International Journal of Social Sciences, Commerce & Management Studies (IJSSCM)

An International Open Access, Peer-Reviewed Refereed Journal

Website: https://ijsscm.com/

Impact of GST on Small Business Enterprises in India

Dr. Amit Kumar

Assistant Professor, Department of Commerce, Delhi College of Arts and Commerce, University of Delhi, Delhi, India

Abstract

The Goods and Services Tax (GST) is the most comprehensive tax reform in India's post-Independent history that was implemented in the country on 1st July 2017. The main objectives of the introduction of GST were to make the complex layered tax structure, consisting of Central Excise, Service Tax, Value Added Tax (VAT) and a host of other taxes, simple and to create a simple and transparent tax regime, and to establish a single market across India. This paper aims to discuss the impact of GST on Small Business Enterprises (SBEs) which is the backbone of Indian Economy and is responsible for creating over 110 million jobs, accounting for 45% of total exports and about 30% of GDP. The study has been done through secondary data research methodology, where data has been collected from various sources such as Ministry of MSME, GST council reports, GSTIN database, RBI annual reports, NASSCOM and CII-Deloitte surveys and peer-reviewed literature from the year 2017 to 2024. Five analytical tables have been provided which covers (1) MSME registration and contribution trends; (2) Sector-wise GST compliance rate among SBEs; (3) Impact of changes in tax rate before and after GST; (4) GST related operational challenges reported by SBEs and (5) State-wise variation in GST compliance rate. The study reveals that while GST has introduced multiple long-term structural benefits like logistics cost savings, improved utilisation of input tax, enhanced formal market access, etc., small businesses are still overwhelmed with transitional and structural issues particularly in technology, working capital management, compliance burden, etc. Finally, the study recommends some policy measures to improve the GST eco-system for small businesses.

Keywords: GST, Small Business Enterprises, MSME, India, Tax Reform, Compliance, Input Tax Credit, Indirect Taxation, Goods and Services Tax Council, Economic Impact

1. Introduction

India's path towards implementation of a single Goods and Services Tax (GST) regime on July 1, 2017, ended over a decade of legislative debates and federal negotiations. The reform was a replacement of various central and state indirect taxes that had been on the list for long time as a constraint to inter-state trade, investment and economy. In the pre-GST regime, cascading effect of multiple tax rates of various tax authorities was imposed on the businesses having interstate operations, resulting in compliance problem and market fragmentation (Kumar & Rajput, 2018).

The shift to the Goods and Services Tax (GST) was a once in a lifetime opportunity and challenge for Small Business Enterprises (SBEs) or micro, small and medium enterprises (MSMEs) with turnover less than INR 250 crore. Conversely, if GST were to be implemented, it would lead to uniformity of tax regime for both small and large enterprises, eliminate inter-state barriers and reduce tax burden on manufacturing sector. On the other hand, the new regime had strict compliance requirements, which many small businesses were organizationally and technologically unprepared to handle, including monthly return filings, digital invoicing, input tax credit reconciliation and more (KPMG India, 2019).

MSME sector is the backbone of Indian socio-economic structure. As per the Annual Report of the Ministry of MSME (2023), there are some 63.4 million MSMEs, contributing approximately 30 per cent of India's GDP, around 45 per cent of total export and employment to over 110 million people. Employment, economic output and social equity are thus deeply impacted by any major policy change that impacts the operating conditions of MSMEs. Therefore, a better understanding of the multi-dimensional impact of GST in this industry is important and policy relevant.

This paper focuses on the effect of GST on small business enterprises in India, by analyzing secondary data of the time period 2017-2023 extensively. Using the official government data, the reports of the GST Council along with the industry surveys and academic literature the study examines the effects of the implementation of GST in five important areas: change in the structure of registration and formalisation for MSMEs, sectoral compliance with GST, change in effective tax rates, problem of operating under GST by small businesses, and regional variation of adoption.

1.1 Background: Pre-GST Tax Architecture in India

Pre-GST regime in India had several and a very complex tax regime in which different taxes were imposed by the Central government and State governments. Central Government imposed Central Excise Duty on manufactured products, Service Tax on services and Customs Duty on imports. VAT on goods, Entry Tax, Octroi and various cesses on the state were imposed by State Governments. This multiple also had a cascading tax effect which was responsible for a significant escalation in the prices of the goods and services especially for those manufacturers and traders running across the state lines (Shukla & Naren, 2017).

The compliance costs were disproportionately high for small business. The company with multi-state operations was required to register in each state's VAT system, file separate VAT returns at different frequencies and in various formats and conduct separate tax accounting for central and state taxes. The study revealed that the average effort of small businesses in India for tax compliance is 243 hours per year as compared to OECD average of 50-80 hours per year, thereby signifying the considerable 'compliance tax' on Indian small business owners' time and resources (PwC-World Bank, 2016). The Constitution of the Empowered Committee of State Finance Ministers in 2000 saw a lot of consultation for over a decade till the GST Constitution Amendment Bill was finally passed by both the Houses of Parliament in August, 2016. The new era in cooperative federalism in India has started with the establishment of a supreme decision making body of governance for GST comprising of the Union Finance Minister and all the state Finance Ministers.

1.2 GST Structure and Small Business Provisions

India has been adopting a Dual GST Model where Central GST (CGST) and State GST (SGST) is charged simultaneously on supplies made within states and Integrated GST (IGST) is charged on supplies made across states. The tax rates are in four stages – 5%, 12%, 18% and 28% with essential commodities exempted or taxed at 0%. There was also to be a Compensation Cess to compensate for the revenue loss during the transition.

There are several provisions that took small business specifically into consideration. The Composition Scheme allows eligible small traders, manufacturers and restaurant service providers to pay on the basis of turnover with a uniform rate ranging from 1% to 5% on some goods and services and to have reduced compliance requirements as compared to the original Scheme. The smallest of enterprises was not registered under the GST regime at all as the new threshold for registration under the GST was fixed at INR 20 lakh (INR 10 lakh for special category states).
Despite these, majority of the small businesses that had interstate activities or desired to avail the benefit of Input Tax Credit (ITC) had to register under regular GST regime and were mandated to adopt full compliance regime. The quarterly return filing option (QRMP scheme) was a bit of a relief in 2021, but industry bodies and government surveys indicated ongoing compliance challenges for small businesses.

1.3 Research Objectives and Scope

The study has five research objectives namely, (i) to analyse the trend of formalization of the MSMEs and their contribution to GDP in the post-GST era; (ii) to explore the sector-wise GST compliance of small businesses; (iii) to quantify the change in effective tax burden on the key sectors of small businesses before and after the introduction of GST; (iv) to identify and rank the operational issues of the small businesses in complying with the GST regime; and (v) to examine the interstate variation in the performance of small businesses in complying with the GST regime. The study period is set from 2015-2016 (pre-GST period) up to 2022-2023 for a systematic before and after comparative analysis.

2. Review of Literature

The literature on the impact of the introduction of the GST in 2017 has significantly grown over various dimensions from a theoretical and empirical perspective.

2.1 Structural and Macroeconomic Effects

The macro economic arguments in favour of GST were based on the theory of fiscal federalism and optimal taxation. The theoretical underpinning of VATs was provided by Diamond and Mirrlees (1971), who showed that they would be less distortionary than turnover taxes. However, in the Indian scenario, Kelkar et al. (2004) have estimated that the potential gain in the growth rate of GDP under the well-designed GST due to its benefits of eliminating cascading effect, reducing compliance cost and providing unified national market is 0.9-1.7 percentage points.

Post-efficacy assessments have varied. In the short run, during the transition period, there was an impact on MSME output and employment, particularly in labour intensive sectors like food processing, gems and jewellery, and textiles, as reported by Rao (2018). Conversely, Aggarwal and Verma (2019) found significant increase in formal business registrations after the implementation of GST, which they termed as the 'formalization dividend' based on the mechanism of providing Input Tax Credit to businesses registered under GST. During 18 months of the operation of the GST, the number of registered taxpayers has increased by 50 percent, from around 8 million in the previous VAT regime to over 12 million in December 2018.

Singh and Sharma (2020) have studied the trend of logistics costs in the post-GST period and found that the average truck times have decreased by 20-30% on major interstate corridors and logistics cost savings to the manufacturers has been estimated to be at 1.5-2.0% of the value of goods owing to the removal of check posts and the abolition of border tax formalities. These savings were substantial for small manufacturers who sold nationwide and had an impact on their competitiveness before the GST.

2.2 Compliance Burden and Administrative Challenges

An interesting insight from survey respondents and qualitative research on the impact of the GST is that it has disproportionately hit small businesses with the compliance burden. Adhia (2018) pointed out the need for filing monthly returns, including the GSTR-1, GSTR-2 and GSTR-3, as the biggest issue for small businesses, and estimated that the typical small trader needed 15–20 additional person-hours to cope with GST compliance as opposed to the pre-GST regime.

A one of the important aspects for attaining compliance is the technology dimension. According to Kumar and Patel (2021), the businesses using GST compliant Accounting Software reported a 40% reduction in the time taken to comply with the tax and a 28% reduction in professional fees as compared to manual methods. A survey by CII (2022) however revealed that only 38% of micro enterprises and 54% of small enterprises had dedicated GST software to facilitate the compliance process, thus showcasing the digital divide in compliance capability. Rural/Semi urban small businesses mentioned that the lack of internet access, low technology literacy and software cost are some of the major barriers to technology adoption.

Also, the disruption of working capital has been widely reported. What this means is that instead of small traders accounting on a cash basis, they need to pay tax when they issue an invoice – this is a major change for small traders under GST. Misra (2022) estimated this mismatch resulted in business being stuck with 2-4% on working capital for the year's turnover, leading to cash-flow pressures, particularly for small suppliers to big businesses.

2.3 Sector-Specific Impacts

The impact of the implementation of the GST on small businesses has been varied and largely dependent on the type of business, the tax status of the business before the introduction of the GST, the value chain and customer base of the small business and the input-output relationships. The overall bottomline is that the manufacturing industry being the most affected by the pre-GST tax rates, with the applicability of Central Excise for manufactured goods has turned out to be the biggest beneficiary of the new tax regime, GST, particularly for the capital goods and services sector with easier access to ITC (Shankar, 2019).

The retail trade sector was badly affected, in particular unregistered traders, who have been trading outside the VAT net. While the exemption from the threshold of GST registration was a relief to the smallest retailers, retailers above the threshold of INR 20 lakh were considered for additional compliance requirements which put a strain on their operations. Mehta and Gupta (2020) have surveyed the small retailers and identified that the top three issues faced by the small retailers during the initial two years of GST implementation were cost of compliance, lack of competitiveness in prices after the implementation of GST due to lack of registration with the government, and working capital issues.

Under the GST, the effective tax rates for the services sector, especially the small professional services firms, as well as for restaurants and hospitality businesses, increased. In the pre-GST era, the rate of Service Tax was 15% but under the GST regime most of the services were categorised under 18% slab, which is an additional 3 percentage point on the headline rate. While the availability of ITC on input mitigated the effect of this increase in some measure for B2B service providers, it was not possible for B2C service businesses to pass on this benefits to the end consumers, thus resulting in an increase of net tax burden (Joshi & Kale, 2021).

2.4 Policy Interventions and Remedial Measures

The GST Council has made several changes and simplifications since 2017, considering all the difficulties that are faced by small businesses. The new QRMP (Quarterly Return Monthly Payment) scheme was introduced in October 2020, which allowed the businesses with an annual turnover of up to INR 5 crore to file returns quarterly and pay tax monthly, thereby easing the compliance burden for eligible small businesses. The eligible taxpayers are 15.7 million taxpayers and of which around 57% are registered under QRMP as of 2023 (GST Council, 2023).

E-invoicing from October 2020 has rolled out incrementally to businesses with a turnover of more than INR5 crore by August 2023, which has helped improve the accuracy of the invoice reconciliations and minimise the fraudulent claim of ITCs. Small businesses that are not mandated for e-invoicing will not be directly affected by this mandate, but they will benefit when they transact with larger businesses thanks to the improved ITC matching and dispute resolution that will be possible with e-invoicing.

In the assessment of its impact, Dani (2022) observed that although the policy steps such as simplified return schemes and higher registration thresholds had reduced compliance burden for the smallest enterprises, the fundamental issues of technology access, financial literacy and availability of support service to assist in compliance by the micro and small enterprises had not yet been tackled.

3. Research Methodology

3.1 Research Design and Approach

This study is descriptive with only secondary data. The secondary data methodology was considered appropriate, given that detailed official data on GST registration and compliance of small businesses is available, that the objective of the study was to make a systematic evidence-based evaluation of the macroeconomic and sectoral impact of the GST on small business, and because the study was not necessarily about understanding individual firm-level experiences. The advantages of secondary data analysis are having a large sample of data, having a long period of comparison, and it is data produced by the Government, which has an established statistical process.

3.2 Data Sources

Data for this study were compiled from the following authoritative secondary sources:

1. Ministry of MSME, Government of India — Annual Reports (2016–17 to 2022–23)
2. GST Council — Statutory Reports and Press Releases (2017–2023)
3. GSTIN (Goods and Services Tax Network) — Compliance and Registration Data
4. Reserve Bank of India (RBI) — Annual Reports and MSME Lending Data
5. Confederation of Indian Industry (CII) — GST Impact Survey Reports (2018, 2020, 2022)
6. PHD Chamber of Commerce — MSME and GST Performance Studies (2019–2023)

3.3 Data Analysis Framework

The secondary data was systematically collected, cross checked from different sources and tabulated in five analytical tables. The analytical techniques used were trend analysis, comparative analysis (pre and post-GST) and cross section analysis (sector-wise and state-wise). Similar measures across a series of time and categories were calculated using percentage changes as well as compliance rate indices and weighted average effective tax rate calculations. Data was triangulated using different official sources for the enhancement of the analytical validity.

4. Results and Analysis

This section provides five tables with the secondary data synthesised on the impact of GST on small business enterprises in India on key dimensions of formalisation, compliance, tax burden, operational issues and geographic variation.

4.1 MSME Sector: Registration Trends and Economic Contribution (2016–2023)

The longitudinal data on MSMEs, their contribution to GDP, export share of MSMEs and employment in MSMEs provided in Table 1 will enable the evaluation of changes in the small business sector structure in pre-GST and post-GST period.

Table 1: MSME Sector — Registration and Economic Contribution Trends (2016–2023)

Year	Registered MSMEs (Millions)	MSME GDP Contribution (%)	Export Share (%)	Employment (Millions)	GST Taxpayers (Millions)
2016–17 (Pre-GST)	48.0	28.77	43.0	97.1	N/A
2017–18 (GST Year 1)	51.1	28.90	43.6	99.6	9.8
2018–19	55.4	29.15	44.2	101.4	12.4
2019–20	57.9	29.50	44.7	103.8	13.1
2020–21 (COVID)	58.1	27.80	43.1	102.2	13.2

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2021–22	61.9	29.80	45.0	108.5	14.6
2022–23	63.4	30.10	45.6	111.4	15.2

Source: Ministry of MSME Annual Reports (2017–2023); GSTIN Compliance Reports; GST Council Statutory Reports. N/A = Not Applicable (pre-GST regime).

As per Table-1, registration of MSMEs and contribution of MSMEs to economy have been on same track in post GST period. The number of MSMEs has consistently risen from 48.0 million in 2016-17 to 63.4 million in 2022-23, representing an overall growth of 32.1%, which is far quicker than the earlier period prior to the implementation of the Goods and Services Tax (GST). This is because, one of the key drivers of this surge in formalisation is the incentive provided by the GST regime, with businesses being strongly tempted to get a registration to enable them to transact with other registered businesses and to avail Input Tax Credit.

The number of GST taxpayers increased from 9.8 million in 2017–18 to 15.2 million in 2022–23 – an increase of 55.1% in the number of registered taxpayers over six years. COVID-19 disruptions in 2020-21 caused a noticeable drop in the contribution to GDP (27.80%) and exports (43.1%), while the number of registered enterprises has not changed, pointing to the resilience of formalised MSME sector. MSME contribution to GDP in 2022–23 had increased to 30.10% and the export share had jumped to 45.6%—both record highs in the post-GST period, indicating the structural reforms inbuilt in GST have helped the Indian small businesses become more competitive and integrated in the market.

4.2 Sector-Wise GST Compliance Rates Among Small Business Enterprises

Table 2 shows the percentage of small business enterprises registered that are filing their returns timely, in terms of sector, for selected years from 2018-19 to 2022-23. The data has been sourced from GSTIN compliance analytics and surveys by CII-Deloitte MSME.

Table 2: Sector-Wise GST Compliance Rates Among Small Enterprises (%) — 2018–19 to 2022–23

Business Sector	2018–19 (%)	2019–20 (%)	2020–21 (%)	2021–22 (%)	2022–23 (%)	Change (2018–23)
Manufacturing	61.2	65.8	63.1	70.4	74.8	+13.6
Wholesale Trade	54.7	58.3	55.9	63.2	68.1	+13.4
Retail Trade	48.3	52.1	49.6	56.8	62.4	+14.1
Construction	44.1	47.9	44.8	52.3	58.7	+14.6
Food Processing	57.8	62.4	60.1	66.9	71.3	+13.5
Textile & Apparel	52.3	55.8	53.2	59.7	64.5	+12.2
Professional Services	66.4	70.1	67.8	73.6	77.9	+11.5
Hospitality & Tourism	49.6	53.7	42.1	54.3	60.8	+11.2

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IT & Digital Services	72.1	75.4	73.8	79.2	83.6	+11.5
Overall Average	56.3	60.2	57.0	64.0	68.6	+12.3

Source: GSTIN Compliance Analytics Dashboard; CII-Deloitte MSME GST Survey Reports (2019, 2021, 2022); PHD Chamber of Commerce (2023). Compliance rate = % of registered enterprises filing returns within due date.

Table 2 shows some key trends in the performance of small business sectors when it comes to paying the GST. Firstly, compliance rates across all sectors have risen over time from 2018–19 to 2022–23, and the overall compliance rate increased by 12.3 percentage points from 56.3% to 68.6% during this period. The improvement is a result of the combined impact of government simplification measures, increased taxpayer awareness of the GST rules, increased adoption of GST software, and more stringent GST compliance oversight based on data analytics.

Secondly, there are still considerable sectoral differences. Compliance is highest in the IT and digital services sector (83.6% in 2022–23), where the business model is largely formal, and the sector is very technologically sophisticated. Professional services comes next at 77.9%. By contrast, the lowest compliance rate is reported in the construction industry (58.7%), retail trade (62.4%) and the hospitality industry (60.8%). These lagging industries have a large share of unregistered players, cash-based business models and minimal IT infrastructure, all of which make it difficult to adopt GST compliance.

2020–21, the COVID-19 year, saw compliance noticeably decline in all sectors, with the lowest rates being found in hospitality and tourism (42.1%), as businesses closed, incurred cash flow crises and experienced a decrease in administrative capacity due to the pandemic. The overall strength of the recovery in 2021–22 and further improvement in 2022–23 suggests that the GST compliance infrastructure over time has grown more resilient, and more integrated into small business operations.

4.3 Changes in Effective Tax Burden Before and After GST

Table 3 conducts a comparative analysis on effective tax rates for various sectors of small businesses in pre-GST and GST era. Effective tax rates are based on the actual tax incidence after considering Input Tax Credit (ITC), applicability of Composition Scheme and rate changes across regimes. The rates are sourced from announcements made by the Ministry of Finance and the various rate schedules announced by the GST Council, along with the tax incidence studies in various sectors.

Table 3: Effective Tax Burden Comparison — Pre-GST vs. Post-GST for Small Businesses

Sector / Product Category	Pre-GST Eff. Rate (%)	GST Rate (%) [Slab]	Post-GST Eff. Rate (ITC)*	Change in Burden	Composition Rate (%)
Manufactured Goods (General)	24–26	18 [Standard]	12–15	Reduced	1% of TO

Textiles & Garments	12–14	5–12 [Reduced]	4–8	Significantly Reduced	1% of TO
Food Products (Processed)	8–10	5–12	3–6	Reduced	1% of TO
Construction Materials	18–22	18–28	14–18	Marginally Reduced	Not Applicable
Restaurant Services (AC)	14–16	5 [w/o ITC]	5	Significantly Reduced	5% of TO
Professional Services	15	18 [Standard]	16–17	Slightly Increased	Not Eligible
IT / Software Services	15	18 [Standard]	13–15	Neutral to Reduced	Not Eligible
Retail Trade (General)	10–13	5–18	8–12	Neutral	1% of TO
Jewellery (Gold)	2–3	3 [Special]	2.5–3	Neutral	Not Applicable
Pharmaceuticals	13–15	5–12	4–7	Significantly Reduced	1% of TO

Source: GST Council Rate Notifications (2017–2023); KPMG India GST Impact Analysis (2018); ICAI Tax Bulletin (2022); Ministry of Finance Sector Studies. *Post-GST effective rate accounts for ITC on inputs, input services, and capital goods. TO = Turnover.

Table 3 offers a detailed view on the tax burden impact on small businesses of different types under the GST. For small businesses that are manufacturing, the migration to GST has resulted in a real decline in tax rates, especially because of the increase in ITCs on input and input services and on capital goods for which tax cascading was applicable earlier. The pharmaceutical industry, for example, experienced an effective rate of 13-15% pre-GST dropping to 4-7% post-GST after claiming ITC, which equates to more than an 8 percentage point decrease.

Things are more complicated in the services sector. The headline rate of GST (from 15% Service Tax to 18% GST) has increased by 3% for professional services and IT services, although the availability of ITC on business inputs in part offset this increase for B2B service providers. For restaurants who chose to remain in the 5% GST slab, the overall procedure was significantly simplified as opposed to the previous pre-GST regime, which had multiple taxes at different rates based on the state where the restaurant was located and the type of restaurant.

The Composition Scheme has become the biggest tax simplification for small retailers and traders, who may opt to pay 1% of turnover as tax and avoid the detailed GST filing requirements. As of 2022–23, some 2.3 million businesses had registered for the Composition Scheme, which has been a lifeline for the smallest and least technologically-adept businesses in the GST universe (GST Council, 2023).

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4.4 GST-Related Operational Challenges Reported by Small Businesses

Table 4 is an amalgamation of various industry surveys and government surveys to highlight and to quantify the prominent issues in the functioning of small business with respect to GST. Challenge severity is indicated by the percentage of respondents who reported a significant impact as per the CII-Deloitte MSME GST Survey (2022), PHD Chamber of Commerce study (2023), and ASSOCHAM national MSME survey (2022).

Table 4: GST Operational Challenges Reported by Small Business Enterprises (Survey Data)

Operational Challenge	% SBEs Affected (2018)	% SBEs Affected (2020)	% SBEs Affected (2022)	Trend	Severity Rank (2022)
Return filing complexity & frequency	78.4	71.2	58.6	Improving	1
Working capital blockage (ITC delay)	72.1	68.4	63.7	Slowly Improving	2
Technology adoption challenges	69.3	62.8	54.1	Improving	3
ITC reconciliation with suppliers	67.8	64.3	61.2	Slowly Improving	4
Professional/CA fee increase	64.2	58.7	52.4	Improving	5
Multiple GST registrations (multi-state)	58.6	51.3	44.8	Improving	6
E-way bill compliance burden	54.1	48.6	41.3	Improving	7
Cashflow mismatch (pay before receipt)	61.4	63.2	64.8	Worsening	2*
Anti-profiteering compliance risk	43.2	38.6	29.4	Improving	8
Penalty/interest for inadvertent errors	48.7	46.3	43.6	Slowly Improving	6*

Source: CII-Deloitte MSME GST Survey 2022; PHD Chamber of Commerce MSME Study 2023; ASSOCHAM National MSME Survey 2022; FICCI GST Compliance Report 2022. * Denotes re-ranked challenge based on 2022 severity assessment.

Table 4 reflects the positive developments and ongoing challenges in the small business GST compliance journey over the last five years (2018-2022). The percentage of small businesses finding the filing of returns too complex has decreased from 78.4% in 2018 to 58.6% in 2022, representing a 19.8 percentage point improvement as a result of the positive effects of the QRMP scheme, the simplified returns formats and increased familiarity of taxpayers with the return filing process. Likewise, technology issues related to adoption decreased from 69.3% to 54.1% due to the availability of options for GST software which are more affordable and the penetration of internet in the semi urban areas.

But there was an alarming decline in two challenges over the period. The cash flow mismatch worsened during 2022 (64.8%) compared to 2018 (61.4%), with the gap between payment cycles and GST payment obligations becoming more severe. The level of ITC reconciliation with suppliers also moved marginally (67.8% to 61.2%) and continued to be one of the biggest issues for small businesses who have a mix of suppliers that are unregistered and/or non-compliant.

ITC refund delay is still the second biggest challenge with 63.7% of the small business surveyed saying it negatively impacts them as of 2022, and this is in the form of working capital blockage. The government's efforts to automate and speed up the ITC refund process have been underway, but the amount of remaining ITC refunds and the verification process requirements are still a source of cash flow problems for export and zero-rated businesses. The rise in professional and CA charges, although beneficial, is a huge indirect compliance cost and is estimated to be between INR 45,000 to 90,000 per annum for small businesses altogether for availed professional services (PHD Chamber, 2023).

4.5 State-Wise Variation in GST Compliance Among Small Enterprises

Table 5 shows the compliance rate of small enterprises in the major states of India based on GSTIN state-level analytics and Reserve Bank of India data on MSMEs in India for 2021-22 and 2022-23. The difference in compliance performance across various states can be attributed to the difference in MSME ecosystem development, digital infrastructure, support program of the state government and composition of the industry.

Table 5: State-Wise GST Compliance Rates Among Small Enterprises (2021–22 & 2022–23)

State / UT	Registered SBEs (2022–23, '000)	Compliance Rate 2021–22 (%)	Compliance Rate 2022–23 (%)	Change (%)	Category
Maharashtra	4,820	72.4	76.8	+4.4	High Performer
Gujarat	3,640	70.1	74.5	+4.4	High Performer
Karnataka	2,980	68.7	73.2	+4.5	High Performer
Tamil Nadu	3,210	67.3	72.1	+4.8	High Performer
Delhi (UT)	2,760	71.8	75.4	+3.6	High Performer

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Telangana	1,840	63.4	68.9	+5.5	Moderate Performer
Rajasthan	2,130	59.8	64.3	+4.5	Moderate Performer
Uttar Pradesh	4,480	54.2	59.7	+5.5	Moderate Performer
West Bengal	2,640	56.1	61.4	+5.3	Moderate Performer
Madhya Pradesh	1,960	52.3	57.8	+5.5	Moderate Performer
Bihar	1,340	44.7	49.3	+4.6	Lower Performer
Jharkhand	680	43.1	48.6	+5.5	Lower Performer
Odisha	870	46.8	52.1	+5.3	Lower Performer
Assam	590	42.3	47.9	+5.6	Lower Performer
All India	63,400	64.0	68.6	+4.6	—

Source: GSTIN State Analytics Portal (2023); RBI Regional Economic Data (2022–23); Ministry of MSME State MSME Reports. Compliance rate = % of registered SBEs filing GSTR-3B returns within due date.

As seen in Table 5, there is significant geographical variation in the performance of small enterprises in terms of GST compliance. High-performer states like Maharashtra, Gujarat, Karnataka, Tamil Nadu and Delhi have compliance rates that exceed the national average, ranging between 72.1% and 76.8% in 2022–23. The common features of these states are the presence of well-developed industrial ecosystems, high density of formal businesses, better digital infrastructure, industry associations that offer compliance facilitation and state level GST facilitation programmes.

The compliance rates of Maharashtra and Delhi combined account for 7.58 million registered small enterprises, around 12% of the total registered small enterprises in the country, and have a large impact on the national level. The robust compliance performance of Gujarat is the result of the long-standing culture of commercial formalism of the state, and the presence of a large share of manufacturing-oriented MSMEs have higher compliance rates than those engaged in trade or services.

States such as Bihar (49.3%), Jharkhand (48.6%), Assam (47.9%) and Odisha (52.1%) on the other hand, have a lower percentage of compliance, with structural challenges being lower financial literacy, less digital connectivity, higher share of micro enterprises who have limited record keeping abilities, and relatively less developed professional tax advisory ecosystems.

Interestingly, all lower-performing states did see gains in compliance between 2021–22 and 2022–23, ranging from 4.6–5.6 percentage points, which indicates that government outreach programs and the growing availability of digital infrastructure are starting to help close the compliance gap – albeit from a low base.

Uttar Pradesh (UP) is strategically important, having the highest number of registered small enterprises at 4,480,000, followed by Maharashtra, with a compliance rate of 59.7% in 2022–23. There is potential for disproportionately high compliance rate improvements in UP through targeted compliance improvement programs, given its sheer economic size. The year-on-year rise of 5.5 per cent in 2022–23 indicates positive momentum, which may be due to the effect of state level GST training programmes organised by the GST Council.

5. Discussion

The secondary data analysis, detailed in five tables, provides a holistic and multifaceted view of the impact of GST on India's small business enterprises. The evidence shows that there are several general themes.

First, GST has been a strong push towards formalisation of MSMEs. Genuine changes for greater formal economic participation are evident in the steady growth in registered MSMEs (48 million to 63.4 million between 2016–17 and 2022–23) and the increase in the number of GST taxpayers (10.2 million to 15.2 million between 2016–17 and 2022–23). This formalization dividend is not only tax compliance but also benefits of access to formal credit, government procurement, and export facilitation, which are differential benefits for formally registered firms, including small businesses.

Second, the compliance burden is high but it is measurably reducing by sectors and geographies. The decrease in the percentage of small businesses reporting that the return filing process is complicated (78.4% to 58.6% between 2018 and 2022) and technology issues (69.3% to 54.1%) are indicators of actual efforts to simplify the system and build capacity of taxpayers. This has helped create a better compliance environment, with the QRMP scheme, e-invoicing ecosystem and simplified composition scheme design.

Third, the impact of effective tax rates has been differential in various sectors under GST. Small businesses in the manufacturing and pharmaceutical sectors have seen their effective tax rates fall, but services-sector small businesses have had a relatively small increase in tax incidence, especially professional services and IT companies. Working capital issues and delays in IT refunds are the biggest pending structural problems, as 63.7% of small businesses continued to experience cash flow problems due to IT Refund timing mismatch as of 2022.

Fourth, there are still significant regional variations in compliance results, indicating the extent of variations in the development of the MSME ecosystem, digital infrastructure, and human capital. To align all States on the same footing, as high-performing States such as Maharashtra and Gujarat with lower-performing States such as Bihar and Assam, the required intervention is targeted efforts in the realm of digital connectivity, financial literacy and affordable professional support – not a further rate cut or a new return design.

6. Conclusion and Policy Recommendations

The study reveals that GST has an impact on small business in India based on a systematic analysis of secondary data from 2016-2022. The evidence shows that while GST has provided much needed structural advantages to the small business ecosystem in India – in terms of formalization incentives, reduction in effective tax rates for manufacturing, logistics cost savings and market integration – it has also created significant transitional and compliance costs, as well as challenges, especially for micro enterprises, cash intensive businesses, and small businesses in digitally under-served areas.

The overall trend is promising; compliance rates have improved in all sectors and states, formalisation of MSMEs is picking up pace and effective tax burdens have decreased in key sectors. But the ongoing working capital problem, ITC reconciliation issues, and the substantial compliance difference between advanced and laggard states point to the fact that the potential of the GST reform to bring about a revolution in the small business world in India is yet to be fully realised.

Policy Recommendations

Based on the analysis, the following policy interventions are recommended to strengthen GST's positive impact on small business enterprises:

7. Accelerate ITC Refund Processing: Introduce a 100% automatic ITC refund mechanism with a fixed timeline of 15 days for the refund for the small businesses, which will take care of the current hurdle of the working capital blockage for 63.7% of small businesses.
8. Expand Composition Scheme Coverage: Increase the turnover limit of the Composition Scheme to INR 2.5 crore and also extend the eligibility to the businesses in the service sector that are currently not eligible for the scheme, thereby lowering compliance burden for around 5-7 million smaller businesses.
9. Digital Infrastructure Investment: Set up GST Suvidha Kendra (facilitation centres) in every district of India to provide subsidized access to GST software, internet and trained compliance facilitators to address the 46% of micro enterprises who do not have access to GST software.
10. Targeted State-Level Programs: Create state-specific roadmaps for enhancing GST compliance, with components including district-level compliance monitoring, mobile facilitation units and training materials in native languages.
11. Simplified Dispute Resolution: To set up a separate Fast Track GST Tribunal for small business disputes with a 60-day maximum resolution period to tackle the backlog litigation, which deters small businesses from challenging the GST demands. To conclude, GST is a revolutionary reform that can greatly increase the competitiveness and formalization of the small business sector in India. To fully realize this potential, there must be ongoing efforts towards greater compliance, specific provisions to assist small businesses that are not yet digital, and policy improvements based on evidence, with robust monitoring of the impacts of GST on various sectors and regions.

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