

# **Conceptualization and Impact of GST on Indian Economy: An Analysis**

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## **ABSTRACT**

*On July 1st 2017, the popular Goods and Service Tax is implemented in the most populous and diverse country (India) of the world. The objective of this tax reform according to the government is to ease the trade and exchange between the states of the country. GST in this relation is referred as 'Good and Simple tax' by Indian Prime Minister Mr. Narendra Modi. As the goods and services tax is a much glorified institution which fosters the growth and development of our economy. The major impact of GST according to the available literature discusses is in its merit as a stimulant of economic growth and development by bringing down the complexities of VAT. GST is already been proved a successful tool in many countries like United Kingdom, Canada, Australia, and Singapore etc. The objectives of this paper are two: first, to analyze GST as a good and simple tax, and second, its effect on Indian economy.*

*Thus the first part of the paper focuses on verifying the characteristics of GST based on the on four 'maxims' provided by the Father of modern economics Adam Smith, in his book "An Inquiry into the Nature and Causes of Wealth of Nations" (1776). The second part of the paper deals with analysis of GST as a stimulant to economic growth and development. The parameters to assess the second objective will be Real GDP, tax revenue collection from GST and the share of GDP among three major sectors of the Indian Economy. The last part of this paper will conclude the result of the analysis.*

*Keywords: GST, VAT, Canons of Taxations, Adam Smith, Real GDP growth, Tax revenue generation, Indirect taxes.*

## **I. INTRODUCTION**

From 1<sup>st</sup> July 2017 Indian government under its fiscal policy reforms has implemented GST which is 'Goods and Service Tax.' It is an indirect tax which is substituting the other different indirect taxes of central and state. It replaces the Central's excise tax and service tax and VAT (value added tax) of the State. Indirect tax is a tax which is levied on the seller but goes from the pocket of the buyers. The incidence of tax will be shared between the buyers and the sellers based on the elasticity of demand for that particular good and service (Frank et al., 2017). There will be price changes in either direction for the consumers depending on the purchase of the goods and services.

This section of the article tries to identify the factors which make GST a 'good and simple tax' as referred by the Indian Prime Minister Mr. Narendra Modi (The Economic Times, 2018). To analyze GST on the ground of its goodness and simplicity, we are using the four 'maxims' provided by Adam Smith, the Father of modern economics in his book "An Inquiry into the Nature and Causes of Wealth of Nations" (1776). Smith in his writings mentions these principles (canons) to be followed by any tax system in general (Smith, 2005, p. 1045)

These four maxims are also in line with the "six general rules" proposed by Henry Home in 1774 (Oll.libertyfund.org, 2018).

To understand Indian GST and whether it qualifies to be a "good and simple tax" we need to compare the present Indian tax system with the previous one. Of course, nothing can be as good and as simple in its absolute sense; therefore we are analyzing Indian GST, its goodness, and its simplicity comparing the previous tax system and the GST of the other countries as well.

Smith not only emphasized on direct taxes such as rent, profit and interest of the private individuals as the source of revenue for a sovereign but also considered consumable commodities as a good source of tax revenue. Smith, says,

The impossibility of taxing the people, in proportion to their revenue, by any capitation, seems to have given occasion to the invention of taxes upon consumable commodities. (Smith, 2005, p. 1102)

To tax people on their ability to pay and in proportion to their wealth, indirect tax on their expenditure would be in the majority of the cases are in proportion to their revenue. Not only the direct taxes but indirect taxes also should contain the characteristics of good taxation.

The four maxims or the features which are proposed by Smith are the equality, certainty, convenience of payment, and economy of collection. On the other hand, modern economists added other canons of taxation like productivity, elasticity, desirability and flexibility to make the taxation system in any country an efficient one.

## II. CANONS OF TAXATION AND GST

### 2.1. Canon of equality

The canon of *equality* is one of the first maxims proposed by Smith for good taxation by the state. The revenue or the funds of the sovereign to defend the society and other necessary expenses of the government must be derived from the commonwealth or the incomes of the private individuals (Smith, 2005, p. 1102). These taxes must be collected based on the abilities of the citizens depending on their income and wealth. The inspiration behind this maxim is that the wealthy individuals can enjoy these revenues only because they are protected by the state. In the words of Henry Home, one of his six general rules states, “to remedy” inequality of riches “as much as possible, by relieving the poor and burdening the rich. (Econlib.org, 2017)

To follow the principle of equality, it is advisable to follow the nature and type of the expenses consumers make on consumable commodities. The consumable commodities are further divided into necessities and luxuries. The necessities are those things which are required for an individual to live with, either rendered by nature or by rules of decency. Luxuries are all rest of the things which are not necessary for the support of life and custom does not render them as indecent to live without them (Smith, 2005, p.1103-4)

Indian GST follows the canon of equality to a great extent. It has four tax slabs to make sure that consumers pay according to their ‘ability to pay’, where rich would be paying more tax on their monthly consumption and average to poor people would pay lesser tax. GST Council has decided four GST Rates for the nation as **5%, 12%, 18% and 28%** (GST India, 2018). The fifth is zero percent which is on the goods required for a bare minimum living (food staples) for instance milk and dairy products, printed books, hotels, and lodges with tariff below 1000 and grandfathering services etc. are exempted from tax rates.

The 5% tax slab includes those items which are not the food staples but are required to improve the standard of living of the people. For instance branded cottage cheese, frozen vegetables, footwear below Rs 500, cream and skimmed milk, fish fillet and packaged food items, etc. The items which come under 5% tax slab are mostly those which have substitutes (local vendors) in the market at zero percent tax rate. Therefore this tax system also provides better competitive ability to local vendors against established shops and brands.

The 12% tax slab includes butter, ghee, packaged dry fruits sausage, etc. it is a mix of both nutritious items and luxury items, with the substitutes available at lesser tax rates. As it is desired to tax the rich on their high income, it is also desired to tax poor on the consumption of commodities not necessary to health and efficiency (Dalton, 1970, p. 32). Thus, those who will have the ability to pay with good wealth would buy these items.

The 18% tax slab has those goods and services which fall mostly in the definition of luxury goods and services given by Smith. Commodities like refined sugar, pasta, cakes and pastries, cornflakes, etc. These products are more luxurious than the goods and services under 12% tax slab. The consumers with the higher income and wealth can afford to purchase and therefore paying more tax as per their ability to pay.

The goods which come under luxury items come under 28% tax slab. Not only the luxuries like personal aircraft and SUVs but also goods like tobacco, cigarettes, and airplanes for personal use are also added under this category. The economic rationale behind this is collecting more revenue. Goods which have a relatively inelastic demand for tobacco cigarette and liquor generates more income for the government than elastic goods if the tax is increased on these items (Mankiw, 2007). Moreover taxing goods which are evil for the society is a good idea as per Professor Dalton. According to him taxing such goods by raising its price and reducing its consumption is a better policy (Dalton, 1970, p. 5).

Compare to other countries where GSTs have a maximum of one or two tax slabs, the reason for four tax slabs in India is to bring social and economic justice among the citizens. The income inequality in India is wider than those countries. In absolute terms, the income inequality in the year 2015 in India is far higher than in the colonial period. The transformed political economy since the 1980s increases the average income per citizen, but the gains went to the top 1% of the rich and inequality exploded (Basole, 2015).

In many countries which adopted GST, we find that they have single tax slab or maximum two tax slabs, for instance, Malaysia, Canada, UK, and Singapore, etc (Business Insider, 2018). Compare to other countries where GSTs have a maximum of one or two tax slabs, the reason for four tax slabs in India is to bring social and economic justice among the citizens. The income inequality in India is wider than those countries. In absolute terms, the income inequality in the year 2015 in India is far higher than in the colonial period. The transformed political economy since the 1980s increases the average income per citizen, but the gains went to the top 1% of the rich and inequality exploded (Basole, 2015).

Dalton in his book *Principles of public finance* mentions some characteristics of a good tax system. He discusses the merits of multiple tax system over single tax regime. He writes that the single tax system does not generate enough revenue, and also it leads to an unfair distribution of the burden of taxation (Dalton, 1970, p. 29). The same logic is applicable in the case of single vs. multiple tax rates under GST. Single tax slab under GST will not generate enough revenue because of the different elasticities of demand for various types of good. On the other hand, there will be the less equal distribution of tax burden if GST contains only one or two tax slabs especially in India where we see wide inequality of income and wealth.

The different tax slabs can also be seen as the progressive tax rate where low taxes are charged for necessity items, and high taxes are charged for luxury items. Necessity items mostly are not very costly and highly priced so tax on those would be lesser than luxury items which are highly priced. It is precisely in line with lower income pay lower income tax rate and higher income pay higher income tax rate. Progressive tax rates generate greater equality as per ability to pay than a single tax in other countries. Kautilya also in his most famous book *Arthashastra* advocates proportionally higher income tax on wealthy and higher sales tax on the luxury goods (Jaico, 2009, p. 83).

By above analysis, we can say that GST in India follows the principles and the rules prescribed by the great economists for making it justified and equal. It is self-enforcing, and the burden of tax comes to consumers only if they are willing to bear that. It is nondiscriminatory compared to previous Value Added Tax, which was discriminating the buyers by states they were living. The same movie was priced differently in Uttar Pradesh, Karnataka, and Maharashtra, etc.

## **2.2. Canon of Certainty**

The next parameter to analyze GSTs goodness and simplicity is its canon of certainty. A tax system would be good if it is not ambiguous and uncertain. Uncertainty creates information asymmetry which increases transaction costs for the society. Information asymmetry is a source of market failure and leads to misallocation of the resources (Akerlof, 1970). Smith (2003) says that the tax rates should not be arbitrary. The tax payer should know in advance the amount of tax, the date and time and in what forms the tax should be paid (Smith, 2005)

At the same time, a good tax system also ensures that the government is also confident about the amount that will be collected by way of tax. The higher the uncertainty, the greater will be the misallocation of resources. The revenue collection also lowers with uncertainty in the tax structure. As Dalton (1970, p.32) says

“It is best to rely on a few substantial taxes for the bulk of the tax revenue.”

There are two approaches to understand Indian GST under the canon of certainty- one is to compare between VAT and GST India, and other is to differentiate between Indian GST and other nations' GST structure. VAT in India was more ambiguous for investors and people in business than GST. The vat was controlled by the governments of different States under separate VAT Act. The procedure for VAT registration, rates, due dates, and deadlines for VAT returns were all different which makes it less certain (Indiafilings.com, 2014). GST, on the other hand, is 'one nation one tax' is comparatively superior to VAT.

From another perspective between Indian and foreign nations' GST, India has four tax slabs than one or two in other countries. It makes the Indian GST less certain compared to GST in other countries. However, to go for 'ideal GST' India must have all the features of a developed country, where there is no poverty, less population and no or less income inequality. The four tax slabs as discussed above makes it more just and fair. The multiplicity in tax was more under VAT regime than under GST.

### **2.3. Canon of convenience**

Canon of convenience is another important characteristic of a good a tax system (Smith, 2005). The simplicity of a tax system is based on its convenience to pay for the tax payers regarding time and mode of payment. Indirect taxes for consumers are always convenient regarding time and mode of payment. Taxation should not be a painful process for the people, regarding its convenience and burden (Jaico, 2009 p. 83). Taxes on commodities are 'pay as you purchase' in the form of higher prices. Thus Both VAT and GST are equally good and qualify to be a convenient tax system.

There is the news of uncertainty with GST in media since it has been adopted by the government. Let us not get confused this with the canon of convenience. These are short term issue and mostly related to the teething problem of anything adopted for the 1<sup>st</sup> time. The long term benefits of GST are far beyond these smaller issues.

### **2.4. Canon of economy**

Canon of economy is another important feature which makes any tax system a good tax system. The whole purpose of taxation will fail if tax collection is not efficient. The revenue from tax should be more than the cost of collection. VAT due to it is too much of complexity was uneconomical, as too high a multiplicity is not desirable. According to Arthur Young a large number of taxes, however small, usually involve large cost and a large amount of vexation in the collection.

“...simplicity in taxation is the greatest additional weight that can be given to taxes, and ought in every country to be most sedulously avoided.” (Pinkerton, 1808)

In this sense it can be said that GST compare to VAT is more economical because under VAT the multiplicity of the tax base has resulted in a complex system and the society was facing the cascading effects of taxation. The lack of integration between the Centre and the State legislation makes it more complicated and hampers the GDP growth. The cost of collecting and maintaining tax records are higher compared to GST which will be levied on the final use of the goods and services. Adam Smith if tax structure is difficult to administer, it does not serve the real purpose of the taxation.

Thus it can be said that GST compare to VAT is more economical because under VAT the multiplicity of the tax base has resulted in a complex system and the society was facing the cascading effects of taxation. The lack of integration between the Centre and the State legislation makes it more complicated and hampers the GDP growth. The cost of collecting and maintaining tax records are higher compared to GST which will be levied on the final use of the goods and services. According to Adam Smith (2005) if tax structure is difficult to administer, it does not serve the real purpose of the taxation (Singh, 2017).

### III. IMPACT OF GST ON INDIAN ECONOMY

Taxation has major effect on the growth of any economy. With the changes in tax rates, aggregate demand changes, which in turn affects the economic growth rate. Taxes, direct and indirect are considered to be one of the major sources of government revenue in India. The goals of Indirect taxes in India are: 1) raising revenue to reduce fiscal deficit. 2) restrict the use of a particular goods and services which are not considered as 'goods' for society, e.g. cigarettes. 3) Maintain price stability by changing tax rates as per the requirement under fiscal policy.

In the present section we will analyze the effects of GST on Indian economy by looking at data on GDP growth rate, inflation rate, and fiscal deficit and GST revenue collection.

The data of real GDP is collected from the RBI website and growth rate is calculated by the researcher. From table 1 it's been observed that the GDP growth rate is positive throughout after the implementation of GST from July 2017. Since quarter 1 of 2018-19 real GDP is depicting a slowdown trend with fall in GDP growth rate from 2.9 in quarter 4 of 2017-18 to 1.3% in quarter 1 of 2019-20. During this period it has experienced a negative growth in quarter 2 of 2018-19. If we examine the annual trend of GDP growth rate in table 2 we find a falling trend in growth rate from 8.03% in the year 2015-15 to 6.63% in 2018-19.

Tax revenue collection is a vital component of public finance for a socialist economy to spend on health, education and other social services. Unless the institutions to optimally maximize tax revenues are strong, developing economies like India will experience huge public and foreign debt to perform such activities, since it is difficult for such countries to raise revenue from unorganized and underdeveloped tax base.

As per the literature, GST suppose to smoothen the complexities of the sellers/ tax payers to maximize gains from taxes. Therefore, ideally the amount of tax collection should be higher in case it is easy and simple for the tax payers to pay taxes. The chart given below depicts the comparison of the revenue collection under GST from financial year 2018-19 to 2019-20.

Except in the month of September and October, the amount of revenue collection through GST is higher in current year compare to previous financial year. This result can be interpreted as proving GST to be achieving one of the goals revenue generation of taxation. This can also be interpreted as a simpler tax in comparison of VAT which was complicated and therefore was difficult to file.

This can also be verified considering the fiscal deficit of Indian economy from last 10 years. Chart no. 2 given below depicts the data on fiscal deficit as percent of GDP. The consolidated fiscal deficit in March 2019 was recorded as -3.4% compare to 3.8% in 2016 and 3.5 % of its nominal GDP in 2017. There is a continuous decline in the fiscal imbalance since the inception of GST from July 2017.

Another benefit of GST is said to maintain its price stability, lowering consumer price index by reducing the cascading effect of indirect taxes of the previous tax system (Jaiswal 2017). In order to validate this benefit, data on monthly inflation rate is been collected from RBI website. We can see from the table no. 3 on an average monthly inflation rate in year 2018-19 is nearly 3 to 4%, compare to 3.6% in 2018-19 and 4.5% in 2016-17.

### IV. CONCLUSION

To sum up, a tax system is good and simple, if it strikes a balance between the interests of the taxpayer and the tax authorities. It should bring about efficiency, revenue adequacy, equality, simplicity and accountability. By above analysis, we can say that GST in India follows the principles and the rules prescribed by the great economists for making taxation regime justified and equal. With GST government aims at giving boost to "Make in India" campaigns. GST in India harmonies and consolidate multiple indirect taxes in India and make India a common national market by widening the tax base and cutting down exemptions. the second section this paper to some extent helps in establishing the fact that following the canons of taxation GST can be called as a '*good and simple tax*' so that its benefits can be accrued to both producers and consumers for the growth and economic development of the country.

To corroborate the findings of section two we analyzed the impact of GST on Indian economy through economic indicators. To sum up the indicators of economic performance are showing positive trends after the implementation of the GST in 2017. Although, the data on GDP growth rate has shown a slight slowdown of nearly 1%, which is not remarkable to explain any impact of GST on Indian economy's national income. With ease in starting business and filing taxes, from large to small and local firms, the base of GDP calculation is broaden which will bound to capture higher income, which was earlier went unaccounted in measuring GDP.

Collection of GST in 2019 is showing a better picture compare to previous figures. The fiscal balance of India has shown an improvement, with lesser GDP-debt ratio. This indicates more investment from savings in near future, the large portion of which goes to pay the public debt. Inflation rate is stabilized to almost 3.5 to 4% which is considered to be the best range to promote business activities, as inflation is not always bad.

Therefore it can be concluded that despite the criticism government has gone through for implementing GST, Indian economy is looking in better condition than before. . However, the success of GST in long run depends on its acceptability, good IT infrastructure and support system from all ends. Although it's too early to conclude that it's all because of the new tax reforms, but the benefits of GST will be more remarkable once it picks up its pace. The effect of GST appear to be dynamic, where not only National Income, Inflation and Fiscal Deficit are getting affected positively, but also growth stimulants like FDI, Exports and Foreign Exchange will also get a boost with proper implementation of a bold an effective institution like GST.

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**ANNEXURE**

**Table-1: REAL GDP at constant price (2011-12)**

Year	Quarter	GDP Growth Rate (%)	Year	Quarter	GDP Growth Rate (%)
2014-15	Q1	1.2	2017-18	Q1	2.2
	Q2	0.1		Q2	0.4
	Q3	3.3		Q3	2.2
	Q4	1.7		Q4	2.9
2015-16	Q1	2.5	2018-19	Q1	2.0
	Q2	0.7		Q2	-0.4
	Q3	2.3		Q3	1.7
	Q4	3.0		Q4	2.3
2016-17	Q1	3.0	2019-20	Q1	1.3
	Q2	-0.2			
	Q3	1.5			
	Q4	2.3			

Source: National Statistical Office (NSO).

**Table-2: REAL GDP at constant price (2011-12)**

Year	GDP Growth Rate (%)
2012-13	5.42
2013-14	6.05
2014-15	7.15
2015-16	8.03
2016-17	7.88
2017-18	6.94
2018-19	6.63

Source: National Statistical Office (NSO).

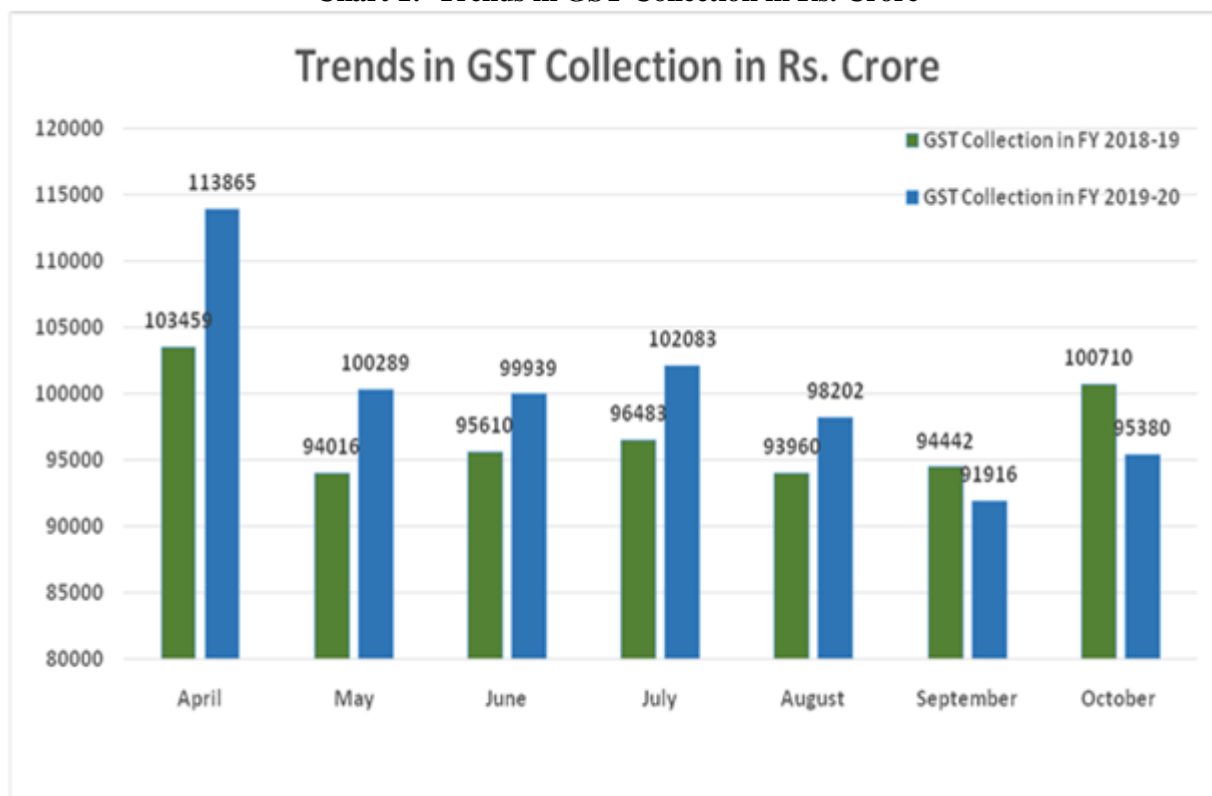
**Table-3: New CPI – Combined**

**Base: 2012 = 100**

Year	APR	MAY	JUN	JUL	AUG	SEP	OCT	NOV	DEC	JAN	FEB	MAR	Avg
2015-16	4.9	5	5.4	3.7	3.7	4.4	5	5.4	5.6	5.7	5.3	4.8	4.91
2016-17	5.5	5.8	5.8	6.1	5	4.4	4.2	3.6	3.4	3.2	3.7	3.9	4.55
2017-18	3	2.2	1.5	2.4	3.3	3.3	3.6	4.9	5.2	5.1	4.4	4.3	3.60
2018-19	4.6	4.9	4.9	4.2	3.7	3.7	3.4	2.3	2.1	2	2.6	2.9	3.44
2019-20	3	3	3.2	3.1	3.3	4	4.7						3.47

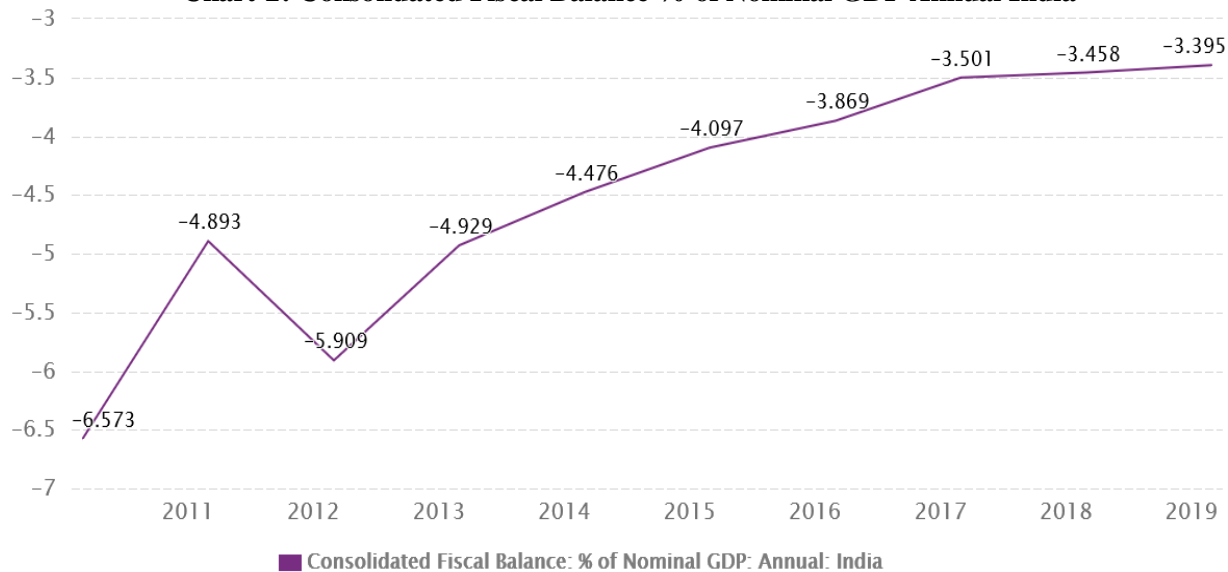
Source: National Statistical Office (NSO), Ministry of Statistics and Programme Implementation, Government of India

**Chart 1: Trends in GST Collection in Rs. Crore**



Source: <https://pib.gov.in/newsite/PrintRelease.aspx?relid=194164>

**Chart-2: Consolidated Fiscal Balance % of Nominal GDP Annual India**



Source:<https://www.ceicdata.com/en/indicator/india/consolidated-fiscal-balance--of-nominal-gdp>

SOURCE: WWW.CEICDATA.COM | CEIC Data