sin” items. Reports already highlight a proposed **40% slab for tobacco, pan masala, online gaming, and luxury vehicles**.⁴ The case of **cement** is telling: long taxed at 28% like a luxury item, it is now expected to move to **18% because of its mass impact**.²² These classification decisions directly shift both consumer burdens and government revenues.
- ii. **Targeted Cess & Specific Duties:** Even with promises of simplification, product-specific cess will remain. **Tobacco** already carries duties that push effective tax well above 100%²⁵ while **SUVs** pay a **22% cess on top of 28% GST**, clarified by a January 2023 circular²⁶ Such targeted cess provide stable revenue for states as the **compensation cess sunsets in March 2026**.⁵ But overreliance risks creating a de facto fourth slab.
- iii. **Narrowing the Mass Bucket:** Even while promising that **all food and textiles will move to 5%**, the government could quietly **restrict what qualifies**, leaving some sub-segments at 18%.²¹ Similarly, exemptions may be narrowed, so fewer goods actually benefit from the lower rate. This allows for a headline “Diwali gift” while containing fiscal costs—though it risks credibility and more disputes over fine-print classification.
- iv. **MRP-Based Valuation:** Another idea floated in commentary is taxing on **Maximum Retail Price (MRP)** instead of **transaction value**. This would raise collections since discounts in garments or medicines would no longer lower the taxable base. MRP-based valuation was a feature of the old Central Excise regime for certain goods, and moving back to it would be a significant

regression from the globally accepted "transaction value" principle that underpins a modern VAT/GST system. This clearly breaks with GST's logic as a value-added tax: the law (Section 15 of the CGST Act) clearly pegs GST on transaction value.²⁷ Industry notes caution not to confuse MRP revision for passing on rate cuts with levying GST on MRP.²⁸

- v. **Expanding the High-Rate Basket with Micro Levies:** Beyond the 40% slab, authorities could add **micro-cess** or **surcharges** on fast-growing sectors like **high-end hospitality, or premium entertainment**.²⁹ These are politically easier to tax and generate visible yield. But sweeping them all into one bucket risks confusion and can drive users toward grey or offshore alternatives.

- vi. **Nil GST on Insurance Without ITC:** The GoM has proposed fully exempting **life and health insurance premiums**.³⁰ On the surface, this looks like consumer relief. But if **input tax credits (ITC)** on commissions, reinsurance, and admin costs are denied, insurers' costs rise and premiums go up. Analysts note a better compromise is **5% GST with ITC retention**,⁵ which balances affordability with neutrality.

VII. SOCIAL IMPACT OF DISTORTIONS

Tax policy shapes **who consumes what, and when**. If GST 2.0 reduces tax on **mass-consumption goods** but offsets it with **across-the-board "high" rates** on a broad set of "non-essentials," it can inadvertently deepen a **class divide**: aspirational items remain out of reach for lower-income households, especially when **discretionary spending** is already diverging between urban and rural groups. Official consumption data (HCES 2022-23) show meaningful increases in **average MPCE**, but also persistent gaps between **rural and urban consumption** profiles. The reform must be careful not to **harden** these gaps.^{31|32}

A more **surgical design**—two slabs + **specific cess** for narrow categories—reduces the risk of **one-size-fits-all "luxury" taxes** that penalize diverse goods with very different **elasticities** and **illicit-market** profiles. **Tobacco** is not **luxury cars**; **gaming** is not **liquor**; **aerated beverages** are not **cigarettes**. Treating them as identical invites **distortion** and lowers the **legitimacy** of the system.³³



AVERAGE MPCE (2022-23):

₹3,773 rural; ₹6,459 urban; real growth since 2011-12 is 40% (rural) & 33% (urban).



HCES SAMPLE:

2.62 lakh households; official factsheet/report published by MoSPI for 2022-23.



DISCRETIONARY DIVERGENCE (CONTEXT ON DINING OUT & URBAN SKEW):

recent analysis shows widening gaps in certain discretionary categories.

VIII. TOP 6 RECOMMENDATIONS

- (a) **Lock the architecture to three instruments—not three “slabs”:** 5% (merit/essentials), 18% (standard), and a specific, transparent additional cess/duty for a narrow list of demerit/luxury goods.

A separate “40% slab” should be avoided. When a **high tax incidence** is needed, a **specific additional duty/cess with clear rationale + indexation rules** is better: it is **transparent, predictable, and less distortionary** than an undifferentiated “high” base slab. This also gives the Council **room to tune** for illicit-market risk (e.g., tobacco) vs. social externality (e.g., sugary drinks) vs. luxury signaling (e.g., super-luxury cars).^{24|15}

One Nation, One Tax: Why India Must Cap the Peak Rate

The idea of a third GST slab at 40% may look harmless if restricted to a handful of sin and luxury goods today. But as incomes grow, demand for ultra-high luxury goods—cars, watches, designer items—will expand, and these will inevitably be pulled into the 40% bracket. Once the avenue of a higher slab exists, tax authorities will be tempted to keep widening its scope, shifting India’s GST rate to 40% by default, eroding the very principle of simplification.

In contrast, most advanced economies have VAT/GST capped at or below 20%—France and the UK at 20%, Germany at 19%, Canada effectively below 20%, and Australia at 10%. India already taxes heavily, with an effective incidence above 50% on certain items. Formalizing a 40% slab as a core part of the GST construct risks isolating India from global practice and locking in distortions.

The corrective course is clear: amend legislation to cap indirect taxes—including GST and cess—at a peak rate of 20%, in a phased manner as GST 2.0 delivers buoyant revenues through higher compliance and a broader base. Such moderation will reduce grey markets, expand compliance, and unleash consumption-led growth. Over time, this will pave the way to move India to a single GST rate, fulfilling the true promise of One Nation, One Tax.

- (b) **Publish a “Cess Rulebook” with guardrails, indexation, and sunset checks.**

Codify **when** a specific duty is used (e.g., smuggling risk, negative externality, luxury); **how** it is **indexed** (to inflation/quantity); **how often** it is reviewed; and **how** proceeds are shared to **protect states** post-compensation-cess era. Sunset reviews (every 24-36 months) should be mandatory, with data on **revenue neutrality** and **market outcomes** (licit vs. illicit share).¹²

Clearly specify how this cess/ duty would be shared between centre and the states, to get the states on-board with the concept.

- (c) **No “backdoor” revenue devices.**

While GST 2.0 seeks to simplify the rate structure, there is a risk that revenue shortfalls will be addressed through indirect or opaque tweaks. These “backdoor” devices should be resisted, or at the very least implemented with full transparency and safeguards:

- i. **40% slab + cess**

The proposed **40% sin slab** undermines simplification.⁴ If higher taxes are needed, use **narrow, product-specific cess**, not a blanket third slab.

- ii. **Narrowing the Mass Bucket**

Shifting food and textiles to **5% GST** risks being diluted if sub-segments are quietly kept at 18%.

²¹ Such fine print erodes credibility.

iii. **MRP-based valuation**

Taxing on **MRP instead of transaction value** would inflate collections and penalise discounts, breaking GST's design. ²⁷ Keep GST anchored to invoices.

iv. **Micro levies**

Adding **surcharges on gaming, luxury hospitality, or entertainment** may look attractive ²⁹, but bundling diverse sectors into “sin” risks distortions and grey-market growth.

v. **Nil GST on insurance without ITC**

Exempting insurance but denying **input tax credits** raises premiums ⁵, A **5% rate with ITC** is fairer and neutral.

(d) **Use the reform to shrink litigation.**

Alongside rate changes, issue binding classification notes for major sectors (autos, FMCG, pharma, F&B, e-commerce fees), consolidating past AAR/AAAR and Council clarifications (e.g., SUVs). Commit to a rolling “Compendium of Clarifications” with a 90-day SLA for ambiguous items. ¹⁵

(e) **Targeted relief to mass consumption with strict revenue accounting.**

If food/textiles migrate to 5%, pair that with a published, state-wise revenue backfill model (via cess proceeds or devolution adjustments). Transparently present projected consumption uplift vs. revenue impact, updated quarterly. ²¹

(f) **Phase the roll-out and monitor.**

Adopt a two-phase plan (Q3-Q4 FY26) with interim dashboards (refund times, ITC utilization, e-way bill compliance, price pass-through). Make the Council meeting calendar public, with agenda papers on rate migrations and impact notes. ⁷



Illustrative effective incidences today:

- SUVs (Engine >1500cc, Length >4000mm, Ground Clearance >170mm): 28% GST + 22% Cess ⁵⁹
- Large Cars / Sedans (Engine >1500cc and Length >4000mm): 28% GST + 20% Cess ⁶⁰
- Mid-Segment Cars (Engine <1500cc and Length >4000mm): 28% GST + 17% Cess **8%** + **1%/3%** (category-dependent). ⁶⁰
- **Cigarettes:** 28% + cess (up to 290% ad valorem or ₹4,170/1,000 sticks whichever is higher). ⁶¹



Consumption/revenue modeling (SBI):

+₹1.98 lakh crore demand; -₹85,000 crore revenue (gross).



Social baselines:

MPCE levels & gaps; survey coverage.

IX. WAY FORWARD AND CONCLUSION

GST 2.0 can deliver a genuine leap if the simplification is **real**, not cosmetic. The path that best balances growth, equity, and federal finances is:

- Keep the core system at **two slabs (5%/18%)**.
- Treat **sin/luxury items** via **specific, transparent, indexed cess (not a broad “40% slab”)**.
- Publish a **Cess Rulebook** and a **State Revenue Protection framework** to replace the expiring compensation cess regime.
- Resist **backdoor measures** (Nil without ITC, MRP-based taxation) that look neat on paper but raise costs, complicate compliance, and **undercut trust**.
- Use **phased roll-out** with **public dashboards**, to ensure **pass-through to consumers** and timely **course correction**.

India’s macro environment—**global tariff pressures** on exports and a **cautious China thaw**—argues for a **clean, growth-friendly GST** that **reduces friction** for businesses, **lowers prices** for households, and **assures states** of a stable, predictable fiscal stream. The political economy will always tug at tax design; the test of GST 2.0 is whether **design discipline** can prevail. If it does, the reform will not just make goods cheaper; it will **raise the credibility** of India’s tax regime and **anchor** the next leg of consumption-led growth. ⁹



About the Author:

Prof. Nilanjan Banik, is a leading Indian Economist, and holds the following academic positions:

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TCF has hosted major dialogues such as "The New Tax Code: Ideas for Building Tomorrow's India" (Nov 2024), introducing the F.L.A.T. taxation philosophy—Fewer and Lower rates, Litigation reduction, an All-inclusive base, and Tax without withholding. It has also produced pivotal studies, including on the illegal offshore betting economy, and delivered sharp pre-budget policy recommendations.

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